REGULATION OF FIRE INSURANCE RATES

By Robert B. Ely, III †

I. INTRODUCTION

The case of American Eagle Fire Ins. Co. v. Jordan,¹ decided June 25, 1946, by Holtzoff, J. of the U. S. District Court for the District of Columbia, touches upon a number of issues of basic importance in the field of insurance administrative law.

As the court indicates, this was a case involving the Act of Congress.² Section 1403 of the Act reads:

"The Superintendent is empowered to investigate the necessity for an adjustment of the rates . . . and to order an adjustment . . . whenever he determines after investigation . . . that the rates . . . are excessive, inadequate, or unreasonable . . . The Superintendent shall give consideration to all factors reasonably attributable to the risks, to the conflagration or catastrophe hazard . . . and to a reasonable profit."

The court recites the facts of the case as follows:

"Acting under the authority of this statute, the Superintendent . . . promulgated an order reducing fire insurance rates . . . This suit was brought . . . to enjoin the enforcement of the . . . order . . . on several grounds. First, it is contended that the Superintendent's failure to accord a hearing . . . was illegal . . . Second, . . . the rates fixed . . . are confiscatory. . . . Third, . . . the basic computations . . . were erroneous."

As to the proceedings before the Superintendent, the court recites that:

"No formal proceedings had been instituted . . . no hearing had been held . . . and no notice . . . had been given to any one. The order appears to have been issued in a purely ex-parte manner. . . . The Superintendent . . . took the position . . . that he had the authority to proceed without any hearing."

In the light of these facts, after a discussion of a number of cases in the general field of rate making, the court concludes that:

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¹ C. C. H. Ins. L. R., 6 Fire & Casualty Cases 114 (1946).
² 58 STAT. 267 (1944), D. C. CODE (Supp. 1944) tit. 35, §§ 1402, 1403.

(59)
"The word 'investigation' as used in the act, means a proceeding in which a full and fair hearing is accorded to all interested parties, evidence is taken, a record is made, and findings of fact are reached on the basis of the record."

In so doing, the court cites the insurance rate case of American Employers' Ins. Co. v. Com'r. of Ins.3 In view of this conclusion, Judge Holtzoff held that the Superintendent's proceedings and resulting order should be set aside.

Turning next to the question of confiscation, the court refers to that phase of the Missouri Rate Cases in which the United States Supreme Court, in Aetna Ins. Co. v. Hyde,4 supports the conclusion declared by Judge Holtzoff, namely,

"In order to sustain the burden of proof that the rates are confiscatory, it is incumbent upon individual companies to demonstrate that the result would be confiscatory as to them. A speculative and conjectural calculation based on the average of all companies involved is not sufficient."

As to the supposed error in the basic computations on which the Superintendent predicated his action, the court said:

"the order of the Superintendent will be set aside for failure to comply with the basic requirement of a fair and full hearing. At such a hearing, counsel for the Superintendent, as well as counsel for all interested parties, will be in a position to offer evidence on these disputed issues, and for this reason, it seems best not to pre-judge them."

Elsewhere in the opinion there is discussed the manner in which the Superintendent had arrived at an "allowable expense ratio" through what the court describes as "the exercise of his judgment and discretion." The court is careful to point out that this review of the theories employed by the Superintendent is made simply to illustrate how important a full and fair hearing is. The judge remarks:

"If a full and fair hearing had been held at which pertinent evidence had been adduced and if the Superintendent had acted on the evidence thus presented, it may well be that the expense ratio employed by him might be justified, or, on the other hand, the opposite conclusion might be reached. Unfortunately, however, there is no evidence on the basis of which the court is in a position to review his conclusions."

In short, this opinion decides that the Superintendent made so basic a procedural error that his order could not be affirmed. No at-

4. 275 U. S. 440 (1928).
tempt is made to settle what should be the theories which must guide a supervisory official when he proceeds in a proper manner. On the contrary, these questions are expressly reserved for later decision.

It is the purpose of this discussion to deal with each of the three points touched upon by the court in its opinion, since they are the ones most likely to be raised by any future litigation. We shall compare Judge Holtzoff’s rulings and *dicta* with (1) the rate regulatory legislation in other jurisdictions, (2) the decisions of other courts thereon and (3) the provisions of the Model Insurance Rate Regulatory Bills.

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   Louisiana—La. Laws 1926, No. 302, §§ 9, 10.
   Maryland—Md. Laws 1945, c. 927.
   Minnesota—Minn. Laws 1915, c. 101, § 6; id. 1929, c. 321, § 2.
   Mississippi—Gen. Laws of Miss. 1936, c. 106.
   Missouri—Rev. Stat. of Mo. (1929), c. 37; §§ 5873.
   New Mexico—N. M. Laws 1945, c. 116.
   North Dakota—N. D. Laws 1929, c. 152, § 2.
   South Carolina—S. C. Civil Code (1942), c. 157, § 8016; id. (1932), § 8016; id. (1922), § 4130.
   South Dakota—S. D. Session Laws 1945, c. 135.
   Texas—Tex. Laws 1917, c. 73; id., c. 106; id. (1st Called Session) 1929, c. 37, p. 84.
   Vermont—Vt. Laws 1945, No. 162.
   West Virginia—W. Va. Code Ann. (Michie, 1943) § 3373; id. (Barnes, 1923), c. 34, § 76b.
   Wisconsin—Wis. Laws 1937, c. 208.

6. In the form in which the Model Fire, Marine and Inland Marine Rate Regulatory Bill now stands for presentation to the 1947 Session of the Pennsylvania Legislature, the relevant sections read as follows:

"Sec. 1—Purpose of Act
The purpose of this Act is to promote the public welfare by regulating insurance rates to the end that they shall not be excessive, inadequate or unfairly discriminatory.

Sec. 3—Making of Rates...
2. Rates shall not be excessive, inadequate or unfairly discriminatory.
3. Due consideration shall be given to past and prospective loss experience within and outside this state, to the conflagration and catastrophe hazards, to a reasonable margin for underwriting profit and contingencies, to dividends, savings or unabsorbed
proposed by the All-Industry Conference Committee and the National Association of Insurance Commissioners.

We are not concerned herein with any type of state regulation of insurance other than compulsory increases or reductions of rates in a whole class of insurance. We, therefore, exclude questions of discrimination by individual companies. We will first dispose of matters of procedure, and then those of substance.

II. THE NEED FOR A HEARING

As to the need for a hearing, the District of Columbia Court's decision in this respect needs least comment. Of the thirty-two jurisdictions in which supervisory officials are given authority to order general increases or reductions, all but nine specifically provide for notice and hearing. In three of these nine, the courts have mentioned that hearings are, in fact, granted, though not required. In the remaining six states the question had not been litigated prior to American Eagle v. Jordan.

premium deposits allowed or returned by insurers to their policyholders, members or subscribers, to past and prospective expenses both countrywide and those specially applicable to this state, and to all other relevant factors within and outside this state; and in the case of fire insurance rates consideration shall be given to the experience of the fire insurance business during a period of not less than the most recent five year period for which such experience is available.

Sec. 4—Rate Filings...
(c) The commissioner shall review filings as soon as reasonably possible after they have been made in order to determine whether they meet the requirements of this Act.

Sec. 5—Disapproval of Filings...
(c) If... the (commissioner) finds that a filing does not meet the requirements of this Act, he shall, after a hearing held upon not less than ten days' written notice, specifying the matters to be considered at such hearing, to every insurer and rating organization which made such filing, issue an order specifying in what respects he finds that such filing fails to meet the requirements of this Act, and stating when, within a reasonable period thereafter, such filing shall be deemed no longer effective.

(d) Any person or organization aggrieved with respect to any filing which is in effect may make written application to the (commissioner) for a hearing thereon, provided, however, that the insurer or rating organization that made the filing shall not be authorized to proceed under this subsection...

Sec. 13—Rate Administration
(a) Recording and Reporting of Loss and Expense Experience.

The commissioner shall promulgate reasonable rules and statistical plans, reasonably adopted to each of the rating systems on file with him, which may be modified from time to time and which shall be used thereafter by each insurer in the recording and reporting of its loss and countrywide expense experience, in order that the experience of all insurers may be made available at least annually in such form and detail as may be necessary to aid him in determining whether rating systems comply with the standards set forth in Section 3...

Sec. 16—Hearing Procedure and Judicial Review

Any order or decision of the Insurance Commissioner shall be subject to review in accordance with the provisions of the Administrative Agency Law of June 4, 1945, P. L. 1368, and any amendment or re-enactment hereof."

7. See note note 1, supra.
Even in Wisconsin, where the Commissioner is authorized to review rates on his own motion in the first instance, although required to grant a hearing if requested, we find the court saying in State v. Whitman: 10

"The error of the commissioner in proceeding as he did arbitrarily to find the rates established by the bureau unreasonable and discriminatory from his own predilections and conceptions and to evolve from his inner consciousness a reasonable rate, is an error so fundamental in character as to pervade the whole proceeding."

The decision under discussion would unquestionably be followed in any of the jurisdictions in which no litigation has occurred. Its principle is adopted in the Model Rate Regulatory Bill. 11

III. Confiscation

In this branch of his discussion Judge Holtzoff confined himself to the precise issue presented to him; but we shall want to make a wider survey. The plaintiffs in the American Eagle case claimed "that rates fixed by the Superintendent . . . result in taking property without due process of law, in contravention of the Fifth Amendment (to the Constitution of the United States)." Had the case arisen in a State, instead of the District of Columbia, the same objection would have been raised under the Fourteenth Amendment.

To support their contention plaintiffs were required to establish both of two points: first, that they had been "deprived of property," and second, that this was done "without due process of law." The court, as we have seen, ruled for the plaintiffs on the second point. The lack of hearing constituted want of "due process." However, as to "deprivation of property" the court did not, and could not, support the plaintiffs—since, as is said in the opinion:

"There is no showing of the effect of the order on any individual company."

It is when we go beyond the facts presented in this case and consider the situation which is most likely to arise in future litigation that we reach the most interesting questions. Let us suppose that some individual company or group of companies is able to show that rates established after a full and proper hearing will, if used, compel that company or group to operate at less than a fair rate of return. Further to simplify the problem, let us assume that the rates have been com-

10. 195 Wis. 472, 220 N. W. 929 (1928).
puted by the Superintendent under a mandatory formula so that all questions of abuse of administrative discretion are eliminated. Could protection still be gotten from the Fifth or Fourteenth Amendment?

The answer would seem to be in the negative. In *Aetna Insurance Company v. Hyde,* 12 cited by Judge Holtzoff, we find this significant dictum:

"The Fourteenth Amendment does not protect against competition. Moreover, 'aggregate collections' sufficient to yield a reasonable profit for all do not necessarily give to each just compensation for the contracts of insurance written by it. It has never been and cannot reasonably be held that state-made rates violate the Fourteenth Amendment merely because the aggregate collections are not sufficient to yield a reasonable profit or just compensation to all companies that happen to be engaged in the affected business."

In other words, Amendments V and XIV do not prohibit Congress and the state legislatures from setting up, or permitting administrative officers to fix rates which may drive some companies out of business. The real problem is to decide whether a given rate regulatory measure prescribes or permits such rates.

One answer is found in the *Hyde* case. The statute 13 there considered provided that the Superintendent might order a rate reduction if it appeared that there had been "an aggregate profit in excess of what is reasonable." We have supplied emphasis to the word "aggregate" because Mr. Justice Butler specifically states that when it is used the Superintendent

"is not authorized to determine whether, when applied to the Missouri business of the several companies, or of any of them, the existing or prescribed rates had been or would be just or reasonable."

Presumably, the same answer would be given under the statutes of all seven of the jurisdictions 14 in which use is made of the word "aggregate."

However, it is not so clear what the answer would be where the rate reduction is to be ordered where existing rates yield more than a "reasonable profit," as in the D. C. case, and in the Model Bill 15 as originally drawn. Under such statutes, is the Superintendent to consider rates company by company, or throughout the industry as a whole?

15. See Model Code, § 3.3, cited supra note 6.
Here again the latter seems to be the correct answer. Although some Federal Department of Justice officials appear to entertain a contrary view, it seems to be universally agreed in the insurance industry that uniformity of rates within a class is to be sought. This is seen to be the legislative intent in the vast majority of jurisdictions by reference to express provisions for standard rates, and for “deviations” from them. Such provisions are found in the Model Bill. Moreover, there appears to be no reported case in which an individual insurance company has successfully overthrown a general rate level on the ground that the general rates forced that particular company to operate at less than a fair return. The Minnesota Rate Cases and the Missouri Rate Cases, cited in the D. C. opinion were not in insurance, but in public utility rating fields. On the other hand, confining ourselves to insurance, we find that even where a statute provides for individual, “deviating,” rates the reasonableness of those individual rates is to be tested against the overall (not necessarily “aggregate”) experience of the business.

In American Druggists Fire Ins. Co. v. State Ins. Board, there was before the court a statute allowing higher or lower than the uniform rates to be charged, subject to insurance board approval, and provided the deviating rate be “reasonable.” The court, in the course of its opinion, says:

"Petitioner argues that the reasonableness of the rate is determined by the underwriting experience of the individual company making the filing. Theoretically this is correct. However, the extent of the underwriting experience of all the companies (as evidenced by the schedule compiled by the Oklahoma Inspection Bureau) may be looked to for the purpose of determining the reasonableness."

To summarize: Even where the word "aggregate" is not used in rate regulatory laws in conjunction with "reasonable profits" or "reasonable rates," the supervisory officials are not required to tailor-make rates for each and every company. They are permitted a degree of discretion, the extent of which we now consider.

17. See note 5, supra.
18. Section 7 reads, in part, "Every member of or subscriber to a rating organization shall adhere to the filings made on its behalf by such organization except that any such insurer may make written application to the (commissioner) for permission to file a deviation from the case rates, schedules, rating plans or rules respecting any kind of insurance, or class of risk within any kind of insurance, or combination thereof."
19. 184 Okla. 66, 84 P. (2d) 614 (1938).
IV. Rules for the Guidance of Superintendent

As to existing legislative standards for rates, as we have mentioned before, in all but sixteen states, the Insurance Commissioner or Superintendent is authorized to order a general reduction whenever, upon his own motion, or after investigation, or notice and hearing, he finds that existing rates do not comply with certain standards. The phrasing of that standard varies widely. It has been provided that rates must (apart from being non-discriminatory):

- be "just," equitable to the insured and the insurer alike;
- adequate (for the safeness and soundness of the insurer);
- fair (to the insurer and insuring public);
- reasonable;
- made up correctly; or
- give an ("aggregate") ("underwriting") profit that is fair or "not excessive;" or
- give an ("aggregate") ("underwriting") ("underwriting") profit that is fair or "not in excess of 5%.

By and large, these standards are substantially identical with those of the Model Bill, that rates shall not be "excessive, inadequate, or unfairly discriminatory," as to the first two of which the main consideration stated in that Bill is "a reasonable margin for underwriting profit." We will have occasion to note below the significance of the qualifying term "underwriting," used in only seven statutes.

In each jurisdiction, except Illinois, Minnesota, New Hampshire, North Dakota, Oklahoma, South Dakota, Texas, Vermont, West Virginia and Wisconsin, there are listed the various tests which the supervisory official is to take into consideration in deciding whether the rates under his control meet the prescribed standards. These considerations vary as widely as the standards themselves.

23. Ariz.
27. Wis.
28. Wis.
30. N. D.
31. Okla.
34. Ark., Colo., Ind., Ky., La., S. C., Wyo.
35. Ariz., Md., Miss., N. C.
37. Ark., Colo.
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The catch-all phraseology is "all branches and phases of the business," 38 "reasonable elements," 39 and "factors" which are "reasonable and related," 40 "relevant," 41 "attributable to the risk," 42 or "applied by insurers and rating organizations generally." 43 The specific factors enumerated, in addition to profits, include the conflagration 44 and catastrophe 45 hazards within and without the state; loss experience 46 and trend; 47 dividends, savings or unabsorbed premiums of participating companies; 48 the experience during a five-year period; 49 the condition of the insurers, 50 their method of operation, 51 acquisition costs, 52 administration expenses 53 and earnings. 54

In the Model Bill we find that the catch-all phrase employed is number 41, "all other relevant factors," while the specific items are, in addition to "underwriting profit," those numbered 46, 47, 44, 45, 48, in that order, together with "past and prospective expenses both countrywide and... applicable to this state" (a combination of numbers 52 and 53 and number 49). In short, the bill combines nearly every consideration employed throughout the country.

The sum and substance of all these regulatory laws is simply this:—On the one hand, the public should not be charged any higher rates than are necessary to give insurance companies a fair return on their money. On the other hand, the companies should not be permitted to sell policies at lower rates than are sufficient to produce the funds needed to meet the losses which occur. How is a supervisory official to decide whether existing rates fall between these limits?

Clearly he must examine the results of using these rates, generally, as we have seen, over the five-year period preceding his examination. 55

38. Va.
41. Ky., N. M.
42. Ala., Ariz., D. C., Fla.
43. Fla., N. J.
50. Fla., N. J.
51. Fla., N. J.
52. Mo.
53. Mo.
54. Mo.
55. See note 49, supra.
This leads us to a consideration of the form in which those results are tabulated.

Originally the statutes or judicial construction provided for records of premiums written, and of losses and expenses paid to be used as a basis of computation. The first item represented cash income and the last two cash outlay. The difference was taken as profit, and the percentage it was of premiums written determined whether the rates which produced it were reasonable.

Since those days the only real change has been to shift from a "cash" to an "incurred" basis. This change first gained wide recognition at the 1921 Convention of Insurance Commissioners, who produced the so-called "Convention Formula," which is now so universally employed that it was not even considered necessary to mention it in the Model Bill.

The Convention Formula defines "Profit" as Earned Premiums less Losses Incurred and Expenses Incurred. For simplicity's sake we will use the abbreviated form \( P = EP - LI - EI \). Each of these elements requires brief discussion. We shall find the last to be the one of major significance.

The amount of allowable profit (P) is generally described as what is "reasonable," a term which has been frequently defined by statute or decision as 5% of Earned Premiums (EP). As to the kind of profit to be considered, we find that use has been made of the qualifying terms "aggregate" and "underwriting." We have already discussed the former. The latter has led to considerable judicial discussion. In a case where "underwriting" was used, we find the Arkansas court saying:

"The thing the commissioner determines is not the general business outcome of the reporting companies, but their underwriting profits in this State. He has no concern at all in making the tabulations with the investment end of the insurance business, either in or out of the state."

On the other hand, we find in a Virginia case where "underwriting" was not used:

"Profits from investment of capital, surplus, undivided profits and borrowed money are not profits produced by rates; but income

56. See Wis. Laws 1917, c. 61.
from (a) premiums paid by policyholders, and (b) income from
the investment of premium income which is being held to meet
presently existing but future payable liabilities, are both income
produced by rates, and should be included in computing profits pro-
duced by rates."

In construing another statute in which, also, the word was missing,
the Kansas court said: 60

"Turning our attention to the next question: (2) In deter-
mining the income of plaintiffs, should consideration be taken of
their investment earnings? Plaintiffs contend their investment
earnings are entirely independent and distinct from underwriting
profits and should not be included in their gross income for rate-
making purposes. We are unable to see merit in this contention.
No reason suggests itself why the business of insurance should not
be regarded as a whole. So far as the real owners of the busi-
ness, the stockholders, are concerned, all income arising from the
business, and all expenses and loss incident thereto, should be con-
sidered and must of necessity be considered, in determining whether
or not there has been a profit, and the extent and amount thereof."

At this writing there is disagreement as to what should be the
 wording of the Model Bill. The All-Industry Conference Committee
believes the word "underwriting" should precede the word "profit."
The National Association of Insurance Commissioners is giving further
study to this matter. The word is used in the Pennsylvania draft.

A full discussion of the term Earned Premium (EP) and the arith-
metic difficulties it involves is unnecessary. Suffice it to say that earned
premiums bear a definite, but not too simple relation to premiums
written. Of each dollar which a policyholder pays to his insurer, cus-
tom or statute prescribes both the portion (earned) which the company
can consider at any time during the term as compensation for coverage
already given, and the portion (unearned) which must be reserved for
future coverage. We deal here only with the first portion, the earned
premium. It is to be noted that they vary directly with the volume of
business and with the rates charged.

Under a fire or lightning policy a loss is incurred (LI) as soon as
the flames break out or the bolt strikes. The loss will not be deter-
mined in amount and actually paid until considerably later. It is cus-
tomary, however, to estimate these losses with great accuracy almost
immediately upon their being incurred. We deal with such estimates.

Expenses are incurred (EI) when they are contracted for or esti-
In Acta Ins. Co. v. Travis, 124 Kan. 350, 259 Pac. 1068 (1927) (construing KAN.
Rev. St. (1923), c. 40, §§ 111, 113, 201 et seq.
may be deferred. Here we can deal with exact figures or with quite accurate estimates.

We have referred to the formula, \( P = EP - LI - EI \), and discussion has shown that when the propriety of existing rates is under consideration, Superintendents or Commissioners are not primarily concerned with the numbers of dollars profits made. Their real concern is with the ratio \( \frac{P}{EP} \), and with whether that ratio does or does not exceed a given percentage, which for simplicity's sake we shall hereafter take to be 5%.

Since this is so, let us rewrite our formula after dividing throughout by \( EP \). We then have

\[
\frac{P}{EP} = \frac{LI}{EP} - \frac{EI}{EP}, \quad \text{or}
\]

we may introduce new terms

\[
PR = 100\% - LR - ER
\]

where \( PR = \) rate of profit

\[
LR = \text{"Loss Ratio,"} \quad \text{and}
\]

\[
ER = \text{"Expense Ratio."}
\]

Written in this form, the equation makes more clear the implications of a rate reduction which is intended to lower \( PR \), the rate of profit.

Unless one is authorized to consider "trends," as in the case of seven existing statutes,61 and the Model Bill,62 one must assume that the future volume of business and future amount in dollars of \( LI \) will be the same. Consequently a reduction in rates would lower the amount of \( EP \), while leaving \( LI \) the same. This means that with the same numerator (\( LI \)) and a smaller denominator (\( EP \)), the term \( LR (= \frac{LI}{EP}) \) would increase. In a similar fashion, if one assumes the amount in dollars of \( EI \) is to remain the same, then \( ER (= \frac{EI}{EP}) \) would increase if rates were reduced. Consequently, a reduction in rates will, without more, reduce the rate of profits (\( PR \)).

We have just made two assumptions: first, that the amount of losses will not change after a reduction in rates; and second, that the amount of expenses will likewise remain unchanged. Let us test their validity.

As to losses, it is obvious that at least their amount (given the same risks) is beyond the control of the supervisory authorities. Fire and lightning operate on other than earthly laws. The same is not equally true of expenses. To the extent that they are contractual they can be said to be within the control of the insurers, although the extent of that control, as a practical matter, is highly debatable.

Nevertheless, there would seem to be some precedent for taking as true the assumption that expenses are in fact controllable, and, as a consequence, exercising certain legal control over them. However, the extent of that control has been heretofore strictly limited so far as administrative officials are concerned.

In discussing the powers of an insurance board which had been given no statutory authority over expenses, we find the Texas court saying:

"We can see no more reason in principle for permitting the Board to definitely fix and regulate one operating expense of a fire insurance company than to permit the fixing of another or of all of said expenses. And for the Board to be permitted under its regulatory power to fix all of such expense items, or the major portion of same, it could and would usurp the control and management of such corporation itself, a function vested by law in its board of directors."

It has also been held that in the absence of statutory authority a Superintendent might not control dividends paid, nor limit "operating" expenses to a fixed percentage of net premiums received.

It is not to be inferred from this that expenses of insurance companies are beyond the reach of the law. There are numerous cases upholding the right of the legislature to control such expenses, and to delegate such control to its administrative officers. However, it would seem that if a supervisory official desires to regulate any particular item of expense (such as commissions, salary, or rent) he is required to show specific statutory authority so to do. No such authority was shown, nor sought to be exercised in the American Eagle case.

On the other hand, when we turn to the question of a more general control of expenses, the situation appears different. Judge Holt-
zoff refers to "the dispute between the parties over the proper expense ratio which should be employed in computing the amount of expenses with which the companies are to be credited." In this respect he said:

"Obviously, the superintendent is clothed with broad discretion in determining this ratio, as well as all other factors that enter into fixing a reasonable rate."

We stress the use of the word "ratio" since it emphasized the fact that there is left to the companies the discretion as to which particular items of expense are to be reduced to compensate for the reduction in income produced by lower rates.

In making this ruling, the judge overlooked the absence from the Congressional Act of any reference to expenses, but his conclusion is supported by the practice in Virginia, and is in accordance with the wording of the Model Bill. It is based on the logically sound premise that a reasonable rate requires reason in all its components (losses, expenses and profits).

To conclude the discussion of the details of rate regulation, let us take it for granted that the superintendent has the right to control the "expense ratio." How is this control exercised?

Let us take a hypothetical jurisdiction in which "aggregate" figures for the preceding five years show the following results (figures are in millions of dollars):

\[
\begin{array}{cccc}
P & EP & LI & EI \\
6 & 100 & 40 & 54 \\
\end{array}
\]

P/EP being 6%, the superintendent feels this is too great by 1% and that he should reduce the rates. By how much should he do so? To simplify the problem as much as possible, assume he makes his computations to cover the next five years, instead of one year, so that we may use comparable figures.

Using this hypothesis, and on the premises that the dollar volume of business and of losses will remain the same during that period, he will still have LI of 40 million dollars. What he is looking for is a new amount of EP (call it X) which will give him a P/EP equal to 5%. To compute X he has an equation as follows:

\[
\begin{align*}
P & EP & LI & EI \\
.05X & = X & 40 & ? \\
\end{align*}
\]

If the Superintendent feels the past ER (54/100) has been proper, then we place .54X in the EI column, and get a new equation

70. See Model Code, § 3.3, cited supra, note 6.
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\[0.05X = X - 40 - 0.54X\]

i.e. \[0.41X = 40\]

\[X = 97.5\] plus

That is to say, rates should be cut to the point where earned premiums would be reduced by 2.5 million dollars.

Suppose, however, the Superintendent wishes to disregard the 54 million dollar expenses (which in this case gave a loss ratio of 54%), on the grounds that he feels this is too high. This was a problem discussed by Judge Holtzoff, who said:

"It may hardly be contended that the superintendent was obligated to accept the expense ratio of each company, no matter how high it may be. In order to exclude all higher expense ratios, however, there should have been some evidence justifying such a result. No such showing is made here. For example, it does not appear that the companies with a higher expense ratio were wilfully extravagant, or inefficiently managed, or that their expenses were excessive, or that there was some other reason why they should not be included in the computation."

The judge then goes on to point out, however, with respect to the expense ratio which the Superintendent finally adopted as "allowable" as a matter of judgment:

"There was no evidence adduced before the Superintendent, either by his own counsel, or by any interested party, which warranted him in arriving at this or any other figure."

The implications of this reasoning, which seems amply supported by authority,71 appear to be: a) In arriving at an expense ratio to be used in rate making, the supervisory official must employ actual expense figures, except insofar as any particular figures are shown to represent improper (wasteful, extravagant, etc.) items; but b) The formula whereby these figures are combined lies in the reasonable discretion of the official.

To illustrate these implications, let us apply them to our hypothetical case. Suppose the aggregate figures break down as follows:

<table>
<thead>
<tr>
<th></th>
<th>P</th>
<th>EP</th>
<th>LI</th>
<th>EI</th>
<th>ER</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Company</td>
<td>1.5</td>
<td>10</td>
<td>0.5</td>
<td>8</td>
<td>80%</td>
</tr>
<tr>
<td>B Company</td>
<td>1.0</td>
<td>20</td>
<td>11.0</td>
<td>8</td>
<td>40%</td>
</tr>
<tr>
<td>C Company</td>
<td>1.5</td>
<td>30</td>
<td>13.5</td>
<td>15</td>
<td>50%</td>
</tr>
<tr>
<td>D Company</td>
<td>2.0</td>
<td>40</td>
<td>15.0</td>
<td>23</td>
<td>57.5%</td>
</tr>
<tr>
<td></td>
<td>6.0</td>
<td>100.0</td>
<td>40.0</td>
<td>54.0</td>
<td>54%</td>
</tr>
</tbody>
</table>

A comparison of A Company's figures with those of the rest indicate there is something amiss. The D. C. case stands for the rule that if it can be shown what, in fact, is wrong, then the A figures as given may be disregarded. If, for example, it could be shown by proper evidence at a rate hearing that 5 of the 8 million expenses were unacceptable for one reason or another, there is no doubt that an appropriate adjustment could be made. This would reduce aggregate expenses to 49 million, and, if the "Missouri" rule were used, would indicate 49% as an "allowable expense ratio" in making up new rates. Similarly, if it could be shown that any other grounds for so doing (such as enumerated by Judge Holtzoff) existed, corresponding adjustments might be made in the data by the Superintendent before he began his computations.

It is when we come to the question of the computations themselves that the most interesting problems in this phase of the case arise. To make comparison of methods easier, let us assume that the Superintendent has no evidence to discredit the A figures. How is he to go about the establishment of an "allowable expense ratio"?

At least three alternatives are possible. How many more there may be, and which of them a court would sustain, cannot be definitely said. The presently known ones are:

First: The "aggregate." We have already discussed it, and seen that it would require a reduction of earned premiums by 2.5 million.

Second: The "average." In our hypothetical case we have past expense ratios of 80%, 40%, 50% and 57.5%. They average to 56.9%. If this last ratio is taken as allowable for the future, it will be seen that the new aggregate earned premiums should be 105 million. This would actually mean a general increase in rates! It was this formula which the companies suggested in the American Eagle case.

Third: What Judge Holtzoff called the "second average." Here the Superintendent takes the four known expense ratios (80%, 40%, 50% and 57.5%), computes the average (56.9%) and substitutes for all above the average the average itself. In this case the ones above average are A and C companies: Substituting for them the average of 56.9%, we have a new set of four, i.e., 56.9%, 40%, 50% and 56.9%. Their "second" average is 50.9%. With this as an "allowable" future expense ratio, it will be found that future aggregate earned

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72. Since we then have an equation,

\[ .95X = X - 40 - .569X \]
\[ .381X = 40 \]
\[ X = 104.9 + \]
premiums should be approximately 90.7 million, requiring an aggregate reduction of 9.3 million. This was the formula advocated by the D. C. Superintendent.

Of these three formulae, we have already noted that there is authority for the first in Missouri. We have quoted Judge Holtzoff as to the second and third, to the effect:

"If a full and fair hearing had been held . . . and if the Superintendent had acted on the evidence . . . it may well be that the expense ratio employed by him might be justified, or . . . the opposite conclusion might be reached."

It remains to be seen which one of these, or what other scheme, may be generally adopted. The reader can see the range of possible results. We are here interested only in which can be sustained in litigation. This leads us to a consideration of judicial review.

The Model Bill provides for variation from state to state, and this is most understandable when we note the extent of that variation as it now exists.

The most unusual provisions are for "an action . . . in a court of competent jurisdiction," or by "appeal." In some cases it is speci-

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73. In this case the equation is:

\[ 0.05X = X - 40 - 0.511X \]
\[ -0.439X = 40 \]
\[ X = 90.7 \]

75. In the form drafted by the All Industry Committee and the National Association of Insurance Commissioners, it read
"Sec. 16—Hearing Procedure and Judicial Review

(a) Any insurer or rating organization aggrieved by any order or decision of the (commissioner) made without a hearing, may, within thirty days after notice of the order to the insurer, or organization, make written request to the (commissioner) for a hearing thereon. The (commissioner) shall hear such party or parties within twenty days after receipt of such request and shall give not less than ten days' written notice of the time and place of the hearing. Within fifteen days after such hearing the (commissioner) shall affirm, reverse or modify his previous action, specifying his reasons therefor. Pending such hearing and decision thereon the (commissioner) may suspend or postpone the effective date of his previous action.

(b) Nothing contained in this Act shall require the observance at any hearing of formal rules of pleading or evidence.

(c) Any order or decision of the (commissioner) shall be subject to review (here insert language indicating scope of the review) ................................. by (appeal)* (writ of certiorari)* to (the ...................................... court)* at the instance of any party in interest.

The court shall determine whether the filing of the (appeal)* (petition for such writ)* shall operate as a stay of any such order or decision of the (commissioner). The court may, in disposing of the issue before it, modify, affirm or reverse the order or decision of the (commissioner) in whole or in part.

*Consideration should be given to the practice and procedure in each state."
fied that the proceedings be “in equity,” 78 “summary,” 79 on “cer-
tiorari,” 80 or “in accordance with court rules.” 81

As to the record to be considered, some states provide that the
record before the Superintendent is admissible 82 and is prima facie sup-
port for the order. 83 Three states 84 allow new evidence, while
five 85 provide for trials de novo. The right to affirm, modify, reverse
or repeal the Superintendent’s order is expressly given in nine states, 86
and the right to remand for further proceedings in two; 87 while in
seven 88 the proceedings are merely to be “as in other cases.”

It has been said in many cases that “the fixing of rates for public
service is a legislative and not a judicial act,” 89 that “Rate making is
a governmental process which, according to the accepted classification,
is legislative, not judicial,” 90 or that “it is not within the province of
the court by its judgment to establish a rate.” 91 This view is so
strongly held that courts will not even accept rate-making authority
when the legislature attempts to confer it. In a Texas case 92 the
statute provided that “the court may enter a judgment correcting the
Board’s order and fixing such rates as may be proper.” 93 In refusing
to exercise this power it is said:

“It (the court) cannot substitute its rates for those of the
board. To permit a court to do that would be to confer on it a
legislative prerogative . . . in contravention of . . . our State
Constitution.” 94

It was for this reason that the court in the District of Columbia
suit went only so far as to send the matter back to the Superintendent
for further proceedings in accordance 95 with the principles the court
announced.

References:
78. Ala., Miss.
80. Ala., Miss., N. J., Tenn., Vt.
81. Fla., Va.
83. Minn., Mo., N. H., N. C.
87. Ky., Miss.
88. Ark., Colo., Ind., Kan., La., Okla., Wyo.
89. American Employers' Ins. Co. v. Comm. of Ins., 298 Mass. 261, 10 N. E. (2d
76 (1937).
91. State ex rel. Wis. Inspection Bureau v. Whitman, 196 Wis. 472, 220 N. W.
929 (1928).
93. Id. at 217.
94. Id. at 220 (Texas Constitution, Art. II, Sec. 1).