No. 01-1289

In The
Supreme Court of the United States

STATE FARM MUTUAL
AUTOMOBILE INSURANCE COMPANY,

Petitioner,

vs.

CURTIS B. CAMPBELL and
INEZ PREECE CAMPBELL,

Respondents.

**On Writ Of Certiorari To The
Utah Supreme Court**

**BRIEF *AMICI CURIAE* OF TRUCK
INSURANCE EXCHANGE, USAA AND
AMERICAN INTERNATIONAL COMPANIES
IN SUPPORT OF PETITIONER**

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INTEREST OF *AMICI CURIAE* [1]

The Farmers Insurance Group of Companies®, based in Los Angeles, California, operates in 41 states and provides automobile, homeowners and commercial insurance to more than 15 million customers. The Farmers Insurance Group of Companies® is the nation's third-largest writer of both private passenger automobile and homeowners insurance. Truck Insurance Exchange, in whose name this brief is filed, is one of three reciprocal or interinsurance exchanges in the Farmers Insurance Group of Companies®.[2]

USAA is a worldwide insurance and diversified financial services association that has provided insurance and financial services to the United States military community and their families since 1922. A member-owned Fortune 500 company, the USAA group of companies provides life, homeowners, and auto insurance to more than 4.7 million members. The association is headquartered in San Antonio, Texas, with offices throughout the United States and Europe.

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[1] This brief was authored by the *amici* and their counsel listed on the front cover, and was not authored in whole or in part by counsel for a party. No one other than the *amici* or their counsel made any monetary contribution to the preparation or submission of this brief.

[2] The Farmers Insurance Group of Companies® is a service mark used to collectively identify the entities in the Farmers family of companies. Farmers Group, Inc. is a provider of insurance management services and a holding company. Acting under the dba Farmers Underwriters Association, and with its wholly-owned subsidiaries Truck Underwriters Association and Fire Underwriters Association, Farmers Group, Inc. acts as the attorneys-in-fact for three reciprocals or interinsurance exchanges – Farmers Insurance Exchange, Truck Insurance Exchange, and Fire Insurance Exchange.

The American International Companies are wholly owned subsidiaries of American International Group, Inc. They issue insurance policies throughout the United States.

Amici have experienced the harmful effects of punitive damage awards imposed without meaningful judicial review or proper consideration of wealth. *Amici* are particularly concerned about the problem exemplified by the present case, in which erroneous measures of the defendant's wealth were used to reinstate a $145 million punitive award.

Amici have the consent of the parties to file this brief. Letters of consent have been filed separately with the Court.

SUMMARY OF ARGUMENT

Petitioner's Brief explains how the Utah Supreme Court's reinstatement of the $145 million punitive damage award in this case violates due process and impermissibly intrudes on state sovereignty and interstate commerce by, *inter alia*, punishing dissimilar out-of-state conduct and placing excessive reliance on petitioner's wealth generated nationwide. *Amici* explain why, assuming petitioner's wealth is even relevant to the constitutional "fair notice" punitive damages analysis under *BMW of North America, Inc. v. Gore*, 517 U.S. 559 (1996),[3] the two measures of

[3] In *amici*'s view, the defendant's wealth has no bearing on the due process "fair notice" analysis set forth in *BMW*. In *BMW*, this Court made clear that the defendant's wealth cannot justify a punitive

(Continued on following page)

wealth used by the Utah Supreme Court reflect a fundamental misunderstanding of insurance company financial structure and greatly overstate petitioner's wealth, to the detriment of its policyholders.

STATEMENT OF THE CASE

Amici hereby adopt and incorporate by reference the Statement of the Case set forth in Petitioner's Brief.

damages award that otherwise violates due process: "The fact that BMW is a large corporation rather than an impecunious individual does not diminish its entitlement to fair notice of the demands that the several States impose on the conduct of its business." *BMW*, 517 U.S. at 585. Since *BMW*, there has been a debate over what role, if any, wealth should play in due process analysis. *See, e.g.*, Christine D'Ambrosia, *Punitive Damages in Light of BMW of North America, Inc. v. Gore: A Cry for State Sovereignty*, 5 J.L. & Pol'y 577, 621-23 (1997) (identifying as an issue "left open" by *BMW* the use of wealth as a factor in due process punitive award analysis); John Zenneth Lagrow, *BMW of North America, Inc. v. Gore: Due Process Protection Against Excessive Punitive Damage Awards*, 32 New Eng. L. Rev. 157, 209-11 (1997) (debating whether wealth is an appropriate factor in due process analysis after *BMW*).

Amici agree with, and respectfully ask the Court to adopt, the arguments concerning the inappropriateness of considering wealth in due process punitive damages analysis contained in the *amicus curiae* brief of the Business Roundtable in support of petitioner. For purposes of this brief, however, we will assume that the defendant's wealth does have a role to play in reviewing a punitive damages award under *BMW*.

ARGUMENT

THE TWO MEASURES OF FINANCIAL CONDITION USED BY THE UTAH SUPREME COURT – GROSS ASSETS AND POLICYHOLDERS' SURPLUS – GREATLY OVERSTATE THE DEFENDANT'S WEALTH.

A. GROSS ASSETS GREATLY OVERSTATE THE DEFENDANT'S WEALTH BY NOT TAKING INTO ACCOUNT CORRESPONDING LIABILITIES.

The Utah Supreme Court measured defendant State Farm Auto's[4] wealth by reference to *gross* assets – the combined *gross* assets of State Farm Auto *and* other State Farm companies. (*See* Pet. App. 17a; *see also id*. at 111a-12a (trial court's measure of State Farm's wealth). *Compare* exh. 126-P (chart prepared by plaintiffs' expert: State Farm gross assets in 1995 were over $54 billion) with exh. 65 at trial pages 5, 24 (State Farm Auto 1995 Annual Statement: Gross assets of State Farm Auto *and affiliates* were over $54 billion).)

Gross assets do not account for liabilities and, therefore, are a highly inaccurate measure of a defendant's wealth. As one California court has explained: "Plaintiff would compare the punitive damage award with defendant's gross assets and/or gross income. We do not find comparison to these gross figures meaningful. Gross assets might be very substantial but if liabilities are even greater, the company would be insolvent. Similarly, gross

[4] State Farm Mutual Automobile Insurance Company is the only State Farm corporate entity named as a defendant in this case.

income might be very large, but if expenses are even larger, the company would be incurring a loss. It is the net figures with which comparison should be made [for punitive damages purposes]." *Little v. Stuyvesant Life Ins. Co.*, 136 Cal. Rptr. 653, 663 n.5 (Ct. App. 1977). For example, a defendant with $1 million in assets and no liabilities is in a much stronger financial position than a defendant with $1 million in assets and $900,000 in liabilities, but a comparison of each defendant's gross assets, without more, would lead to the misleading conclusion that each had the same ability to pay a $100,000 punitive award.

Instead of gross assets, "[t]he defendant's net worth (assets minus liabilities) is the traditional guideline for assessing the amount of punitive damages."[5] Annotation, *Punitive Damages: Relationship to Defendant's Wealth as Factor in Determining Propriety of Award*, 87 A.L.R. 4th 141, 157-58 (1991); *see also Devlin v. Kearny Mesa AMC/Jeep/Renault*, 202 Cal. Rptr. 204, 210 (Ct. App. 1984) ("Net worth generally is considered the best measure of a defendant's 'wealth' for purposes of assessing punitive damages."); *Kenly*, 19 Cal. Rptr. 2d at 777 ("[T]he net worth standard assures the award complies with the

[5] Several of the cases adopting net worth as the measure of a defendant's *wealth* for punitive damage purposes also refer to the measure of a defendant's *ability to pay* a punitive damage award. *E.g.*, *Kenly v. Ukegawa*, 19 Cal. Rptr. 2d 771, 777 (Ct. App. 1993). As the *amicus curiae* brief filed by the Business Roundtable in support of the petitioner makes clear, however, the real issue is not the defendant's *ability* to pay, but how much is sufficient to *deter* reprehensible conduct. *See also Adams v. Murakami*, 284 Cal. Rptr. 318, 320 (1991) (the "key question" in reviewing the excessiveness of a punitive award is whether the amount of punitive damages "'exceeds the level necessary to . . . deter'").

'ability to pay' criterion."); *Jonathan Woodner Co. v. Breeden*, 665 A.2d 929, 941 (D.C. 1995) ("[C]urrent net worth fairly depicts a [defendant's] ability to pay punitive damages. . . ."); *Fopay v. Noveroske*, 334 N.E.2d 79, 94 (Ill. App. Ct. 1975) ("Traditionally courts have used net worth to measure the defendant's wealth. . . ."); *Walker v. Dominick's Finer Foods, Inc.*, 415 N.E.2d 1213, 1217 (Ill. App. Ct. 1980) ("The purpose of admitting this [financial] evidence is to give the jury a true idea of [a] defendant's financial ability to pay the judgment. . . . Net sales are not necessarily correlated to net worth or a defendant's ability to pay a judgment."); *Cent. Bank-Granite City v. Ziaee*, 544 N.E.2d 1121, 1127 (Ill. App. Ct. 1989) ("[N]et worth is still the preferred method of assessing" a defendant's wealth); *Southland Corp. v. Burnett*, 790 S.W.2d 828, 830 (Tex. App. 1990) ("[A] defendant's monthly gross [income] does not equate with . . . net worth and in fact, has no reasonable relationship to it. It was error to admit evidence of gross sales or gross receipts as relevant to a determination of Southland's ability to pay exemplary damages."); *Wal-Mart Stores, Inc. v. Alexander*, 868 S.W.2d 322, 331 (Tex. 1993) (Gonzalez, J., concurring) ("Not all financial information relating to a defendant will be relevant to its net worth. A corporate defendant's assets are irrelevant in determining its wealth until its liabilities are subtracted. Similarly, a company's gross sales are only remotely related to its wealth until the company's expenses are subtracted."); *Welty v. Heggy*, 429 N.W.2d 546, 549 (Wis. Ct. App. 1988) ("If, as here, the assessment of punitive damages takes into account the defendant's wealth, then that wealth must be measured by net worth, the difference between the value of the defendant's assets and liabilities. Any other measure is illusory."); *cf. Pac. Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1, 22 (1991) (in assessing punitive damages, "[t]he factfinder must be guided by more than the defendant's *net worth*." (emphasis added)).

Only the *named* corporate defendant's net worth is properly taken into account. Absent a showing that the corporate veil should be pierced, the net worth of the named corporate defendant's affiliate or parent corporations is irrelevant to determining the named defendant's wealth. *See, e.g.*, *Tomaselli v. Transamerica Ins. Co.*, 31 Cal. Rptr. 2d 433, 441-42 (Ct. App. 1994); *Ramada Hotel Operating Co. v. Shaffer*, 576 N.E.2d 1264, 1268-71 (Ind. Ct. App. 1991); *Liberty Fin. Mgmt. Corp. v. Beneficial Data Processing Corp.*, 670 S.W.2d 40, 51-53 (Mo. Ct. App. 1984); *George Grubbs Enters., Inc. v. Bien*, 900 S.W.2d 337, 339 (Tex. 1995) ("Awarding exemplary damages against one defendant according to the wealth of a separate entity substantially increases the risk of unjust punishment."); *United Techs. v. Am. Home Assurance Co.*, 118 F. Supp. 2d 174, 180-81 (D. Conn. 2000) (refusing to assess punitive damages based on the net worth of defendant insurance company's parent corporation because parent corporation was not a named defendant and no showing was made that the subsidiary was merely an alter ego for the parent); *Cont'l Trend Res., Inc. v. Oxy USA, Inc.*, 810 F. Supp. 1520, 1533 (W.D. Okla. 1992) ("The financial worth of a parent corporation is generally irrelevant in assessing punitive damages on a subsidiary unless the corporate veil is pierced. . . ."); *Herman v. Hess Oil V. I. Corp.*, 379 F. Supp. 1268, 1276 (D. V.I. 1974) (holding size of defendant's parent corporation is irrelevant in assessing punitive damages against defendant).

Amici respectfully request that this Court make clear that, if wealth is a factor to be considered under *BMW*, it must not be measured by gross assets, and it must not include the wealth of parent or affiliated corporations (unless the corporate veil is pierced).

As we now explain, the wealth of an insurance company must be measured with particular care, taking into account the minimum capital requirements required by state regulation and the strong public policy that seeks to protect the interest of the policyholders in having their future claims paid.

B. POLICYHOLDERS' SURPLUS GREATLY OVERSTATES THE DEFENDANT'S WEALTH BY NOT TAKING INTO ACCOUNT THE FACT THAT SURPLUS IS NEEDED, INDEED LEGALLY REQUIRED, TO SATISFY POLICYHOLDERS' CLAIMS.

1. Introduction: Policyholders' Surplus Is Not Really "Surplus"

In addition to comparing the punitive damage award to gross assets, the Utah Supreme Court compared it to State Farm's policyholders' surplus, which the court valued at $25 billion.[6] (Pet. App. 17a; *see also* Pet. App. 111a-12a; exh. 125; exh. 64 at trial page 95.) Although

[6] Just as it did with gross assets, the Utah Supreme Court erroneously considered the surplus of *other* State Farm companies in measuring the wealth of State Farm. Plaintiffs' expert admitted on cross-examination that State Farm *Auto*'s policyholders' surplus was $12.5 billion, not $25 billion. (*See* Tr. 12-114 to 116; *see also* exh. 65 at trial page 7 (Management's Discussion and Analysis of 1995 State Farm Mutual Automobile Insurance Company's Annual Statement: After segregation of surplus funds attributable to other State Farm companies, State Farm *Auto's* policyholders' surplus was $12.3 billion in 1995)).

technically equivalent to net worth, policyholders' surplus greatly overstates an insurance company's wealth because of the important solvency and loss payment functions that surplus performs. The unrestricted use of policyholders' surplus to measure wealth reflects a fundamental misunderstanding of the financial structure of an insurance company.

"Conventional accounting terminology states that assets minus liabilities equals net worth. Using insurance accounting terminology, this relationship is expressed as admitted assets minus liabilities equal[s] 'policyholders' surplus.' " Cormick L. Breslin & Terrie E. Troxel, Property-Liability Insurance Accounting and Finance 19 (American Institute for Property and Liability Underwriters, 1st ed. 1978).

"The term policyholders' surplus is meant to convey the idea that total balance sheet assets are available *primarily for the satisfaction of policy holder claims*." *Id.*, (emphasis added). Surplus thus is *not* "free and clear money" (Tr. 12-84 (plaintiffs' expert)) readily available to pay punitive damages.[7] As State Farm's Regional Manager testified in this case: "Those funds just don't sit there as

[7] The term "surplus" is a misleading term and as a result has gained disfavor outside the statutory insurance accounting context. Donald E. Kieso & Jerry J. Weygandt, Intermediate Accounting 790 n.28 (8th ed. 1995); *see also id*. at 790 ("The accounting profession has suggested the term 'surplus' not be used in financial statements. Substitute terminology is recommended because the term 'surplus' connotes a residue or 'something not needed.' . . . The persistent use of these 'surplus' terms . . . can perhaps be attributed to the numerous state incorporation acts that still contain antiquated terminology in their provisions. . . . ").

extra funds. . . . [T]hey're intended to take care of policy holders in the[ir] time of need. . . . Those monies are set aside to take care of those accidents that are [presently] unknown." (Tr. 21-204 to 205.)

Policyholders' surplus is not just tied up practically, but legally: State regulators require insurers to maintain a minimum level of surplus just to stay in business. "Although capital and surplus of an insurer represent equity in the business by its owners, insurance regulation considers its primary role as being the protection of . . . policyholder[s'] surplus. Accordingly, state insurance department concern for the protection of policyholders will cause the continued regulation of company surplus." Property-Liability Insurance Accounting 131 (Robert W. Strain ed., 3d ed. 1986) [hereinafter Strain]. These regulatory requirements reflect the broad societal interest that insurance serves.

2. Because of the Public Role Insurance Companies Play, State Regulators Monitor Their Solvency and Require That Policyholders' Surplus Be Maintained at Specified Levels.

"[T]he trade of insurance gives great security to the fortunes of private people, and, by dividing up among a great many that loss which would ruin an individual, makes it fall light and easy upon the whole society." K. Borch, Advanced Textbooks in Economics: Economics of Insurance 2 (Elsevier Science Publishers 1990) (quoting Adam Smith, Wealth of Nations, Book V, Chapter 1 (n.p. 1776)). *See also* John Washburn, *State Regulators and the NAIC: Innovators in Improving Consumer Protection*, 6 J. Ins. Reg. 187, 187-89 (1987) ("Insurance provides a definite and known cost for indefinite and unknown events, and thus provides security for the insurance consumer. To provide this security to the policyholder, the product and entity offering the product must be reliable and solvent.").

"Insurance is an important, and perhaps essential, aspect of the business and personal lives of the vast majority of individuals living in the United States. For example, insurance is acquired by most businesses to transfer at least some portion of the risks associated with the fabrication, distribution, and use of manufactured or processed products. Similarly, billions of dollars of liability insurance coverage are purchased by enterprises and individuals to cover the risks incident to the use or ownership of property, operation of motor vehicles, and the pursuit of various business or professional activities." Robert R. Keeton & Alan I. Widiss, Insurance Law: A Guide to Fundamental Principles, Legal Doctrines and Commercial Practices 1 (West 1988).

"Because of the public nature of the insurance business, regulators[8] impose a higher standard of financial

[8] Following "the enactment by Congress of the McCarran-Ferguson Act in 1945, state governments . . . have had primary responsibility for insurance regulation. Some coordination and uniformity among the states have been achieved through actions of the National Association of Insurance Commissioners (NAIC), a voluntary association of state insurance commissioners." Scott E. Harrington, *Should the Feds Regulate Insurance Company Solvency*?, *State Solvency Regulation*, 14 Regulation No. 2 *at* http://www/cato.org/pubs/regulation/reg14n2d.html (last visited July 2002); *see also* George K. Gardner, *Insurance and the Anti-trust Laws – A Problem in Synthesis*, 61 Harv. L. Rev. 246, 247 n.8 & 248 n.9 (1948) (cataloguing various state laws regulating property/casualty insurers); Strain, *supra* at 3-18 (tracing the evolution of

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solidity on insurance companies than is expected of other corporations." Breslin, *supra* at 6. Statutory insurance accounting "emphasize[s] *solvency* by use of the balance sheet formula. Income measurement is of secondary importance." *Id*. at 59, emphasis added; *see also id*. at 61-64 (analyzing seven major areas of difference between statutory insurance accounting and generally accepted accounting principles for property and liability insurers); Michael Willenborg, *Regulating and Monitoring Insurer Solvency: An Assessment of Statutory Accounting Principles*, 12 J. Ins. Reg. 515, 519 (1994) ("[T]he solvency principle is the basic distinguishing feature of insurance accounting and reflects the fundamental fiduciary nature of the business. Insurers are in a position of trust with regard to their policyholders, and thus their system of accounts reflects a basic concern with this principle.").

"In a regulatory context, an insurance company is solvent if its admitted assets exceed liabilities by a margin at least equal to the minimum capital and/or minimum surplus required by law." Breslin, *supra* at 278. In short, a "solvent insurer (1) collects premiums that realistically can be expected to satisfy anticipated loss settlements and meet all operating expenses; and (2) maintains admitted assets sufficient to cover its existing liabilities, with a remaining safety margin that is at least equal to the statutory net worth requirements." *Id*.

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insurance regulation by the states, and acknowledging the "major role in the history of insurance accounting and . . . regulation" played by the NAIC).

"Detecting insurers that are in, or heading toward, a hazardous financial condition is a major function of regulation. The goal is to detect problems early enough so that they can be corrected before a company becomes insolvent or cannot be rehabilitated." Martin Grace et al., *Identifying Troubled Life Insurers: An Analysis of the NAIC FAST System*, 16 J. Ins. Reg. 249, 252 (1998) [hereinafter Grace, *An Analysis of the NAIC FAST System*]; *see also* Dan R. Anderson & Roger A. Formisano, *Causal Factors Associated with Property-Liability Insurance Company Insolvencies*, 6 J. Ins. Reg. 449, 459-60 (1988) ("In most industries, business failures are a natural and necessary condition of a healthy and efficient market. In most industries, the customer is not hurt by a bankruptcy, *e.g.*, a customer can shop at a different store, eat at a different restaurant, etc. But because of the adverse financial consequences on policyholders and on their insurers . . . it becomes prudent to try to understand and prevent insurer insolvencies.").

Regulators detect financial problems primarily through review of an insurance company's Annual Statement. "The Annual Statement is the primary financial report required by state insurance departments . . . from property-liability insurance companies. The format of the Statement and the rules to be followed in preparing it are established by the National Association of Insurance Commissioners (NAIC)." Strain, *supra* at 22.

The NAIC previously used a series of eleven ratios known as IRIS to test insurer solvency. "If the tests indicate[d] a company's financial ratios [were] outside the normal range in more than four areas, its finances [would be] reviewed in greater detail to determine whether it

[was] in need of immediate regulatory attention." Insurance Information Institute, Hot Topics & Insurance Series: Insolvencies/Guaranty Funds, *supra* at 3. Seven of the eleven ratios focused on policyholders' surplus. Strain, *supra* at 28-30 (ratios included: (1) premium to surplus, (2) change in premium writings, (3) surplus aid to surplus, (4) two-year overall operating ratio, (5) investment yield, (6) change in surplus, (7) liabilities to liquid assets, (8) agents' balances to surplus, (9) one-year reserve development to surplus, (10) two-year reserve development to surplus, and (11) estimated current reserve deficiency to surplus).

IRIS was expanded in 1990 to include a new solvency screening model (FAST) for "nationally significant" insurers. The majority of these tests also focused on policyholders' surplus. *See* Grace, *An Analysis of the NAIC FAST System*, *supra* at 254; *id*. at 288 (listing 17 Financial Analysis Solvency Tracking (FAST) variables for life insurers, nine of which focus on surplus ratios); Martin F. Grace et al., *Risk-Based Capital and Solvency Screening in Property-Liability Insurance: Hypotheses and Empirical Tests*, 65 J. Risk Ins. 213, 241 (1998) [hereinafter Grace, *Hypotheses and Empirical Tests*] (11 of the 25 FAST variables for property-liability insurance focus on surplus).

"In 1993, the NAIC adopted risk-based capital (RBC) standards. . . . [These] compar[e] [a company's] total adjusted capital . . . with its RBC – an amount of capital that reflects the level of risk the company has assumed. The greater the total riskiness, the greater the minimum financial cushion must be. The result is expressed as the company's RBC ratio."[9] Insurance Information Institute, Hot Topics & Insurance Series: Insolvencies/Guaranty Funds, *supra* at 3-4; *see also What is Risk-Based Capital*?, The Insurance Forum, Aug. 2000, at 72 (describing the elements of the RBC Ratio and RBC Zones that trigger regulatory action). "One of the components of the RBC formula is the minimum surplus requirement for loss reserves. Insurers with higher-risk loss reserve portfolios are expected to maintain a correspondingly higher minimum level of surplus as a cushion against adverse development." Michael M. Barth, *Capital Requirements to Support Adverse Loss Development*, 14 J. Ins. Reg. 437, 438 (1996). "Failure to maintain surplus amounts meeting various benchmarks of the minimum risk-based capital determined for each insurer creates legal grounds for regulatory intervention by the insurer's state regulator."[10] John M. Covaleski, *Regulators Soften Their October Surprise*, Best's Review, Jan. 1994, at 45.

[9] Risk-based capital standards compute the amount of capital or surplus required for a particular insurance company to offset four risk elements: asset risk (*e.g.*, default, illiquidity, market decline); credit risk (default); loss/LAE reserve risk (adverse development/excess growth); and written premium risk (inadequate pricing, excessive growth). Eric M. Simpson & Peter B. Kellogg, *NAIC's RBC: A Virtual Reality*, Best's Review, Feb. 1994, at 92; *see generally* Grace, *Hypotheses and Empirical Tests*, *supra* at 213-14 (describing RBC test and comparing it to prior tests).

[10] Insurance company financial rating services like A.M. Best (the oldest and most widely recognized rating agency dedicated to the insurance industry) also apply their own capitalization tests, which, like state regulations, emphasize surplus. *See* A.M. Best, Best's Insurance Reports – Property/Casualty vii, viii, xi-xii (2000).

Policyholders' surplus also dictates the amount of insurance that may be underwritten in a given year. If policyholders' surplus is too low in relation to the amount of premium taken in, the insurer is undercapitalized. For example, a company with $100 million in premiums and $100 million in surplus has a healthy 1 to 1 ratio of premiums written to surplus available to cover loss reserves and pay extraordinary claims on those policies. A company with $400 million in premiums and $100 million in surplus, in contrast, is undercapitalized with a 4 to 1 ratio of premiums to surplus, and, under traditional ratio tests, would be subject to regulatory scrutiny and, perhaps, action.[11]

"[M]ost insurers opt to hold higher than the minimum surplus level for a number of reasons: to increase franchise value, because of tax considerations, to supplement or replace reinsurance, or simply because the managers have

[11] *See generally* S.S. Huebner et al., Property and Liability Insurance 613 (3d ed. 1982) (for more than 40 years, the rule employed by regulators was that "the premium volume should not exceed two times policyholder[s'] surplus"); David H. Marshall et al., Accounting and Finance for Insurance Professionals 464 (1st ed. 1997) ("A rule of thumb against which the premium to surplus ratio can be evaluated states that premiums should not exceed surplus by more than two to one"); *see also* Insurance Information Institute, Hot Topics & Insurance Series: Insolvencies/Guaranty Funds, *supra* at 5 ("If a company appears to be in poor financial health, regulators are empowered to take certain steps to strengthen the insurer's position and, if all else fails, to liquidate it."); *id*. at 3 ("All insurers are required to file annual financial statements with regulators in all states in which they are licensed to do business. Statistical data from these statements are run through the [NAIC] tests. If the tests indicate a company's financial ratios are outside the normal range in more than four areas, its finances are reviewed in greater detail to determine whether it is in need of immediate regulatory attention.").

a higher level of risk aversion. The optimum level of surplus for an insurance company is therefore generally higher than the minimum standards under RBC, and often that optimum level is considerably higher than the regulatory minimum." Barth, *supra* at 438.

The purpose of surplus further explains why a company might choose to maintain it at higher than regulatory levels.

3. Surplus Protects Policyholders Against Adverse Underwriting Results and Investment Performance, Inadequate Loss Reserves, and Catastrophic Losses.

"The policyholders' surplus account is meant to act as a safety cushion for policy holders in the event that an insurer suffers adverse results in the various aspects of the insurance business." Breslin, *supra* at 142. "Four variables principally affect policyholders' surplus of a property and liability company: (1) its underwriting results, (2) its investment performance, (3) developments in its loss reserves, and (4) its growth rate. . . . The purposes of policyholders' surplus, then, may be thought of as providing the safety cushion to absorb . . . adverse results. Policyholders' surplus protects the policy holder as well as the company by maintaining the company's solvency during periods of unfavorable operating results." *Id.* at 179-80.

One function of policyholders' surplus is to cover shortfalls in the pricing of insurance. "With insurance products, the timing of costs and revenues are reversed [from that in most industries] . . . [t]hat is, the revenues in the form of premiums are received first, while the primary costs of insurance are determined in the future as claims are paid. If future claims are not estimated properly in determining current premiums, it is possible that the insurance product is being sold below cost. . . . [Moreover] [p]erfectly good premium estimates can be rendered inadequate if conditions change and cause claims to increase."[12] Anderson, *supra* at 455; *see also Equities, Underwriting Hit P/C Insurers' Surplus*, BestWeek, Aug. 12, 2002, at 21 (volatility in the stock market and poor underwriting experiences caused a 3.8 to 34% drop in policyholders' surplus among the top 25 property and casualty insurers in 2001; the State Farm Group of Companies alone lost over $4 billion in surplus).

[12] Unfortunately, one of the factors influencing premium estimates is fraudulent claims. False insurance claims cost insurers, and the insurance buying public, billions of dollars each year. A 1995 study by the Rand Institute for Civil Justice revealed that 35 to 42 percent of people injured in automobile accidents exaggerate their injuries. This cost consumers an additional $13 to $18 billion in automobile insurance premiums in 1993 alone. Stephen Carroll et al., *The Costs of Excess Medical Claims for Automobile Personal Injuries* 3 (RAND Institute for Civil Justice 1995). According to the Insurance Information Institute, property/casualty fraud cost insurers over $27 billion in 2001. Insurance Information Institute, Hot Topics & Insurance Issues: Insurance Fraud 1 (March 2002), *at* http://www.iii.org/media/hottopics/insurance/fraud (last visited July 2002).

In addition to combating insurance fraud, insurance companies have an obligation to their owners not to dissipate reserves or surplus through the payment of meritless claims. *See generally* Paul I. Thomas & Prentiss B. Reed, Sr., Adjustment of Property Losses 17 (4th ed. 1977) ("[o]verpayment of claims . . . can be . . . harmful."); Bernard L. Webb et al., Insurance Company Operations 25 (American Institute for Property and Liability Underwriters, 1st ed. 1978) (responsibilities of insurance claims managers include "making certain that there is adequate resistance to faulty, unreasonable, or questionable claims").

Another function of policyholders' surplus is to cover shortfalls in loss reserves. Loss reserves are money set aside to pay current claims. The reserves are based on the estimated value of each claim. "Inadequate loss reserves . . . distort the insurer's surplus position. Surplus [*i.e.*, the amount available to pay future claims for which no loss reserves have been set aside] is overstated to the extent that loss reserves are inadequate." Anderson, *supra* at 456.

Another very important function of policyholders' surplus is to cover catastrophic losses. According to a 1994 Congressional Budget Office Study, "[i]nsured losses on property from catastrophes amounted to more than $38 billion in the past few years, mostly the result of Hurricanes Hugo, Andrew and Iniki. These losses dealt a severe blow to the finances of the industry and forced more than a dozen small insurers into insolvency. The losses from a particularly catastrophic earthquake in California could amount to as much as $60 billion. Claims for environmental damage could amount to more than $100 billion in certain worst case scenarios. Given that the capital and surplus of the whole property and casualty industry amounted to $163 billion at the end of 1992, such calamities could wipe out a significant portion of the net worth of the property and casualty industry." Congress of the United States, Congressional Budget Office, A CBO Study: The Economic Impact of a Solvency Crisis in the Insurance Industry x (Apr. 1994).

Commentators predict that catastrophic losses in the property and casualty industry could increase in the coming decades as a result of, *inter alia*, global warming's impact on the environment. *See, e.g.*, Kelly Quirke, *Global*

Warming and Increasing Catastrophe Losses: the Changing Climate of Financial Risk, 12 J. Ins. Reg. 452, 453-54 (1994) ("A litany of many of the predicted impacts of climate change – increasingly intense and frequent hurricanes, rising sea levels, coral bleaching, widespread droughts of long duration, record freezes, floods and storms – are becoming common headlines. On the insurance front, the current record is alarming. Between 1966 and 1987, no catastrophes occurred for which the insured losses topped $1 billion. Yet . . . in the period from 1987 through the first quarter of 1993, the billion dollar mark was topped by 11 windstorms, led by the $16.5 billion in insured losses from Hurricane Andrew. Since then, the climate-related disasters of the Mississippi flood, the Los Angeles and Sydney fires, and the harshest East Coast winter in memory have added to the tally."); Scott R. Harrison & Eric C. Nordman, *Introduction to the Symposium on Catastrophe Modeling*, 15 J. Ins. Reg. 315, 316 (1997) ("Exposure to catastrophe losses has been a topic that has garnered much attention from the insurance regulatory community since the wake-up call known as hurricane Andrew. Other significant reminders like hurricane Hugo, hurricane Iniki and the Northridge and Loma Prieta earthquakes have served to focus attention on property insurers' significant exposure to catastrophe losses. Some claim these events represent the beginning of a period that will be marked by increased seismic activity and development of significantly worse weather patterns."); Stephen J. Larson, *Weathering the Storm: Using Exposure and Financial Variables to Predict Insurance Company Failure After Hurricane Andrew*, 17 J. Ins. Reg. 64, 65 (1998) ("Insurance company solvency has become more serious in recent years due to the increasing frequency of catastrophes such as Hurricane Andrew. . . .

Fifteen of the 176 insurance companies domiciled in the southeastern region of the United States failed during the 16-month period following Hurricane Andrew.”).

In light of property and casualty insurers’ current total policyholders’ surplus, one study concluded that “the U.S. property-liability insurance industry could withstand a loss of $40 billion with minimal disruption of insurance markets,” but “a $100 billion loss would create major problems . . . by causing sixty insolvencies and leading to significant premium increases and supply side shortages.” Howard Kunreuther, *The Role of Insurance in Managing Extreme Events: Implications for Terrorist Coverage*, Business Economics, Apr. 2002, at 10.

A single natural disaster or terrorist attack could cause a sudden, huge drain on policyholders’ surplus. *See* William J. Warfel, *Market Failure in Property Insurance Markets: the Case for a Joint Region-Federal Disaster Insurance Program*, 12 J. Ins. Reg. 486, 487 (1994) (“The estimated maximum credible insured property loss for a category five hurricane (the most powerful storm) is $50 billion if such a hurricane struck a major urban area. . . . Overall damage caused by a major earthquake would approach at least $50 billion.”); Insurance Information Institute, Hot Topics & Insurance Issues: Catastrophes: Insurance Issues 2, 6-7, 13 (July 2002), *at* http://www.iii.org/media/hottopics/insurance (last visited July 2002) (estimated insurance company payments in recent catastrophes include $40.2 billion for the terrorist attacks on the World Trade Center and $15.5 billion for Hurricane Andrew; if Hurricane Andrew had struck the New England coastline, it could have created $110 billion in insured damage); Fran Matso Lysiak, *Reinsurance Markets Uncertain*, Best’s Review, Jan. 2002, at 27 (“The Sept. 11

terrorist attacks qualify as the largest catastrophe to hit the insurance industry. Estimates of total insured losses range from $30 billion to $70 billion."); Barbara Bowers, *Storm Warning: If Hurricane Andrew Struck the Same Area Today, Insured Losses Could be Nearly Double What They Were 10 Years Ago*, Best's Review, June 2002, at 21 (catastrophe modeling reveals that "if Hurricane Andrew were to happen in South Florida this season, the area could expect a total loss of about $23 billion"; if Hurricane Andrew's path had been 3 degrees north, it would have directly hit Miami and caused $48.2 billion in damage in today's dollars).

Not all catastrophic losses are caused by sudden forces of nature or terrorism. The recent resurgence of asbestos claims, for example, could cause a surplus deficit similar to that of a major hurricane. *See* Robert P. Hartwig, Industry Financials and Outlook: 2002-First Quarter Results 2-4 (Insurance Information Institute June 26, 2002), *at* http://www.iii.org/media/industry/financials/2002firstquarter (last visited July 2002) (property/casualty industry's total combined surplus is $295.1 billion in 2002; however, threats to that surplus include an estimated $65 billion in new asbestos claims and directors and officers insurance claims stemming from corporate financial collapses like the $60 billion Enron bankruptcy).

4. Policyholders' Surplus Should Play Only a Limited Role in Measuring an Insurance Company's Wealth.

It should now be apparent that policyholders' surplus is *not* freely available to pay punitive damages. Huge punitive damage awards like the one in this case, by depleting policyholders' surplus, threaten all policyholders.

Indeed, the punitive damages award here can be fairly characterized as a transfer of $145 million in policyholders' surplus from all State Farm policyholders to the one State Farm policyholder in this case.

Amici urge this Court to rule that, at the very least, in determining an insurance company's net worth for purposes of punitive damages, the state-required minimum amount of policyholders' surplus should be subtracted from the total amount of policyholders' surplus. *See Denesha v. Farmers Ins. Exch.*, 161 F.3d 491, 504 (8th Cir. 1998) ("Farmers' surplus . . . was $1.64 billion at the time of trial. However, state regulations require the company to retain a minimum surplus of $1.5 billion. . . . "; the remaining $140 million in excess of surplus was used to measure Farmers' net worth for punitive damages purposes).

Amici also urge this Court to rule that courts assessing an insurance company's wealth for due process punitive damage purposes should further take into account the additional protection afforded policyholders by the policyholders' surplus in excess of the state-required minimum amount.

CONCLUSION

Amici urge that *if* a defendant's wealth is taken into account in due process punitive damage analysis, courts reviewing punitive damage awards should (1) measure the defendant's wealth by net worth, not by gross assets, (2) measure an insurer's net worth by policyholders' surplus in excess of the state-required minimum, not by the entire policyholders' surplus, and (3) further take into account the additional protection afforded policyholders by the policyholders' surplus over and above the state-required minimum in assessing an insurance company's wealth.

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