Legal Backgrounder

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SAFECO v. BURR: HOW DOES RULING REFLECT ON FEDERAL ROLE IN INSURANCE?

by

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Anyone who read the transcript of the oral arguments that took place before the U.S. Supreme Court in *Safeco v. Burr*[1] could not have been surprised by the outcome. On June 4, 2007, the Court overturned key elements of the U.S. Court of Appeals for the Ninth Circuit's implausible construction of a provision in the Fair Credit Reporting Act (FCRA or the Act), 15 U.S.C. § 1681 et seq. That provision requires property-casualty insurers to send written notices to consumers who are adversely affected by an insurer's use of a credit report. The transcript revealed several Justices' palpable skepticism at attempts by the respondent-plaintiffs to defend the appellate court's ruling.

Apart from clarifying insurers' obligations under the FCRA, the case provides a glimpse into how the federal government might go about regulating the business of insurance if it had the authority to do so. Proposals are pending in Congress that would establish an optional federal charter for insurance regulation. The legislation would allow insurance companies to choose to be regulated by a single federal regulatory authority instead of the current system of regulation by state governments.[2] The bill would establish an Office of National Insurance presided over by a national insurance commissioner appointed by the President.

Background. In January 2006, the Ninth Circuit ruled that the FCRA's "adverse action" notice provision requires insurers to notify current policyholders, as well as applicants for new policies, if the insurer's use of a credit score adversely affects the premium amount the policy holder is charged for coverage. *Reynolds v. Hartford Fin. Servs. Group, Inc.*, 435 F.3d 1081, 1091 (9th Cir. 2006). Since the Act defines an adverse action as "an increase in any charge for … any insurance," 15 U.S.C. § 1681a(k)(1)(B)(i), many insurers assumed that the notice requirement applied only to situations in which an

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[1] *Safeco Ins. Co. of America v. Burr*, 127 S. Ct. 2201 (2007).

[2] *See,* Sen. 40, 110th Cong. (May 24, 2007).

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unfavorable credit report caused an existing policyholder to experience a rate increase. The word "increase," as used in the statute, was understood to mean a change in treatment for an insured, which assumes a previous charge for comparison. Insurers reasoned that new customers with poor credit scores could hardly be said to have experienced an "increase," since they were being charged for the first time. Not so, said the Ninth Circuit.

The Ninth Circuit also ruled that the FCRA requires adverse action notices be sent to every consumer—whether new applicant or existing policyholder—who fails to qualify for the insurer's lowest possible rate. *Reynolds* at 1093. This requirement, according the court, applies even in instances where the insurer's use of a credit report resulted in a rate lower than the rate that would have been charged if the credit report had not been considered. In practice, this meant that upwards of 90 percent of consumers suffer adverse actions due to insurers' use of credit reports, and every one them would have to be notified.

Finally, the Ninth Circuit defined "willful violation" in a way that, on remand, would almost certainly cause the trial court to conclude that any insurance company that had not acted in accordance with the Ninth Circuit's odd construction of the FCRA was guilty of willfully violating the Act. This definition of "willful violation" would expose the companies to massive civil liability.

Why and How Insurers Use Credit Information. Insurers use personal credit reports together with more traditional indicators of risk to create "credit-based insurance scores" for individual consumers. The scores are then used to decide whether to issue or renew a policy, and to establish the premium. Although numerous studies have confirmed that a person's credit history is highly predictive of his future claim costs,[3] the use of credit reports to price automobile and homeowners insurance policies has been and remains politically controversial. *See* Robert Detlefsen, *Court's Ruling Applying Credit Act to Insurers Legally Unsupportable*, LGL. BACKGROUNDER (Wash. Lgl. Found'n), Vol. 21, No. 4 (Jan. 27, 2006). Several state legislatures and insurance departments have attempted through various means to ban or severely restrict the practice, often asserting that it constitutes "unfair discrimination" because of its allegedly disproportionate impact on minorities and the poor.[4] *See* Robert Detlefsen, *"Disparate Impact" Theory Provides No Support for Banning Credit Scoring in Insurance*, LGL. BACKGROUNDER (Wash. Lgl. Found'n), Vol. 20, No. 17 (Apr. 8, 2005).

Knowing this history, it is tempting to read the Ninth Circuit decision as judicial activism—an attempt to eradicate a perceived inequity from the insurance underwriting and pricing system. After all, fanciful statutory construction to prohibit or discourage business practices that are contrary to activist judicial value preferences is not unknown in the annals of the Ninth Circuit. Judge Stephen Reinhardt, the author of the Ninth Circuit ruling, has extolled judges with "a liberal philosophy and an expansive approach to jurisprudence." Stephen Reinhardt, *Who Will Keep the Liberal Flame, If Not Breyer?; Supreme Court: We Need a Jurist With a Passion for Justice, Not Another Technocrat*, L.A. TIMES (May 26, 1994), at B7. He has practiced what he's preached during his nearly thirty years on the appellate court.

It may be, however, that something other than "liberal" judicial bias was behind the Ninth Circuit's dubious construction of the FCRA's adverse action notice requirement. A more charitable explanation is that Judge Reinhardt and his colleagues simply lacked sufficient understanding of the business of insurance.

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[3] According to a recent report by the Federal Trade Commission, credit-based insurance scores "are predictive of the number of claims consumers file and the total cost of those claims. The use of scores is therefore likely to make the price of insurance better match the risk of loss posed by the consumer. Thus, on average, higher-risk consumers will pay higher premiums and lower-risk consumers will pay lower premiums." Federal Trade Commission, *Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance: A Report to Congress by the Federal Trade Commission* (July 2007), at 3.

[4] For example, FLA. ADMIN. CODE ANN. r. 69B-125.004, provides its purpose is "[t]o prevent the unfairly discriminatory use of credit reports in underwriting insurance applications." The Florida Office of Insurance Regulation has maintained that use of a credit reports is "unfairly discriminatory" if it has a "disproportionate effect" on more than a dozen discrete demographic groups within the insured population.

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The Government's Brief Foreshadows Federal Approaches to Insurance Regulation. Failure to grasp how insurance underwriting and pricing works would also explain the otherwise unfathomable decision of the U.S. Department of Justice (DOJ) to enter the case as *amicus curiae* in support of the Ninth Circuit's "best rate" construction of the notice requirement, as well as its insistence that a rate "increase" could apply to a first-time customer. While agreeing that the defendant insurers did not willfully violate the Act by failing to send adverse action notices to all but a relative handful of consumers with impeccable credit reports, the DOJ nevertheless argued that even in the absence of any prior dealing, a new applicant for insurance could experience a rate "increase" based on the insurer's use of a credit report. The Department used the following analogy to illustrate its point:

> Had Edo[5] pulled into a gas station and been charged ten cents a gallon more because of his race, gender, or the fact that his license plate ended in an odd, rather than an even, number, Edo would have suffered an 'increase[d]' charge for gasoline, regardless of whether he had ever purchased gasoline at that station before.[6]

That analogy—which was embraced by the Supreme Court—ignores a fundamental characteristic of insurance, which is that unlike a commodity such as gasoline, insurance policies do not come with a fixed, predetermined price. The premium for each policy is determined by a multitude of individual risk factors (one of which could be a credit report), and thus will vary significantly from one policyholder to the next. Since there is no "posted price" for insurance coverage (as there is for gasoline), the only reference point for determining whether an individual has experienced a price "increase" is the price previously paid by that same individual.

Then there is the question of whether every consumer who failed to qualify for the insurer's lowest possible rate suffered an adverse action if the proffered rate was based, at least in part, on a credit report. Noting that the FCRA defined "adverse action" as an insurance price increase "based in whole or in part on any information contained in a consumer report," 15 U.S.C. § 1681m(a), GEICO concluded that an adverse action would occur only if the use of a credit report caused it to charge a rate higher than it would have charged had it not considered the customer's credit report. GEICO sent adverse action notices to all such customers, but it did not send notices to customers who were charged a rate equal to or lower than the rate it would have charged but for its use of a credit report. Doing so would be tantamount to telling tens of thousands of policyholders who were actually helped by GEICO's use of their credit reports that, in fact, they had suffered an adverse action.

According to the Ninth Circuit and the Department of Justice, this bizarre scenario is exactly what Congress had in mind when it enacted the FCRA. The DOJ dismissed GEICO's contention that because its consideration of Edo's credit report did not result in a rate increase, he had not been treated adversely based on his credit report. Rather, the DOJ emphasized that GEICO "in fact, obtained and used Edo's actual credit score and, on that basis, charged him a higher rate for insurance than what was offered to certain other customers and what would have been offered to him if his credit score had been better." Brief for United States at 26.

Well, yes—GEICO did charge Edo more than it charged customers who had better credit scores, and more than what it would have charged Edo had his credit score been better. But the fact remains that GEICO did not increase Edo's rate based on his credit score. As Justice Souter observed in his opinion for

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[5]Ajene Edo was the named plaintiff in *GEICO v. Edo*, the companion case to *Safeco v. Burr*.

[6]Brief for United States as *Amicus Curiae* at 26, *Safeco Ins. Co. of America v. Burr*, 127 S. Ct. 2201 (2007) (Nos. 06-84 and 06-100).

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the Court, the FCRA plainly says that a notice is required only when the adverse action is "based in whole or in part on" a credit report. *Safeco* at 2205. As he further noted:

> In common talk, the phrase 'based on' indicates a but-for causal relationship and thus a necessary logical condition. Under this most natural reading of Sec. 1681m(a), then, an increased rate is not 'based in whole or in part on' a credit report unless the report was a necessary condition of the increase.[7]

Justice Souter's analysis of the semantics is surely correct, but even he failed to pinpoint the DOJ's main error. At bottom, none of the federal entities that examined this case seem to understand the complex interplay of risk variables that define the insurance underwriting process. If I install storm shutters on the windows of my home to reduce the severity of damage from a windstorm, my property insurer may reduce my rate to reflect my decreased risk of loss. But the fact that I was offered what amounts to a premium discount because I took steps to mitigate my risk does not mean that my neighbor, who did not install storm shutters and whose rate therefore remains unchanged, has experienced a rate increase because my rate was lowered. By the same token, if I add a teenage driver to my automobile insurance policy, the fact that my rate is increased does not translate to a rate decrease for everyone who does not include a teenage driver under his insurance policy. Likewise, if I conduct my financial affairs in a way that raises my credit score and thus lowers my insurance premium, my lower premium does not constitute a rate increase for anyone else.

Some attributes and behaviors increase risk, while others decrease risk. In a competitive insurance market, insurers set premiums based on the level of risk they assume, which they determine based on their analysis of dozens of risk variables. The goal of this exercise is to ensure that similar risks are treated similarly; it is not to create a zero-sum game that pits insurers against insureds. But apparently the U.S. Justice Department thinks otherwise. Its brief declares that "if an insurance company opts to use the credit reporting system *and enjoy its benefits*, it must also comply with the FCRA's obligations." Brief for United States at 28 (emphasis added). Of course it must, but the implication that policyholders do not also enjoy the benefits of accurate pricing based on actuarially sound risk analysis betrays a glaring misunderstanding of the insurance enterprise.

Though hailed as a victory for insurers, *Safeco v. Burr* raises troubling questions about the approach that federal officials would bring to insurance regulation. For proponents of a federal insurance regulatory regime, *Safeco v. Burr* should serve as a cautionary tale.

[7] *Safeco* at 2212.

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