SUPERIOR COURT OF THE STATE OF CALIFORNIA

FOR THE COUNTY OF LOS ANGELES

JERRY HILL, et al. Plaintiffs, vs. STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY, et al., Defendants.	Case No. BC 194491 OPINION AND ORDER ON DEFENDANT STATE FARM'S MOTION FOR SUMMARY JUDGMENT

Defendant State Farm Mutual Automobile Insurance Company ("State Farm") moves for summary judgment of the claims alleged in this certified class action. The court has considered all of the briefs, evidence, objections and arguments presented on behalf of the class ("Plaintiffs") and on behalf of State Farm. For the reasons stated in the following Opinion and Order, State Farm's Motion for Summary Judgment is granted.

I. FACTUAL AND PROCEDURAL SUMMARY

State Farm is a mutual automobile insurance company. Plaintiffs allege that State Farm's Board of Directors did not pay dividends as promised. Plaintiffs plead causes of action for breach of contract; for breach of the implied covenant of good faith and fair dealing; for unlawful and deceptive business practices under California's Unfair Competition Law (California Business and Professions Code section 17200, *et seq.*); and

for an accounting. This case has been certified as a nationwide class action for the period 1983 through 1998.

The procedural history of this case need not be set forth at length here. Three prior opinions are a roadmap of this case: (1) an opinion of the Court of Appeal overruling a trial court decision sustaining a demurrer without leave to amend (*Hill v. State Farm Mutual Automobile Ins. Co.* (Cal.Ct.App. Jan. 30, 2001) slip op., No. B133262 (*Hill I*)); (2) an opinion of the Court of Appeal holding that Illinois substantive law governs this case, setting forth applicable principles of Illinois law and holding that the "internal affairs doctrine" does not require dismissal of the case. (*Hill v. State Farm Mutual Automobile Ins. Co.* (2003) 114 Cal.App.4th 434 (*Hill II*)); (3) an opinion and order of this court dated June 13, 2005 denying State Farm's motion to dismiss on grounds of forum non conveniens.[1]

In its Motion for Summary Judgment, State Farm primarily argues that the business judgment rule bars Plaintiffs' claims. Plaintiffs acknowledge, as they must in light of *Hill II*, the relevance of the Illinois business judgment rule. However, Plaintiffs contend they have offered evidence sufficient to prove the applicability of several exceptions to the business judgment rule. The parties' arguments are addressed at length below.

II. LEGAL ANALYSIS

A. Standards for Summary Judgment

A motion for summary judgment is properly granted if there is no question of fact and the issues raised by the pleadings may be decided as a matter of law. Code of Civil

[1] This case was before the Court of Appeal on a third occasion, when that Court denied a Petition for Writ of Mandate seeking to require a previously assigned trial judge to accept a peremptory challenge filed after the decision in *Hill II*.

Procedure section 437c(c); *Aguilar v. Atlantic Richfield Co.* (2001) 25 Cal.4th 826, 843. "To secure summary judgment, a moving defendant may show that one or more elements of the cause of action cannot be established or that there is a complete defense to the cause of action." *Adams v. Explorer Ins. Co.* (2003) 107 Cal.App.4th 438, 446. If defendant offers evidence sufficient to establish a defense, the burden shifts to the plaintiff to show the existence of a triable issue of material fact on that issue. Code of Civil Procedure section 437c(o)(2); *Alex R. Thomas & Co. v. Mutual Service Casualty Ins. Co.* (2002) 98 Cal.App.4th 66, 76.

B. The Illinois Business Judgment Rule

As the Court of Appeal held in *Hill II*, Illinois law applies to the substantive legal issues in this case. 114 Cal.App.4th at 449-450. Under Illinois law, decisions concerning how much surplus is appropriately retained in a corporation and when a dividend should be declared are committed to the sound discretion of the directors of a corporation. *Id.* at 449-450, *citing Hall v. Woods* (1927) 325 Ill. 114, 140-141. Illinois law precludes courts from second-guessing directors' decisions concerning dividend declarations "unless the withholding is fraudulent, oppressive or totally without merit." *Romanik v. Lurie Home Supply Center, Inc.* (1982) 105 Ill.App.3d 1118, 1134, *quoted with approval in Hill II*, 114 Cal.App.4th at 450.

The Illinois business judgment rule substantially insulates from review a corporate board's decision making on matters within its purview. "[T]he business judgment rule is a presumption that corporate decisions made by directors are made on an informed basis and with the honest belief that the course taken is in the best interests of the corporation. . . . The burden is on the party challenging the decision to present facts

rebutting the presumption." *Ferris Elevator Company, Inc. v. Neffco, Inc.* (1996) 285 Ill.App.3d 350, 355 (citations omitted). The business judgment rule's presumption may be overcome by presenting evidence of one of the exceptions to the rule: "fraud, oppression, dishonesty, total lack of merit, illegality, or a failure of the board of directors to become sufficiently informed to make an independent decision . . . ." *Hill II*, 114 Cal.App.4th at 451.

C. State Farm Has Offered Sufficient Evidence to Prove a Defense Based on the Business Judgment Rule and to Shift the Burden to Plaintiffs

The first issue to be considered is whether State Farm presented sufficient evidence in its Motion for Summary Judgment to shift the burden to Plaintiffs to offer facts sufficient to establish an exception to the business judgment rule.

State Farm presented undisputed evidence that over the 15 years of the class period, 1983 to 1998, its Board of Directors declared 10 dividends to its automobile insurance policyholders in an amount totaling $2,866,660,000. (UF 1110) Dividends were declared in April 1983, April 1984, November 1987, November 1988, December 1991, August 1992, October 1993, April 1994, November 1997, and June 1998.

State Farm also presented evidence of the basic strategy the company pursued in declaring dividends. Roger S. Joslin, who was a principal financial officer of State Farm during the entire class period and a member of the Board of Directors since 1988 testified as follows:

> I participated in considering, analyzing, recommending, and ultimately voting for each of [the dividends declared between 1988 and the end of the class period]. As an Officer and Director, I concluded that each of these dividends was appropriate in amount and in the best interests of State Farm Mutual's policyholders. In the dividends for 1988, 1991, 1992, 1993, 1994, 1997, and 1998, I and other senior members of management concluded that it was

> appropriate to declare a dividend state-by-state in the approximate amount by which underwriting performance during the period prior to the dividend was in excess of an underwriting income target. I and other senior members of management concluded that it would be appropriate to pay this dividend to policyholders in the states that had shown better earnings than the target underwriting return (which was uniform for all states). In my judgment as an Officer and Director, this was a proper and reasonable dividend and a proper and reasonable method for paying this dividend to policyholders. In my judgment, additional dividends or dividends in a higher amount would not have served the policyholders' best interests. The respective Boards of Directors, after due consideration, declared the dividends.
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> . . . . . .
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> It was also my judgment as an Officer and Director of State Farm Mutual that dividends should not be paid in 1989, 1990, 1995, and 1996. Underwriting losses coupled with catastrophic events and the need to assess the full impact of those events made dividends inappropriate in those years in my judgment.

Joslin Declaration, paragraphs 16-17. Mr. Vincent Joseph Trosino, State Farm's current President and Chief Operating Officer and a member of the Board of Directors since 1987, also testified that the decisions to declare dividends, and not to declare dividends in certain years, reflected a reasonable "policy of declaring dividends to policyholders in states that had shown better earnings than the target underwriting return." Trosino Declaration, paragraphs 15-16.

Neither the language of State Farm Mutual's automobile policies nor the provisions of State Farm's bylaws require that any particular formula be used in determining dividends. The policy language entitled policyholders to "receive dividends the Board of Directors in its discretion may declare in accordance with reasonable classification and groupings of policyholders established by such Board." State Farm's bylaws provide that the Board "may authorize from time to time such refunds or credits to policyholders from the savings and gains of the Corporation and upon such terms and

conditions and in such amounts or percentage as may, in their judgment, be proper, just and equitable."

The evidence described above meets State Farm's summary judgment burden to show that the Board of Directors did exercise discretion in declaring dividends which totaled more than $2.8 billion during the class period. The Court of Appeal, in *Hill II*, affirmed that decisions concerning when a dividend should be declared are committed to the sound discretion of the directors of a corporation. 114 Cal.App.4th at 449-450. Such decisions are protected from challenge by the Illinois business judgment rule. *Id.* at 450. The burden therefore shifts to Plaintiffs to offer evidence (disputed or undisputed) sufficient to prove one of the circumstances that will overcome the presumption of the business judgment rule.

D. The Evidence Offered by Plaintiffs Is Insufficient to Make Out an Exception to the Business Judgment Rule

Plaintiffs argue that they have presented evidence sufficient to establish three exceptions to the Illinois business judgment rule: (1) that the Directors' decisions regarding dividends were totally lacking in merit; (2) that the Board did not sufficiently inform itself in making decisions about dividends; and (3) that the Directors' decisions regarding dividends were infected by fraud. The evidence with respect to each of these exceptions is discussed below.

1. Plaintiffs' Arguments that the Board's Decisions Regarding Dividends Were Totally Without Merit

Plaintiffs contend that "State Farm's limitation of consideration of dividends to 'underwriting profit' amounted to a conscious, consistent and arbitrary failure by State Farm and its Board to consider the interests of policyholders in sharing in the

accumulated and current savings and gains of the company that their premiums had made possible, without consideration of the extent to which such savings and gains actually needed to be retained by State Farm to prudently operate and grow its insurance business." Contrary to Plaintiffs' argument, however, there are several meritorious rationales for State Farm's determination to accumulate surplus rather than to liquidate its surplus assets to pay dividends. Plaintiffs' evidence that contrary actions might have been of more benefit to shareholders does not meet the requirement that Plaintiffs prove the Directors' decisions were "totally without merit" in order to overcome the presumption of the business judgment rule.

The Board of Directors was permitted to operate State Farm in accordance with the general theories underlying operation of a mutual insurance company. "Such companies do not generate traditional entrepreneurial profits, but rather seek to meet their obligations at the lowest possible cost to the policyholders . . . ." Allegaert, *Derivative Actions by Policyholders on Behalf of Mutual Insurance Companies* (1966) 63 *U.Chi.L.Rev.* 1063, 1067 (quoted with approval in *Hill II*, 114 Cal.App.4th at 440). "[M]utual insurers have greater difficulty [than stock insurers] in raising capital to fund growth, and hence, must rely to greater extent on accumulated surplus and income from new members to support growth" so that decision makers "tend to exercise more discretion which tends to favor long-term stability over greater risk." Klein, A Regulator's Introduction to the Insurance Industry (Nat. Assn. of Ins. Comrs. 1999) p. 5-4 (quoted with approval in *Hill II*, 114 Cal.App.4th at 440-441).

Defendants presented evidence concerning the application of these general principles to State Farm. Dr. James Q. Wilson, a Professor of Management and Public

Policy at UCLA, and a State Farm Board member since 1995, testified at his deposition that "[surplus is] especially important for a mutual company, because having no stockholders, we cannot raise money in the stock market. We can borrow money up to some limit, but essentially, our ability to pay policyholders, now and in the future, depends upon retained earnings." Wilson Deposition at 19 (see UF 13). Dr. Robert Jaedicke, a State Farm Board member from 1991 through 1999, and former Dean of the Stanford University Graduate School of Business, testified that "State Farm as a mutual company did not have the normal access to the capital markets, and so more of their growth and development needed to be financed internally." Jaedicke Deposition at 119 (see UF 14).

Moreover, part of State Farm's strategic plan was to use its surplus to allow lower insurance rates for State Farm policyholders. See UF 92. Mr. Vincent Joseph Trosino, the Chief Operating Officer of State Farm during the class period and a member of the Board of Directions since 1987, explained:

> In my judgment at the time, it was more appropriate and in the best interests of our policyholders to retain our investment earnings, including the unrealized gains on Surplus to allow for greater security and financial strength for our policyholders and to enhance our ability to provide stable and low rates and premiums to our policyholders. At all times, our Surplus is invested and the resulting earnings are used to offset the cost of operations and thus reduces or lessens the sizes of increases of rates and premiums. The existence of our Surplus position allowed us to charge lower rates and premiums to policyholders across the board than would otherwise have been possible. This, in my judgment, was a far more appropriate course of action than liquidating our Surplus in order to pay a one-time dividend.

Trosino Declaration, paragraph 15.[2] See also, Deposition of Gregory Hayward (Assistant Vice President and Actuary for State Farm) at pages 90-91 (additional surplus generates additional income and allows rates to be lowered for the benefit of policyholders/shareholders).

Much of the evidence Plaintiffs cite in opposition to summary judgment is directed toward arguing that State Farm's Board of Directors could have, *and should have* paid a dividend out of the company's surplus. For example, Plaintiffs present an extensive discussion of the premium-to-surplus ratio (and the surplus-to-premium ratio) in an attempt to demonstrate that "excess" surplus was available from which dividends could be paid. While interesting, this discussion merely criticizes the decisions made by the Board of Directors in light of other possible analyses of data. Plaintiffs are urging the sort of second-guessing of actions of the Board of Directors that the business judgment rule precludes.

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[2] Plaintiffs purport to dispute State Farm's proposed Undisputed Fact Number 92, which offers evidence that "State Farm's surplus was a critical factor in allowing State Farm to reduce its underwriting return targets and to lower insurance rates for its policyholders." The purported basis for the dispute is that State Farm used a two-to-one premium-to-surplus ratio in its filings with the insurance commissioner and that, if it had taken its entire surplus into account and calculated premiums based on a reasonable rate of return for its entire surplus, higher rates would have resulted.

This argument does not bear scrutiny. The portion of the deposition of Gregory Hayward cited by Plaintiffs in opposition to Undisputed Fact Number 92 is taken out of context. The testimony of Mr. Hayward at pages 104 through 112 of his deposition explains that, in filings with the insurance commissioner, the insurer is asked to calculate a return on an amount that represents a minimal level of surplus, not the full amount of surplus retained by the insurer. The insurer must justify that the premium it proposes includes a reasonable return on that minimum surplus. Plaintiff's expert agreed that the two-to-one ratio in the regulatory filings was State Farm's statement of a safe minimum surplus and that it was not improper for State Farm actually to maintain a larger surplus. Deposition of Michael L. Toothman at pages 199-200. *See generally, 20th Century Ins. Co. v. Garamendi* (1994) 8 Cal.4th 216, 302 (cited by Plaintiffs in Opposition Brief at p. 26; discussing regulatory scheme whereby insurance premiums need not provide a return on "surplus surplus," *i.e.*, capital that is not required for insurance business).

Therefore, nothing in State Farm's insurance filings disputes the fact that State Farm did maintain a larger surplus than the minimum two-to-one premium-to-surplus ratio, and that the earnings from this larger surplus in fact allowed State Farm to charge lower rates.

Under the governing insurance policies and the company's bylaws, the Board was empowered to declare a dividend, but it had no duty to do so and in particular had no duty to pay out "excess" surplus in dividends. The provision of the company bylaws on which Plaintiffs rely states that the Board "may authorize" dividends from "savings and gains" of the corporation. This language does not require dividends to be declared, nor does it specify a definition of the "savings and gains" that the Directors must consider. Plaintiffs only can challenge the Board's dividend determinations if they can offer evidence that those decisions were completely without merit (or demonstrate some other exception to the business judgment rule).

As the Court of Appeal recognized in its previous opinion in this case, "[i]t is impossible to specify the 'right' amount of [surplus] for most insurers through a formula." Cummins et al., *An Economic Overview of Risk-Based Capital Requirements for the Property-Liability Insurance Industry* (1993) 11 J.Ins.Reg. 427-435 (quoted with approval in *Hill II*, 114 Cal.App.4th at 441). "Each insurance company has its own method for determining the amount of surplus it considers to be adequate." *Hill II*, 114 Cal.App.4th at 441.

The dividends declared by State Farm's Board took into account the extent to which underwriting performance in a particular state was in excess of an underwriting target. The Board permitted surplus to accumulate rather than reducing it by declaring dividends. The Directors viewed the accumulation of surplus as serving several purposes that benefited policyholders/shareholders: it reduced risk, compensated for the fact that mutual insurers cannot raise money in the stock market and permitted lower premiums for policyholders/shareholders. Plaintiffs have not shown that State Farm's decision to

accumulate surplus rather than selling assets to pay dividends was so irrational as to be "totally without merit." *Hill II*, 114 Cal.App.4th at 450, quoting *Romanik v. Lurie Home Supply Center, Inc.* (1982) 105 Ill.App.3d 1118, 1134.[3]

2. Plaintiffs' Arguments That the Board Did Not Become Sufficiently Informed to Make an Independent Decision

Plaintiffs argue that the Board of Directors of State Farm did not sufficiently inform itself in making dividend decisions. However, undisputed evidence establishes that substantial information and analysis about the company's financial position and surplus was presented to the Board, and that the Board discussed this information, including the size and fluctuation of the surplus.

The declaration of Mr. Trosino, in paragraph 4, details the many financial reports received by the Board on a regular basis. These reports included detailed information about State Farm's surplus, various categories of surplus and increase or decrease in surplus. For example, the "Quarterly Operations Review" received by the Board "contained a report on each component of State Farm Mutual's Surplus for the year, including what was referred to as the 'investment fluctuation reserve,' the Surplus assigned to subsidiaries, and other special categories of Surplus. This statement kept State Farm's directors informed of how the size of the company's surplus had grown or fallen and also of which components of Surplus were most affected." Trosino Declaration, paragraph 4B at p. 3.

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[3] Plaintiffs argue that the Board's decisions concerning dividends were totally without merit because the Board did not consider paying dividends in lieu of reducing rates. But the exception to the business judgment rule that considers whether a board decision is totally without merit concerns the outcome of board decision making, asking whether the result is rational. This exception to the business judgment rule does not consider the adequacy of board processes. Whether or not the Plaintiffs have offered evidence sufficient to demonstrate that the Board failed to become sufficiently informed to make an independent decision is discussed below.

State Farm also presented undisputed evidence that the Board discussed the company's financial condition on a regular basis, including the company's surplus and its fluctuation. Presentations to the Board about State Farm's financial condition were "interactive" and the "discussions, combined with the written materials which were provided to the Board, allowed the Directors to gain a good, working understanding of the essential aspects of State Farm Mutual's operations and finances, including its Surplus position and how that position was evolving." *Id.*, paragraph 6 at pages 5-6. Indeed the portion of the deposition of Dr. Jaedicke cited by Plaintiffs in paragraph 111 of their Separate Statement of Disputed Facts demonstrates that the Board's "conservative" decisions about dividends were made in the context of a discussion of the company's overall financial condition:

> At every [Board] meeting, there was an elaborate – quite an extensive financial report, and so we were continually looking at not only the operations, the total profit, the investment gains, and using that to assess the financial health of the company, the long-term financial health.
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> In that context, I do not recall anybody on the Board of Directors suggesting that somehow we ought to weaken that financial condition by monetizing some asset or set of assets and paying a dividend. We were much more concerned with the long run financial health of the company, the ability for it to meet its obligations when they came due. But that was a constant discussion in every Board meeting.

Jaedicke Deposition at 50-51.

Mr. Joslin also testified that "[d]uring each Board meeting, I or a member of my staff reviewed State Farm Mutual's Surplus position and, as reflected above, this was a topic of discussion at meetings of the Board." Joslin Declaration, paragraph 15. "At no time did the Board reach a conclusion that the surplus retained was in excess of reasonable limits." *Id.*, paragraph 14.

Plaintiffs do not challenge these facts concerning the information that was available to the Board of Directors. The evidence on which Plaintiffs rely in attempting to create an issue of fact with respect to whether the Board sufficiently informed itself in making dividend decisions is set forth primarily in Plaintiffs' Separate Statement of Disputed Facts, paragraphs 15 and 111.

Plaintiffs refer to the State Farm Board minutes, which do not evidence that the Board ever deliberated concerning whether any portion of State Farm's accumulated surplus or investment income should be distributed to policyholders. They cite deposition testimony by Directors to the effect that the Board did "not consider[ ] dividending out surplus for the purpose of paying a dividend." Trosino Deposition at 104-105. They also cite a "Memorandum to File" re "Dividends" authored by Mr. Joslin in 1987, which states: "While not prohibited from doing so, we are reluctant to take any action which appears to return investment income to policyholders. Our philosophy has been to return unneeded premium rather than a portion of total profits."

Plaintiffs also rely on testimony that the Board did not discuss "what [was] an appropriate amount of surplus" for State Farm. Wilson Deposition at 20. They cite testimony of State Farm's Chief Actuary that he had never analyzed whether State Farm had "adequate surplus." Deposition of Gary Grant at 21.

Plaintiffs also refer to paragraphs 10 through 13 of the expert declaration of Michael L. Toothman, an actuary. In these somewhat confusing paragraphs, Mr. Toothman criticizes an evaluation of State Farm's surplus dated August 30, 1991 and states that there were no subsequent reviews of surplus between 1991 and the end of the class period. Based on this, he concludes that "the Board was not provided with

sufficient information on which to base a proper dividend decision at any point during this time period." Toothman Declaration, paragraph 13.

Plaintiffs cite the fact that when management recommended that the Board declare a dividend, the Board was presented with a one-page worksheet showing a state-by-state breakdown of profit and loss based on the underwriting experience for automobile insurance during a particular period. Declaration of Mark Anchor Albert, Exhibit 67. They refer to testimony by Dr. Jaedicke that he did "not recall anybody on the Board of Directors suggesting that somehow we ought to weaken [the company's] financial condition by monetizing some asset or set of assets and paying a dividend." Jaedicke Deposition at 50-51. Plaintiffs also refer to evidence that the Board did not modify management's dividend recommendations or discuss alternative methods of calculation. Wilson Deposition at 14-15.

This evidence does not create an issue of fact as to what information actually was before the Board of Directors. Rather, Plaintiffs argue that the court should recognize an exception to the business judgment rule because (1) the Board did not have before it particular types of analyses of the company's surplus position when the Board made decisions on dividends, and (2) the Board did not actually deliberate about paying dividends from the company's surplus.

a. Absence of Particular Types of Analyses of Surplus

With respect to Plaintiffs' first argument, Mr. Toothman criticizes an analysis of State Farm's surplus needs prepared by the company in 1991. Mr. Toothman then opines that in subsequent years the Board could not have acted rationally in declaring dividends

without conducting additional analyses of the company's "surplus needs or adequacy . . . ." Toothman Declaration, paragraph 13.

Plaintiffs' argument incorrectly assumes that an allegation that the Board could have had additional information requires the conclusion that the information the Board did consider was inadequate. In this case, the Board had significant information about State Farm's surplus condition. As described above, it is undisputed that substantial information about the amount of the company's surplus, its constituent parts and the contribution of the surplus to the health of the ongoing enterprise was both presented to the Board and discussed by the Board.

Mr. Toothman's opinion that a different or supposedly better study could or should have been done does not constitute evidence that the information before the Board was inadequate. The deference to decision making by corporate boards that is inherent in the business judgment rule extends to information gathering and analysis by corporate boards. "[T]he amount of information that it is prudent to have before a decision is made is itself a business judgment of the very type that courts are institutionally poorly equipped to make." *In re RJR Nabisco, Inc. Shareholders Litigation* (Del.Ch. 1989) 1989 Del.Ch.LEXIS 9, *57-*58. It is always possible to allege that something more or something different could have been considered in making a corporate decision. The analysis Mr. Toothman recommends is not so significantly different from the information that was routinely considered by the State Farm Board that the absence of the recommended analysis constitutes evidence that the Board was insufficiently informed in making its decision.

Moreover, Plaintiffs' argument that the State Farm Board should have analyzed the company's surplus to determine when it had reached a level of maximum adequacy or minimum sufficiency is premised on the incorrect notion that the State Farm Board was required to accept the relevance of those concepts. The State Farm Board was not required to look at business decisions in a particular way just because Plaintiffs would have preferred that they make a different decision. As the Court of Appeal has recognized, "[e]ach insurance company has its own method for determining the amount of surplus it considers to be adequate." *Hill II,* 114 Cal.App.4th at 450.

The undisputed testimony of members of the Board is that they wanted to be certain that State Farm had adequate surplus to meet its obligations and to provide a cushion in the event the company needed additional capital. The strategy implemented by State Farm benefited shareholders because income from the surplus permitted stable and low rates and premiums for the policyholder/shareholders. To pursue these goals, the Board apparently did not find it necessary to consider the concept of determining a "minimum" adequate surplus. Under the guise of urging that the Board perform a different analysis of the company's surplus, Plaintiffs actually are urging that the Board should have adopted their preferred alternate approach to considering and paying dividends.

As a separate and alternative ground for decision, this court finds that Mr. Toothman's opinions concerning the surplus needs of State Farm and the analysis of those needs are inadmissible. State Farm filed objections to the Declaration of Mr. Toothman, arguing that he is not qualified to testify about the surplus needs of a mutual insurance company. The court finds that he is not qualified to offer an opinion about

whether State Farm retained "excess" surplus, about the surplus needs of a mutual insurance company or about the information State Farm's Directors should have obtained concerning State Farm's surplus.

Mr. Toothman is "an actuary, specializing in property and casualty insurance and in risk management issues for property and casualty exposures." Toothman Declaration, paragraph 2. There is no evidence that Mr. Toothman has experience in determining what level of surplus is appropriately retained by a mutual insurance company. There is no testimony that Mr. Toothman has written an article in a recognized journal on the subject of the surplus needs of mutual insurance carriers, that he has advised a mutual insurance carrier on the subject, that he has been consulted by a Board of Directors concerning this or related issues or that he has served as a member of a Board of Directors of a mutual insurance company. In his deposition he testified that he could not recall having been consulted by a mutual insurance company to perform a surplus needs analysis. Toothman Deposition at 20-21. While he is skilled in risk analysis for insurers, there is no evidence that he has expertise in corporate governance issues or the significance of surplus as capital in a mutual insurance company. As the Court of Appeal's previous decision in this case recognizes, mutual insurers use surplus to control risk in ways that are different from stock insurance companies. *Hill II,* 114 Cal.App.4th at 440-441. Mr. Toothman lacks the appropriate credentials to render an expert opinion on the analysis of surplus needs of a mutual insurance company.[4]

Moreover, an expert who testifies that the conduct of another does not meet a required standard must have knowledge of the standard and its proper application. *See*

[4] In making this determination the court has not considered the fact that Mr. Toothman is a member of the plaintiff class (Toothman Deposition at 8-11), because issues of bias may not be considered by the court in deciding a Motion for Summary Judgment.

Evans v. Ohanesian (1974) 39 Cal.App.3d 121, 128 (to qualify as a medical expert in a malpractice case, witness must be familiar with the standard required of physicians under similar circumstances). Mr. Toothman testifies that the "Board was not provided with sufficient information on which to base a proper dividend decision," but his credentials do not establish that he has expertise in the standards required for boards of directors to exercise proper oversight and decisionmaking.

This court's conclusion about the admissibility of the testimony of Mr. Toothman is bolstered by the fact that Plaintiffs' other expert, Professor Lucian A. Bebchuk, was unwilling to opine that State Farm's Board had inadequate information from which to assess State Farm's surplus needs.[5] To be sure, Professor Bebchuk criticizes State Farm for failing to determine the "*minimum* level of surplus that was adequate for State farm [sic] to have at the given point in time taking into account the risks State Farm faced." Bebchuk Declaration, paragraph 22 (emphasis added). However, Professor Bebchuk stops short of opining that the absence of such an analysis breached the Board's duty to become sufficiently informed to make an independent decision. Rather, Professor Bebchuk testifies only that "[w]ithout receiving adequate information and adequate input from expert staff, it is *doubtful* that the directors would have been able to make adequate determination of the needed level of surplus by themselves even with substantial deliberation and time investment." *Id.*, paragraph 29 (emphasis added).

It is undisputed that there were regular presentations by management and interactive Board discussions about the company's surplus and its role in State Farm's overall financial condition. Participants in those discussions included Directors with

[5] Plaintiffs' Separate Statement of Disputed Facts relies on the testimony of Mr. Toothman, not the testimony of Professor Bebchuk, in attempting to establish that the Directors were insufficiently informed.

impressive academic credentials in business. Professor Bebchuk does not opine that the Directors could not have satisfied their duty to shareholders by considering the available information about the company's surplus and financial condition, coupled with input from State Farm's staff and application of the Directors' substantial expertise. Mr. Toothman's credentials do not allow him to fill that gap in testimony.

b. Absence of Deliberations About Reducing Surplus by Paying Dividends

Plaintiffs also argue that this court should recognize an exception to the business judgment rule because Plaintiffs have offered evidence that the Board did not actually deliberate about paying dividends from the company's surplus. As discussed above, however, it is undisputed that the Board did deliberate about the uses and adequacy of the Company's surplus. And as a result of these deliberations, members of the Board never came to the conclusion that the State Farm's surplus was greater than what was prudently retained. The predicate for reducing surplus by paying dividends is a determination that the operational needs of the company are adequately met by the amount of surplus it has. Members of the State Farm Board never concluded that those predicate conditions existed, and therefore they did not breach a duty by failing to deliberate about payment of dividends from surplus.

Members of the Board of Directors who have testified in this proceeding have stated that they never concluded that State Farm had sufficient surplus to allow consideration of reducing that surplus. Dr. Wilson testified in his deposition: "There could be in principle 'too much net worth.' In my judgment, as a director for the seven or so years that I've been on the board, we've never been in a position where we had too much." Wilson Deposition at 19-20. Dr. Jaedicke stated that the Board "considered the

amount of the surplus as one element in assessing overall financial condition at almost every meeting. . . . As I indicated, I don't think there was ever a time when we were concerned that we had – or when I was on the Board, that we had too much." Jaedicke Deposition at 120. Mr. Joslin's declaration states that "[a]t no time did the Board reach a conclusion that the surplus retained was in excess of reasonable limits." Joslin Declaration, paragraph 14. Mr. Trosino testified that:

> In my judgment as a Director and Officer of State Farm Mutual, State Farm Mutual's Surplus was never excessive. At no time during my tenure as a Director, did I believe that State Farm Mutual was overcapitalized, nor did I believe that State Farm Mutual had "too much" Surplus. In my role first as Vice President and Chief Administrative Officer and later as President and Chief Operating Officer, in addition to being a member of the Board, I continually analyzed our Surplus position as well as other significant aspects of our operations. Throughout this period, I concluded that retaining Surplus as we did each year provided an important margin of safety and financial strength to best serve our policyholders both in the present and in the long-run. Furthermore, this Surplus supported State Farm Murual's ability to meet the needs of its policyholders, remain competitive, charge lower premiums, and support the reasonable growth of its business. In my judgment as an Officer and Director, the Surplus levels maintained by State Farm Mutual represented the appropriate balance of financial strength, a very low risk of ruin, low rates and premiums, and stability for the long-term.

Trosino Declaration, paragraph 12.

In light of this undisputed testimony, the Board never was presented with a factual scenario that would call for Members to consider reducing surplus by paying dividends.

In *Stamp v. Touche Ross & Co.* (1993) 263 Ill.App.3d 1010, the Illinois Court of Appeal considered the sufficiency of a complaint alleging that corporate directors failed to oversee the performance of managing general agents and failed to ensure that the corporation was properly managed and supervised. *Id.* at 1017. The Court of Appeal

found that these allegations attacked the directors' exercise of their business judgment and therefore the challenged conduct was "within the protected parameters of the business judgment rule." *Id.* The Illinois Court of Appeal rejected the plaintiff's contention that the complaint adequately pleaded "the absence of business judgment" so as to come within an exception to the business judgment rule. *Id.* The Court of Appeal stated:

> Nowhere in the complaint does plaintiff allege that the defendants did not make informed judgments or use due care in arriving at those judgments, facts which are essential for the plaintiff to recover for negligence. . . . Nor does the complaint allege that defendants acted other than in the best interest of the corporation, a fact necessary to recover for breach of fiduciary duty. Instead, plaintiff's complaint questions those decisions which defendants made. This is exactly the type of second-guessing which the business judgment rule was designed to preclude.

Id.

Although Plaintiffs have alleged that the State Farm Directors did not use due care because they relied on insufficient information, Plaintiffs have not supported this contention with admissible evidence, as discussed in the preceding subsection of this Opinion and Order. Having exercised due care, it is not a violation of the business judgment rule that the Board decided to retain surplus and made the judgment that the amount of surplus was appropriate to the company's needs. If the Directors were correct in their judgments about State Farm's surplus needs, then the issue of whether surplus should be reduced was precluded by the business judgments the Directors had made. To require that the Directors deliberate about reducing surplus to pay dividends, as Plaintiffs urge, would be to question the decisions about State Farm's surplus needs that the Board had made. As the Illinois Appellate Court stated in *Stamp v. Touche Ross & Co.*,

"plaintiff's [contentions] question[ ] those decisions which defendants made. This is exactly the type of second-guessing which the business judgment rule was designed to preclude." *Id.*

As discussed above, undisputed evidence establishes that the Board of Directors of State Farm monitored the company's surplus and made informed judgments about the appropriate level of surplus for the benefit of the Company. At root, Plaintiffs' evidence is directed toward questioning the Directors' judgments about the surplus, in particular their judgment that the surplus was not at a level greater than what was appropriate for State Farm's operational needs. Plaintiffs have failed to offer evidence sufficient to establish an exception to the business judgment rule based on the Directors' failure to make informed judgments in managing the Company.

3. Plaintiffs' Arguments That the Board's Decisions Were Infected by Fraud

Plaintiffs argue that they have offered evidence sufficient to establish an exception to the business judgment rule because of disclosures and non-disclosures made by State Farm to policyholders. They make essentially two arguments. First, they contend that "[a]t no time and in no fashion did State Farm ever disclose to policyholders that . . . State Farm had determined that policyholders would never 'share in the earnings and savings of the company' their premiums had made possible." Opposition Brief at 30 (emphasis in original). Second, Plaintiffs argue that "an envelope insert that contains a brief table that purports to summarize State Farm's 'Statement of Condition' (*i.e.*, its balance sheet) and Operating Data (*i.e.*, income and expenses)" sent by State Farm to its policyholders once a year was calculated to confuse and mislead policyholders about the size of State Farm's surplus. *Id.*

These arguments miss the point and would not establish an exception to the business judgment rule even if Plaintiffs' contentions were supported by admissible evidence. It is important to recall that the primary claim asserted in this case is a cause of action for breach of contract based on a claimed entitlement to dividends under State Farm policies. The complaint does not assert a breach of fiduciary duty claim based on non-disclosure of material facts.

The Court of Appeal has held that the State Farm Board of Directors' decisions concerning dividends are protected by the Illinois business judgment rule. Plaintiffs assert the exception to the business judgment rule based on fraud. But this exception is concerned with fraud, oppression or dishonesty in the directors' decision that is being challenged; in this case, the Board's decision to declare dividends that were not based on growth in State Farm's surplus. Plaintiffs do not offer evidence that the dividend decisions themselves were fraudulent, self-interested or dishonest.

Illinois and Delaware cases articulating and applying the fraud exception to the business judgment rule address situations where there is reason to question the propriety of directors' motivations in making a challenged decision. For example, in *Hall v. Woods* (1927) 325 Ill. 114, 140-141, the Illinois Supreme Court examined a claim that directors' decisions were "actuated by merely selfish motives" in order to determine whether the directors acted "in good faith and in honesty of purpose" or whether their actions demonstrated "fraud, oppression or dishonest conduct." In *Lower v. Lanark Mutual Fire Ins. Co.* (1983) 114 Ill.App.3d 462, 467, the Illinois appellate court described the fraud exception to the business judgment rule as considering whether corporate directors acted "without corrupt motive and in good faith." In *Revlon, Inc. v.*

MacAndrews & Forbes Holdings, Inc. (Del. 1986) 506 A.2d 173, 180, the business judgment rule was defined as requiring that directors act "in good faith and in the honest belief that the action taken was in the best interests of the company."

There are no allegations, and certainly no evidence, that the Directors of State Farm acted in their own self interest or with any other dishonest or corrupt motives in making dividend decisions. The non-disclosure issues raised by Plaintiffs simply do not implicate the motivations of the directors and do not create an inference that the Directors acted with anything other than good faith in declaring dividends. There is no evidence that, in making decisions concerning dividends or surplus, the State Farm Board had anything to gain other than what the Directors perceived as the best interests of State Farm.

Insofar as Plaintiffs challenge the statements made in the summary Statement of Condition sent to policyholders, Plaintiffs fail to offer evidence that links this summary to the Board's decisions concerning dividends and surplus in a way that would cast doubt on the good faith of the Directors in making those decisions. Plaintiffs do not offer evidence that this communication was from the Board of Directors or was approved by the Board. The cases cited by Plaintiffs that impose liability on corporate directors for breach of fiduciary duty based on communications to shareholders involve communications directly from, or approved by, a board of directors. *Malone v. Brincat* (Del. 1998) 722 A.2d 5, 14 (directors' fiduciary duty is violated when they deliberately misinform shareholders about the business of a corporation, either directly or by a public statement); *Marhart, Inc. CalMat Co.* (Del.Ch. 1992) 1992 Del.Ch.LEXIS 85 *7-*8 (when corporate directors undertake to give out written statements concerning the condition of the

corporation, they must honestly disclose all material facts).[6] Again, no evidence offered by Plaintiffs casts doubt on the good faith or honesty of purpose of the State Farm Directors.

Plaintiffs also contend that State Farm should have disclosed to policyholders that the company had determined that policyholders would never share in the growth of the company's surplus. But there is no evidence that the Board of Directors made a policy decision that the company's surplus never should be reduced by payment of dividends. Dr. Wilson testified that "[t]here could be in principle 'too much net worth.'" Wilson Deposition at 19. Moreover in June of 2000, subsequent to the class period at issue in this case, State Farm declared a dividend representing all of State Farm's pre-tax net income for 1999. (UFs 119-120) Thus, there is no basis for Plaintiff's argument that State Farm should have made a disclosure that the company had decided never to declare dividends from surplus, because the Directors never made such a decision, and, indeed, the Directors acted to declare such a dividend in 2000.[7]

Plaintiffs have failed to offer evidence sufficient to establish an exception to the business judgment rule based on fraud, bad faith or other dishonest conduct by the State Farm Board of Directors.

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[6] *Johnson v. Central Standard Life Ins. Co.* (1968) 102 Ill.App.2d 15, 31-32,also cited by Plaintiffs, involves misleading conduct by the chief executive and principal owner of a company acting for his own personal advantage.

[7] In reply to Plaintiffs' arguments concerning the fraud exception to the business judgment rule, State Farm presents several documents that are State Farm communications to policyholders explaining that dividends are paid in recognition of lower than expected claims costs. Thus, State Farm shareholders were correctly informed of the basis on which dividends were being calculated. *See* State Farm Reply Brief at pages 34-35 and exhibits cited therein.

E. The Business Judgment Defense is Applicable to the Claim for Breach of the Covenant of Good Faith and Fair Dealing

In *Hill I*, the Court of Appeal held that Plaintiffs' claim for breach of the covenant of good faith and fair dealing could proceed as an independent claim. Slip op. at 17. However, in *Hill II* the Court of Appeal emphasized that "[i]f the board's decision is proper under the business judgment rule, then the covenant of good faith and fair dealing – an aid in determining contract rights – cannot be used as an end-run to impose liability here." *Hill II*, 114 Cal.App.4th at 453. Thus, because State Farm is entitled to summary judgment based on the business judgment rule, Plaintiffs cannot succeed on their cause of action for breach of the covenant of good faith and fair dealing.

F. Plaintiffs' Claims Under the UCL and for an Accounting Fail as Well.

In their cause of action under the California Unfair Competition Law, Plaintiffs[8] seek to impose liability on State Farm for not declaring dividends. The Court of Appeal's decision in *Hill II* holds that any liability based on failure to declare dividends pertains to internal corporate governance and therefore is governed by the law of State Farm's place of incorporation, *viz.*, Illinois. *Id.* at 449. The UCL is California statutory law. California Business and Professions Code section 17200, et seq. Under *Hill II*, Plaintiffs cannot use a cause of action under California law to attempt to create liability for State Farm's governance of its internal corporate affairs, and therefore Plaintiffs' cause of action under the UCL fails as a matter of law.

With respect to Plaintiffs' cause of action for an accounting, under Illinois law a policyholder of a mutual insurance company has no right to compel an accounting in the

[8] The claim under California Business and Professions Code section 17200 was not certified for class adjudication. The individual named plaintiffs continue to pursue this cause of action on their own behalf.

absence of proof or wrongdoing or mistake. *Lubin v. Equitable Life Assurance Soc'y* (1945) 326 Ill.App. 358, 370-371. Because Plaintiffs' evidence is insufficient to create an issue of fact as to any wrongdoing by the State Farm Board of Directors, their cause of action for an accounting cannot succeed.

ORDER

State Farm's Motion for Summary Judgment is granted.

Dated: August 3, 2006

Carolyn B. Kuhl
Judge of the Superior Court