

STATE OF MICHIGAN
IN THE SUPREME COURT
Appeal From the Court of Appeals
(White, PJ, and Zahra and Kelly, JJ)

INSURANCE INSTITUTE OF MICHIGAN,
HASTINGS MUTUAL INSURANCE COMPANY,
FARM BUREAU GENERAL INSURANCE COMPANY OF MICHIGAN,
FRANKENMUTH CASUALTY INSURANCE,
WALTER STAFFORD, JR., and MICHAEL FLOHR,

Plaintiffs-Appellees,

and

MICHIGAN INSURANCE COALITION and
CITIZENS INSURANCE COMPANY OF AMERICA,

Intervening Plaintiffs-Appellees,

v

COMMISSIONER, FINANCIAL & INSURANCE
SERVICES, DEPARTMENT OF LABOR &
ECONOMIC GROWTH,

Defendant-Appellant.

INSURANCE INSTITUTE OF MICHIGAN,
HASTINGS MUTUAL INSURANCE COMPANY,
FARM BUREAU GENERAL INSURANCE COMPANY OF MICHIGAN,
FRANKENMUTH CASUALTY INSURANCE,
WALTER STAFFORD, JR., and MICHAEL FLOHR,

Plaintiffs-Appellants,

and

MICHIGAN INSURANCE COALITION and
CITIZENS INSURANCE COMPANY OF AMERICA,

Intervening Plaintiffs-Appellants,

v

COMMISSIONER, FINANCIAL & INSURANCE
SERVICES, DEPARTMENT OF LABOR &
ECONOMIC GROWTH,

Defendant-Appellee.

Docket No. 137400

Court of Appeals No. 262385

Barry County Circuit Court
LC No. 05-000156-CZ

Docket No. 137407

Court of Appeals No. 262385

Barry County Circuit Court
LC No. 05-000156-CZ

**REPLY BRIEF – APPELLANTS INSURANCE INSTITUTE OF MICHIGAN, ET AL IN DOCKET 137407
ORAL ARGUMENT REQUESTED**

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TABLE OF CONTENTS

	<u>Page</u>
INDEX OF AUTHORITIES.....	ii
I. INTRODUCTION	1
II. ARGUMENT.....	2
A. The OFIS Rules Violate The Insurance Code.....	2
B. The Use Of Insurance Scoring Does Not Produce Rates That Are Unfairly Discriminatory	3
C. Judicial Review Of Agency Rules Under APA § 64	7
D. Section 244(1) Does Not Provide The Exclusive Means By Which To Seek Judicial Review Of Rules.....	9
III. RELIEF REQUESTED.....	10

INDEX OF AUTHORITIES

Cases

Consumers Power Co v MPSC, 460 Mich 148; 596 NW2d 126 (1999) 2

Health Ins Ass'n of America v Corcoran, 154 AD2d 61; 551 NYS2d 615 (NY AD Dept 3, 1990) 5, 6, 7

In re Complaint of Rovas Against SBC Michigan, 482 Mich 90; 754 NW2d 259 (2008) 1

Insurance Comm'r for the State of Maryland v Engelman, 345 Md 402; 692 A2d 474 (1997)..... 5

Life Ins Ass'n v Comm'r of Ins, 403 Mass 410; 530 NE2d 168 (1988)..... 6, 7

Ludington Serv Corp v Acting Comm'r of Ins, 444 Mich 481; 511 NW2d 661 (1994)..... 8

Luttrell v Dep't of Corr, 421 Mich 93; 365 NW2d 74 (1984) 1

Spanish Speaking Citizens' Foundation, Inc v Low, 85 Cal App 4th 1179; 103 Cal Rptr 2d 75 (2000)..... 4

State of Florida, Dep't of Insurance v Insurance Services Office, 434 So2d 908 (Fla App - Dist 1, 1983)..... 5, 6, 7

Telles v Comm'r of Ins, 410 Mass 560; 574 NE2d 359 (1991) 6, 7

Statutes

15 USC 1681 et seq..... 4

California Ins Code, § 1861.02(a)(4)..... 4

MCL 24.263 8

MCL 24.264..... 8, 9, 10

MCL 500.1214(2) 7

MCL 500.1361 7

MCL 500.1507..... 7

MCL 500.2027 5, 7

MCL 500.2080(7) 7

MCL 500.2109(1)(c).....	3, 4, 5
MCL 500.2110a	2
MCL 500.2111(4)	2
MCL 500.2403(1)(c).....	2
MCL 500.2403(1)(d).....	4, 5
MCL 500.244(1)	9, 10
MCL 500.2603(1)(c).....	2
MCL 500.2603(1)(d).....	4, 5
MCL 500.737	7

Other Authorities

DON LEDUC, MICHIGAN ADMINISTRATIVE LAW § 4:35 (West 2001).....	8
DON LEDUC, MICHIGAN ADMINISTRATIVE LAW § 4:06 (West 2001).....	2

Rules

MRE 702.....	3
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I. INTRODUCTION

The issue here is whether the OFIS Rules were adopted in violation of the Insurance Code. The answer depends on whether 1) the Commissioner exceeded her rulemaking authority by issuing a blanket prohibition on the use of insurance scores, or 2) the Rules conflict with provisions in the Insurance Code. If the answer to either of these questions is in the affirmative, the Rules are invalid under the second prong of the test established in *Luttrell v Dep't of Corr*, 421 Mich 93; 365 NW2d 74 (1984).¹ The issue is purely a question of law, which must be resolved upon de novo review by the judicial branch. Because its resolution depends upon the proper interpretation of a statute, no special deference is due to the Commissioner's interpretation; interpreting statutes is a judicial function. *In re Complaint of Rovas Against SBC Michigan*, 482 Mich 90; 754 NW2d 259 (2008).

It is equally important to understand what is *not* at issue in this case:

- This is not a challenge to the procedures utilized by OFIS to adopt the Rules (see Comm'r Br at 2, 23-24); it is a challenge to the validity of the Rules (see Pl Br at 20-29). Moreover, the Plaintiffs have never asserted that the rulemaking hearings conducted by OFIS had to employ the rules of evidence (see Comm'r Br at 22), but only that the information accumulated at these hearings is not admissible as evidence and therefore cannot be treated as such by the courts.
- Whether insurance scoring should, as a matter of public policy, be prohibited is also not at issue. (See Comm'r Br at 2.) That is a question for the Legislature, not one for the courts or for OFIS. (See Pl Appellee Br at 38-42.) Revealing, however, is the fact that before she adopted the Rules, the Legislature declined the Commissioner's request to adopt a statute prohibiting the use of insurance scores. (Pl Appellee Br at 42-43.)
- This is also not an appeal from an agency action. (See Pl Br at 36-38.) Under the APA, there is no such thing as an appeal from a rulemaking any more than there is an appeal from the enactment of a statute. Rulemaking is a quasi-*legislative* function. A rule is prospective in effect and affects

¹ The second prong of the *Luttrell* test is whether Rules are consistent with the legislative intent of the statute they implement. *Luttrell*, 421 Mich at 100.

the rights of all who are subject to it. See generally LEDUC, MICHIGAN ADMINISTRATIVE LAW § 4:06 (West 2001). Appeals are taken from quasi-judicial decisions which involve the application of legal standards to specific facts ascertained by the agency. Quasi-judicial decisions are not forward looking and are binding only on the parties before the tribunal.

- Because this is not an appeal, no deference is due the factual conclusions of the agency and there is no "record" to be reviewed.

II. ARGUMENT

A. The OFIS Rules Violate The Insurance Code

The Commissioner asserts that the OFIS Rules are valid (Comm'r Br at 6-20), but they are not. Administrative agencies such as OFIS may only exercise powers expressly granted by the Legislature. See *Consumers Power Co v MPSC*, 460 Mich 148, 155; 596 NW2d 126 (1999) (agencies "possess only that authority granted by the Legislature"). While the Legislature itself has prohibited the use under Chapter 21 of certain rating factors such as sex or marital status, MCL 500.2111(4), it has not authorized OFIS to adopt an across-the-board prohibition on the use of *any* rating factors by administrative rule. By issuing the OFIS Rules, the Commissioner exceeded her delegated rulemaking authority. In addition, the OFIS Rules conflict with the procedures in the Insurance Code by which the Commissioner may challenge rate plans filed by insurance companies. Those procedures require the Commissioner to provide an opportunity for each company to demonstrate in a contested case hearing a rate plan's compliance with statutory criteria. A blanket prohibition deprives insurance companies of this right. (See Pl Br at 23-24.)

The OFIS Rules conflict with the provisions of Chapters 24 and 26 of the Insurance Code that allow rating factors that "measure any differences among risks that may have a probable effect upon losses and expenses" (MCL 500.2403(1)(c), MCL 500.2603(1)(c)) and the provision of Chapter 21 that allows discounts based on a factor that "reflects reasonably anticipated reductions in losses or expenses" (MCL 500.2110a). Before the Circuit Court and in the

Commissioner's rulemaking hearings, see Pl Appellee Br at 24-37, statistical data were presented showing strong correlation between insurance scores and risk of loss. The Circuit Court found "that there is no question that there is a high correlation between insurance scores and the expected risk and expenses associated with a policyholder." (Pl App 257a.) The Commissioner refused to consider the companies' statistical data or the prior commissioner's report finding a correlation (Pl App 42a). Contrary to her current position before this Court that admissible evidence is not necessary in a rulemaking (Comm'r Br at 22-23), the Commissioner's stated basis for rejecting the companies' statistical data was that "none of the charts on a particular insurer's book of business have been scrutinized for admissibility of testimony by experts under Rule 702 of the Michigan Rules of Evidence in either an APA contested case or a Michigan trial court." (JCAR Report at 20; Pl Appellee App 230b.) On this "basis," the Commissioner refused to acknowledge the actuarial soundness of rates based on insurance scores.

B. The Use Of Insurance Scoring Does Not Produce Rates That Are Unfairly Discriminatory

The Commissioner asserts that insurance scoring is "unfairly discriminatory" in violation of MCL 500.2109(1)(c) because "significant errors" and "incomplete" information render credit reports "unreliable" such that "insurance scoring is likely to misclassify individuals and impose premiums on them that do not accurately reflect their true expected risk based on their actuarial characteristics." (Comm'r Br at 7-8.) However, the Commissioner's reasoning is fatally flawed because it relies on abstract notions of "fairness" that simply have no basis either in the language of the statute or in principles of insurance law generally.²

² The Commissioner is also wrong on the facts. She presented no evidence to the Circuit Court showing that credit reports are unreliable and the General Accounting Office study upon which she relied during the rulemaking proceeding concluded that there was not

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Sections 2109(1)(c), 2403(1)(d), and 2603(1)(d) expressly provide that a rate is not "unfairly discriminatory" if (1) the differential between the rate and other rates is reasonably justified by differences in losses or expenses, (2) the justification is supported by a reasonable classification system, and (3) the justification is supported by sound actuarial principles and by actual and credible loss and expense statistics. Thus, despite the Commissioner's assertion, the statutory framework established by the Legislature does not require that each individual person perfectly match the identical risk characteristics of every other person in the same rating category.³ Instead, §§ 2109(1)(c), 2403(1)(d), and 2603(1)(d) require only that rates be *actuarially* sound. Support for this analysis can be found in several decisions from other jurisdictions recognizing that where, as here, the Legislature has specifically authorized use of actuarially-justified rating factors, those factors are not "unfairly discriminatory." For example, in *Spanish Speaking Citizens' Foundation, Inc v Low*, 85 Cal App 4th 1179 (2000), the court rejected the argument that abstract notions of "equity," as opposed to actuarial standards, controlled in determining whether rates are "unfairly discriminatory" under California law. *Id.* at 1224-1225. Construing statutory language similar to that in §§ 2109(1)(c), 2403(1)(d) and 2603(1)(d),⁴ the *Low* court found the provision at issue to "link the concept of 'unfair discrimination' with that of 'substantial relationship to the risk of loss.'" *Id.* at 1227. See also

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enough information on the reliability of credit reports upon which to form a conclusion. (See Pl Appellee App 76b, 78b, and 85b.)

³ If a person has been misclassified because of credit report errors, Congress has established a correction mechanism. See 15 USC 1681 et seq. The Commissioner lacks authority to require perfect rate classifications, even if such things existed.

⁴ The statute at issue in *Low* provided in relevant part that rates could not be approved unless they "have a substantial relationship to the risk of loss," and that "the use of any criterion without such approval shall constitute unfair discrimination." *Id.* at 1227, citing California Ins Code, § 1861.02(a)(4).

Insurance Comm'r for the State of Maryland v Engelman, 345 Md 402, 413; 692 A2d 474 (1997) ("Unfair discrimination, as the term is employed by the Insurance Code, means discrimination among insureds of the same class based upon something other than actuarial risk.").

The Commissioner's argument is nearly identical to one that was persuasively rejected in *State of Florida, Dep't of Insurance v Insurance Services Office*, 434 So2d 908 (Fla App - Dist 1, 1983). There, the court addressed the validity of a rule barring the use of sex, marital status, and scholastic achievement as automobile insurance rating factors. In invalidating the rule, the court relied on statutory language which provided that a rate "shall be deemed unfairly discriminatory . . . if it clearly fails to reflect equitably the difference in expected losses and expenses." *Id.* at 912. In light of that language, the court rejected the department's reliance on general notions of equity and fairness, finding that the proper focus is instead on whether the factors being utilized in determining rates are "actuarially sound." *Id.* at 912-913. See also *Health Ins Ass'n of America v Corcoran*, 154 AD2d 61; 551 NYS2d 615 (NY AD Dept 3, 1990) ("[A] health insurance underwriting practice that is valid in reasonably assessing risks of future health costs on an actuarial basis cannot be prohibited by [the insurance commissioner]. Such an underwriting practice is not unfair, inequitable, misleading or discriminatory."). Similarly here, the language of §§ 2109(1)(c), 2403(1)(d), and 2603(1)(d) is unambiguous in providing that with certain limited exceptions not applicable here,⁵ classifications are not "unfairly discriminatory" so long as they are actuarially sound. The Commissioner's contrary argument without citation to any authority (Comm'r Br at 7-8), is without merit.

Moreover, a general statutory authorization to promulgate rules is plainly not sufficient to convey the extraordinary authority that the Commissioner now claims. In Massachusetts, the

⁵ See MCL 500.2027 (barring underwriting based on race, color, creed, or national origin).

commissioner issued a rule banning health insurers from underwriting on the basis of exposure to the AIDS virus because it was unfairly discriminatory. The court overturned the regulation, holding that the commissioner lacked authority to make this determination:

The basic principle underlying statutes governing underwriting practices is that insurers have the right to classify risks and to elect not to insure risks if the discrimination is fair. ... The intended result of the process is that persons of substantially the same risk will be grouped together, paying the same premiums, and will not be subsidizing insureds who present a significantly greater hazard. ... The statutory pattern authorizing insurers to discriminate fairly and to seek information from insureds in order to do so is antithetical to any implication of a right in the commissioner to forbid or limit insurers' conduct in this respect. There are, to be sure, instances in which the Legislature has prohibited certain underwriting practices and may thereby have prescribed insurance classifications that do not reflect fair discrimination of the type we have been discussing. ... These specific prohibitions tell us that the Legislature knows how to regulate underwriting practices. They do nothing toward providing an implied authority to issue the regulations in this case.

Life Ins Ass'n v Comm'r of Ins, 403 Mass 410, 415-416; 530 NE2d 168 (1988). See also *State of Florida, Dep't of Insurance*, 434 So2d 908 (rejecting a regulation barring the use of sex, marital status or scholastic achievement without a statutory basis, noting "unfair discrimination" is a technical term of art that is measured by the predictive accuracy of the rating factor); *Telles v Comm'r of Ins*, 410 Mass 560, 564-565; 574 NE2d 359 (1991) (overturning rules barring the use of gender in underwriting life insurance as an improper interpretation of unfair discrimination); *Health Ins Ass'n of America*, 551 NYS2d at 619 (holding that regulations were impermissible because "appropriate classification of risks is sanctioned and encouraged throughout the Insurance Law").

In each of these cases, the commissioner promulgating the regulations, like OFIS here, relied on a general statutory provision authorizing the commissioner to promulgate rules. Because the legislatures in each of these states had prohibited the use of some rating factors as

unfairly discriminatory despite their predictive value, the courts concluded that it was the legislature – not the agency – that had the power to expand the list of prohibited rating factors:

It is the legislative, not the executive, branch which is given the power to make laws. Whatever the merits of the regulations may be, the doctrine of separation of powers ... requires that an administrative agency receive a proper delegation of authority before promulgating rules of general application. An administrative body does not have any inherent authority to issue regulations.

Telles, 410 Mass at 565.⁶ The same result is true in Michigan. Where the Legislature intended to bar the use of a rating factor, it stated so explicitly. MCL 500.2027. When the Legislature intended for the Commissioner to exercise her rulemaking authority, it expressly granted that authority.⁷ The Legislature’s decisions cannot be overturned by administrative fiat.⁸

C. Judicial Review Of Agency Rules Under APA § 64

Judicial review of the OFIS Rules is not limited to the rulemaking record, and, indeed, there is no "administrative record" that has been developed by the parties. (Pl Br at 33-43; Pl Appellee Br at 24-37.) In response, the Commissioner continues exposition of her theory that

⁶ See *Health Ins Ass’n of America*, 551 NYS2d at 619 (“Without legislation more clearly suggesting that a specific, sound underwriting practice is condemned, an insurance regulation forbidding the practice is, in effect, a rule making illegal that which is permitted by law” (citations omitted)); *State of Florida, Dep’t of Insurance*, 434 So2d at 913 (rejecting a rule as not authorized by statute when the legislature had expressly stated rating factors that could and could not be used).

⁷ The Legislature expressly provided authority when it intended for the Commissioner to promulgate rules on a particular issue. See, e.g., MCL 500.737 (rules for reserve standards for disability insurance); MCL 500.1214(2) (rules for agent licensing); MCL 500.1361 (rules for holding company act); MCL 500.1507 (rules for premium finance companies); and MCL 500.2080(7)(rules for improper sales solicitations).

⁸ “If we were to accept the commissioner’s argument that he had implied authority to issue these regulations governing the underwriting practices of insurance companies, it is hard to see what restrictions there would be on the commissioner’s right to control any and all activities of insurers by regulation.” *Life Ins Ass’n*, 403 Mass at 417.

review of a rule is confined to the record. See, e.g. Comm'r Br at 28 ("Section 64 does not state that a de novo standard applies to declaratory judgments challenging the validity of administrative rules under that section. It does not say that the Circuit Court may establish its own record and disregard the record produced in the process of adopting rules"); Comm'r Br at 29 ("[E]ven if section 64 were found to apply to this case, nothing in that section requires de novo review or authorizes the Circuit Court to ignore the agency record and create its own"). The Commissioner ignores the fact that under section 64, there is never an agency record to review.

The sections of the APA relied on by the Commissioner generally concern judicial review of adjudicative acts. These record-based arguments pertain to the *applicability* of rules to a particular factual scenario. Judge Zahra recognized this: "[t]his action involves a challenge to the validity of the administrative rules, not a challenge to the applicability of them." (Zahra Op at 3; Pl App 283a.) There simply is no "administrative record" in a proceeding challenging the validity of a rule. "In Michigan the development of rules is never done . . . on the basis of an evidentiary or formal fact-finding record." LEDUC, MICHIGAN ADMIN LAW § 4:35, p 223.

But even a review of sections 63 and 64 reveals the fallacy of the Commissioner's argument in the context of adjudicatory proceedings. Section 63 of the APA allows for declaratory rulings by agencies as to the *applicability* of statutes, rules, or orders. MCL 24.263. Where an agency issues a declaratory ruling, there is an agency record that can be reviewed in accordance with Chapter 6 of the APA.⁹ Section 64 explicitly permits an original action in circuit court where the plaintiff has requested a declaratory ruling and "the agency has denied the

⁹ The administrative record under Section 63 is the "actual state of facts" submitted by the person seeking the agency declaratory ruling and agreed upon by the agency. See *Ludington Serv Corp v Acting Comm'r of Ins*, 444 Mich 481, 488-89 n 11; 511 NW2d 661 (1994).

request or failed to act upon it expeditiously." MCL 24.264. Even the Commissioner recognizes this, stating that under section 64, the agency "may accept the declaratory ruling request and issue a ruling, in which case judicial review" proceeds in the same manner as in a contested case, *or* the agency "may deny the request and defend against the declaratory judgment action in Circuit Court." (Comm'r Br at 27.)

If a declaratory ruling request is either declined or not issued expeditiously, section 64 unequivocally allows for a declaratory judgment action in circuit court. And in such case, there is *no agency record* to review because there were no proceedings before the agency. Rather, the declaratory action proceeds in circuit court, evidence is adduced accordingly, and review of the rule by the circuit court is quite obviously *de novo*. On its face, section 64 simply cannot be construed as limiting review to the agency record as suggested by the Commissioner.

**D. Section 244(1) Does Not Provide The Exclusive Means
By Which To Seek Judicial Review Of Rules**

The Commissioner continues a mission to enshrine her concept that section 244(1) of the Insurance Code, MCL 500.244(1), provides "the exclusive means for challenging" the OFIS Rules. (Comm'r Br at 30-33.) First, the Commissioner ignores the fact that the trial court, Judge White, and Judge Zahra all concluded that section 244(1) does not provide the exclusive procedure for challenging an administrative rule. (Tr at 26; Pl App 204a; White Op at 12; Pl App 270a, Zahra Op at 2; Pl App 282a; Pl Br at 46-48.)

Second, the Commissioner ignores the means by which administrative rules are challenged for invalidity. There are only two methods for challenging the validity of a rule: 1) one may seek a declaration of invalidity (or validity) from a court; or 2) one may await action

taken by a governmental entity to enforce the rule.¹⁰ In the latter method, one may assert a rule's invalidity in an action by an agency to enforce the rule. Section 244(1) provides that a person aggrieved by a "rule" may seek judicial review under the APA. MCL 500.244(1). Where a party contests the application or validity of a rule in a contested case, review is appropriate under section 244(1). An appeal of such a ruling proceeds by way of a petition for review, is confined to the record before the agency, and section 244(1) allows for judicial review in such circumstances under chapter 6 of the APA. But nothing in section 244(1) even remotely suggests that it is the exclusive means by which to seek judicial review of rules. Thus, by its express terms, the validity of a rule may be challenged under section 64 of the APA.

III. RELIEF REQUESTED

Plaintiffs respectfully request that this Court reverse the judgment of the Court of Appeals, affirm the decision of the Circuit Court, and grant such other relief as is equitable.

Respectfully submitted,

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¹⁰ Section 64 of the APA plainly allows for the assertion of invalidity in a non-declaratory judgment context: "This section shall not be construed to prohibit the determination of the validity of the rule in another action or proceedings in which its validity or inapplicability is asserted." MCL 24.264.