ALASKA LEGISLATURE COMMITTEE FILES 1995-1996 8672

9052 SENATE STATE AFFAIRS

First American Title Company of Alaska

510 W. TUDOR, SUITE 1 ANCHORAGE, ALASKA 99503 PHONE (907) 562-0610 FAX (907) 562-0173

Senator Bert Sharp, Chairman
Senate State Affairs Committee
Alaska State Legislature
State Capitol (MS 3100)
Juneau, Alaska 99801-1182

Re: CSSB 231 -- An Act Related to Title Insurance

Dear Senator Sharp:

This letter is intended to restate this company's and the industry's continued opposition to the above referenced legislation, as revised by the recent committee substitute.

It is encouraging to the industry that the provisions of the former draft attempting to directly legislate the price of insurance we offer has been eliminated. This is in response, we hope and believe, to our prior comments and testimony that such a low rate would make it impossible to produce the title insurance which it affected. We thank Senator Rieger and the committee for their consideration of our viewpoint on this issue.

The new version of the bill is completely different than the prior version. As we understand it, the bill is intended to deregulate the so-called "non-insurance" portion of the title premium rate. In fact, however, as currently written, the bill may logically be interpreted to deregulate all aspects of title premiums, because any portion of the premium based on "determination of insurability" would also not be regulated, and that is what underwriting of title insurance is all about. In short, the bill is written much more broadly than may have been intended, and does not result in the sponsor's stated intent.

Even if this is corrected, however, there are still problems. Title agents, regulation of whose charges the bill seeks to change, face not only issues relating to contract liability based on the policies they issue, but also negligence liability under the minority position taken by our Supreme Court. That liability is not covered by underwriting, and the bill does not account for the State's need to be concerned not only with the solvency of underwriters, but also agents. Further, agents bear risk as insurers as well, because agents are liable for the first portion of a loss based on claim deductibles. Agents are additionally responsible for the maintenance of title plants, and upholding standards of review of title. This bill will require agents to cut costs to compete, and with the previously discussed side effect of

decreased competition will also come the specter of agent default and defalcation, a problem in other states which, for the most part, Alaska has avoided.

It also simply cannot be discounted that Alaska has not been a particularly friendly state in which to write title insurance, as is witnessed by the number of underwriters who have left. This bill makes it less so. Underwriters also own agencies, as both active underwriters in Alaska do, and what hurts agents hurts underwriters. In a state where the real estate laws are frankly somewhat chaotic anyway, one would hope the government would be looking for ways to encourage the industry rather than discourage it. Instead, it seems, one branch or the other of the government seems to decide about every four years that the industry needs to be turned on its head. Four years ago, the we were told that title companies were cutting rates too low, and we were required to raise them and collect cancellation fees. Now we are told we are making too much, despite the lack of any evidence to support that charge. You can be sure that if we were making too much money in Alaska, there would be ten underwriters represented here and not just two. In addition to this bill there is a house bill pending which, by changing the mechanic's lien statute, would make it impossible to issue extended lender's coverage insurance, a basic requirement of all institutional lenders, so loans can be sold on the secondary market.

We hope the committee will consider the total impact of what this bill proposes. The net result will be the loss of agents (and therefore competition), of agent solvency, and perhaps even of an underwriter. We are scheduled to meet with the Division of Insurance next month to discuss what, if any rate changes are justifiable and feasible. Neither legislating rates or complete deregulation, both of which have been proposed in the two incarnations of this bill, are the answer.

Further, it was stated during the hearing on March 14 that the bill is based on Pennsylvania law. It is noteworthy that in fact rates eventually ended up being higher there than in Alaska. Further, the basic rate for title insurance in Alaska has not changed since 1968.

Finally, there is an adverse fiscal impact to the state due to the bill, as is disclosed by the Department of Commerce and Economic Development's fiscal note. It hardly seems sensible to endorse a loss of state revenue in these tight budgetary times.

Senator Bert Sharp
March 22, 1996
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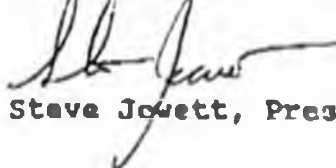
We urge you and the other members of the committee to vote "Do Not Pass" on the bill. If you have any questions, please do not hesitate to contact me.

Very truly yours,

FIRST AMERICAN TITLE AGENCY OF ALASKA



Steve Jewett, President

DOCK STREET TITLE AGENCY, INC
[illegible] Dock Street
P O Box [illegible]
Ketchikan, Alaska [illegible]
(907) [illegible]

March 22, 1996

Senator Bert M. Sharp
119 N. Cushman, Suite 201
Fairbanks, Alaska 99701

RE: SB 231

Dear Senator Sharp:

During discussion of Senate Bill 231 Senator Reiger made reference to title insurance rates in Pennsylvania.

The first thing that came to mind was the fact that in Pennsylvania title insurance agents do not own and maintain title plants, therefor, a comparison of Alaska and Pennsylvania is similar to the old apples and oranges comparison.

AS 21.66.200 requires that title insurance companies and agencies have and maintain a title plant.

In Pennsylvania title searches are conducted at the appropriate state offices using state owned equipment.

If you count the pages of recorded instruments in the state recorders office and multiply that number by $.35 then count the plat maps as well as the applicable status plats on file with the Federal Bureau of Land Management office and multiply the number of maps by $4.00 put these two figures together and you have a good start at building a title plant as required by AS 21.66.200. You will still have to purchase some pretty spendy office equipment such as microfilm reader-printers.

After you compile the records and equipment you can either purchase or rent space to store and use them. Keep in mind that as more instruments are recorded every day you should allow space to expand and employees to maintain the title plant.

As the state of Pennsylvania does not require title insurance agents to own and maintain title plants we would assume that the title insurance agent could produce the same product for less money. (Let the state provide the office space and equipment to search records)

Enclosed please find a copy of the basic title insurance rate schedule as filed with the State of Alaska and in use by all Stewart Title Guaranty company agents.

Also please find a copy of a rate schedule provided by Great Valley Abstract Corporation of Wayne, Pennsylvania.

You will note that even with the cost of the title plant being assumed by the state they charge more.

Also I have been advised that a higher rate has been approved by the State of Pennsylvania and will be affective in April, 1996.

Sincerely,

Mike Jausoro

SECTION 1.11

BASIC INSURANCE RATE SCHEDULE "A"
FOR
TITLE INSURANCE
STATEWIDE

AMOUNT OF INSURANCE	RATE	AMOUNT OF INSURANCE	RATE	AMOUNT OF INSURANCE	RATE
$ 1,000	$250.00	$35,000	$292.00	$ 69,000	$458.00
2,000	250.00	36,000	298.00	70,000	462.00
3,000	250.00	37,000	304.00	71,000	466.00
4,000	250.00	38,000	310.00	72,000	470.00
5,000	250.00	39,000	316.00	73,000	474.00
6,000	250.00	40,000	322.00	74,000	478.00
7,000	250.00	41,000	328.00	75,000	482.00
8,000	250.00	42,000	334.00	76,000	486.00
9,000	250.00	43,000	340.00	77,000	490.00
10,000	250.00	44,000	346.00	78,000	494.00
11,000	250.00	45,000	352.00	79,000	498.00
12,000	250.00	46,000	358.00	80,000	502.00
13,000	250.00	47,000	364.00	81,000	506.00
14,000	250.00	48,000	370.00	82,000	510.00
15,000	250.00	49,000	376.00	83,000	514.00
16,000	250.00	50,000	382.00	84,000	518.00
17,000	250.00	51,000	386.00	85,000	522.00
18,000	250.00	52,000	390.00	86,000	526.00
19,000	250.00	53,000	394.00	87,000	530.00
20,000	250.00	54,000	398.00	88,000	534.00
21,000	250.00	55,000	402.00	89,000	538.00
22,000	250.00	56,000	406.00	90,000	542.00
23,000	250.00	57,000	410.00	91,000	546.00
24,000	250.00	58,000	414.00	92,000	550.00
25,000	250.00	59,000	418.00	93,000	554.00
26,000	250.00	60,000	422.00	94,000	558.00
27,000	250.00	61,000	426.00	95,000	562.00
28,000	250.00	62,000	430.00	96,000	566.00
29,000	256.00	63,000	434.00	97,000	570.00
30,000	262.00	64,000	438.00	98,000	574.00
31,000	268.00	65,000	442.00	99,000	578.00
32,000	274.00	66,000	446.00	100,000	582.00
33,000	280.00	67,000	450.00		
34,000	286.00	68,000	454.00		

For each $1,000 or fraction thereof above $ 100,000.00
- ADD $3.00 per $1,000 up to and including $ 500,000.00
- ADD $2.50 per $1,000 up to and including $ 750,000.00
- ADD $2.00 per $1,000 up to and including $2,000,000.00
- ADD $1.25 per $1,000 up to and including $5,000,000.00
- ADD [illegible].20 per $1,000 over $5,000,000.00

GREAT VALLEY ABSTRACT CORP

Agent for **Fidelity National Title Insurance Company**

OF PENNSYLVANIA

AREA ONE RATES

(Effective March 1, 19[illegible])

UNIT OF INSURANCE OR FRACTION THEREOF	BASIC	REISSUE	UNIT OF INSURANCE OR FRACTION THEREOF	BASIC	REISSUE
0 - $30,000	$380.00	$330.00	$97,001 - 98,000	$806.75	$719.00
30,001 - 31,000	387.25	336.50	98,001 - 99,000	812.75	724.50
31,001 - 32,000	394.50	343.00	99,001 - 100,000	818.75	730.00
32,001 - 33,000	401.75	349.50	100,001 - 101,000	823.75	734.25
33,001 - 34,000	409.00	356.00	101,001 - 102,000	828.75	738.50
34,001 - 35,000	416.25	362.50	102,001 - 103,000	833.75	742.75
35,001 - 36,000	423.50	369.00	103,001 - 104,000	838.75	747.00
36,001 - 37,000	430.75	375.50	104,001 - 105,000	843.75	751.25
37,001 - 38,000	438.00	382.00	105,001 - 106,000	848.75	755.50
38,001 - 39,000	445.25	388.50	106,001 - 107,000	853.75	759.75
39,001 - 40,000	452.50	395.00	107,001 - 108,000	858.75	764.00
40,001 - 41,000	459.75	401.50	108,001 - 109,000	863.75	768.25
41,001 - 42,000	467.00	408.00	109,001 - 110,000	868.75	772.50
42,001 - 43,000	474.25	414.50	110,001 - 111,000	873.75	776.75
43,001 - 44,000	481.50	421.00	111,001 - 112,000	878.75	781.00
44,001 - 45,000	488.75	427.50	112,001 - 113,000	883.75	785.25
45,001 - 46,000	494.75	433.00	113,001 - 114,000	888.75	789.50
46,001 - 47,000	500.75	438.50	114,001 - 115,000	893.75	793.75
47,001 - 48,000	506.75	444.00	115,001 - 116,000	898.75	798.00
48,001 - 49,000	512.75	449.50	116,001 - 117,000	903.75	802.25
49,001 - 50,000	518.75	455.00	117,001 - 118,000	908.75	806.50
50,001 - 51,000	524.75	460.50	118,001 - 119,000	913.75	810.75
51,001 - 52,000	530.75	466.00	119,001 - 120,000	918.75	815.00
52,001 - 53,000	536.75	471.50	120,001 - 121,000	923.75	819.25
53,001 - 54,000	542.75	477.00	121,001 - 122,000	928.75	823.50
54,001 - 55,000	548.75	482.50	122,001 - 123,000	933.75	827.75
55,001 - 56,000	554.75	488.00	123,001 - 124,000	938.75	832.00
56,001 - 57,000	560.75	493.50	124,001 - 125,000	943.75	836.25
57,001 - 58,000	566.75	499.00	125,001 - 126,000	948.75	840.50
58,001 - 59,000	572.75	504.50	126,001 - 127,000	953.75	844.75
59,001 - 60,000	578.75	510.00	127,001 - 128,000	958.75	849.00
60,001 - 61,000	584.75	515.50	128,001 - 129,000	963.75	853.25
61,001 - 62,000	590.75	521.00	129,001 - 130,000	968.75	857.50
62,001 - 63,000	596.75	526.50	130,001 - 131,000	973.75	861.75
63,001 - 64,000	602.75	532.00	131,001 - 132,000	978.75	866.00
64,001 - 65,000	608.75	537.50	132,001 - 133,000	983.75	870.25
65,001 - 66,000	614.75	543.00	133,001 - 134,000	988.75	874.50
66,001 - 67,000	620.75	548.50	134,001 - 135,000	993.75	878.75
67,001 - 68,000	626.75	554.00	135,001 - 136,000	998.75	883.00
68,001 - 69,000	632.75	559.50	136,001 - 137,000	1,003.75	887.25
69,001 - 70,000	638.75	565.00	137,001 - 138,000	1,008.75	891.50
70,001 - 71,000	644.75	570.50	138,001 - 139,000	1,013.75	895.75
71,001 - 72,000	650.75	576.00	139,001 - 140,000	1,018.75	900.00
72,001 - 73,000	656.75	581.50	140,001 - 141,000	1,023.75	904.25
73,001 - 74,000	662.75	587.00	141,001 - 142,000	1,028.75	908.50
74,001 - 75,000	668.75	592.50	142,001 - 143,000	1,033.75	912.75
75,001 - 76,000	674.75	598.00	143,001 - 144,000	1,038.75	917.00
76,001 - 77,000	680.75	603.50	144,001 - 145,000	1,043.75	921.25
77,001 - 78,000	686.75	609.00	145,001 - 146,000	1,048.75	925.50
78,001 - 79,000	692.75	614.50	146,001 - 147,000	1,053.75	929.75
79,001 - 80,000	698.75	620.00	147,001 - 148,000	1,058.75	934.00
80,001 - 81,000	704.75	625.50	148,001 - 149,000	1,063.75	938.25
81,001 - 82,000	710.75	631.00	149,001 - 150,000	1,068.75	942.50
82,001 - 83,000	716.75	636.50	150,001 - 151,000	1,073.75	946.75
83,001 - 84,000	722.75	642.00	151,001 - 152,000	1,078.75	951.00
84,001 - 85,000	728.75	647.50	152,001 - 153,000	1,083.75	955.25
85,001 - 86,000	734.75	653.00	153,001 - 154,000	1,088.75	959.50
86,001 - 87,000	740.75	658.50	154,001 - 155,000	1,093.75	963.75
87,001 - 88,000	746.75	664.00	155,001 - 156,000	1,098.75	968.00
88,001 - 89,000	752.75	669.50	156,001 - 157,000	1,103.75	972.25
89,001 - 90,000	758.75	675.00	157,001 - 158,000	1,108.75	976.50
90,001 - 91,000	764.75	680.50	158,001 - 159,000	1,113.75	980.75
91,001 - 92,000	770.75	686.00	159,001 - 160,000	1,118.75	985.00
92,001 - 93,000	776.75	691.50	160,001 - 161,000	1,123.75	989.25
93,001 - 94,000	782.75	697.00	161,001 - 162,000	1,128.75	993.50
94,001 - 95,000	788.75	702.50	162,001 - 163,000	1,133.75	997.75
95,001 - 96,000	794.75	708.00	163,001 - 164,000	1,138.75	1,002.00

AREA ONE

UNIT OF INSURANCE OR FRACTION THEREOF	BASIC	REISSUE	UNIT OF INSURANCE OR FRACTION THEREOF	BASIC	REISSUE
$165,001 - $166,000	$1,148.75	$1,010.50	$233,001 - $234,000	$1,488.75	$1,299.50
166,001 - 167,000	1,153.75	1,014.75	234,001 - 235,000	1,493.75	1,303.75
167,001 - 168,000	1,158.75	1,019.00	235,001 - 236,000	1,498.75	1,308.00
168,001 - 169,000	1,163.75	1,023.25	236,001 - 237,000	1,503.75	1,312.25
169,001 - 170,000	1,168.75	1,027.50	237,001 - 238,000	1,508.75	1,316.50
170,001 - 171,000	1,173.75	1,031.75	238,001 - 239,000	1,513.75	1,320.75
171,001 - 172,000	1,178.75	1,036.00	239,001 - 240,000	1,518.75	1,325.00
172,001 - 173,000	1,183.75	1,040.25	240,001 - 241,000	1,523.75	1,329.25
173,001 - 174,000	1,188.75	1,044.50	241,001 - 242,000	1,528.75	1,333.50
174,001 - 175,000	1,193.75	1,048.75	242,001 - 243,000	1,533.75	1,337.75
175,001 - 176,000	1,198.75	1,053.00	243,001 - 244,000	1,538.75	1,342.00
176,001 - 177,000	1,203.75	1,057.25	244,001 - 245,000	1,543.75	1,346.25
177,001 - 178,000	1,208.75	1,061.50	245,001 - 246,000	1,548.75	1,350.50
178,001 - 179,000	1,213.75	1,065.75	246,001 - 247,000	1,553.75	1,354.75
179,001 - 180,000	1,218.75	1,070.00	247,001 - 248,000	1,558.75	1,359.00
180,001 - 181,000	1,223.75	1,074.25	248,001 - 249,000	1,563.75	1,363.25
181,001 - 182,000	1,228.75	1,078.50	249,001 - 250,000	1,568.75	1,367.50
182,001 - 183,000	1,233.75	1,082.75	250,001 - 251,000	1,573.75	1,371.75
183,001 - 184,000	1,238.75	1,087.00	251,001 - 252,000	1,578.75	1,376.00
184,001 - 185,000	1,243.75	1,091.25	252,001 - 253,000	1,583.75	1,380.25
185,001 - 186,000	1,248.75	1,095.50	253,001 - 254,000	1,588.75	1,384.50
186,001 - 187,000	1,253.75	1,099.75	254,001 - 255,000	1,593.75	1,388.75
187,001 - 188,000	1,258.75	1,104.00	255,001 - 256,000	1,598.75	1,393.00
188,001 - 189,000	1,263.75	1,108.25	256,001 - 257,000	1,603.75	1,397.25
189,001 - 190,000	1,268.75	1,112.50	257,001 - 258,000	1,608.75	1,401.50
190,001 - 191,000	1,273.75	1,116.75	258,001 - 259,000	1,613.75	1,405.75
191,001 - 192,000	1,278.75	1,121.00	259,001 - 260,000	1,618.75	1,410.00
192,001 - 193,000	1,283.75	1,125.25	260,001 - 261,000	1,623.75	1,414.25
193,001 - 194,000	1,288.75	1,129.50	261,001 - 262,000	1,628.75	1,418.50
194,001 - 195,000	1,293.75	1,133.75	262,001 - 263,000	1,633.75	1,422.75
195,001 - 196,000	1,298.75	1,138.00	263,001 - 264,000	1,638.75	1,427.00
196,001 - 197,000	1,303.75	1,142.25	264,001 - 265,000	1,643.75	1,431.25
197,001 - 198,000	1,308.75	1,146.50	265,001 - 266,000	1,648.75	1,435.50
198,001 - 199,000	1,313.75	1,150.75	266,001 - 267,000	1,653.75	1,439.75
199,001 - 200,000	1,318.75	1,155.00	267,001 - 268,000	1,658.75	1,444.00
200,001 - 201,000	1,323.75	1,159.25	268,001 - 269,000	1,663.75	1,448.25
201,001 - 202,000	1,328.75	1,163.50	269,001 - 270,000	1,668.75	1,452.50
202,001 - 203,000	1,333.75	1,167.75	270,001 - 271,000	1,673.75	1,456.75
203,001 - 204,000	1,338.75	1,172.00	271,001 - 272,000	1,678.75	1,461.00
204,001 - 205,000	1,343.75	1,176.25	272,001 - 273,000	1,683.75	1,465.25
205,001 - 206,000	1,348.75	1,180.50	273,001 - 274,000	1,688.75	1,469.50
206,001 - 207,000	1,353.75	1,184.75	274,001 - 275,000	1,693.75	1,473.75
207,001 - 208,000	1,358.75	1,189.00	275,001 - 276,000	1,698.75	1,478.00
208,001 - 209,000	1,363.75	1,193.25	276,001 - 277,000	1,703.75	1,482.25
209,001 - 210,000	1,368.75	1,197.50	277,001 - 278,000	1,708.75	1,486.50
210,001 - 211,000	1,373.75	1,201.75	278,001 - 279,000	1,713.75	1,490.75
211,001 - 212,000	1,378.75	1,206.00	279,001 - 280,000	1,718.75	1,495.00
212,001 - 213,000	1,383.75	1,210.25	280,001 - 281,000	1,723.75	1,499.25
213,001 - 214,000	1,388.75	1,214.50	281,001 - 282,000	1,728.75	1,503.50
214,001 - 215,000	1,393.75	1,218.75	282,001 - 283,000	1,733.75	1,507.75
215,001 - 216,000	1,398.75	1,223.00	283,001 - 284,000	1,738.75	1,512.00
216,001 - 217,000	1,403.75	1,227.25	284,001 - 285,000	1,743.75	1,516.25
217,001 - 218,000	1,408.75	1,231.50	285,001 - 286,000	1,748.75	1,520.50
218,001 - 219,000	1,413.75	1,235.75	286,001 - 287,000	1,753.75	1,524.75
219,001 - 220,000	1,418.75	1,240.00	287,001 - 288,000	1,758.75	1,529.00
220,001 - 221,000	1,423.75	1,244.25	288,001 - 289,000	1,763.75	1,533.25
221,001 - 222,000	1,428.75	1,248.50	289,001 - 290,000	1,768.75	1,537.50
222,001 - 223,000	1,433.75	1,252.75	290,001 - 291,000	1,773.75	1,541.75
223,001 - 224,000	1,438.75	1,257.00	291,001 - 292,000	1,778.75	1,546.00
224,001 - 225,000	1,443.75	1,261.25	292,001 - 293,000	1,783.75	1,550.25
225,001 - 226,000	1,448.75	1,265.50	293,001 - 294,000	1,788.75	1,554.50
226,001 - 227,000	1,453.75	1,269.75	294,001 - 295,000	1,793.75	1,558.75
227,001 - 228,000	1,458.75	1,274.00	295,001 - 296,000	1,798.75	1,563.00
228,001 - 229,000	1,463.75	1,278.25	296,001 - 297,000	1,803.75	1,567.25
229,001 - 230,000	1,468.75	1,282.50	297,001 - 298,000	1,808.75	1,571.50
230,001 - 231,000	1,473.75	1,286.75	298,001 - 299,000	1,813.75	1,575.75
231,001 - 232,000	1,478.75	1,291.00	299,001 - 300,000	1,818.75	1,580.00
232,001 - 233,000	1,483.75	1,295.25			

On the excess over $300,000	BASIC	REISSUE
$300,001 - $500,000 – Add per $1,000	$5.00	$4.25
$500,001 - $1,000,000 – Add per $1,000	3.75	3.50
$1,000,001 - $2,000,000 – Add per $1,000	2.75	2.50

For insurances in excess of $2,000,000.00 please contact Fidelity National Title or Agent for Quotes

STATE OF ALASKA

DEPARTMENT OF COMMERCE AND
ECONOMIC DEVELOPMENT

DIVISION OF INSURANCE

TONY KNOWLES, GOVERNOR

P.O. BOX 110805
JUNEAU, ALASKA 99811-0805
PHONE (907) 465-2515

RECEIVED FEB 29 1996

NOTICE OF PUBLIC MEETING

Notice is given that the Division of Insurance is seeking people interested in participating on a task force to discuss and advise the director on issues related to title insurance. The initial meeting of this task force will be held on April 11, 1996, from 1:00 p.m. to 4:00 p.m. at the following three video conference locations:

1. University of Alaska Anchorage, 3890 University Lake Drive, Suite 102, Anchorage, Alaska.

2. University of Alaska Fairbanks, Elmer E. Rasmuson Library, Room 407, Fairbanks, Alaska.

3. Goldbelt Building, Education Board Room, 1st Floor, Juneau, Alaska.

The meeting will be moderated from the Anchorage location. Written comments may be sent to the Division of Insurance, Attention: Sarah McNair-Grove, P.O. Box 110805, Juneau, Alaska 99811-0805, to be received no later than 4:30 p.m. on April 9, 1996, to be included in the initial meeting of the task force.

This will be a working meeting and interested people should be prepared to raise and discuss issues related to title insurance. The following questions and topics are suggested in order to focus on some of the issues that should be addressed by the task force. Additional questions raised by participants will also be discussed at this meeting.

1. What are some possible methodologies that could be used to support rates filed by title companies? Can existing data be used or does additional data need to be collected? What data is available now? What additional data would be feasible to collect? What data should the agent supply?

2. Would a rate of return method be appropriate to use to support rate filings? What definition of rate of return should be used? How should the standard for such a method be determined?

3. What types of discounts should be allowed? How should the amount of the discount be determined so that the discounted rate still covers the cost and risk of producing the title project? What data exists or is needed to support such discounts?

06-H11LH

4. Is a discount appropriate for refinances? Is it appropriate to have a discount regardless of the amount of time since the original policy was purchased? If not, how long? If it is appropriate, how can the amount of the discount be determined so that the discounted rate still covers the cost and risk of producing the title project?

5. Should the noninsurance portion of title insurance be deregulated? What would be the impact on the marketplace?

6. Is the commission split approach appropriate for determining title insurance premium?

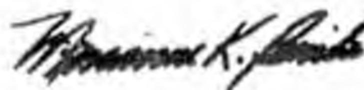
7. How do we assure that the title insurer's risk portion of premium is stabilized and adequate?

8. What should constitute an illegal inducement?

9. Incorporation of the NAIC model acts for regulation of title agents and regulation of title insurers into the Alaska Insurance Code.

If you are a person with a disability who may need a special accommodation in order to participate in this public meeting, please contact Barbara Karl at (907) 269-7900, or TDD (907) 465-5437, no later than April 4, 1996, to ensure that any necessary accommodations can be provided.

Date: February 21, 1996



Marianne K. Burke
Director of Insurance

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The United States Law Week

Extra Edition No. 1
Supreme Court
Opinions

June 9, 1992 • THE BUREAU OF NATIONAL AFFAIRS, INC., WASHINGTON, D.C. • Volume 60, No. 48

OPINIONS ANNOUNCED JUNE 12, 1992

The Supreme Court decided:

ANTITRUST—Immunity

Title insurers' setting of uniform rates for title search, examination, and settlement services through private rating bureaus in Wisconsin and Montana pursuant to "negative option rule," under which rates become effective unless rejected by state agency within set time, was potentially subject to active state supervision that was not realized in fact, in that rate filings were checked, if at all, for mathematical accuracy and additional requested information was either not supplied or delayed for years, and thus is not immune from antitrust scrutiny under state action doctrine. (*Federal Trade Commission v. Ticor Title Insurance Co.*, No. 91-72) .... Page 4512

COURTS AND PROCEDURE—Venue

Montana venue rules that permit domestic corporations to be sued only in county of their principal place of business but that permit foreign corporations to be sued in any county rationally further legitimate state interest in resolving disparate interests of litigants in location of trial and, therefore, do not violate Fourteenth Amendment's Equal Protection Clause. (*Burlington Northern Railroad Co. v. Ford*, No. 91-779) ..... Page 4515

ENVIRONMENT AND CONSERVATION—Endangered Species

Environmental group's affidavits stating that two of its members have been to foreign countries to view endangered species and intend to return for same purpose do not establish injury in fact needed to confer Article III standing to challenge administrative rule limiting application of Endangered Species Act to federal agency actions within United States or on high seas; nor is injury-in-fact requirement of standing satisfied by ESA citizen suit provision's conferral upon all persons of right to challenge federal agency's failure to comply with ESA obligations. (*Lujan v. Defenders of Wildlife*, No. 90-1424) .... Page 4495

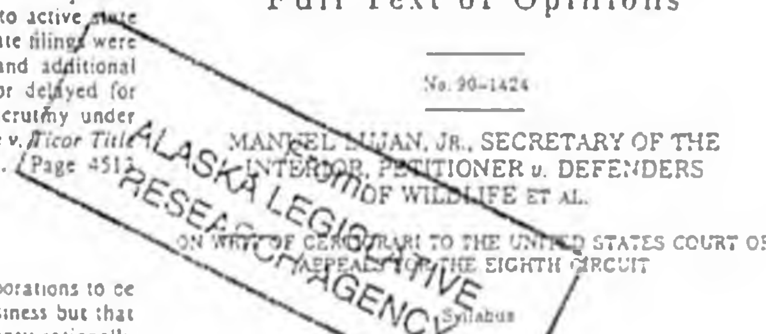
FOREIGN AFFAIRS—Sovereign Immunity

Foreign sovereign's issuance of ordinary debt instruments is type of action in which private commercial party engages and thus constitutes "commercial activity" within meaning of Foreign Sovereign Immunities Act, and its subsequent default and rescheduling of maturity dates on those instruments payable in New York has "direct effect" in United States, and therefore federal district court may assert jurisdiction under FSIA over breach-of-contract claim based on that rescheduling. (*Republic of Argentina v. Weltover Inc.*, No. 91-763) ...... Page 4510

Full Text of Opinions

No. 90-1424

MANUEL LUJAN, JR., SECRETARY OF THE INTERIOR, PETITIONER *v.* DEFENDERS OF WILDLIFE ET AL.


ALASKA LEGISLATIVE RESEARCH AGENCY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Syllabus

No. 90-1424. Argued December 3, 1991—Decided June 12, 1992

Section 7(a)(2) of the Endangered Species Act of 1973 divides responsibilities regarding the protection of endangered species between petitioner Secretary of the Interior and the Secretary of Commerce, and requires each federal agency to consult with the relevant Secretary to ensure that any action funded by the agency is not likely to jeopardize the continued existence or habitat of any endangered or threatened species. Both Secretaries initially promulgated a joint regulation extending §7(a)(2)'s coverage to actions taken in foreign nations, but a subsequent joint rule limited the section's geographic scope to the United States and the high seas. Respondents, wildlife conservation and other environmental organizations, filed an action in the District Court, seeking a declaratory judgment that the new regulation erred as to §7(a)(2)'s geographic scope, and an injunction requiring the Secretary of the Interior to promulgate a new rule restoring his initial interpretation. The Court of Appeals reversed the District Court's dismissal of the suit for lack of standing. Upon remand, on cross-motions for summary judgment, the District Court denied the Secretary's motion, which renewed his objection to standing, and granted respondents' motion, ordering the Secretary to publish a new rule. The Court of Appeals affirmed.

Held: The judgment is reversed, and the case is remanded.

911 F. 2d 117, reversed and remanded.

JUSTICE SCALIA delivered the opinion of the Court, except as to Part III-B, concluding that respondents lack standing to seek judicial review of the rule.

(a) As the parties invoking federal jurisdiction, respondents bear the burden of showing standing by establishing, *inter alia*, that they have suffered an injury in fact, *i. e.*, a concrete and particularized, actual or imminent invasion of a legally-protected interest. To survive a summary judgment motion, they must set forth by affidavit

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NOTE: Where it is deemed desirable, a syllabus (headnote) will be released * * * at the time the opinion is issued. The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Lumber Co.*, 200 U.S. 321, 337.

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would qualify as its "principal place of business" if it were a Montana corporation.

Burlington's claim fails. Montana could reasonably have determined that a corporate defendant's home office is generally of greater significance to the corporation's convenience in litigation than its other offices; that foreign corporations are unlikely to have their principal offices in Montana; and that Montana's domestic corporations will probably keep headquarters within the State. We cannot say, at least not on this record, that any of these assumptions is irrational. Cf. *G. D. Searle & Co.* v. *Cohn*, 455 U. S. 404, 410 (1982); *Metropolitan Casualty Ins. Co.* v. *Brownell*, 294 U. S. 580, 585 (1935). And upon them Montana may have premised the policy judgment, which we find constitutionally unimpeachable, that only the convenience to a corporate defendant of litigating in the county containing its home office is sufficiently significant to outweigh a plaintiff's interest in suing in the county of his choice.

Of course Montana's venue rules would have implemented that policy judgment with greater precision if they had turned on the location of a corporate defendant's principal place of business, not on its State of incorporation. But this is hardly enough to make the rules fail rational-basis review, for "rational distinctions may be made with substantially less than mathematical exactitude." *New Orleans* v. *Dukes*, 427 U. S. 297, 303 (1976); see *Hughes* v. *Alexandria Scrap Corp.*, 426 U. S. 794, 814 (1976); *Lindsley* v. *Natural Carbonic Gas Co.*, 220 U. S. 61, 78 (1911). Montana may reasonably have thought that the location of a corporate defendant's principal place of business would not be as readily verifiable as its State of incorporation, that a rule hinging on the former would invite wasteful side shows of venue litigation, and that obviating the side shows would be worth the loss in precision. These possibilities, of course, put Burlington a far cry away from the point of discharging its burden of showing that the under- and overinclusiveness of Montana's venue rules is so great that the rules can no longer be said rationally to implement Montana's policy judgment. See, *e.g.*, *Brownell*, *supra*, at 584. Besides, Burlington, having headquarters elsewhere, would not benefit even from a scheme based on domicile, and is therefore in no position to complain of Montana's using State of incorporation as a surrogate for domicile. See *Roberts & Schaefer Co.* v. *Emmerson*, 271 U. S. 50, 53-55 (1926); cf. *United States* v. *Raines*, 362 U. S. 17, 21 (1960).

Burlington is left with the argument that *Power Manufacturing Co.* v. *Saunders*, *supra*, controls this case. But it does not. In *Saunders*, we considered Arkansas' venue rules, which restricted suit against a domestic corporation to those counties where it maintained a place of business, 274 U. S., at 491-492, but exposed foreign corporations to suit in any county, *id.*, at 492. We held that the distinction lacked a rational basis and therefore deprived foreign corporate defendants of the equal protection of the laws. *Id.*, at 494. The statutory provision challenged in *Saunders*, however, applied only to foreign corporations authorized to do business in Arkansas, *ibid.*, so that most of the corporations subject to its any-county rule probably had a place of business in Arkansas. In contrast, most of the corporations subject to Montana's any-county rule probably do not have their principal place of business in Montana. Thus, Arkansas' special rule for foreign corporations was tailored with significantly less precision than Montana's, and, on the assumption that *Saunders* is still good law, see *American Motorists Ins. Co.* v. *Starnes*, 425 U. S. 637, 645, n. 6 (1976), its holding does not invalidate Montana's venue rules.

In sum, Montana's venue rules can be understood as rationally furthering a legitimate state interest. The judgment of the Supreme Court of Montana is accordingly

Affirmed.

BETTY JO CHRISTIAN, Washington, D.C. (CHARLES G. COLE, JERALD S. HOWE JR., VIRGINIA L. WHITE-MAHAFFEY, HELEN HISER RECINOS, STEPTOE & JOHNSON, EDMUND W. BURKE, RICHARD V. WICKA, KURT W. KROSCHEL, and KURT W. KROSCHEL & ASSOCIATES, on the briefs) for petitioner; JOEL I. KLEIN, Washington, D.C. (ROBERT S. FAIN JR., [illegible]IN, FARR, SMITH & TARANTO, and WRIGHT, TOLLIVER & GUTHALS P.C., on the briefs) for respondents.

No. 91-72

FEDERAL TRADE COMMISSION, PETITIONER *v.* TICOR TITLE INSURANCE COMPANY ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Syllabus

No. 91-72. Argued January 13, 1992—Decided June 12, 1992

Petitioner Federal Trade Commission filed an administrative complaint charging respondent title insurance companies with horizontal price fixing in setting fees for title searches and examinations in violation of § 5(a)(1) of the Federal Trade Commission Act. In each of the four States at issue—Connecticut, Wisconsin, Arizona, and Montana—uniform rates were established by a rating bureau licensed by the State and authorized to establish joint rates for its members. Rate filings were made to the state insurance office and became effective unless the State rejected them within a specified period. The Administrative Law Judge held, *inter alia*, that the rates had been fixed in all four States, but that, in Wisconsin and Montana, respondents' anticompetitive activities were entitled to state-action immunity, as contemplated in *Parker* v. *Brown*, 317 U. S. 341, and its progeny. Under this doctrine, a state law or regulatory scheme can be the basis for antitrust immunity if the State (1) has articulated a clear and affirmative policy to allow the anticompetitive conduct and (2) provides active supervision of anticompetitive conduct undertaken by private actors. *California Retail Liquor Dealers Assn.* v. *Midcal Aluminum, Inc.*, 445 U. S. 97, 105. The Commission, which conceded that the first part of the test was met, held on review that none of the States had conducted sufficient supervision to warrant immunity. The Court of Appeals reversed, holding that the existence of a state regulatory program, if staffed, funded, and empowered by law, satisfied the active supervision requirement. Thus, it concluded, respondents' conduct in all the States was entitled to state-action immunity.

Held:

1. State-action immunity is not available under the regulatory schemes in Montana and Wisconsin.

(a) Principles of federalism require that federal antitrust laws be subject to supersession by state regulatory programs. *Parker*, *supra*, at 350-352; *Midcal*, *supra*; *Patrick* v. *Burget*, 486 U. S. 94. *Midcal's* two-part test confirms that States may not confer antitrust immunity on private persons by fiat. Actual state involvement is the precondition for immunity, which is conferred out of respect for the State's ongoing regulation, not the economics of price restraint. The purpose of the active supervision inquiry is to determine whether the State has exercised sufficient independent judgment and control so that the details of the rates or prices have been established as a product of deliberate state intervention. Although this immunity doctrine was developed in actions brought under the Sherman Act, the issue whether it applies to Commission actions under the Federal Trade Commission Act need not be determined, since the Commission does

not assert any superior pre-emption authority here.

(b) Wisconsin, Montana, and 34 other States correctly contend that a broad interpretation of state-action immunity would not serve their best interests. The doctrine would impede, rather than advance, the States' freedom of action if it required them to act in the shadow of such immunity whenever they entered the realm of economic regulation. Insistence on real compliance with both parts of the *Midcal* test serves to make clear that the States are responsible for only the price fixing they have sanctioned and undertaken to control. Respondents' contention that such concerns are better addressed by the first part of the *Midcal* test misapprehends the close relation between *Midcal*'s two elements, which are both directed at ensuring that particular anticompetitive mechanisms operate because of a deliberate and intended state policy. A clear policy statement ensures only that the State did not act through inadvertence, not that the State approved the anticompetitive conduct. Sole reliance on the clear articulation requirement would not allow the States sufficient regulatory flexibility.

(c) Where prices or rates are initially set by private parties, subject to veto only if the State chooses, the party claiming the immunity must show that state officials have undertaken the necessary steps to determine the specifics of the price-fixing or ratesetting scheme. The mere potential for state supervision is not an adequate substitute for the State's decision. Thus, the standard relied on by the Court of Appeals in this case is insufficient to establish the requisite level of active supervision. The Commission's findings of fact demonstrate that the potential for state supervision was not realized in either Wisconsin or Montana. While most rate filings were checked for mathematical accuracy, some were unchecked altogether. Moreover, one rate filing became effective in Montana despite the rating bureau's failure to provide requested information, and additional information was provided in Wisconsin after seven years, during which time another rate filing remained in effect. Absent active supervision, there can be no state-action immunity for what were otherwise private price-fixing arrangements. And state judicial review cannot fill the void. See *Patrick, supra*, at 103–105. This Court's decision in *Southern Motor Carriers Rate Conference, Inc. v. United States*, 471 U. S. 48, which involved a similar negative option regime, is not to the contrary, since it involved the question whether the first part of the *Midcal* test was met. This case involves horizontal price fixing under a vague imprimatur in form and agency inaction in fact, and it should be read in light of the gravity of the antitrust offense, the involvement of private actors throughout, and the clear absence of state supervision.

2. The Court of Appeals should have the opportunity to reexamine its determinations with respect to Connecticut and Arizona in order to address whether it accorded proper deference to the Commission's factual findings as to the extent of state supervision in those States.

922 F. 2d 1122, reversed and remanded.

KENNEDY, J., delivered the opinion of the Court, in which WHITE, BLACKMUN, STEVENS, SCALIA, and SOUTER, JJ., joined. SCALIA, J., filed a concurring opinion. REHNQUIST, C. J., filed a dissenting opinion, in which O'CONNOR and THOMAS, JJ., joined. O'CONNOR, J., filed a dissenting opinion, in which THOMAS, J., joined.

JUSTICE KENNEDY delivered the opinion of the Court.

The Federal Trade Commission filed an administrative complaint against six of the nation's largest title insurance companies, alleging horizontal price fixing in their fees for title searches and title examinations. One company settled by consent decree, while five other firms continue to contest the matter. The Commission charged the title companies with violating § 5(a)(1) of the Federal Trade Commission Act, 38 Stat. 719, 15 U. S. C. § 45(a)(1), which prohibits "[u]nfair methods of competition in or affecting commerce." One of the principal defenses the companies assert is state-action immunity from antitrust prosecution, as contemplated in the line of cases beginning with *Parker* v. *Brown*, 317 U. S. 341 (1943). The Commission rejected this defense, *In re Ticor Title Ins. Co.*, 112 F. T. C. 344 (1989), and the firms sought review in the United States Court of Appeals for the Third Circuit. Ruling that state-action immunity was available under the state regulatory schemes in question, the Court of Appeals reversed. 922 F. 2d 1122 (1991). We granted certiorari. 502 U. S. ___ (1991).

I

Title insurance is the business of insuring the record title of real property for persons with some interest in the estate, including owners, occupiers, and lenders. A title insurance policy insures against certain losses or damages sustained by reason of a defect in title not shown on the policy or title report to which it refers. Before issuing a title insurance policy, the insurance company or one of its agents performs a title search and examination. The search produces a chronological list of the public documents in the chain of title to the real property. The examination is a critical analysis or interpretation of the condition of title revealed by the documents disclosed through this search.

The title search and examination are major components of the insurance company's services. There are certain variances from State to State and from policy to policy, but a brief summary of the functions performed by the title companies can be given. The insurance companies exclude from coverage defects uncovered during the search; that is, the insurers conduct searches in order to inform the insured and to reduce their own liability by identifying and excluding known risks. The insured is protected from some losses resulting from title defects not discoverable from a search of the public records, such as forgery, missing heirs, previous marriages, impersonation, or confusion in names. They are protected also against errors or mistakes in the search and examination. Negligence need not be proved in order to recover. Title insurance also includes the obligation to defend in the event that an insured is sued by reason of some defect within the scope of the policy's guarantee.

The title insurance industry earned $1.35 billion gross revenues in 1982, and respondents accounted for 57 percent of that amount. Four of respondents are the nation's largest title insurance companies: Ticor Title Insurance Co., with 16.5 percent of the market; Chicago Title Insurance Co., with 12.8 percent; Lawyers Title Insurance Co., with 12 percent; and SAFECO Title Insurance Co. (now operating under the name Security Union Title Insurance Co.), with 10.3 percent. Stewart Title Guarantee Co., with 5.4 percent of the market, is the country's eighth largest title insurer, with a strong position in the West and Southwest.

The Commission issued an administrative complaint in 1985. Horizontal price-fixing was alleged in these terms:

> "Respondents have agreed on the price to be charged for title search and examination services or settlement services through rating bureaus in various states. Examples of states in which one or more of the Respondents have fixed prices with other Respondents or other competitors for all or part of their search and examination services or settlement services are Arizona, Connecticut, Idaho, Louisiana, Montana, New Jersey, New Mexico, New York, Ohio, Oregon, Pennsylvania, Wisconsin and Wyoming.'" 112 F.T.C., at 346.

The Commission did not challenge the insurers' practice of setting uniform rates for insurance against the risk of loss from defective titles, but only the practice of setting uniform rates for the title search, examination, and settlement, aspects of the business which, the Commission alleges, do not involve insurance.

Before the Administrative Law Judge (ALJ), the respondents defended against liability on three related grounds.

First, they maintained that the challenged conduct is exempt from antitrust scrutiny under the McCarran-Ferguson Act, 59 Stat. 34, 15 U. S. C. § 1012(b), which confers antitrust immunity over the "business of insurance" to the extent regulated by state law. Second, they argued that their collective ratemaking activities are exempt under the *Noerr-Pennington* doctrine, which places certain "[j]oint efforts to influence public officials" beyond the reach of the antitrust laws. *Mine Workers* v. *Pennington*, 381 U. S. 657, 670 (1965); *Eastern Railroad Presidents Conference* v. *Noerr Motor Freight, Inc.*, 365 U. S. 127, 136 (1961). Third, respondents contended their activities are entitled to state-action immunity, which permits anticompetitive conduct if authorized and supervised by state officials. See *California Retail Liquor Dealers Assn.* v. *Midcal Aluminum Inc.*, 445 U. S. 97 (1980); *Parker* v. *Brown*, 317 U. S. 341 (1943). As to one State, Ohio, the respondents contended that the rates for title search, examination, and settlement had not been set by a rating bureau.

Title insurance company rates and practices in thirteen States were the subject of the initial complaint. Before the matter was decided by the ALJ, the Commission declined to pursue its complaint with regard to fees in five of these States, Louisiana, New Mexico, New York, Oregon, and Wyoming. Upon the recommendation of the ALJ, the Commission did not pursue its complaint with regard to fees in two additional States, Idaho and Ohio. This left six States in which the Commission found antitrust violations, but in two of these States, New Jersey and Pennsylvania, the Commission conceded the issue on which certiorari was sought here, so the regulatory regimes in these two States are not before us. Four States remain in which violations were alleged: Connecticut, Wisconsin, Arizona, and Montana.

The ALJ held that the rates for search and examination services had been fixed in these four States. For reasons we need not pause to examine, the ALJ rejected the McCarran-Ferguson and *Noerr-Pennington* defenses. The ALJ then turned his attention to the question of state-action immunity. A summary of the ALJ's extensive findings on this point is necessary for a full understanding of the decisions reached at each level of the proceedings in the case.

Rating bureaus are private entities organized by title insurance companies to establish uniform rates for their members. The ALJ found no evidence that the collective setting of title insurance rates through rating bureaus is a way of pooling risk information. Indeed, he found no evidence that any title insurer sets rates according to actuarial loss experience. Instead, the ALJ found that the usual practice is for rating bureaus to set rates according to profitability studies that focus on the costs of conducting searches and examinations. Uniform rates are set notwithstanding differences in efficiencies and costs among individual members.

The ALJ described the regulatory regimes for title insurance rates in the four States still at issue. In each one, the title insurance rating bureau was licensed by the State and authorized to establish joint rates for its members. Each of the four States used what has come to be called a "negative option" system to approve rate filings by the bureaus. Under a negative option system, the rating bureau filed rates for title searches and title examinations with the state insurance office. The rates became effective unless the State rejected them within a specified period, such as 30 days. Although the negative option system provided a theoretical mechanism for substantive review, the ALJ determined, after making detailed findings regarding the operation of each regulatory regime, that the rate filings were subject to minimal scrutiny by state regulators.

In Connecticut the State Insurance Department has the authority to audit the rating bureau and hold hearings regarding rates, but it has not done so. The Connecticut rating bureau filed only two major rate increases, in 1966 and in 1981. The circumstances behind the 1966 rate increase are somewhat obscure. The ALJ found that the Insurance Department asked the rating bureau to submit additional information justifying the increase, and later approved the rate increase although there is no evidence the additional information was provided. In 1981 the Connecticut rating bureau filed for a 20 percent rate increase. The factual background for this rate increase is better developed though the testimony was somewhat inconsistent. A state insurance official testified that he reviewed the rate increase with care and discussed various components of the increase with the rating bureau. The same official testified, however, that he lacked the authority to question certain expense data he considered quite high.

In Wisconsin the State Insurance Commissioner is required to examine the rating bureau at regular intervals and authorized to reject rates through a process of hearings. Neither has been done. The Wisconsin rating bureau made major rate filings in 1971, 1981, and 1982. The 1971 rate filing was approved in 1971 although supporting justification, which had been requested by the State Insurance Commissioner, was not provided until 1978. The 1981 rate filing requested an 11 percent rate increase. The increase was approved after the office of the Insurance Commissioner checked the supporting data for accuracy. No one in the agency inquired into insurer expenses, though an official testified that substantive scrutiny would not be possible without that inquiry. The 1982 rate increase received but a cursory reading at the office of the Insurance Commissioner. The supporting materials were not checked for accuracy, though in the absence of an objection by the agency, the rate increase went into effect.

In Arizona the Insurance Director was required to examine the rating bureau at least once every five years. It was not done. In 1980 the State Insurance Department announced a comprehensive investigation of the rating bureau. It was not conducted. The rating bureau spent most of its time justifying its escrow rates. Following settlement in 1981 of a federal civil suit challenging the joint fixing of escrow rates, the rating bureau went out of business without having made any major rate filings, though it had proposed minor rate adjustments.

In Montana the rating bureau made its only major rate filing in 1983. In connection with it, a representative of the rating bureau met with officials of the State Insurance Department. He was told that the filed rates could go into immediate effect though further profit data would have to be provided. The ALJ found no evidence that the additional data were furnished.

To complete the background, the ALJ observed that none of the rating bureaus are now active. The respondents abandoned them between 1981 and 1985 in response to numerous private treble damage suits, so by the time the Commission filed its formal complaint in 1985, the rating bureaus had been dismantled. The ALJ held that the case is not moot, though, because nothing would preclude respondents from resuming the conduct challenged by the Commission. See *United States* v. *W. T. Grant Co.*, 345 U. S. 629, 632-633 (1953).

These factual determinations established, the ALJ addressed the two-part test that must be satisfied for state-action immunity under the antitrust laws, the test we set out in *California Retail Liquor Dealers Assn. v. Midcal Aluminum, Inc.*, 445 U. S. 97 (1980). A state law or regulatory scheme cannot be the basis for antitrust immunity unless, first, the State has articulated a clear and affirmative policy to allow the anticompetitive conduct, and second, the State provides active supervision of anticompetitive conduct undertaken by private actors. *Id.*, at 105. The Commission having conceded that the first part of the test was satisfied in the four States still at issue, the immunity question, beginning with the hearings before the ALJ and in all later proceedings, has turned upon the proper interpretation and application of *Midcal's* active supervision requirement. The ALJ found the active supervision test was met in Arizona and Montana but not in Connecticut or Wisconsin.

On review of the ALJ's decision, the Commission held that none of the four states had conducted sufficient supervision, so that the title companies were not entitled to immunity in any of those jurisdictions. The Court of Appeals for the Third Circuit disagreed with the Commission, adopting the approach of the First Circuit in *New England Motor Rate Bureau, Inc., v. FTC*, 908 F. 2d 1064 (1990), which had held that the existence of a state regulatory program, if staffed, funded, and empowered by law, satisfied the requirement of active supervision. *Id.*, at 1071. Under this standard, the Court of Appeals for the Third Circuit ruled that the active state supervision requirement was met in all four states and held that the respondents' conduct was entitled to state action immunity in each of them.

We granted certiorari to consider two questions: First, whether the Third Circuit was correct in its statement of the law and in its application of law to fact, and second, whether the Third Circuit exceeded its authority by departing from the factual findings entered by the ALJ and adopted by the Commission. Before this Court, the parties have confined their briefing on the first of these questions to the regulatory regimes of Wisconsin and Montana, and focused on the regulatory regimes of Connecticut and Arizona in briefing on the second question. We now reverse the Court of Appeals under the first question and remand for further proceedings under the second.

II

The preservation of the free market and of a system of free enterprise without price fixing or cartels is essential to economic freedom. *United States v. Topco Associates, Inc.*, 405 U. S. 596, 610 (1972). A national policy of such a pervasive and fundamental character is an essential part of the economic and legal system within which the separate States administer their own laws for the protection and advancement of their people. Continued enforcement of the national antitrust policy grants the States more freedom, not less, in deciding whether to subject discrete parts of the economy to additional regulations and controls. Against this background, in *Parker v. Brown*, 317 U. S. 341 (1943), we upheld a state-supervised market sharing scheme against a Sherman Act challenge. We announced the doctrine that federal antitrust laws are subject to supersession by state regulatory programs. Our decision was grounded in principles of federalism. *Id.*, at 350–352.

The principle of freedom of action for the States, adopted to foster and preserve the federal system, explains the later evolution and application of the *Parker* doctrine in our decisions in *Midcal, supra*, and *Patrick v. Burget*, 486 U. S. 94 (1988). In *Midcal* we invalidated a California statute forbidding licensees in the wine trade from selling below prices set by the producer. There we announced the two-part test applicable to instances where private parties participate in a price fixing regime. "First, the challenged restraint must be one clearly articulated and affirmatively expressed as state policy; second, the policy must be actively supervised by the State itself." *Midcal*, 445 U. S., at 105 (internal quotation marks omitted). *Midcal* confirms that while a State may not confer antitrust immunity on private persons by fiat, it may displace competition with active state supervision if the displacement is both intended by the State and implemented in its specific details. Actual state involvement, not deference to private price fixing arrangements under the general auspices of state law, is the precondition for immunity from federal law. Immunity is conferred out of respect for ongoing regulation by the State, not out of respect for the economics of price restraint. In *Midcal* we found that the intent to restrain prices was expressed with sufficient precision so that the first part of the test was met, but that the absence of state participation in the mechanics of the price posting was so apparent that the requirement of active supervision had not been met. *Ibid.*

The rationale was further elaborated in *Patrick v. Burget*. In *Patrick* it had been alleged that private physicians participated in the State's peer review system in order to injure or destroy competition by denying hospital privileges to a physician who had begun a competing clinic. We referred to the purpose of preserving the State's own administrative policies, as distinct from allowing private parties to foreclose competition, in the following passage:

> "The active supervision requirement stems from the recognition that where a private party is engaging in the anticompetitive activity, there is a real danger that he is acting to further his own interests, rather than the governmental interests of the State. . . . The requirement is designed to ensure that the state-action doctrine will shelter only the particular anticompetitive acts of private parties that, in the judgment of the State, actually further state regulatory policies. To accomplish this purpose, the active supervision requirement mandates that the State exercise ultimate control over the challenged anticompetitive conduct. . . . The mere presence of some state involvement or monitoring does not suffice. . . . The active supervision prong of the *Midcal* test requires that state officials have and exercise power to review particular anticompetitive acts of private parties and disapprove those that fail to accord with state policy. Absent such a program of supervision, there is no realistic assurance that a private party's anticompetitive conduct promotes state policy, rather than merely the party's individual interests." 486 U. S., at 100–101 (internal quotation marks and citations omitted).

Because the particular anticompetitive conduct at issue in *Patrick* had not been supervised by governmental actors, we decided that the actions of the peer review committee were not entitled to state-action immunity. *Id.*, at 106.

Our decisions make clear that the purpose of the active supervision inquiry is not to determine whether the State has met some normative standard, such as efficiency, in its regulatory practices. Its purpose is to determine whether the State has exercised sufficient independent judgment and control so that the details of the rates or prices have been established as a product of deliberate state intervention, not simply by agreement among private parties. Much

as in causation inquiries, the analysis asks whether the State has played a substantial role in determining the specifics of the economic policy. The question is not how well state regulation works but whether the anticompetitive scheme is the State's own.

Although the point bears but brief mention, we observe that our prior cases considered state-action immunity against actions brought under the Sherman Act, and this case arises under the Federal Trade Commission Act. The Commission has argued at other times that state-action immunity does not apply to Commission action under §5 of the Federal Trade Commission Act, 15 U. S. C. §45. See U. S. Bureau of Consumer Protection, Staff Report to the Federal Trade Commission on Prescription Drug Price Disclosures, Chs. VI (B) and (C) (1975); see also Note, The State Action Exemption and Antitrust Enforcement under the Federal Trade Commission Act, 89 Harv. L. Rev. 715 (1976). A leading treatise has expressed its skepticism of this view. See 1 P. Areeda & D. Turner, Antitrust Law ¶218 (1978). We need not determine whether the antitrust statutes can be distinguished on this basis, because the Commission does not assert any superior pre-emption authority in the instant matter. We apply our prior cases to the one before us.

The respondents contend that principles of federalism justify a broad interpretation of state-action immunity, but there is a powerful refutation of their viewpoint in the briefs that were filed in this case. The State of Wisconsin, joined by Montana and 34 other States, has filed a brief as *amici curiae* on the precise point. These States deny that respondents' broad immunity rule would serve the States' best interests. We are in agreement with the amici submission.

If the States must act in the shadow of state-action immunity whenever they enter the realm of economic regulation, then our doctrine will impede their freedom of action, not advance it. The fact of the matter is that the States regulate their economies in many ways not inconsistent with the antitrust laws. For example, Oregon may provide for peer review by its physicians without approving anticompetitive conduct by them. See *Patrick, supra,* at 105. Or Michigan may regulate its public utilities without authorizing monopolization in the market for electric light bulbs. See *Cantor* v. *Detroit Edison Co.*, 428 U. S. 579, 596 (1976). So we have held that state-action immunity is disfavored, much as are repeals by implication. *Lafayette* v. *Louisiana Power & Light Co.*, 435 U. S. 389, 398–399 (1978). By adhering in most cases to fundamental and accepted assumptions about the benefits of competition within the framework of the antitrust laws, we increase the States' regulatory flexibility.

States must accept political responsibility for actions they intend to undertake. It is quite a different matter, however, for federal law to compel a result that the States do not intend but for which they are held to account. Federalism serves to assign political responsibility, not to obscure it. Neither federalism nor political responsibility is well served by a rule that essential national policies are displaced by state regulations intended to achieve more limited ends. For States which do choose to displace the free market with regulation, our insistence on real compliance with both parts of the *Midcal* test will serve to make clear that the State is responsible for the price fixing it has sanctioned and undertaken to control.

The respondents contend that these concerns are better addressed by the requirement that the States articulate a clear policy to displace the antitrust laws with their own forms of economic regulation. This contention misapprehends the close relation between *Midcal's* two elements. Both are directed at ensuring that particular anticompetitive mechanisms operate because of a deliberate and intended state policy. See *Patrick, supra,* at 100. In the usual case, *Midcal's* requirement that the State articulate a clear policy shows little more than that the State has not acted through inadvertence; it cannot alone ensure, as required by our precedents, that particular anticompetitive conduct has been approved by the State. It seems plain, moreover, in light of the *amici curiae* brief to which we have referred, that sole reliance on the requirement of clear articulation will not allow the regulatory flexibility that these States deem necessary. For States whose object it is to benefit their citizens through regulation, a broad doctrine of state-action immunity may serve as nothing more than an attractive nuisance in the economic sphere. To oppose these pressures, sole reliance on the requirement of clear articulation could become a rather meaningless formal constraint.

III

In the case before us, the Court of Appeals relied upon a formulation of the active supervision requirement articulated by the First Circuit:

> "'Where . . . the state's program is in place, is staffed and funded, grants to the state officials ample power and the duty to regulate pursuant to declared standards of state policy, is enforceable in the state's courts, and demonstrates some basic level of activity directed towards seeing that the private actors carry out the state's policy and not simply their own policy, more need not be established.'" 922 F. 2d, at 1136, quoting *New England Motor Rate Bureau, Inc.* v. *FTC*, 908 F. 2d 1064, 1071 (CA1 1990).

Based on this standard, the Third Circuit ruled that the active supervision requirement was met in all four states, and held that the respondents' conduct was entitled to state-action immunity from antitrust liability. 922 F. 2d, at 1140.

While in theory the standard articulated by the First Circuit might be applied in a manner consistent with our precedents, it seems to us insufficient to establish the requisite level of active supervision. The criteria set forth by the First Circuit may have some relevance as the beginning point of the active state supervision inquiry, but the analysis cannot end there. Where prices or rates are set as an initial matter by private parties, subject only to a veto if the State chooses to exercise it, the party claiming the immunity must show that state officials have undertaken the necessary steps to determine the specifics of the price-fixing or ratesetting scheme. The mere potential for state supervision is not an adequate substitute for a decision by the State. Under these standards, we must conclude that there was no active supervision in either Wisconsin or Montana.

The respondents point out that in Wisconsin and Montana the rating bureaus filed rates with state agencies and that in both States the so-called negative option rule prevailed. The rates became effective unless they were rejected within a set time. It is said that as a matter of law in these States inaction signified substantive approval. This proposition cannot be reconciled, however, with the detailed findings, entered by the ALJ and adopted by the Commission, which demonstrate that the potential for state supervision was not realized in fact. The ALJ found, and

the Commission agreed, that at most the rate filings were checked for mathematical accuracy. Some were unchecked altogether. In Montana, a rate filing became effective despite the failure of the rating bureau to provide additional requested information. In Wisconsin, additional information was provided after a lapse of seven years, during which time the rate filing remained in effect. These findings are fatal to respondents' attempts to portray the state regulatory regimes as providing the necessary component of active supervision. The findings demonstrate that, whatever the potential for state regulatory review in Wisconsin and Montana, active state supervision did not occur. In the absence of active supervision in fact, there can be no state-action immunity for what were otherwise private price fixing arrangements. And as in *Patrick*, the availability of state judicial review could not fill the void. Because of the state agencies' limited role and participation, state judicial review was likewise limited. See *Patrick*, 486 U. S., at 103–105.

Our decision in *Southern Motor Carriers Rate Conference, Inc.* v. *United States*, 471 U. S. 48 (1985), though it too involved a negative option regime, is not to the contrary. The question there was whether the first part of the *Midcal* test was met, the Government's contention being that a pricing policy is not an articulated one unless the practice is compelled. We rejected that assertion and undertook no real examination of the active supervision aspect of the case, for the Government conceded that the second part of the test had been met. *Id.*, at 62, 66. The concession was against the background of a district court determination that, although submitted rates could go into effect without further state activity, the State had ordered and held rate-making hearings on a consistent basis, using the industry submissions as the beginning point. See *United States* v. *Southern Motor Carriers Rate Conference, Inc.*, 467 F. Supp. 471, 476–477 (ND Ga. 1979). In the case before us, of course, the Government concedes the first part of the *Midcal* requirement and litigates the second; and there is no finding of substantial state participation in the rate setting scheme.

This case involves horizontal price fixing under a vague imprimatur in form and agency inaction in fact. No antitrust offense is more pernicious than price fixing. *FTC* v. *Superior Court Trial Lawyers Assn.*, 493 U. S. 411, 434, n. 16 (1990). In this context, we decline to formulate a rule that would lead to a finding of active state supervision where in fact there was none. Our decision should be read in light of the gravity of the antitrust offense, the involvement of private actors throughout, and the clear absence of state supervision. We do not imply that some particular form of state or local regulation is required to achieve ends other than the establishment of uniform prices. Cf. *Columbia* v. *Omni Outdoor Advertising, Inc.*, 499 U. S. ___ (1991) (city billboard zoning ordinance entitled to state-action immunity). We do not have before us a case in which governmental actors made unilateral decisions without participation by private actors. Cf. *Fisher* v. *Berkeley*, 475 U. S. 260 (1986) (private actors not liable without private action). And we do not here call into question a regulatory regime in which sampling techniques or a specified rate of return allow state regulators to provide comprehensive supervision without complete control, or in which there was an infrequent lapse of state supervision. Cf. *324 Liquor Corp.* v. *Duffy*, 479 U. S. 335, 344, n. 6 (1987) (a statute specifying the margin between wholesale and retail prices may satisfy the active supervision requirement). In the circumstances of this case, however, we conclude that the acts of the respondents in the States of Montana and Wisconsin are not immune from antitrust liability.

IV

In granting certiorari we undertook to review the further contention by the Commission that the Court of Appeals was incorrect in disregarding the Commission's findings as to the extent of state supervision. The parties have focused their briefing on this question on the regulatory schemes of Connecticut and Arizona. We think the Court of Appeals should have the opportunity to reexamine its determinations with respect to these latter two States in light of the views we have expressed.

The judgment of the Court of Appeals is reversed and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

JUSTICE SCALIA, concurring.

The Court's standard is in my view faithful to what our cases have said about "active supervision." On the other hand, I think THE CHIEF JUSTICE and JUSTICE O'CONNOR are correct that this standard will be a fertile source of uncertainty and (hence) litigation, and will produce total abandonment of some state programs because private individuals will not take the chance of participating in them. That is true, moreover, not just in the "negative-option" context, but even in a context such as that involved in *Patrick* v. *Burget*, 486 U. S. 94 (1988): Private physicians invited to participate in a state-supervised hospital peer review system may not know until after their participation has occurred (and indeed until after their trial has been completed) whether the State's supervision will be "active" enough.

I am willing to accept these consequences because I see no alternative within the constraints of our "active supervision" doctrine, which has not been challenged here, and because I am skeptical about the *Parker* v. *Brown* exemption for state-programmed private collusion in the first place.

CHIEF JUSTICE REHNQUIST, with whom JUSTICE O'CONNOR and JUSTICE THOMAS join, dissenting.

The Court holds today that to satisfy the "active supervision" requirement of state action immunity from antitrust liability, private parties acting pursuant to a regulatory scheme enacted by a state legislature must prove that "the State has played a substantial role in determining the specifics of the economic policy." *Ante*, at 11. Because this standard is neither supported by our prior precedent, nor sound as a matter of policy, I dissent.

Immunity from antitrust liability under the state action doctrine was first established in *Parker* v. *Brown*, 317 U. S. 341 (1943). As noted by the majority, in *Parker* we relied on principles of federalism in concluding that the Sherman Act did not apply to state officials administering a regulatory program enacted by the state legislature. We concluded that state action is exempt from antitrust liability, because in the Sherman Act Congress evidences no intent to "restrain state action or official action directed by a state." *Id.*, at 351.[1] "The *Parker* decision was premised on the

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[1] The Court states that "[v]igorous enforcement of the national antitrust policy grants the States more freedom, not less, in deciding

assumption that Congress, in enacting the Sherman Act, did not intend to compromise the States' ability to regulate their domestic commerce." *Southern Motor Carriers Rate Conference, Inc.* v. *United States*, 471 U. S. 48, 56 (1985) (footnote omitted).

We developed our present analysis for state action immunity for private actors in *California Retail Liquor Dealers Assn.* v. *Midcal Aluminum, Inc.*, 445 U. S. 97 (1980). We held in *Midcal* that our prior precedent had granted state-action immunity from antitrust liability to conduct by private actors where a program was "clearly articulated and affirmatively expressed as state policy [and] the policy [was] actively supervised by the State itself." *Id.*, at 105 (internal quotation marks and citation omitted). In *Midcal*, we found the active supervision requirement was not met because under the California statute at issue, which required liquor retailers to charge a certain percentage above a price "posted" by area wholesalers, "[t]he State has no direct control over wine prices, and it does not review the reasonableness of the prices set by wine dealers." *Id.*, at 100. We noted that the state action defense does not allow the States to authorize what is nothing more than private price fixing. *Id.*, at 105.

In each instance since *Midcal* in which we have concluded that the active supervision requirement for state action immunity was not met, the state regulators lacked authority, under state law, to review or reject the rates or action taken by the private actors facing antitrust liability.[1] Our most recent formulation of the "active supervision" requirement was announced in *Patrick* v. *Burget*, 486 U. S. 94 (1988), where we concluded that to satisfy the "active supervision" requirement, "state officials [must] have and exercise power to review particular anticompetitive acts of private parties and disapprove those that fail to accord with state policy." *Id.*, at 101. Until today, therefore, we have never had occasion to determine whether a state regulatory program which gave state officials authority—"power"—to review and regulate prices or conduct, might still fail to meet the requirement for active state supervision because the state's regulation was not sufficiently detailed or rigorous.

Addressing this question, the Court of Appeals in this case used the following analysis:

> "Where, as here, the state's program is in place, is staffed and funded, grants to the state officials ample power and the duty to regulate pursuant to declared standards of state policy, is enforceable in the state's courts, and demonstrates some basic level of activity directed towards seeing that the private actors carry out the state's policy and not simply their own policy, more need not be established." 922 F. 2d 1122, 1136 (CA3 1991), quoting *New England Motor Rate Bureau, Inc.* v. *FTC*, 908 F. 2d 1064, 1071 (CA1 1990).

The Court likens this test to doing away all together with the active supervision requirement for immunity based on state action. But the test used by the Court of Appeals is much more closely attuned to our "have and exercise power" formulation in *Patrick* v. *Burget* than is the rule adopted by the Court today. The Court simply doesn't say just how active a State's regulators must be before the "active supervision" requirement will be satisfied. The only guidance it gives is that the inquiry should be one akin to causation in a negligence case; does the State play "a substantial role in determining the specifics of the economic policy." *Ante*, at 11. Any other formulation, we are told, will remove the active supervision requirement all together as a practical matter.

I do not believe this to be the case.[3] In the States at issue here, the particular conduct was approved by a state agency. The agency manifested this approval by raising no objection to a required rate filing by the entity subject to regulation. This is quite consistent with our statement that the active supervision requirement serves mainly an "evidentiary function" as "one way of ensuring that the actor is engaging in the challenged conduct pursuant to state policy. . . ." *Hallie* v. *Eau Claire*, 471 U. S. 34, 46 (1985).

The Court insists that its newly required "active supervision" will "increase the States' regulatory flexibility." *Ante*, at 12. But if private actors who participate through a joint rate filing in a State's "negative option" regulatory scheme may be liable for treble damages if they cannot prove that the State approved the specifics of a filing, the Court makes it highly unlikely that private actors will choose to participate in such a joint filing. This in turn *lessens* the States' regulatory flexibility, because as we have noted before, joint rate filings can improve the regulatory process by ensuring that the state agency has fewer filings to consider, allowing more resources to be expended on each filing. *Southern Motor Carriers Rate Conference, Inc.* v. *United States*, *supra*, at 51. The view advanced by the Court of Appeals does not sanction price fixing in areas regulated by a State "not inconsistent with the antitrust laws." *Ante*, at 11. A State must establish, staff, and fund a program to approve jointly set rates or prices in order for any activity undertaken by private individuals under that program to be immune under the antitrust laws.[2]

The Court rejects the test adopted by the Court of Appeals, stating that it cannot be the end of the inquiry. Instead, the party seeking immunity must "show that state officials have undertaken the necessary steps to determine the specifics of the price-fixing or ratesetting scheme." *Ante*, at 14.[4] Such an inquiry necessarily puts the federal

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whether to subject discrete parts of the economy to additional regulations and controls." *Ante*, at 8. However, in *Parker*, we held that the Sherman Act simply does not apply to conduct regulated by the State. The enforcement of the national antitrust policy, as embodied in the antitrust laws, may grant individuals more freedom to compete in our free market system, but it does not impair the freedom of the States in deciding whether to regulate.

[1] In *324 Liquor Corp.* v. *Duffy*, 479 U. S. 335 (1987), we held that a New York statute failed to shelter private actors from antitrust liability because the state legislation required retailers to charge 112% of the price "posted" by wholesalers. The New York statute, like the California statute at issue in *Midcal*, gave no power to the state agency to review or establish the reasonableness of the price schedules "posted" by the wholesalers. *Id.*, at 345.

[2] The state regulatory programs in *California Retail Liquor Dealers Assn.* v. *Midcal Aluminum, Inc.*, 445 U. S. 97 (1980), *Patrick* v. *Burget*, 486 U. S. 94 (1988), and *324 Liquor*, *supra*, would all fail to provide immunity for lack of active supervision under the test adopted by the Court of Appeals.

[3] In neither of the examples cited by the majority as instances of state regulation not intended to authorize anticompetitive conduct, would application of a less detailed active supervision test change the result. In *Patrick* v. *Burget*, *supra*, we concluded there was no immunity because the State did not have the authority to review the anticompetitive action undertaken by the peer review committee; in *Cantor* v. *Detroit Edison Co.*, 428 U. S. 579 (1976), it is unlikely that the clear articulation requirement under our current jurisprudence would be met with respect to the market for light bulbs.

[4] It is not clear, from the Court's formulation, whether this is a separate test applicable only to negative option regulatory schemes, or whether it applies more generally to issues of immunity under the state action doctrine.

court in the position of determining the efficacy of a particular State's regulatory scheme, in order to determine whether the State has met the "requisite level of active supervision." *Ante*, at 13. The Court maintains that the proper state action inquiry does not determine whether a State has met some "normative standard" in its regulatory practices. *Ante*, at 10. But the Court's focus on the actions taken by state regulators, *i.e.*, the way the State regulates, necessarily requires a judgment as to whether the State is sufficiently active—surely a normative judgment.

The Court of Appeals found—properly, in my view—that while the States at issue here did not regulate respondents' rates with the vigor the petitioner would like, the States' supervision of respondents' conduct was active enough so as to provide for immunity from antitrust liability. The Court of Appeals, having concluded that the Commission applied an incorrect legal standard, reviewed the facts found by the Commission in light of the correct standard and reached a different conclusion. This does not constitute a rejection of the Commission's factual findings.

I would therefore affirm the judgment below.

JUSTICE O'CONNOR, with whom JUSTICE THOMAS joins, dissenting.

Notwithstanding its assertions to the contrary, the Court has diminished the States' regulatory flexibility by creating an impossible situation for those subject to state regulation. Even when a State has a "clearly articulated policy" authorizing anticompetitive behavior—which the Federal Trade Commission concedes was the case here—and even when the State establishes a system to supervise the implementation of that policy, the majority holds that a federal court may later find that the State's supervision was not sufficiently "substantial" in its "specifics" to insulate the anticompetitive behavior from antitrust liability. *Ante*, at 11. Given the threat of treble damages, regulated entities that have the option of heeding the State's anticompetitive policy would be foolhardy to do so; those that are compelled to comply are less fortunate. The practical effect of today's decision will likely be to eliminate so-called "negative option" regulation from the universe of schemes available to a State that seeks to regulate without exposing certain conduct to federal antitrust liability.

The Court does not dispute that each of the States at issue in this case *could have* supervised respondents' joint ratemaking; rather, it argues that "the potential for state supervision was not realized in fact." *Ante*, at 14. Such an after-the-fact evaluation of a State's exercise of its supervisory powers is extremely unfair to regulated parties. Liability under the antitrust laws should not turn on how enthusiastically a state official carried out his or her statutory duties. The regulated entity has no control over the regulator, and very likely will have no idea as to the degree of scrutiny that its filings may receive. Thus, a party could engage in exactly the same conduct in two States, each of which had exactly the same policy of allowing anticompetitive behavior and exactly the same regulatory structure, and discover afterward that its actions in one State were immune from antitrust prosecution, but that its actions in the other resulted in treble-damage liability.

Moreover, even if a regulated entity could assure itself that the State will undertake to actively supervise its rate filings, the majority does not offer any guidance as to what level of supervision will suffice. It declares only that the State must "pla[y] a substantial role in determining the specifics of the economic policy." *Ante*, at 11. That standard is not only ambiguous, but it also runs the risk of being counterproductive. The more reasonable a filed rate, the less likely that a State will have to play any role other than simply reviewing the rate for compliance with statutory criteria. Such a vague and retrospective standard, combined with the threat of treble damages if that standard is not satisfied, makes "negative option" regulation an unattractive option for both States and the parties they regulate.

Finally, it is important to remember that antitrust actions can be brought by private parties as well as by government prosecutors. The resources of state regulators are strained enough without adding the extra burden of asking them to serve as witnesses in civil litigation and respond to allegations that they did not do their job.

For these reasons, as well as those given by THE CHIEF JUSTICE, I dissent.

LAWRENCE G. WALLACE, Deputy Solicitor General (KENNETH W. STARR, Sol. Gen., JAMES F. RILL, Asst. Atty. Gen., ROBERT A. LONG JR., Asst. to Sol. Gen., JAMES M. SPEARS, FTC Gen. Coun., JAY C. SHAFFER, Dep. Gen. Coun., ERNEST J. ISENSTADT, Asst. Gen. Coun., and LESLIE RICE MELMAN, MICHAEL E. ANTALICS, and ANN MALESTER, FTC attys., on the briefs) for petitioner; JOHN C. CHRISTIE JR., Washington, D.C. (JOHN F. GRAYBEAL, ROBERT H. TILLER, PARKER, POE, ADAMS & BERNSTEIN, DAVID M. FOSTER, MICHAEL P. GOGGIN, FULBRIGHT & JAWORSKI, PATRICK J. ROACH, and BELL, BOYD & LLOYD, on the briefs) for respondents.

Audit Report

DEPARTMENT OF COMMERCE AND
ECONOMIC DEVELOPMENT
DIVISION OF INSURANCE, SELECTED
TITLE INSURANCE RATE ISSUES

December 18, 1995

Audit Control Number:

08-4521-96

Division of Legislative Audit

P.O. Box 113300, Juneau, Alaska 99811-3300

LEGISLATIVE BUDGET AND AUDIT COMMITTEE

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December 18, 1995

Members of the Legislative Budget
and Audit Committee:

In accordance with the provisions of Title 24 of the Alaska Statutes, the attached report is submitted for your review.

DEPARTMENT OF COMMERCE AND ECONOMIC DEVELOPMENT
DIVISION OF INSURANCE SELECTED TITLE INSURANCE RATE ISSUES

December 18, 1995

Audit Control Number

08-4521-96

As stated in the Objectives, Scope, and Methodology section of this report we reviewed, among other things, the procedures and process in how title insurance rates are established. In addition, we looked at alternative systems of title assurance employed by other states. Specifically, information was obtained on the Iowa title guaranty program and the Torrens land-registration system as administered by Massachusetts.

We recommend that the Division of Insurance (DOI) develop procedures, criteria and an acceptable methodology to assess whether title insurance rates are excessive or inadequate. Since agency commissions represent the most significant cost for title insurance underwriters, this review mechanism should include an analysis of financial data on the operations of insurance agencies. We recommend that DOI seek statutory revisions, if necessary, to accomplish its legislative mandate.

The audit was conducted in accordance with generally accepted government auditing standards. Fieldwork procedures utilized in the course of developing the findings and discussion presented in this report are discussed in the Objectives, Scope, and Methodology section of this report.

Randy S. Welker, CPA
Legislative Auditor

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OBJECTIVES, SCOPE, AND METHODOLOGY

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we conducted an audit of the Division of Insurance (DOI). The Legislative Budget and Audit Committee expressed a concern regarding the appropriateness of title insurance rates in Alaska and requested that we review, among other things, the procedures and process of how these rates are established. In addition, we looked at alternative systems of title assurance employed by other states. Specifically, information was obtained on the Iowa title guaranty program and the Torrens land-registration system as administered by the State of Massachusetts.

Scope and Methodology

During the course of our examination, we reviewed and evaluated the following:

1. DOI's compliance with statutes and regulations pertaining to title insurance rates.
2. Various DOI files, in particular, rate and financial statement information filed with DOI.
3. Market conduct examination reports prepared by DOI personnel.
4. Annual reports issued by DOI.
5. Fall, 1993 *Journal of Insurance Regulation* published by the National Association of Insurance Commissioners.
6. *The Regulatory Economics of Title Insurance* by Nelson R. Lipshutz, 1994.
7. Materials provided by and discussions with Iowa Financing Authority, Title Guaranty Division personnel.
8. *Torrens in the United States A Legal and Economic History and Analysis of American Land-Registration Systems* by Blair C. Shick and Irving H. Plotkin, 1978.
9. Materials provided by and discussions with Massachusetts Land Court personnel.
10. Materials provided by and discussions with personnel of other states regarding their regulation of title insurance.

We also conducted interviews with personnel of DOI and the Department of Law.

ORGANIZATION AND FUNCTION

The Division of Insurance (DOI) is within the Department of Commerce and Economic Development. The director of the division is responsible for the enforcement of the provisions contained within Alaska Statutes Title 21.

According to DOI's annual report for FY 95, the division contains seven sections: actuarial, administrative, consumer services, financial examination, law and enforcement, licensing, and market surveillance. This report obtained information largely from four sections: actuarial, administrative, financial examination, and market surveillance.

Actuarial Section

The primary responsibility of this section involves monitoring rates charged by insurers to ensure that they are not inadequate, excessive, or unfairly discriminatory. This section reviews companies' proposed rate changes before they are implemented. This function has historically been performed by the market surveillance section personnel.

Administrative Section

This section provides support services to the division.

Financial Examination Section

This section performs desk reviews of financial statements filed with the division. In addition, they perform financial examinations of the insurers domiciled in Alaska. This section is responsible for determining the financial condition of insurance companies.

Market Surveillance Section

This section's primary duty is to monitor policy forms established by insurers. This section is also responsible for establishing, monitoring, and enforcing standards of conduct for the insurance industry. Historically, personnel from this section have performed reviews of insurance companies' proposed rate changes to ensure that the rates are not inadequate, excessive, or unfairly discriminatory.

CORRECTION

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OBJECTIVES, SCOPE, AND METHODOLOGY

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we conducted an audit of the Division of Insurance (DOI). The Legislative Budget and Audit Committee expressed a concern regarding the appropriateness of title insurance rates in Alaska and requested that we review, among other things, the procedures and process of how these rates are established. In addition, we looked at alternative systems of title assurance employed by other states. Specifically, information was obtained on the Iowa title guaranty program and the Torrens land-registration system as administered by the State of Massachusetts.

Scope and Methodology

During the course of our examination, we reviewed and evaluated the following:

1. DOI's compliance with statutes and regulations pertaining to title insurance rates.
2. Various DOI files, in particular, rate and financial statement information filed with DOI.
3. Market conduct examination reports prepared by DOI personnel.
4. Annual reports issued by DOI.
5. Fall, 1993 *Journal of Insurance Regulation* published by the National Association of Insurance Commissioners.
6. *The Regulatory Economics of Title Insurance* by Nelson R. Lipshutz, 1994.
7. Materials provided by and discussions with Iowa Financing Authority, Title Guaranty Division personnel.
8. *Torrens in the United States A Legal and Economic History and Analysis of American Land-Registration Systems* by Blair C. Shick and Irving H. Plotkin, 1978.
9. Materials provided by and discussions with Massachusetts Land Court personnel.
10. Materials provided by and discussions with personnel of other states regarding their regulation of title insurance.

We also conducted interviews with personnel of DOI and the Department of Law.

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ORGANIZATION AND FUNCTION

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BACKGROUND INFORMATION

The Division of Insurance (DOI) is responsible for regulating the title insurance industry in Alaska. Alaska Statute 21.66.360 provides that the purpose of title insurance rate regulation "*. . . is to promote the public welfare by regulating title insurance rates so that they are not excessive, inadequate, or unfairly discriminatory. . . .*" Establishing appropriate criteria for regulating insurance rates requires balancing two areas of competing interest. DOI needs to ensure that coverage is available to the consumer by regulating rates that are not excessive. At the same time they need to ensure that the guarantee provided by the insurance company has a solvent financial base. That is, to ensure that adequate premiums are established through regulation so current and future policy losses can be met.

Title insurance offers protection for policy losses resulting from various types of defects (as set out in the policy) which may exist in the title to a specific parcel of real property. In most types of insurance, the risk being insured is based upon the uncertainty of the future. Title insurance, however, insures against unknown past events that may have clouded the ownership and/or lender interests on a parcel of real property. Title insurers attempt to identify these risks and eliminate them from coverage. As a result, policy losses in title insurance should be less than in other insurance lines.

State law requires that a reasonable search and examination of the title of real property be conducted and that a determination of its insurability must be made before a policy of title insurance can be written. The primary source of information used by an insurer or its agent[1] in preparation of a policy in Alaska is the title plant. Companies are required to own and maintain a title plant consisting of adequate maps and indexed records showing all items of record affecting land within the recording district in which they are located. In Alaska, title plant records must include information for at least 25 years immediately preceding the date on which the title insurance policy is written.

The premium charge for a title insurance policy is generally a one time charge. The premium paid is mainly a fee for the expense of searching and analyzing recorded information so that a "chain of title" on a property can be completed. However, as a general rule, claims may be incurred against the policy at any time up to, and when, a new title insurance policy is written on the property.

State statutes require title insurance companies to file their rate schedules with DOI. Alaska Statute 21.66.410 provides that DOI may prescribe, by regulation, guidelines and data to be reported by all title insurance companies. Effective December 1994, 3 AAC 31.230 provided that a rate filing must include both national and Alaska-specific expense information, if available, and any other information requested to support the rate filing. This regulation applies to all types of insurance lines in Alaska. However, according to DOI personnel, national expense information is not relevant to title insurance. Agents may not charge a rate for title

[1] In this report, the use of the word agent is used interchangeably with title insurance limited producers.

insurance except in accordance with the rates that are in effect for the title insurance company they represent. For additional information regarding DOI's rate review procedures, see Auditor's Comments, Item Number 3.

Agents play a significant role in the title insurance industry. Alaska Statute 21.66.480(8) defines a title insurance limited producer as

> *. . . a person, firm, association . . . or other legal entity authorized in writing by a title insurance company to solicit title insurance, collect premiums, determine insurability in accordance with the underwriting rules and standards prescribed by the title insurance company that the licensee represents, and issue policies in its behalf . . . the term "title insurance limited producer" does not include officers and salaried employees of a title insurance company.*

Commissions paid to or retained by title insurance agents are more than a marketing expense or sales commission of the title insurance company. They are a subcontracting fee that compensates the agent, not merely for marketing, but also for underwriting and policy production. As a result, commissions are a significant cost of doing business. DOI personnel indicate that agents retain 88% to 90% of premiums written in Alaska although these percentages have not been audited or verified. The industry average appears to be 80%.[2]

Sixteen title insurance agencies maintain 28 offices in the State. They are affiliated with four title insurance companies.

[2] Source -- *The Regulatory Economics of Title Insurance* by Nelson R. Lipshutz, 1994.

REPORT CONCLUSIONS

The Division of Insurance (DOI) has not established a comprehensive methodology by which rates are reviewed to ensure that rates are not excessive or inadequate. In the last ten years, no documented evidence exists that DOI has been analyzing rates filed by insurers in terms of industry rates of return (see Recommendation No. 1).

DOI has not been receiving or analyzing underlying cost data from title insurance agents in Alaska. Since agency commissions represent the most significant cost for title insurance underwriters, DOI needs to develop regulatory procedures for reviewing agency operations in Alaska if it expects to attain its legal mandate of protecting the consumer (see Recommendation No. 2).

DOI has sporadically performed limited market conduct examinations of title insurance agencies to ensure that rates filed with the State by the insurer are being appropriately charged the consumer. These examinations have noted areas of noncompliance and in some cases, recommendations that re-examinations be performed within one year. No follow-up reviews have been performed within that time frame and some reviews have yet to be performed (see Recommenuation No. 3).

Alaska Statutes require title insurance companies to establish guaranty and reserve funds while doing business in Alaska for the protection of Alaska policyholders. DOI has expressed confusion regarding the interpretation of the statutory requirements concerning title insurance deposits (see Recommendation No. 4).

The traditional title insurance system that is based upon prior research and examination is the most prevalent method found in the United States. However, there are other alternatives to the generally accepted system. Two that we reviewed were the Torrens System and the Iowa System. Specifically, we looked at the attributes of the Torrens land-registration system and the Iowa title guaranty program. A summary of information pertaining to the Massachusetts Torrens system is in Appendix A. An overview of the Iowa program is in Auditor's Comments, Item Number 4.

It is the consensus of many in the title insurance industry that the original registration process of the Torrens System is expensive and time-consuming. Conversely, the greatest strength of the system is that it provides an undisputed right to the property by the registered owner.

The State of Iowa does not allow title insurance companies or agents to solicit the sale of title insurance in Iowa. A title guaranty certificate may be issued after a private attorney examines a certified abstract prepared by a private abstracter. The responsibility for this program rests with the Iowa Finance Authority (a public instrumentality of the State of Iowa), Title Guaranty Division. Estimated costs to consumers for abstract preparation and attorney title examination fees were not available. As a result, the cost-effectiveness of the program was not determinable.

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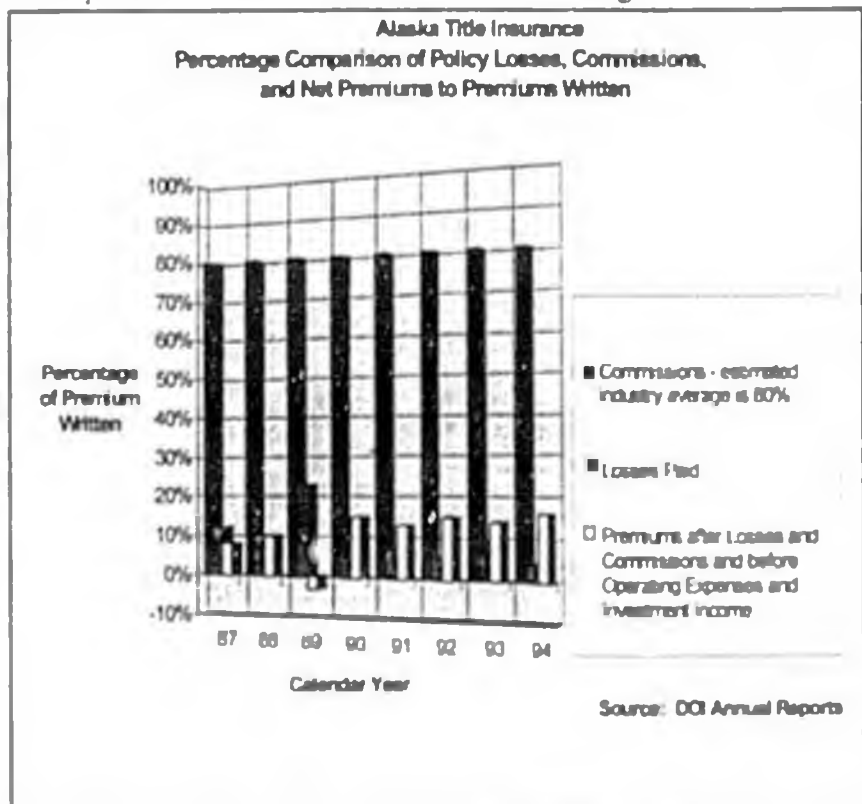
AUDITOR'S COMMENTS

1. **What is the amount of funds paid out in title insurance claims per year compared to premiums received?**

Title insurers are required by statute to file annual financial statements with the Division of Insurance (DOI). This annual statement information is reported on forms approved by the National Association of Insurance Commissioners. The premium income and loss information for each title insurance company admitted to do business in Alaska is incorporated by DOI into its annual report to the Alaska Legislature and the Department of Commerce and Economic Development commissioner. Selected annual statement information for Calendar Year 1994 and 1993 is on the next page.

The following chart juxtaposes the percentage of policy losses, commissions, and net premiums (subtracting the previous two items) to total premiums written. The chart is based upon information provided in the DOI annual reports, Calendar Year 1987 through 1994, for title business in Alaska. For purposes of this analysis we have used 80% of premiums written as the commission percentage.[3] Since agency commissions are the largest single item of expense incurred by title insurance companies, we feel without including an estimated agency commission expense, the requested information would be misleading.

As can be seen at right, policy losses paid in the last five years range from 4% to 7%[4] of total title business written in those years. Premium revenues after considering losses and agency commissions and before operating expenses, approximated 13% to 16% of total premiums written for the last five years. Investment income is not included on this chart since it is not available on a state-by-state basis.



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[3] Source -- *The Regulatory Economics of Title Insurance* by Nelson R. Lipshutz, 1994. DOI personnel indicate that, based upon their inquiries of two companies, the commission rate is 88% to 90%.

[4] The two largest companies, doing 97% of the title business in Alaska, paid zero to 3.5% in policy losses when compared to their premiums in the last five years.

1994 and 1993 Title Business in Alaska

1994 Title Insurance Business in the State of Alaska

Company	Alaska Direct Premiums Written	Alaska Direct Policy Losses Paid[5]	Policy Losses Paid as a % of Premiums Written[6]
Chicago Title Insurance Co.	$ 0	$ 206,519	-
Commonwealth Land Title Insurance Co.[7]	452,752	12,000	2.65%
Fidelity National Title Insurance Co.	0	0	n/a
First American Title Insurance Co.	9,041,398	247,670	2.74%
Land Title Insurance Co.[8]	7,718	20,041	259.67%
Lawyers Title Insurance Corp.	0	26,000	-
Nations Title Insurance Co. (admitted 1/95)	0	0	n/a
Old Republic National Title Insurance Co.	170,419	-4,590	-2.69%
Security Union Title Insurance Co.	0	-14,275	-
Stewart Title Guaranty Co.	9,920,199	66,784	.67%
Ticor Title Insurance Co.	0	140,643	-
Transamerica Title Insurance Co.	0	3,204	-
Totals	$19,592,486	$703,996	[illegible]

1993 Title Insurance Business in the State of Alaska

Company	Alaska Direct Premiums Written	Alaska Direct Policy Losses Paid	Policy Losses Paid as a % of Premiums Written
Chicago Title Insurance Co.	$ 0	$ 857,822	-
Commonwealth Land Title Insurance Co.	426,235	249,874	58.62%
Fidelity National Title Insurance Co.	0	0	n/a
First American Title Insurance Co.	10,299,476	77,301	.75%
Land Title Insurance Co.	301,179	-50,584	-16.80%
Lawyers Title Insurance Corp.	0	47,922	-
Nations Title Insurance Co. (admitted 1/95)	n/a	n/a	n/a
Old Republic National Title Insurance Co.	48,368	8,002	16.54%
Security Union Title Insurance Co.	0	60,903	-
Stewart Title Guaranty Co.	11,738,874	86,148	.73%
Ticor Title Insurance Co.	0	24,977	-
Transamerica Title Insurance Co.	0	66,145	-
Totals	$22,814,132	$1,428,510	6.26%

Source: Division of Insurance
Amounts presented are on a cash basis

[5] As noted previously, the premium charge for a title insurance policy is generally a one time charge. However, as a general rule, losses may be incurred against the policy at any time up to when a new title insurance policy is written on the property. Policy losses paid may be negative due to salvage values greater than policy losses paid.

[6] Some of the percentage relationships in this column are meaningless since some insurance companies are no longer active in the State but still responsible for losses on policies previously written.

[7] In late 1994, this company decided to cease doing business in Alaska due primarily to the remote location of the market place.

[8] In mid-1994, this company decided to cease doing business in Alaska.

2. **What are the costs of maintaining title plants compared to premiums received and the feasibility of maintaining multiple title plants given Alaska's population?**

Title Plant Costs

The cost of maintaining title plants in Alaska is not known by DOI. Early in October 1995, DOI requested agencies to provide income and expense information on their title insurance operations for the previous five years. As of mid-December, six of sixteen agencies have complied with the request. Certain title agencies have refused to submit information because they claim state statutes require only that insurance companies are required to justify the rates established. They believe the information requested goes beyond the financial information required by AS 21.66.280. Since AS 21.66.280(b)(3) addresses agency solvency standards, agents are of the opinion financial statement information regarding solvency is the only information they are required to furnish under the law. DOI has contacted the Department of Law (DOLaw) for advice regarding these arguments (see Recommendation No. 2).

Multiple Title Plants

Alaska Statute 21.66.200 requires insurance companies or their agents to maintain comparable title plants in each recording district in which they maintain an office. In an article written by DOI's chief of market surveillance in the Fall 1993 *Journal of Insurance Regulation*, it was recognized that a ". . . *systemic criticism of requiring a title plant is that the proliferation of title plants is expensive, duplicative, inefficient and acts as a barrier to the entry of new entities.*" Alaska Statute 21.66.240 allows title insurance companies to enter into agreements to participate in the use, ownership, management, and control of a title plant to service the needs of the companies. This is subject to the director's approval as provided for in AS 21.66.210 which allows for joint title plants where two or more agents, title insurance companies, or a combination of the two may own and operate a single title plant. According to DOI personnel, there is one joint title plant in Alaska which is operated in the Anchorage area. From a practical point of view, competing agencies may not desire to share in the creation, ownership, and management of this valuable asset

3. What are the rate setting procedures followed by DOI? How frequently are rate filings audited, and have the audits resulted in reductions of rates? Are negotiated rates prohibited by statute or DOI policies?

Rate Setting and Review Procedures

Insurance companies are responsible for filing their rates with DOI. DOI does not "set" title insurance rates. DOI is responsible for reviewing rate filings, as necessary, to carry out its mandate under AS 21.66.360 to ensure that rates are not excessive, inadequate, or unfairly discriminatory. According to the statutes, a rate filing becomes effective 30 days after it is filed with DOI. DOI may extend this time period in order to complete its review of the filing. If a rate filing is not disapproved by DOI, it is deemed approved.

DOI has not established procedures or a methodology to effectively and comprehensively review insurance rate filings. Based upon a review of selected rate files, documentation exists that indicates DOI has performed limited reviews of the content of rate filings evidenced by questions directed to the rate filers. However, in those files reviewed, information submitted by insurance companies was not sufficient to enable DOI to determine if rates were excessive or adequate (see Recommendation No. 1).

Rate Changes

According to DOI personnel, prior to 1989, the last basic rate schedule[9] change took place in the late 1960s. In 1989, the basic rate upon which different policy charges are calculated, was increased $50 for the first $100,000 of coverage. At that time DOI indicated that the basic rate would be subject to review once the revised general schedule was in place for a period of time. Based upon a review of its files, specific support of the basic rate has yet to be subjected to analysis by DOI.

In 1992, DOI issued regulatory order number 92-14 which disallowed a number of rate discounts which were in existence at the time. According to the order, effective January 1993, many rate discounts filed were unsupported and in some cases did not reflect the insurers' financial risk. Among the discounts disallowed by DOI were a builders and/or subdividers rate, a government contracts rate, a lenders reorganization rate, an employee rate, and a refinance rate. All were identified as unsupported and many were deemed by DOI as unfairly discriminatory.

In 1995, DOI disapproved a rate filing which requested an increase in the basic title insurance rate. In January 1995, DOI noted that they were beginning to look into the development of

> *. . . a way to measure the loss and expense costs that the title insurance premium is intended to cover, and to design a method for collection of the data necessary to evaluate the appropriateness of the title insurance rates and any requested discounts.*

DOI has taken the first step to accomplish this objective by requesting agency financial information. However, it has not established regulatory criteria or procedures by which to evaluate information requested (see Recommendation No. 2).

Negotiated Rates

According to AS 21.66.370, insurance companies and agents must charge the rates that are in effect for each insurance company. Therefore, companies and agents are not allowed to negotiate a rate with a consumer. If an agent or company determines that the risk for a policy being contemplated is not contained within the insurer's rate schedule, the insurance company may file a rate for that risk with DOI for its approval.

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[9] The basic rate schedule identifies premium increments chargeable for given dollar values of insurance coverage being provided. Additional charges can apply.

4. What is the cost-effectiveness of the alternative system used by Iowa for developing marketable title to real property?

The State of Iowa does not allow title insurance companies or agents to solicit the sale of title insurance in Iowa. Instead, they have an alternative system to protect real property titles. According to the 1994 Annual Report on the Iowa Financing Authority (IFA) [10]

> *The Title Guaranty Program offers guaranty certificates protecting real property titles. The program is self-supported, funded through premiums charged for the certificates. The major purposes of the Title Guaranty Division are to facilitate mortgage lender participation in the secondary market and to add to the integrity of the land transfer system. The Division is responsible for making and issuing real property title guaranties in a form acceptable to the national secondary market.*

A title guaranty certificate may be issued after a private attorney's title examination of a certified abstract[11] prepared by a private abstracter participating in the Title Guaranty Program. Abstracters are required to abstract titles to property in accordance with Iowa Land Title Association abstracting standards. The attorney participating in the program examines the abstract in accordance with the established Iowa title standards and will render a professional opinion concerning the title.[12] Some participating attorneys also issue certificates. Title guaranty owners' and lenders' certificates are available. The forms used are based on 1970 American Land Title Association forms and provide identical coverage according to the division. These supplement the abstract-attorney title opinion system in Iowa.

Title Guaranty Division Facts

Premium receipts for FY 94: $2.9 million
Coverage amounts for FY 94: $2.6 billion
Number of policies issued for FY 94: Approximately 36,000
Title Guaranty basic rate: $1 per $1,000 of coverage for first $250,000
(this does not include the cost of abstract and title examination prepared by independent abstracters and attorneys)
Reserves: $1 million plus 15% of premiums
Claim Rate: Negligible
Participants: Approximately 1,700 attorneys, 200 abstractors and 650 lenders

According to the IFA audited financial statements, a title guaranty is an obligation of the division and claims are payable out of the Title Guaranty Division Program Fund. This fund accounts for the administrative costs of the division, proceeds from title guaranty fees, interest on real estate trust accounts, and payments for claims made against the title guaranties. Moneys in this fund, after providing for adequate reserves and operating expenses, are transferred to the Housing Assistance Program Funds to provide financial assistance for development of housing for low and moderate-income families. General

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[10] The above information is based upon materials provided by the IFA, Title Guaranty Division (Division). IFA is a public instrumentality of the State of Iowa. Chapter 16 of the Code of Iowa authorizes the division.
[11] An abstract is a summary of the public records relating to the ownership of a parcel of real estate.
[12] The opinion includes a conclusion as to who owns the land, the defects in or charges against that ownership, and the requirements to make a good record title.

and administrative expenses of the Title Guaranty Division Program Fund were approximately $750,000 according to the IFA audited financial statements for the year ended June 30, 1994. In the same year approximately $450,000 for claims were set aside.

The division purchases reinsurance coverage for title guaranty loss exposure in excess of $100,000 per property.

According to the Title Guaranty Division Lender Manual

> *. . . title insurance companies or agents for title insurance companies may not solicit the sale of title insurance in Iowa. However, according to an Attorney General's opinion, mortgage lenders may go outside the state and purchase title insurance.*

Despite the prohibition against selling title insurance in Iowa, title insurance is still purchased. According to division personnel this could be due to the lender on the property being associated with a title insurance company, lenders who are not aware of the program, cities on the state's borders being influenced by the neighboring state's title insurance requirements, and a lack of enforcement of the prohibition. According to the May 1995 *Title Guaranty Division News* circular, a bill was introduced in the legislature to legalize the sale of title insurance. According to the director the title insurance bill was not voted out of committee.

According to a 1989 IFA Title Guaranty Division document, certain critics claim the system is not as cost-effective as that of private title insurance when the costs of the abstract, attorney's title opinion, and the title guaranty premium are considered. The division director disagrees that the system is not cost-effective and also notes that it is rare for anyone in Iowa to be damaged because of a defective title.

Due to the unavailability of attorney and abstracter fees associated with the Iowa program and the variability between state operations and laws, it is not possible to determine the cost-effectiveness of the Iowa program.

FINDINGS AND RECOMMENDATIONS

Recommendation No. 1

The director of the Division of Insurance (DOI) should develop procedures, criteria and an acceptable methodology to assess whether title insurance rates filed by underwriters are excessive or inadequate. The methodology should include the rate of return concept for insurance companies.[13]

Alaska Statute 21.66.360 establishes the purpose of title insurance rate regulation

> *. . . is to promote the public welfare by regulating title insurance rates so that they are not excessive, inadequate, or unfairly discriminatory. . . . Nothing in this chapter is intended to prohibit or discourage uniformity in title insurance rates, rating systems, and rating plans and practices.*

DOI is responsible for reviewing title insurance company rate filings for compliance with the provisions of AS 21.66. Assessing insurance rates requires balancing two competing interests. The first is the need to provide coverage available to the consumer (rates that are not excessive). The second is the need to ensure that the guarantee provided by the insurance company has a solvent financial base (rates that are adequate).

In the last ten years no documented evidence exists that rates have been analyzed in terms of rates of return for title insurance companies. As a general rule title insurance companies do not report their costs on a state-by-state basis. DOI receives annual statements from insurance companies that contain a variety of information including revenues, expenditures, and balance sheet information. The only state-specific information, however, is title premium income, other operating income, and policy losses for business written in each state. The key to obtaining an accurate picture of the costs that support a title insurance rate structure is a thorough analysis of the expenses that are incurred in that state. Without adequate cost information, resultant profits and rates of return for the State of Alaska cannot be ascertained.

Based upon a review of selected rate files, documentation exists that indicates DOI has performed limited reviews of certain aspects of rate filings evidenced by questions directed to the rate filers. Additionally, DOI issued a regulatory order in 1992 indicating that many rate discounts filed were unsupported and in some cases did not reflect the insurers' financial risk. However, the files do not identify the specific costs that support rate structures or any methodology that would indicate DOI is assessing the rates of return of title insurance companies. DOI personnel believe that statutory revisions would be necessary in order to implement a rate of return methodology.

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[13] The rate of return (the ratio of profits to investments) is universally recognized as the only meaningful way to measure the adequacy of an industry's profit margins. In the insurance industry, profit is made up of underwriting profit as well as profit from investment of equity and reserve funds.

Without a thorough analysis of the basic rate schedule, DOI is unable to assess rate structures for compliance with its legislative mandates. Furthermore, without the essential basic rate information, the value of incremental reviews, such as those performed in 1992, will always be questionable.

Recommendation No. 2

In conjunction with the rate setting methodology recommended above, the director of DOI should adopt procedures to regulate agency commission charges as part of the rate approval process. The review mechanism should include an analysis of financial data on the operating costs and profits of agents in addition to developing solvency standards for agents as envisioned in AS 21.66.280(b)(3).

DOI has not been receiving underlying cost data for title agencies. As a result, it has not analyzed those costs and their relationship to the rates being filed by the insurance companies affiliated with those agencies. As noted in the background information, agents fulfill a significant role in title insurance and their commissions exceed 80% of the title insurance premium. As a result the most significant operating expense incurred by title insurance companies is not being reviewed or regulated by DOI..

The absence of information regarding the percentage of agent commissions paid by an insurance company makes it impossible to assess whether rates are excessive or inadequate. As noted in Lipshutz's book *The Regulatory Economics of Title Insurance*, the absence of information causes the following dilemma

> *From a consumer welfare perspective, it is difficult for the regulator to assess the reasonability of the overall price level. From a solvency perspective, it is difficult for the regulator to ensure that rate relief granted in the hope of bolstering insurer solvency will not be offset by an increase in the agency commission rate. From an insurance availability perspective, it is difficult for the regulator to ensure that the viability of the agency sector is not threatened by the commission structure prevailing at current rate levels.*

Rates should be reflective of underlying costs and premium revenues should be distributed to insurance companies and their agents based upon their respective costs and assumed risks and not on an arbitrary contractual percentage such as is now the case.

In October 1995 DOI requested agencies to provide income and expense information for the previous five years. Information was requested for agents' escrow and title operations. The deadline for this information was originally November 1995 and later extended to December 15, 1995. As of mid-December six of sixteen agencies complied with the request. Some title agencies have refused to present information requested by DOI because they argue the statutes require insurance companies to justify the insurance rates, not the agents. They also assert that requested financial information goes beyond DOI's statutory authority to request such

information and they also have concerns regarding confidentiality of the information being requested. DOI has contacted the Department of Law (DOLaw) for advice regarding these arguments.

DOLaw has not yet made a determination regarding DOI's statutory authority underlying its request for cost information from title agencies. DOLaw has consistently taken the position that confidential commercial documents may be protected from disclosure to the extent that the information is sensitive or proprietary, the release of which would cause appreciable economic or competitive harm to a particular business. DOLaw observes, however, that this right of privacy is not absolute and should be balanced against the public interest that would be served by its disclosure.

Current statutes provide that title agents are to maintain books and records pertaining to the business of title insurance such that DOI may determine whether the agency has complied with the provisions of AS 21.66. For those agents engaged in the business of escrow, AS 21.66.280 provides that a title agent is to "*. . . comply with the standards of solvency*[14] *that the director requires; and . . . submit financial statements that the director requires.*" Alaska Statute 21.66.290 requires that a title agent "*. . . reply in writing promptly . . . to an inquiry of the director relating to the licensee's acts as a title insurance limited producer.*"

DOI should continue its efforts of requiring agents to submit essential financial information and establish criteria and procedures with which to review this data. Additionally, standards of solvency should be incorporated within established review procedures for those agents involved in the business of escrow. If it is determined necessary, we recommend that DOI seek statutory revisions to accomplish its legislative mandate.

Recommendation No. 3

The director of DOI should provide for the periodic examination of title insurance agency activities for compliance with statutory and regulatory laws.

Market conduct examinations of title insurance agencies have not been performed within the time schedule established by DOI. Market conduct examinations of certain title insurance agencies were performed by DOI personnel in 1991 and 1993. Among other things, these examinations ensured that premiums and/or charges filed by the underwriter with DOI were appropriately charged. In addition, these examinations tested to determine if all persons involved in a file were properly licensed. Areas of noncompliance were noted in various examinations. A number of reports generated from these examinations contained recommendations that re-examinations be performed within one year to determine compliance with the recommendations contained within the reports.

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[14] DOI has not established standards of solvency although AS 21.66.280 allows them to do so.

No market conduct examinations of title insurance agencies have been conducted by DOI since 1993. For some agencies their last examinations were performed by DOI in 1991. In addition, market conduct examinations performed since 1989 have been limited to the Anchorage and Fairbanks areas. Lack of timely follow-up by DOI has resulted in allowing certain title insurance agencies, known to have been in noncompliance, to continue operating without verifying that DOI's recommendations have been implemented.

We recommend the director of DOI implement a statewide market conduct examination plan that would encourage compliance with state law. The plan should include timely follow-up reviews for those agents found not complying with state law or DOI's directives.

<u>Recommendation No. 4</u>

<u>The director of DOI should request and implement DOLaw's interpretation of the statutory deposit provisions in AS 21.66.020.</u>

For the protection and security of Alaska policyholders, title insurance companies are required by AS 21.66.020 (deposits in guaranty fund) to deposit with the director 10% of premiums covering Alaska properties received during the previous year. These deposits are required "*. . . until the accumulated deposits, added to the sums originally deposited with the director, as provided in this chapter, total $750,000 . . .*"

In addition, AS 21.66.010(b) requires that, prior to issuing title insurance policies in Alaska, a title insurance company shall have on deposit with the DOI director or insurance commissioner of the state of its domicile, the amount[15] required by AS 21.09.090. That amount is to be increased by the sum of $50,000 for each state (other than the state of domicile) in which it conducts business less amounts deposited in those other states for the security of their policyholders. Alaska Statute 21.66.010(b) further states that when

> *. . . the aggregate of amounts deposited in this or other states . . . has reached the sum of $750,000 no further deposit is required of the title insurance company as a condition of engaging in the business of title insurance in this state.*

DOI personnel have expressed confusion regarding these two provisions and whether they are interrelated or not. If they are, it may mean that the guaranty fund provisions may be satisfied by deposits held in other states. If the provisions are not related, and $750,000 is required to be deposited with the director, regardless of funds deposited with other states, then additional deposits may be required of the insurance companies. At least in one instance, an insurance company's deposits in other states were deemed sufficient by DOI to meet the statutes' deposit requirements. According to DOI personnel, the remaining insurance companies currently have on deposit amounts ranging from $100,000 to $175,000 in custodial accounts.

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[15] Foreign or alien insurers are required under AS 21.09.090 to deposit with the State no less than $300,000 of cash or securities for the protection of their Alaska policyholders. However, DOI can accept evidence satisfactory to DOI that an insurer is maintaining a like amount in trust deposits in other states or in public depositories.

We recommend that the director seek clarification from the Department of Law regarding the statutory deposit requirements of title insurance companies and enforce those requirements accordingly to protect insurance consumers who are relying on the solvency of insurance companies.

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APPENDIX A
TORRENS LAND-REGISTRATION SYSTEM[16]

In a Torrens land-registration system, ownership interests in real property are established and transferred via a governmental certification and registration process. The system is believed to have been modeled after the method used by the British Ships Registry for recording ownership interests in ships. At the end of the nineteenth century, several states authorized the use of land registration. Only a few of these systems remain, one of which is in Massachusetts. The Massachusetts system is administered by a land court and boundaries are also registered along with the title.

Land can be transferred without going through the registration process. The majority of land is unregistered. Only about one quarter of land has been submitted for registration. Generally, it is extremely valuable property which goes through the registration system as well as property with boundary disputes. For example, a fire destroyed the Cape Cod land records which contributed to making that a major area for the use of land registration in Massachusetts.

A landowner seeking registration in Massachusetts applies to the land court for a judicial decree. This application includes a comprehensive survey of the land in question. The petitioner also is required to obtain an examination report on the state of the record title. This examination is performed by private attorneys. The fees for these services are paid by the petitioner directly. The land court examiner (employees of the court) studies the report of the independent examiner, reviews the surveyor's plan, and identifies any requirements necessary to support the petition for registration. After all evidentiary requirements are met, an order for decree is prepared. Only after all objections are dealt with does the court decree become final. The petitioner pays all court costs.

On petitions for registration, a copy of the decree and plan of the land is sent to the assistant recorder for the district where the land is situated. The recorder transcribes the decree in the registration book. The recorder then makes an original certificate of title, which remains on file, and a duplicate certificate which is provided to the owner. On one side of the certificate appears the owner's name and a description of the land. On the other side any encumbrances are noted. Any change in encumbrances is noted both in the registry and on the owner's certificate. Thus, the exact state of the title is shown at any time by the two sides of the certificate.

The initial deposit for a registration is $300 plus one-tenth of one percent of the property's assessed value. The one-tenth of one percent of the assessed value goes to an assurance fund. This fund is used for recovery of damages. It is intended for losses associated with registered property sustained subsequent to initial registration. Potential claimants must exhaust all other

[16] This information is based upon a review of *Torrens in the United States A Legal and Economic History and Analysis of American Land-Registration Systems* by Blair C. Shick and Irving H. Plotkin, 1978. In addition, documents were obtained from, and the system briefly discussed with, Massachusetts' land court personnel.

legal remedies prior to resorting to this fund. According to land court personnel, there have been only three or four claims since the beginning of the system.

According to court personnel, it takes approximately one year to proceed through the original registration process and it is an expensive process. Transferring registered property takes substantially less time and the cost to transfer registered land is about the same as that for unregistered land.

The system cures defects except in the case of forgeries and the program is self-supporting, according to land court personnel. But, it appears that the decision to acquire title insurance is unrelated to the registered status of the land involved. According to land court personnel, title insurance is purchased for registered land since the secondary markets do not recognize the registration system.

According to Lipshutz the greatest strength of a Torrens System is that it provides an unchallengeable right to the property by the registered owner. Once registered, any subsequent claims must be asserted against the Torrens Funds. As noted above, the strength of the system is offset by a somewhat expensive and time-consuming process when real property is first registered.

TONY KNOWLES, GOVERNOR

DEPARTMENT OF COMMERCE AND ECONOMIC DEVELOPMENT

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February 28, 1996

Mr. Randy S. Welker
Legislative Auditor
Division of Legislative Audit
Legislative Budget and Audit Committee
Alaska State Legislature
P.O. Box 113300
Juneau, AK 99811-3300

LEGISLATIVE AUDIT

Dear Mr. Welker:

Re: Preliminary Audit Report - Agency Response
Selected Title Insurance Rate Issues
Audit Control Number 08-4521-96

Thank you for the opportunity to respond to your report transmitted with your correspondence of February 8, 1996. The following comments are intended to offer clarifications or explanations where we believe they are warranted. This Department and the Division of Insurance (DOI) constantly seek ways to improve approaches to meeting the statutory charge for the regulation of the title insurance industry.

This response addresses those issues relating to the title insurance business in Alaska and the title insurance rates in Alaska. We have not responded to the review of alternative systems of title assurance employed by other states, as those are report conclusions on research requested in addition to the review of the DOI regulation of title insurance. Our comments basically follow the report in order of appearance. Bold underlined headings in the response correspond to headings in the report. In addition, we have added a section at the end of the response to discuss alternatives.

Background Information

Since insurance is most often thought of in property/casualty terms, it is important that the distinctions between property/casualty and title insurance be clear and understood. After review of the "Background Information" in the Audit Report, some supplementary information is needed to clarify the difference between property/casualty and title insurance. The following table may be of some assistance in the process:

	TITLE	P/C
Underwriting Function	Risk Elimination	Risk Assumption
Expected Losses	Low	High
Premium Charge	One time	Annually
Policy Period	No limit	Stated
Marketing Strategy	Indirect to Consumer	Direct to Consumer

08-H11LH

In property/casualty (P/C) insurance, the insurer assumes that there will be loss. The rates reflect the high level of expected losses and are generally set so that, on average, 60 percent to 70 percent of the premium is paid out in claims. This approach is substantially driven by the needs of the consumer to identify risk, take steps to reduce that risk, and buy insurance for the exposure that remains.

In title insurance, an entirely different approach is used. The process is to identify the risk of loss through a search and examination of the public record and eliminate identified loss risk from coverage. This is done by providing specific exceptions to coverage for the listed matter of record, usually a lien, encroachment, covenant or easement. This too is driven by the consumer's need to know the condition of title before purchase is actually made. The premium charge for a title insurance policy is a one time charge for a guarantee made as of a specific date. The insurer will pay if an unreported defect causes financial loss. As noted, the expected losses are very low, since the purpose of title insurance is to eliminate known risk of loss. The "risk elimination" approach used in title insurance logically keeps the number of claims relatively few in number. This alone generates difficulty in developing a credible base of losses on which to develop rates.

On page 5, first paragraph, starting on line 5, there is a statement that reads:

> *DOI needs to ensure that coverage is available to the consumer by regulating rates that are not excessive.*

We agree that DOI is mandated to regulate rates so that they are "not excessive, inadequate, or unfairly discriminatory." While excessively high rates may result in insurance being unaffordable for some consumers that is a different concern than lack of availability. Coverage availability becomes a problem only when rates are inadequate and insurers believe that writing business in a particular market is unprofitable. The reason for the requirement that rates not be excessive is to avoid unreasonable profits, not to promote availability. There is no statutory provision that requires the DOI to assure availability though it does consider availability in the actions it takes.

On page 5, second paragraph, the last sentence states:

> *As a result, policy losses in title insurance should be less than in other insurance lines.*

In title insurance, there should be **no** losses. Losses that occur are generally the result of error on the part of the insurer or its agent that has occurred during the search and examination process. The comparison between title insurance and other forms of insurance does not reflect the fact that other lines of insurance operate on the principle of risk assumption while title operates on the principle of risk elimination.

On page 5, fourth paragraph, the second sentence states:

> *The premium paid is mainly a fee for the expense of searching and analyzing recorded information so that a 'chain of title' on a property can be completed.*

Completion of a "chain of title" is but a step in the process of search and examination. A more important step in the search and examination process is the evaluation of matters of record to determine their validity and their potential to generate loss. Anyone can develop a "chain of title" with a visit to the Recorder's office. Identifying items that may affect the property, and determining whether or not the items in that chain are a potential source of loss, is a very different process.

On page 5, last paragraph, the third, fourth, and fifth sentences beginning on line 3 state:

> *Effective December 1994, 3AAC 31.230 provided that a rate filing must include both national and Alaska-specific expense information, if available, and any other information requested to support the rate filing. This regulation applies to all types of insurance lines in Alaska. However, according to DOI personnel, national expense information is not relevant to title insurance.*

When 3AAC 31.230 was adopted, it was intended to provide a structure for all filers of rates in Alaska. More than 95 percent of the rates filed under this structure are property/casualty rates subject to AS 21.39 which contains a provision in AS 21.39.030(a)(2) which states:

> (a) Rates shall be made in accordance with the following provisions:
> (1) rates shall not be excessive, inadequate, or unfairly discriminatory;
> (2) consideration shall be given to past and prospective loss experience inside and outside this state, to the conflagration and catastrophe hazards, to a reasonable margin for underwriting profit and contingencies, to dividends, savings, or unabsorbed 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 inside and **outside this state**; (emphasis added).

There is no similar provision in the statutes dealing with title rates. Title rates are a particularly state specific venture. Of all the kinds of insurance regulated by the various states, title insurance has the least in common with its sister states. Also note that these comments by the auditor conflict with those made under Recommendation No. 1 on Page 15, stating:

> *The key to obtaining an accurate picture of the costs that support a title rate structure is a thorough analysis of the expenses that are incurred in that state.*

We concur with this latter statement.

On page 6, last paragraph, the last sentence states:

> *"They are affiliated with four title insurance companies."*

While this statement is true, it implies that there are four active title insurers; however, only two are active. It would be more accurate to say that there are ten title insurers admitted to write in Alaska and that of the ten,

- two represent 96.8 percent of the premium written,
- three are in the process of withdrawing from the state, and
- five write no business (of the five, three were previously active and significant).

Report Conclusions

The conclusions are also discussed in more detail under Recommendations. To avoid unnecessary duplication, our response to comments in the "Report Conclusions" section is made later in this letter under the appropriate sections dealing with recommendations. This includes:

Page 7, first paragraph. Please see discussion under Recommendation No. 1.

Page 7, second paragraph. Please see discussion under Recommendation No. 2.

Page 7, third paragraph. Please see discussion under Recommendation No. 3.

Page 7, fourth paragraph. Please see discussion under Recommendation No. 4.

Page 7, fifth, sixth, and seventh paragraphs. These paragraphs deal with research projects that are in addition to the review of the DOI regulation of title insurance. We have no comments on these items.

Auditor's Comments

Auditor's Comment on Legislative Concern #1. Pages 9 and 10.

> *What is the amount of funds paid out in title insurance claims per year compared to premiums received?*

The chart appearing on page 9 is misleading as it indicates an inaccurate level of commission. This has been discussed with the auditor but not reflected in this report. The auditor is correct in saying that the information requested in this concern would be misleading without a reflection of agent commission. The chart uses 80 percent but that number is not, nor has it been, reality in Alaska. Historically the level has been at 90 percent. The current level is 88 percent to 90 percent.

The total premium on the chart reflects the title agent's commission and the title insurer's losses and share of the premium. Loss covered by a title insurance policy is a liability of the title insurer as a matter of the insurance contract. The weight of those losses is considerably different if the insurer is receiving 20 percent of the premium rather than the 10 percent to 12 percent actually received in Alaska. We wish to be clear that the title insurance company share noted in the chart represents the operating costs of the insurer, reinsurance, title insurance losses, Alaska insurance premium tax (1 percent of total premium), federal taxes, and profit.

We have enclosed a chart with this response which we believe contains a more accurate representation. This chart shows the title insurer's fixed costs before showing the impact of losses. It also adds columns for premium tax and underwriting profit or loss. This chart reflects the title agent's commission, the operating expenses of the title insurer, its Alaska premium tax liability, paid losses, and underwriting profit or loss. Rates used in Alaska combine all of these components. This has generated the condition referenced in the quote by Mr. Lipshutz which appears on page 16 of the report and states:

> *From a consumer welfare perspective, it is difficult for the regulator to assess the reasonability of the overall price level. From a solvency perspective, it is difficult for the regulator to ensure that rate relief granted in the hope of bolstering insurer solvency will not be offset by an increase in the agency commission rate. From an insurance availability perspective, it is difficult for the regulator to ensure that the viability of the agency sector is not threatened by the commission structure prevailing at current rate levels.*

Since the combined rate approach merges the title insurer's costs and the title agent's commission as title insurance premium, it is extremely difficult to devise a methodology that meets the statutory standards, since the statute addresses the rates from the viewpoint of regulation of the insurer. This is exhibited by the existing Alaska condition in which DOI believes that the title insurance company share of the rate is inadequate while the title agent's share is excessive. It is our belief that a portion of the title premium subsidizes other related services such as escrow, settlement, and closing operations in the agent's office. It is important to understand that the portion of the chart in the audit report labeled "Premiums after Losses and Commissions and before Operating Expenses" represents the operating costs of the insurer, reinsurance, Alaska insurance premium tax (1 percent of total premium), federal taxes, and insurer profit, and does not solely represent profit.

The last sentence in Footnote #3 on page 9 states:

> *DOI personnel indicate that, based upon their inquiries of two companies, the commission rate is 88 percent to 90 percent.*

This comment needs clarification. The two companies contacted were the two representing 96.8 percent of the title business written in Alaska.

The last sentence in Footnote #5 on Page 10 states:

> *"Policy losses paid may be negative due to salvage values greater than policy losses paid."*

The footnote gives the impression that the title insurer makes money from its salvage of property. In almost every case where there is salvage, there is a net loss. An example might help to clarify the situation. Assume the following:

- Title insurer writes a title insurance policy in 1990 for $100,000 coverage at a premium of $562.
- Title insurer suffers a policy limits loss ($100,000) in 1991 which grants them salvage rights to the property.

- In 1992, they cease doing business in Alaska.
- In 1993, they spend another $20,000 in legal fees and are able to resolve the issue causing loss.
- In 1994, they sell the property for $100,000.

The insurers' reports for loss will include the following numbers in the annual report to Alaska:

Year	Written Premium	Paid Losses
1990	$562	$0
1991	$0	$100,000
1992	$0	$0
1993	$0	$20,000
1994	$0	-$100,000
	$562	$20,000

The point is that the negative loss indicates that the salvage received in a particular year is greater than the losses paid on all claims in that year. It does not reflect all the costs paid for the claim in prior years in order to secure the salvage. It also does not consider the loss in investment income on the amounts paid as loss until the time of recovery. A more appropriate way to state what may have been intended with the statement would be:

> *Total policy losses paid by a title insurer may be negative when the salvage recoveries in a year are greater than all policy losses paid in that year.*

Footnote #6 on Page 10 states:

> *Some of the percentage relationships in this column are meaningless since some insurance companies are no longer active in the State but still responsible for losses on policies previously written.*

This footnote suggests that if an insurer leaves the marketplace but is still responsible for losses that continue to occur, it should not be part of the evaluation of the overall losses shown for that year. We disagree that these losses are meaning-less. It is important to compare the total premium written in Alaska with the total losses paid. It does not matter which companies pay the loss; the losses are from Alaska claims and presumably would have occurred even if the insurer was still active.

Auditor's Comment on Legislative Concern #2. Page 11.

> *What are the costs of maintaining title plants compared to premium received and the feasibility of maintaining multiple title plants given Alaska's population?*

Title Plant Costs

The DOI requested financial information from agents in order to research the rate structure, not to evaluate the cost for maintaining a title plant. Cost of title plant creation or maintenance varies widely depending on the size of the recording district in terms of land transactions and does not depend on how frequently the plant is used. Comparability becomes difficult and misleading.

Alaska Statute (AS) 21.66.280(b)(3) is not aimed at the financial solvency of the title insurance operations of a title agent, since the entity at risk in a title insurance policy is the title insurer. The statute is directed to title agents engaged in the business of escrow, closing, and settlement operations, not title insurance operations.

Multiple Title Plants

This section correctly states that there are inefficiencies and duplication in a profusion of title plants. Alaska Statute 21.66.210 was enacted to permit the formation of more efficient and cost effective joint title plants. It should be emphasized that AS 21.66.210 is permissive.

Auditor's Comment on Legislative Concern #3. Pages 11 and 12.

What are the rate setting procedures followed by DOI? How frequently are rate filings audited, and have the audits resulted in reductions of rates? Are negotiated rates prohibited by statute or DOI policies?

Rate Setting and Review Procedures.

This section correctly states the role of DOI in the rate setting and review process. See previous discussion under Concern #1. DOI has several suggestions as to how a workable system can be developed, but each requires statute revision. This is discussed under "Alternatives."

Rate Changes

This section correctly reflects rate change history. However, the report quotes a sentence from a rate disapproval letter discussing that the DOI is looking into a way to measure the loss and expense costs that the title insurance premium is intended to cover, and then states that:

> *"DOI has taken the first step to accomplish this objective by requesting agency financial information."*

This is the latest of a long series of steps the DOI has taken in that process. Order R92-14 issued by the DOI, following a series of examinations, meetings, and hearings, stated that some of the rate discounts then in effect were unsupported by statistical or other data and were, therefore, disapproved. Unsupported discounts conflict with the rate standard found in AS 21.66.360 that rates shall not be unfairly discriminatory. Since that time, the DOI has worked with a number of title agents and insurers in trying to develop the necessary statistical reporting system to collect data

that would support or refute the use of various discounts. This project involved several meetings with members of the title insurance industry, but received little cooperation or participation from insurers and was unsuccessful. Because of this lack of success at developing a statistical reporting system, the division decided in 1995 to take another approach and request the financial data from title agents.

Negotiated Rates

This section correctly states that negotiated rates are prohibited. Pursuant to AS 21.66.370(a), insurers and their agents must use rates the insurer has filed for use in Alaska. Again, negotiated rates would be unsupported and therefore, unfairly discriminatory.

Auditor's Comment on Legislative Concern #4. Pages 13 and 14.

What is the cost-effectiveness of the alternative system used by Iowa for developing marketable title to real property?

Iowa Alternative System.

No comments on this research item.

<u>Findings and Recommendations</u>

Recommendation No. 1.

The director of the Division of Insurance (DOI) should develop procedures, criteria and an acceptable methodology to assess whether title insurance rates filed by underwriters are excessive or inadequate. The methodology should include the rate of return concept for insurance companies.

On Page 15, first paragraph following the text of Recommendation No. 1.

The DOI does not have statutory authority to regulate rates to ensure availability. As discussed on page 2, the auditor has presented a purpose not stated in statute.

On Page 15, the second paragraph following the text of Recommendation No. 1

"In the last ten years, no documented evidence exists that DOI has been analyzing rates filed by insurers in terms of industry rates of return."

The same statement is made in the first paragraph on Page 7. This is true. A "rate of return" methodology is also referenced in several other sections of the report, with the recommendation that the DOI adopt such a methodology to assess the appropriateness of title insurance rates. DOI does not have the statutory authority to impose a "rate of return" methodology. A "rate of return" methodology would typically mandate that an insurer's profit as calculated over a period of time divided by its equity not exceed a stated ratio. In cases where the profit percentage exceeds the stated percentage, the rates would be considered

excessive. The stated percentage used as a benchmark is, by definition, somewhat arbitrary, and the division does not currently have the statutory authority to make such a decision. If "rate of return" is to be used, it must be clearly defined and authorized in statute.

In the last ten years, DOI has held numerous meetings and hearings all aimed at devising some kind of support structure for rate review. While we have not arrived at a successful conclusion to this effort, we have not ignored our responsibility to develop a methodology.

Recommendation No. 2.

> *In conjunction with the rate setting methodology recommended above, the director of DOI should adopt procedures to regulate agency commission charges as part of the rate approval process. The review mechanism should include an analysis of financial data on the operating costs and profits of agents in addition to developing solvency standards for agents as envisioned in AS 21.66.280(b)(3).*

Unfortunately, like Recommendation No. 1, regulating the commission between an agent and an insurer is not authorized by statute. This recommendation would, indeed, be a useful device for making a determination concerning the rate structure. It has been noted in our discussion on Auditor's Comments, Auditor's Comment on Legislative Concern #2, Item #2, Title Plant Costs, that AS 21.66.280(b)(3) is not aimed at the financial solvency of a title agent's title insurance operations since the entity at risk in a title insurance policy is the title insurer. The statute is based on escrow, closing and settlement operations which are technically not the business of insurance.

On Page 16, the sixth paragraph states:

> *"Rates should be reflective of underlying costs and premium revenues should be distributed to insurance companies and their agents based upon their respective costs and assumed risks and not on an arbitrary contractual percentage such as is now the case."*

This comment is one that was made to the auditor by DOI staff who also pointed out that such an action would require enabling legislation.

Recommendation No. 3.

> *"The director of DOI should provide for the periodic examination of title insurance agency activities for compliance with statutory and regulatory laws."*

We disagree with this recommendation for "periodic" examinations. DOI regulates over 1,000 insurers and a substantially greater number of producers, totaling more than 7,500 licensees. Of these, there are 2 active title insurers and 28 title agent offices in the state. The division has conducted 70 market conduct examinations since 1988, of which 16 were of title agents. That is, 23 percent of the examinations performed were on the subject of title insurance. Total premium writings for all lines of insurance for calendar year 1994 were $1,406,672,000. Of that amount, title insurance represented $19,592,000 or 1.4 percent.

It is true that in the examinations conducted, the examiner in charge recommended a revisit due to the numerous violations found. Unfortunately, resources were not available to allocate to the effort. These examinations are conducted by seven staff persons who form two-, three-, or four-person teams to conduct examinations. The examiners also have in-office duties including policy form filing review and market surveillance responsibilities which results in their only being available for field assignments 35 percent of the time.

The examination statutes require examination of insurers but permit examination of producers. The point is that the existing schedule is extraordinary. With the limited resources of the DOI, we believe that it is more critical to allocate those resources to insurers. As problems arise in any segment of the industry, we have managed available resources to attempt to address them. This will undoubtedly continue. Other options exist for compliance issues. Examinations can be used to place the examinee on notice that a particular activity is in violation of statute. When we receive a complaint suggesting that a violation has taken place after examination, our investigator deals with the charge directly for possible administrative action.

Recommendation No. 4.

> *The director of DOI should request and implement Department of Law's interpretation of the statutory deposit provisions in AS 21.66.020.*

This recommendation is already under way.

Alternatives

Clearly, title insurance regulation in Alaska needs repair. DOI recognized this some years ago and further realized that legislation would be required to effect the repairs. To that end, the DOI has been a member of the National Association of Insurance Commissioners' (NAIC) Title Insurance Working Group for the last three years. That group has recently completed work on two model laws. One was adopted by the NAIC in December, and the other is expected to be adopted in March. The DOI is considering these models for Alaska. The models do not directly address rate issues but do address the overall regulation of the line. Any change to the rate regulation needs to seriously consider the implications of these models.

The DOI has prepared a notice for a public meeting to be held in April at which we expect to have interested members of the public, the industry, and the legislature meet to consider a number of issues including:

- Development of title rate statistical support system
- Alternatives to traditional title rate making methodologies
- Definition of rebate and illegal inducement
- Other title insurance related issues
- Adoption of the NAIC Model Title Insurers Act
- Adoption of the NAIC Model Title Insurance Agents Act

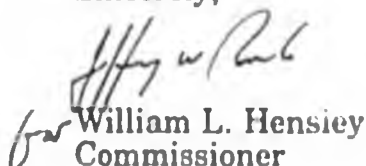
The title rate approach that makes the most sense is one in which the title insurer's portion of the premium is reviewed separately from the title agent's commission. The title insurer's share would be, for support purposes, a stand alone review in which the expenses of the insurer, its losses, tax liability, etc. would be evaluated in light of its underwriting and investment profit or loss. The rates charged by insurers should be sufficient to make a reasonable profit and attract new capital. The title agent's share would be reviewed in a separate, but similar manner.

This will require legislation which the DOI would expect to have ready for the next legislature for its consideration.

Closing

In closing, we sincerely appreciate this opportunity to respond to your concerns by providing additional and clarifying information. We take our responsibilities very seriously and welcome suggestions for improvement.

Sincerely,



for William L. Hensley
Commissioner

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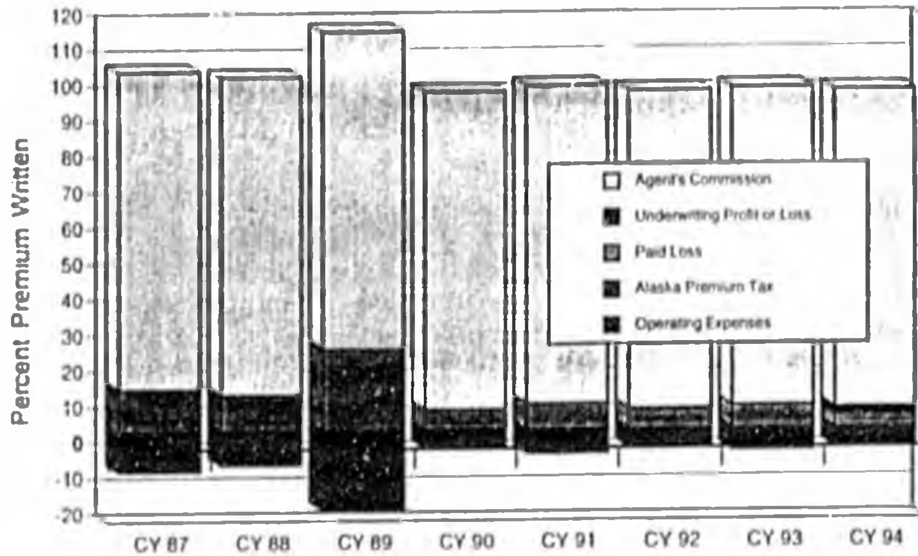

TITLE INSURANCE

Percentage Comparison of Commissions, Operating Expenses, Premium Taxes, Losses, and Profits

Percent Premium Written

30
20
10
0
-10
-20

CY 87 CY 88 CY 89 CY 90 CY 91 CY 92 CY 93 CY 94

Underwriting Profit or Loss
Paid Loss
Alaska Premium Tax
Operating Expenses

ALASKA STATE LEGISLATURE

LEGISLATIVE BUDGET AND AUDIT COMMITTEE

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March 1, 1996

Members of the Legislative Budget
and Audit Committee:

We have reviewed the enclosed Department of Commerce and Economic Development (DCED) response to our review of selected issues regarding the Division of Insurance (DOI). Though nothing in the DCED response has changed our position on issues addressed, **we disagree with the following sections of the DCED response and feel further clarification is in order.**

Page 2, third paragraph and Page 8:

DCED takes exception to our statement that "*DOI needs to ensure that coverage is available to the consumer by regulating rates that are not excessive.*" DCED's statement that "*The reason for the requirement that rates not be excessive is to avoid unreasonable profits, not to promote availability.*" does not take into consideration that prohibitive rates can make coverage unaffordable and therefore unavailable to the consumer. DCED has a legislative mandate to protect the Alaska consumer.

Page 2, fourth paragraph:

DCED responds to our statement that ". . . *policy losses in title insurance should be less than in other insurance lines.*" by stating "*In title insurance, there should be no losses.*" Under title insurance economic theory this idealistic statement is true. However, DCED knows that claim losses do occur. This is one of the reasons the Alaska Legislature has mandated that rate regulation include ensuring that rates are adequate so as to avoid underwriter insolvency. In addition, under a guaranty fund and capital reserves scheme established by AS 21.66.020, AS 21.66.010(b) and AS 21.09.090, the Alaska policyholder is afforded some protection if, and when, excessive losses do occur that affect the solvency of the underwriter.

Page 3, second paragraph and Page 8:

DCED points out that 3 AAC 31.230, which provides that a rate filing must include both national and Alaska-specific expense information, was intended to provide a structure for **all**

filers of rates in Alaska (emphasis added). When we noted that DOI personnel consider national expense information not being relevant to support rate filings for title insurance, they argue that, unlike property and casualty rate filing legal provisions, statutes pertaining to title insurance rates are dissimilar in what should be considered in the making of rates. Rather than resolve this issue by pursuing necessary statute or regulation changes, DCED has chosen to interpret the existing legal scheme as not having the authority to request information essential to the analysis of an insurer's rate structure.

DCED claims that our comments conflict with our recommendation No. 1 where we state:

> *The key to obtaining an accurate picture of the costs that support a title rate structure is a thorough analysis of the expenses that are incurred in that state.*

DCED has taken this statement out of context as it is used in conjunction with our Recommendation No. 1 where we explain that DOI has not been requiring insurance carriers to report Alaska-specific expenses. This statement is consistent with our observations that in order to properly regulate, DCED must know what all costs are in order to achieve its statutory benchmark of ensuring that rates are not excessive, inadequate, or unfairly discriminatory.

Page 4, DCED's response to Auditor's Comments:

During our audit field work, we requested documentation from DOI regarding actual commissions paid to Alaska agents by insurance companies. This is data that is essential for establishing a rate structure. As noted in this report, DOI was unable to demonstrate that a regulation methodology existed and could not present the commission information to us. The marketing surveillance chief instructed one of his associates to call one of the insurance underwriters and request the information for us. Since this information was of a hearsay nature, was not audited or confirmed by DOI, we elected to use the industry average in our report.

In addition to presenting agent commission information in the chart included in DCED's response, DCED has also presented other underwriting data. It is highly doubtful that this information has been confirmed or verified by DCED. Furthermore, we would question the reliability of such information considering the fact that DOI asserted to us that such information was only available for the last four years.

Page 5, first paragraph:

In explaining the various financial expenses and profits included in its charts, DCED makes a statement that, "*Rates used in Alaska combine all of these components.*" Such a statement is totally unsupported as DOI has not established a rate review methodology nor has it reviewed the basic rates, by applying relevant rate-making criteria to components noted in its charts, for at least the last 25 years.

Page 5, third paragraph

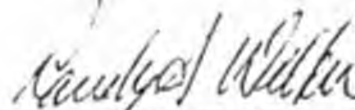
DCED goes on to discuss how difficult it is to devise a rate review methodology because the insurance premium is comprised of both the insurer's costs and the agent's commission but statutory standards only apply to the insurer. It claims "*This is exhibited by the existing Alaska condition in which DOI believes that the title insurance company share of the rate is inadequate while the title agent's share is excessive.*"

Though this statement may be correct, DOI has not demonstrated to us that such a statement can be supported. In 1989, DOI arbitrarily selected five title insurance agents in the Anchorage area and examined the agents' financial operations for one year. It determined that annual escrow operations, when reviewed independently from title insurance operations, failed to be profitable. Though this review may indicate subsidization, this limited study is not conclusive. Such a review would have to be conducted over an extended period of time in order to draw such a conclusion.

As mentioned in its response, DCED readily acknowledges that the extent of its statutory authority in regulating agents is questionable. However, DCED has expended very little effort in seeking legal interpretations from the Alaska Attorney General as to what legal authority it does have. In addition, attempts to clarify perceived conflicting or inadequate laws by seeking statutory amendments through the legislative process have not been aggressively pursued.

Pages 7, 8, and 9 response to rate review procedures and recommendations 1 and 2:

DCED agrees that it is responsible for developing an acceptable rate review methodology. DCED notes that DOI has held meetings and hearings on the topic of rates and notes DOI's lack of success in "*...devising some kind of support structure for rate review.*" We feel very little has been accomplished over the last 25 years in meeting its legislative mandate of ensuring that rates are not excessive, inadequate or unfairly discriminatory. Instead, DCED has chosen to interpret the law as not providing sufficient authority to accomplish its mandate. Rather than resolving perceived restrictions so that it can comply with its legislative mandate of protecting the consumer, DCED has allowed the title insurance industry to operate under little scrutiny or oversight by DOI.



Randy S. Welker, CPA
Legislative Auditor

9-LS1501\F
Ford
2/29/96

CS FOR SENATE BILL NO. 231( )

IN THE LEGISLATURE OF THE STATE OF ALASKA

NINETEENTH LEGISLATURE - SECOND SESSION

BY

Offered:
Referred:

Sponsor(s): SENATORS RIEGER, Frank, Pearce, Miller, Sharp, Taylor

A BILL

FOR AN ACT ENTITLED

1 "An Act relating to title insurance; and providing for an effective date."

2 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

3 * Section 1. AS 21.66.480(4) is amended to read:

4 (4) "rate" means a charge for title insurance risk, [ABSTRACTING,
5 SEARCHING, EXAMINATION OR DETERMINATION OF INSURABILITY,] and
6 every other activity, exclusive of escrow, settlement, or closing charges, whether
7 denominated premium or otherwise, made by a title insurance company or an agent of
8 a title insurance company to an insured or to an applicant for insurance, for a policy or
9 contract of title insurance; however, "rate" does not include charges paid to and retained
10 by an attorney at law, abstractor, surveyor, tax service, or any other person acting in a
11 capacity other than as a title insurance limited producer and on behalf of a client other
12 than a title insurance company, or charges made for abstracting, searching,
13 examination, determination of insurability, or special services, even though performed
14 in connection with a title insurance policy or contract;

15 * Sec. 2. This Act applies to a policy of title insurance issued or renewed on or after the

1 effective date of this Act.

2 * Sec. 3 This Act takes effect July 1, 1996.

SB

234

STATE OF ALASKA
1996 LEGISLATIVE SESSION

FISCAL NOTE

BILL NO: SB 234

Revision Date:
Title: Increase Tobacco Taxes
Sponsor: (S) RLS/LRFPC
Requestor: (S) STA

Dept. Affected: Revenue
BRU: Revenue Operations
Component: Income and Excise Audit
COMPONENT SERIAL NO. 113

Expenditures/Revenues: (Thousands of Dollars)

OPERATING EXPENDITURES	FY 97	FY 98	FY 99	FY 00	FY 01	FY 02
PERSONAL SERVICES	45.6	45.6	45.6	45.6	45.6	45.6
TRAVEL	1.0	1.0	1.0	1.0	1.0	1.0
CONTRACTUAL	8.0	3.0	3.0	8.0	3.0	3.0
SUPPLIES	1.0	1.0	1.0	1.0	1.0	1.0
EQUIPMENT	8.0	0.0	0.0	0.0	0.0	0.0
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	63.6	50.6	50.6	55.6	50.6	50.6
CAPITAL EXPENDITURES						
CHANGE IN REVENUES (GF)	33,426.8	44,781.7	45,040.5	53,932.1	54,212.8	54,493.5

FUND SOURCE (Thousands of Dollars)

FUND SOURCE	FY 97	FY 98	FY 99	FY 00	FY 01	FY 02
1002 Federal Receipts						
1003 GF Match						
1004 GF	63.6	50.6	50.6	55.6	50.6	50.6
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other						
TOTAL	63.6	50.6	50.6	55.6	50.6	50.6

Estimate of any current year (FY96) cost $ 0

POSITIONS:

POSITIONS	FY 97	FY 98	FY 99	FY 00	FY 01	FY 02
FULL-TIME						
PART-TIME						
TEMPORARY						

ANALYSIS: (Attach a separate page if necessary)

(See Attached Analysis)

Prepared by: Paul E. Dick
Division: Income and Excise Audit Division
Approved by Commissioner: Wilson L. Condon
Agency: Department of Revenue
Phone: 465-3691
Date: March 12, 1996
Date: March 12, 1996

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LEG 5B234 XLS

Alaska Department of Revenue
Income and Excise Audit Division

Bill Analysis

Section 1 increases cigarette tax rates as follows:

Effective Date	School Fund Base Rate *(AS 43.50.090)*	General Fund Additional Tax *(AS 43.50.190)*	Rate Increase *(General Fund)*	Total Tax (per pack)
Current	$.05	$.24	N/A	**$.29**
10/1/96	$.05	$.24	$1.00	**$1.29**
7/1/99	$.05	$1.24	$.24	**$1.53**
7/1/02	$.05	$1.48	$.24	**$1.77**
7/1/05*	$.05	$1.72	$.24	**$2.01**

* Rates would increase by 12 mills per cigarette, which is 1.2¢ per cigarette or 24¢ per pack, each succeeding three-year period after July 1, 2005.

Section 2 requires that Department of Revenue give public notice for each rate change.

Section 3 raises the tobacco products tax from 25% to 100% of the wholesale price of the tobacco products.

Section 4 establishes an effective date of October 1, 1996.

Operating Expenditures

Department of Revenue is requesting operating funds to cover the costs of a vacant tax examiner III position which was not funded in FY 97. With such a large increase in taxes due the state (increase from $17 to $50+ million annually), the department anticipates increased taxpayer noncompliance. With significantly higher levels of tax, it is possible that taxpayers will look for loopholes or other methods of tax avoidance. This position will be responsible for insuring that all taxpayers are identified and that taxpayers are filing and paying the proper amount of tax.

Alaska Department of Revenue
Income and Excise Audit Division

Operating Expenditures *(Continued)*

The Department is requesting contractual funding of $5.0 in each year that there is a rate change to cover costs of public notice, forms revisions and postage.

Change in Revenues

The attached spreadsheet details revenue projections from rate increases in this bill.

Alaska Department of Revenue
Income and Excise Audit Division

SB 234
Increase Tobacco Taxes
9-LS1559\A
March 12, 1996

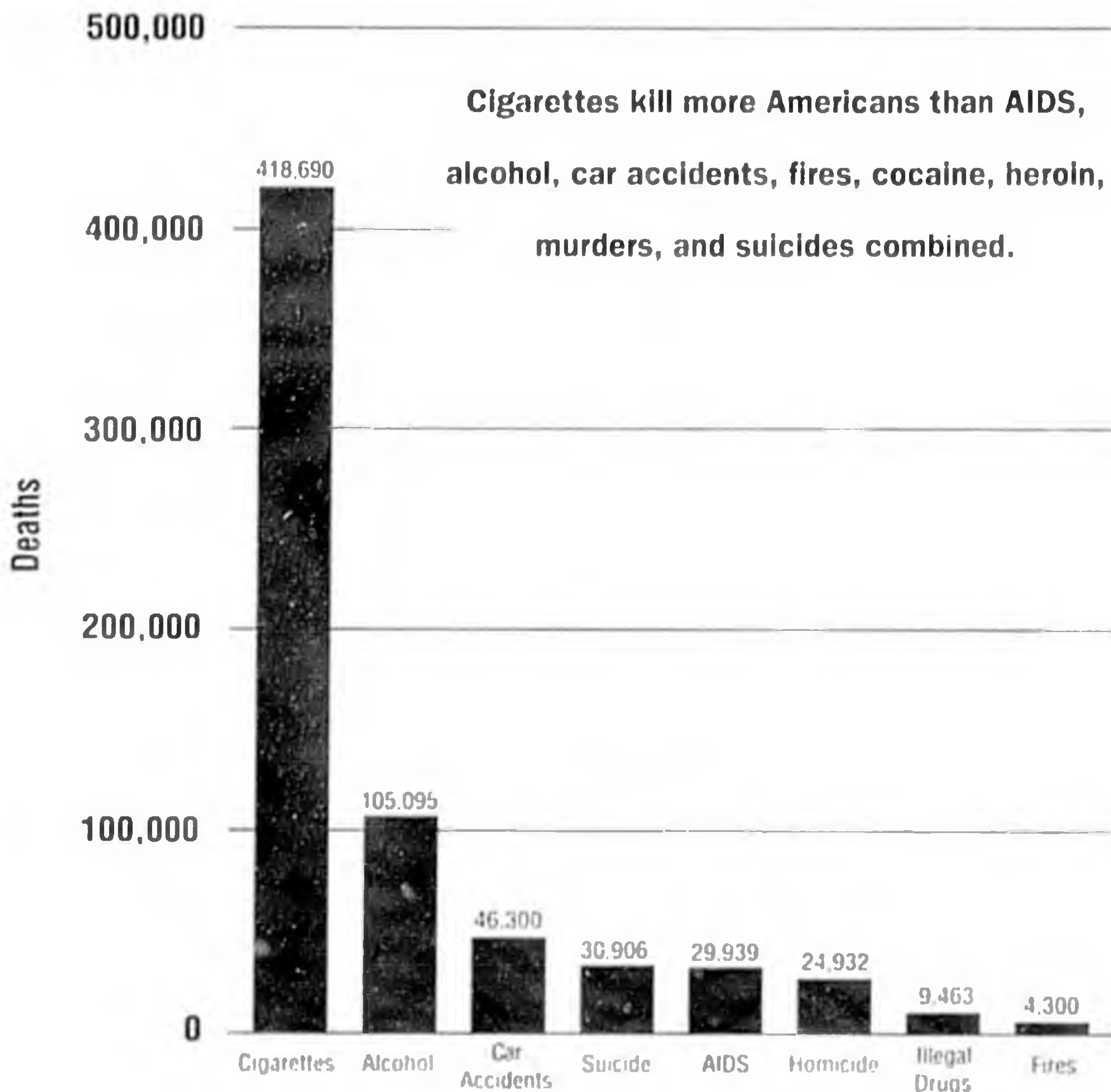
	FY 96 Projected	FY 97 July - Sept	FY 97 Oct - June	FY 97 Total	FY 98	FY 99	FY 00	FY 01	FY 02
Cigarettes									
Elasticity Factor			-18.5%		(-18.5% Annualized)	0.0%	3.0%	0.0%	0.0%
Consumption (packs of cigarettes)	*54,340,000*	13,585,000	33,215,325	46,800,325	44,287,100	44,287,100	42,958,487	42,958,487	42,958,487
Rate	*$0.29*	$0.29	$1.29	*Variable*	$1.29	$1.29	$1.53	$1.53	$1.53
Cigarette Tax	*$15,758,600*	$3,939,650	$42,847,769	$46,787,419	$57,130,359	$57,130,359	$65,726,485	$65,726,485	$65,726,485
Tobacco Products									
Elasticity Factor			18.5%		(18.5% Annualized)				
Consumption (Wholesale Price)	*$6,000,000*	$1,500,000	$3,667,500	5,167,500	$4,890,000	$4,890,000	$4,890,000	$4,890,000	$4,890,000
Rate	*25%*	25%	100%	*Variable*	100%	100%	100%	100%	100%
Tobacco Products Tax	*$1,500,000*	$375,000	$3,667,500	$4,042,500	$4,890,000	$4,890,000	$4,890,000	$4,890,000	$4,890,000
Total Cigarette and Tobacco Tax	***$17,258,600***	**$4,314,650**	**$46,515,269**	**$50,829,919**	**$62,020,359**	**$62,020,359**	**$70,616,485**	**$70,616,485**	**$70,616,485**
Population Increase	*N/A*			1.0038	1.0076	1.0118	1.0158	1.0199	1.0239
Adjusted Increase	*N/A*			51,023,073	62,492,609	62,754,085	71,735,446	72,018,985	72,302,524
Less 1% Commission	*(172,586)*			(510,231)	(624,926)	(627,541)	(717,354)	(720,190)	(723,025)
Net Cigarette and Tobacco Tax	***$17,086,014***			**50,512,842**	**61,867,683**	**62,126,544**	**71,018,091**	**71,298,795**	**71,579,499**
FY 96 Projected Net Tax				(17,086,014)	(17,086,014)	(17,086,014)	(17,086,014)	(17,086,014)	(17,086,014)
Tobacco Tax Increase				**$33,426,828**	**$44,781,669**	**$45,040,530**	**$53,932,077**	**$54,212,781**	**$54,493,485**

SAVING LIVES and raising revenue

THE CASE FOR MAJOR TOBACCO TAX INCREASES IN ALASKA

Protect kids. Tax tobacco.

Nothing Kills Like Tobacco



Source: Centers for Disease Control and Prevention, U.S. Dept. of Health and Human Services, 1990 data

Tobacco Tax Rates in Other States

STATE CIGARETTE EXCISE TAX RATES
in cents per pack of 20, as of January 1, 1996

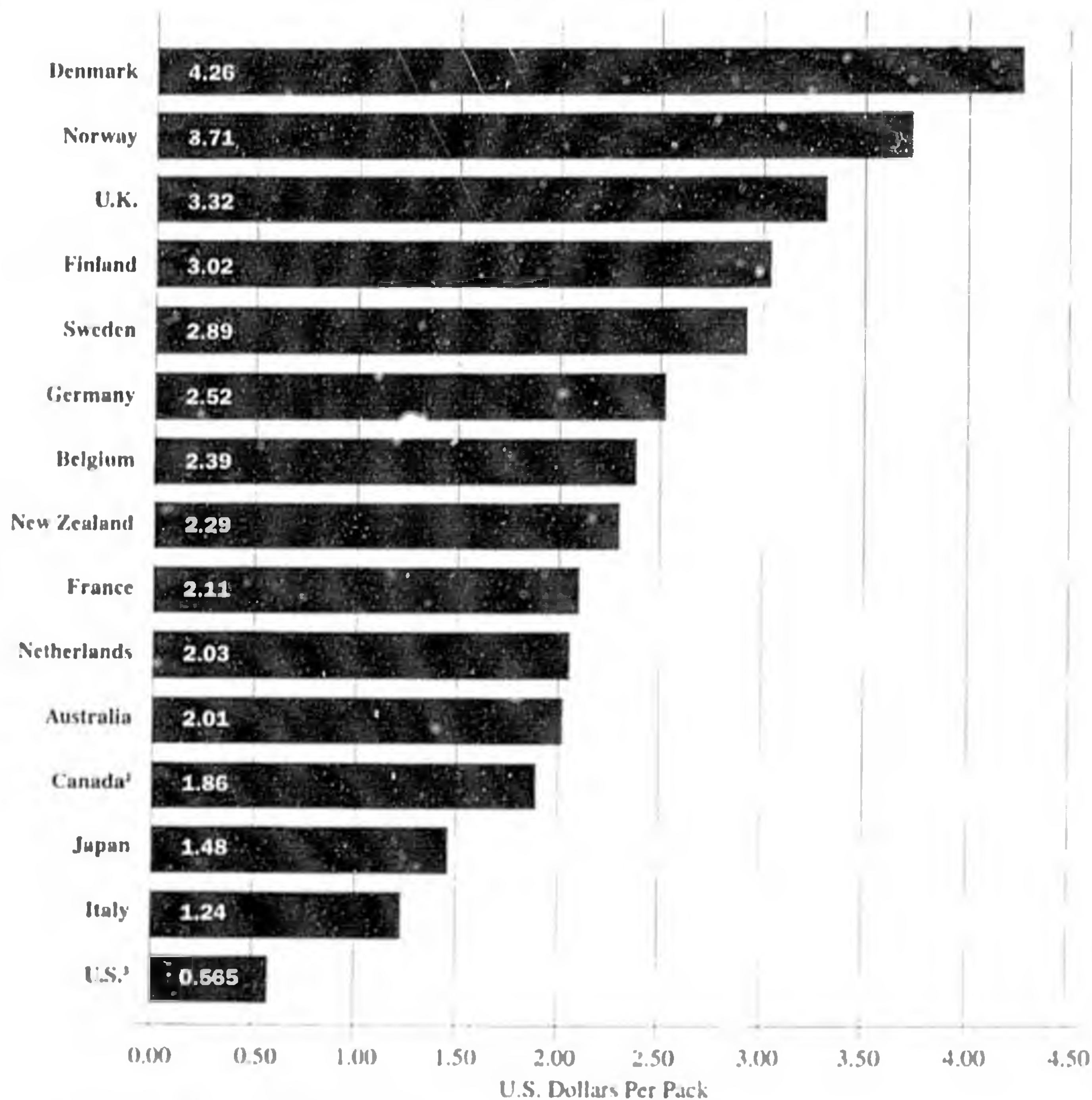
State	Rate
Washington*	81.5
Michigan	75.0
District of Columbia	65.0
Hawaii	60.0
Arizona	58.0
New York	56.0
Rhode Island	56.0
Massachusetts	51.0
Connecticut	50.0
Minnesota	48.0
Illinois	44.0
North Dakota	44.0
Vermont	44.0
Wisconsin	44.0
Texas	41.0
New Jersey	40.0
Oregon	38.0
California	37.0
Maine	37.0
Iowa	36.0
Maryland	36.0
Nevada	35.0
Nebraska	34.0
Florida	33.9
South Dakota	33.0
Arkansas	31.5
Pennsylvania	31.0
Alaska	**29.0****
Idaho	28.0
Utah	26.5
New Hampshire	25.0
Delaware	24.0
Kansas	24.0
Ohio	24.0
Oklahoma	23.0
New Mexico	21.0
Colorado	20.0
Louisiana	20.0
Mississippi	18.0
Montana	18.0
Missouri	17.0
West Virginia	17.0
Alabama	16.5
Indiana	15.5
Tennessee	13.0
Georgia	12.0
Wyoming	12.0
South Carolina	7.0
North Carolina	5.0
Kentucky	3.0
Virginia	2.5

* Washington tax increases by 1¢ on 7/1/96.
**Alaska's tax last raised in 1989.

See back for international tobacco excise tax rates.

TAXES ON CIGARETTES[1] IN MAJOR INDUSTRIALIZED NATIONS

(as of March 22, 1995)



[1] Data based on pack of 20 cigarettes
[2] Average of provinces
[3] Average of 32.5 cents in state taxes and across-the-board 24 cents in federal tax

International data provided by the Non-Smokers' Rights Association of Canada and U.S. data extracted from *The Tax Burden on Tobacco*, Tobacco Institute, 1994; list produced by the Tobacco Tax Policy Project, American Cancer Society.

The Tobacco Industry

"The evidence is unequivocal — the U.S. public has been duped by the tobacco industry. No right-thinking individual can ignore the evidence. We should all be outraged... ."

— Journal of the American Medical Association (July 1995)

NICOTINE ADDICTION IS BIG BUSINESS IN AMERICA. Total net profits of the major tobacco companies in the United States approach $7 billion annually. These companies spend over $6 billion a year on advertising and promotion alone — $16.5 million per day. Only automobiles are more heavily promoted. The most damning information and insights regarding the tobacco industry come from within the industry itself:

- **On addiction** — In public, the industry denies that tobacco is addictive. In April 1994, in testimony before Congress, the heads of the nation's seven largest tobacco companies argued that nicotine is not addictive. William I. Campbell, who was then president of Philip Morris, stated: "I really don't accept that smoking is addictive." In private, however, the tobacco industry has long acknowledged the obvious:

  "We are, then, in the business of selling nicotine, an addictive drug."

  So wrote Addison Yeaman, General Counsel to the Brown & Williamson Tobacco Co., in an internal memo more than three decades ago (1963). In recent years, tobacco company documents show that the industry has been using ammonia-based additives to boost the impact of nicotine in cigarettes. "With ammonia, you get a bigger jag with less nicotine because it is absorbed faster..." acknowledged John Kreisher, formerly of the industry-funded Council for Tobacco Research.

- **On marketing to kids** — Tobacco industry executives have known for years that almost all new smokers are kids, and that the tobacco companies must appeal to children to maintain profitability. From *Planning Assumptions and Forecast for the Period 1977-1986 for R.J. Reynolds Tobacco Company* (March 15, 1976):

  "Evidence is now available to indicate that the 14-18 year-old group is an increasing segment of the smoking population. RJR-T must soon establish a successful new brand in this market if our position in the industry is to be maintained over the long term."

  The document was stamped "secret."

- **On tobacco industry tactics** — Victor Crawford, a former state senator from Maryland who later became a tobacco lobbyist, is now one of the industry's most knowledgeable critics. As a tobacco lobbyist, Crawford was paid up to $200 per hour to buttonhole old colleagues and get them to back off on tobacco legislation. This all changed when he was diagnosed with throat cancer, a result of heavy smoking. Crawford says:

  "[A]nything goes... [the tobacco companies will use] ... any marketing gimmick, any trick, to make you want to smoke."

  Crawford speaks out against not only the dangers of tobacco, but also about industry marketing to teenagers. "It's too late for me," Crawford says, " but it's not too late for you. ... Don't let anybody fool you."

Answering the Opposition

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THE TOBACCO INDUSTRY ARGUES AGAINST INCREASED TOBACCO TAXES for the very same reason that doctors, nurses, health professionals, and other public interest organizations advocate for them — increased tobacco taxes reduce smoking and addiction among children.

A variety of arguments have been advanced by the tobacco industry regarding increased tobacco taxes. Presented below are some of those arguments and responses.

1. **Argument: "The public doesn't want more taxes."**

   In fact, there is broad public support for major tobacco tax increases. As stated by former President Ronald Reagan's U.S. Surgeon General, C. Everett Koop: "Polls show that ... Republicans and Democrats, young and old, men and women [all] support a large cigarette tax." In Alaska, a 1996 statewide survey (Mathematica) found that 74% of respondents support a $1 per pack tax increase. The support was consistent among conservatives, liberals, and moderates. Even 55% of the tobacco users surveyed support the tax increase.

   Martilla & Kiley (April 1993) found that a majority of American voters in every region of the country of every age, income, and education level favored increasing tobacco taxes by $2 per pack. Support was strong among both Republicans (63%) and Democrats (66%). Even leading tobacco-producing states such as Georgia, Kentucky, South Carolina and Virginia strongly supported tax increases. A CNN poll (March 1993) found that 83% of the voting public favors increasing tobacco taxes. A *Wall Street Journal*, NBC news poll found that 70% of adults support a $2 per pack tax increase. Polls in other states confirm the same thing. Michigan residents recently passed a referendum to raise cigarette taxes 50 cents per pack (to 75 cents/pack) and the state legislature subsequently enacted the increase into law.

2. **Argument: "The legislature should cut spending, not raise taxes."**

   The proposal to increase tobacco taxes is fundamentally a matter of health policy. Increased tobacco taxes will prevent addiction among children and save lives. Even if there were no "fiscal gap" in Alaska, a tobacco tax increase is justified to protect and promote the public health.

   With state oil revenue declining, it is clear that State spen[illegible] ll be cut. Both the Legislature and the Administration have pledged to cut spending. But even after making extremely deep cuts, some level of taxation will still be needed to support basic services. Because tobacco taxes protect kids and save lives they enjoy broad public support and have been endorsed by all major health organizations, including the American Cancer Society, American Heart Association, and American Lung Association.

(continued on back)

3. **Argument: "Tobacco taxes are regressive."**

If there is an undue burden being placed upon the poor, it is the disease caused by tobacco — the heart attacks, strokes, and cancer which rob families of their wage earners. The notion that tobacco taxes will hurt lower income individuals is a misleading excuse to keep tobacco taxes low. Since there is evidence that the poor quit smoking in larger numbers in response to price increases, they will benefit to a greater extent than more affluent socio-economic groups. Finally, can it be considered *progressive* to perpetuate addiction, disease and early death?

4. **Argument: "Taxes should not be used for social engineering."**

All taxes produce changes in social behavior. State legislatures and local governments routinely influence social behavior through tax policy. Property taxes discourage property ownership. Sales taxes discourage retail sales. Capital gains taxes discourage profit taking and reinvestment. Oil taxes reduce resource development. Any tax that is levied produces a social and behavioral response. So long as there is a need for taxes to support basic services, it is reasonable to identify those taxes that will have a positive impact. Tobacco taxes will reduce disease and save lives, recover costs now inappropriately paid for by the public at large, and reduce long-term health care costs. In fact, today's low level of taxation — which does not reflect the huge costs of tobacco use paid for by society as a whole — amounts to "social engineering" by default.

5. **Argument: "It doesn't make sense that a government would use tax revenues from an activity it is trying to discourage."**

In fact, it is possible to have it both ways, as many governments have proven. From a health standpoint, it would be ideal if a tobacco tax increase could completely eliminate tobacco use. The fact is that even while tobacco taxes effectively reduce tobacco consumption, they also raise substantial new revenue. In Canada and New Zealand, as well as California and Michigan, significant tobacco tax increases have produced consistent results — revenues are up and consumption is down. Simply stated, more money is spent on fewer cigarettes. The Alaska Department of Revenue projects that a $1 per pack cigarette tax increase in Alaska would yield new revenue of $42 million in the first year after taking into account reduced tobacco consumption as a result of price increases. In its final report, the Long Range Financial Planning Commission also pointed out another fiscal benefit of tobacco taxation: By reducing tobacco-related health care expenditures, more money is left to pay for other public services.

6. **Argument: "Tobacco tax increases will lead to smuggling."**

The tobacco industry greatly exaggerates the concern of smuggling. In Alaska, the potential for cross-border smuggling of Canadian cigarettes is non-existent — even with a $1 per pack increase in taxes, cigarettes would still be cheaper in Alaska than in Canada. Large scale smuggling through other avenues, such as military bases, is also not realistic, as such an operation would be easy to detect.

7. **Argument: "Tobacco taxes are unfair."**

Tobacco taxes are fundamentally a user fee and tobacco users are currently not paying their own way. In Alaska, for every dollar collected in tobacco tax revenue, the Alaskan economy loses $7 due to smoking-related health care costs and lost productivity — $2.26 for every pack of cigarettes sold. Increased tobacco taxes are justified for several reasons: 1) tobacco taxes are the most effective way to prevent young people from becoming addicted to nicotine; 2) smokers cost the general public in the form of added health care costs; and 3) most smokers want to quit, and raising the price of tobacco products provides an added incentive.

Executive Summary

"Cigarette taxes ... are the most effective way to discourage tobacco use among young people. ... Increasing the cigarette tax could be one of the most important public health measures this country has ever taken."

— former Surgeon General C. Everett Koop, appointed by President Ronald Reagan

NOTHING KILLS LIKE TOBACCO. In Alaska, one out of five deaths is caused by tobacco. In the United States, smoking kills almost 420,000 people per year — more than AIDS, alcohol, car accidents, fires, cocaine, heroin, murders, and suicides *combined*. Worldwide, tobacco kills 3 million people per year — someone every 10 seconds.

- **Tobacco use is the leading cause of death in Alaska.** When used as intended, tobacco kills.
- **Adults don't start smoking — kids do.** Almost all tobacco victims become addicted to nicotine as teens or younger. Nicotine is regarded by many authorities to be as addictive as heroin or cocaine. If we can stop kids from getting addicted, we can prevent needless disease and death later in life.
- **Tobacco companies spend over $6 billion a year — about $16.5 million each day — on advertising and promotion in the United States.** Tobacco industry advertising is very effective at reaching children. About 91% of 6 year olds recognize the Old Joe Camel cartoon character, about the same percentage that recognize the Disney Channel-Mickey Mouse logo.
- **Education alone does not work**. For many years, education has been the primary strategy to reduce tobacco use among children. Nevertheless, recent surveys show that smoking among youth is increasing.
- **Increasing tobacco taxes is widely recognized as the single most effective way to reduce tobacco consumption among children.** Children are price sensitive consumers. Research shows that a cigarette price increase of 10% can be expected to reduce consumption by an equal or greater amount by children. A $1 per pack tax increase would reduce youth smoking in Alaska by an estimated 32%.
- **Tobacco taxation is an efficient and appropriate means to offset the enormous costs caused by tobacco.** Alaska's Long Range Financial Planning Commission concluded that a $1 per pack increase in the state's cigarette tax would raise $42 million in new revenues in the first year.
- **Alaska's current tobacco tax is below the national average, even though Alaska has one of the highest rates of tobacco-related death in the nation.** Nor have tobacco taxes in Alaska kept pace with inflation. In 1964, the year that the first Surgeon General's report on smoking and health was released, the state tax comprised 24% of the retail price of cigarettes. Today it is only 14%.
- **The public supports tobacco taxes.** A January 1996 statewide survey found that 74% of Alaskans support an increase of $1 per pack in the state excise tax on cigarettes.

Why Single Out Tobacco?

"If, in the United States, five 727s with 200 people crashed every day of every week of every month of every year, sooner or later someone would say, 'We've got to do something about this.'"

— Dr. John Allen (past president)
American Lung Association

TOBACCO IS A UNIQUE PRODUCT BECAUSE OF THE STAGGERING TOLL IT TAKES ON THE LIVES OF MILLIONS. Each year, tobacco kills more Americans than AIDS, alcohol, car accidents, fires, illegal drugs, murders, and suicides *combined*. It is the only legal product that when consumed exactly as the manufacturer intends, causes addiction, disease, and death.

- **Tobacco is unique in the number of Americans it kills.** Each year 419,000 Americans die from smoking. That's 1,100 Americans each day, one every 75 seconds. One of every five deaths in the U.S. — and in Alaska — are caused by tobacco. Tobacco kills more than *one out of three long-term users*, half of whom die in middle age.
- **Virtually all new users of tobacco products are children.** Almost 90% of all smokers started before the age of 19. The average age of initiation is 14.5 years. Adults don't start smoking — kids do. The same is true of smokeless tobacco use.
- **Tobacco is unique because it is harmful to all users at all doses.** There is no safe level of tobacco use. Smoking just two cigarettes a day doubles one's risk of lung cancer and increases the risk of heart disease and stroke.
- **Tobacco use produces no health benefits.** Unlike some food products which provide nutritional benefit but also contribute to the risk of heart disease under certain circumstances, tobacco provides no nutritional benefit and is harmful under all circumstances. Unlike alcohol, tobacco kills even when used in "moderate" amounts.
- **Tobacco smoke kills users and non-users alike.** The American Heart Association estimates that 52,000 deaths a year are caused by exposure to second-hand smoke, making environmental tobacco smoke the third leading cause of death in the nation (behind active smoking and alcohol abuse). Viewed another way, this means that for every eight smokers that the tobacco industry kills, it takes one non-smoker with them.
- **Tobacco is unique because it contains nicotine, a highly addictive drug.** Researchers widely regard nicotine to be as addictive as heroin or cocaine. Withdrawal from nicotine addiction is like withdrawal from other highly addictive substances: difficult and painful. Seventy percent of smokers say they want to quit, and millions try to quit each year, but only 2.5% succeed in any given year.

Tobacco Taxes and Kids

"There is widespread agreement ... that few measures exhibit the speed and magnitude of impact achieved by increasing taxation on tobacco products. [I]ncreasing tobacco excise taxes must be considered an essential and primary component of any comprehensive tobacco control program."

— *The Impact of Cigarette Excise Taxes on Smoking Among Children and Adults*
National Cancer Institute (August 1993)

EVERY DAY IN THE UNITED STATES, ABOUT 3,000 CHILDREN JOIN THE RANKS OF CIGARETTE SMOKERS. The average age is 14.5 years old. Of these 3,000 new smokers, we can expect that 30 will be murdered, 60 will die in traffic accidents, and 1,000 will be killed from smoking.

- **Adults don't start smoking — kids do. Some 89% of adults who smoke began using cigarettes by or at age 18.** If children can be dissuaded from smoking they almost always lose interest by the time they reach 19, greatly reducing their chance of premature death.
- **Youth smoking and smokeless tobacco use rates in Alaska are higher than the national average.** In 1989, 23% of high school seniors in Alaska reported that they smoked daily. Eighteen percent of 12th grade boys reported daily use of chewing tobacco.
- **As tobacco taxes are increased, youth consumption will drop.** Research shows that a price increase of 10% in cigarettes can be expected to produce a 10% decrease in consumption by youth. A substantial part of the decline is a result of children who will not initiate smoking at higher prices.
- **Children are more influenced by tobacco prices than adults**. Children who smoke may not yet be addicted, and generally have less disposable income. A significant price increase in tobacco products will discourage kids from starting to smoke, while encouraging current smokers to quit or cut back.
- **Experience in Canada demonstrates that increased tobacco taxes will substantially reduce smoking among kids.** During the 1980s, Canada raised tobacco taxes from rates comparable to current U.S. rates to about $3 (U.S.) per pack. Between 1981-1991, teen smoking declined by more than 60% in Canada while it remained relatively constant in the U.S. (See Figure 1.)
- **In 1994, the Alaska Department of Health and Social Services recommended a $2 per pack increase in state cigarette taxes as part of its Cancer Control Plan**. The research team concluded: "Preventing tobacco use by children is the key challenge in tobacco use reduction, and a substantial excise tax increase is our strongest weapon. No other measure can have as great an impact on the public's health and that of our children."

Figure 1: Real cigarette prices and cigarette smoking among Canadians age 15 to 19

Tobacco Taxes and the Economy

"State tobacco tax revenues are up. Monies collected from the tobacco tax are on target... . This is good news. Cigarette consumption in Michigan is down, as was expected and predicted by health and treasury officials. ... Reduced consumption is also good news. ... [M]illions of dollars in health care costs for smoking related disease will be saved as a result of reduced consumption."

— Douglas B. Roberts, Michigan State Treasurer (July 1995)
Statement regarding Michigan tobacco tax increase to 75 cents per pack

SMOKING CAUSES MORE THAN $50 BILLION IN DIRECT HEALTH CARE COSTS EACH YEAR, according to the U.S. Centers for Disease Control and Prevention. Economic productivity losses add another $50 billion, bringing the total cost of smoking to $100 billion per year.

- **In Alaska, smoking is responsible for 23% of all deaths among Alaskans age 35 and older. Direct health care costs attributed to smoking in 1991 for Alaskans in this age group were $45.6 million.** An additional $82 million was lost due to indirect costs (lost productivity), bringing the total economic impact to $127.6 million. For every dollar that's collected in tobacco taxes, the Alaskan economy loses $7 from the impacts of smoking.
- **Smokers use 50% more sick leave and use the health care system 50% more than non-smokers.**
- **Current and former smokers generate an estimated $501 billion in excess health care costs** over the course of their lives, even though smokers die an average of 12 to 15 years younger than non-smokers.
- **Non-smokers pay for 75% of all government expenditures on smoking-related health care through taxes.** Of the $50 billion in U.S. health care expenditures caused directly by smoking in 1993, $22 billion was paid for by government funds.
- **The Alaska Long Range Financial Planning Commission has estimated that a tobacco tax increase of $1 per pack on cigarettes and a comparable increase in taxes on other tobacco products would raise approximately $43 million annually.** The Commission concluded: "This tax increase will dramatically lower teenage smoking and reduce tobacco use by adults, both of which will reduce the State's future expenditures on health care costs."
- **Tobacco tax increases result in increased revenue and reduced consumption.** (See Figure 2.) This is because for most of the population a 10% price increase will result in about a 4% sales decline (with higher declines among kids). The net effect of a tobacco tax increase is that more money gets spent on fewer cigarettes, resulting in major health *and* revenue gains.
- **Increased tobacco taxes offer a win-win-win opportunity,** simultaneously preventing tobacco addiction and death, reducing health care costs, and raising revenue.

Figure 2. Cigarette Sales Versus Tobacco Tax Revenue Canada 1981 - 1992

For more information on **SAVING LIVES and raising revenue**, contact:

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THE ESTIMATED REVENUE EFFECTS OF A PROPOSED $1 PER PACKAGE INCREASE IN THE CIGARETTE TAX RATE IN ALASKA

PREPARED FOR:

THE ALASKA CABARET, HOTEL, RESTAURANT AND RETAIL ASSOCIATION

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DECEMBER 11, 1995

PREFACE

Barents Group LLC of KPMG Peat Marwick LLP was asked by the Alaska Cabaret, Hotel, Restaurant and Retail Association to study a proposal by the State of Alaska Long-Range Financial Planning Commission ("the Commission") to increase the State cigarette tax by $1 per package from $0.29 to $1.29 starting in fiscal year 1996. This report, which describes our findings, has an Executive Summary, four parts, and a technical appendix. Part I is an introduction, Part II describes the methodology used to evaluate the Commission's analysis, Part III describes our results, and Part IV provides our conclusions.

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EXECUTIVE SUMMARY

Barents Group LLC of KPMG Peat Marwick LLP was asked by the Alaska Cabaret, Hotel, Restaurant and Retail Association to study a proposal by the State of Alaska Long-Range Financial Planning Commission ("the Commission") to increase the State cigarette tax by $1 per package from $0.29 to $1.29 starting in fiscal year 1996. The Commission estimates that this proposal would increase cigarette tax revenues (in constant 1996 dollars) by $42 million per year for the period 1996 to 2000 (and beyond).

KPMG Barents found several major shortcomings in the Commission's estimating procedures that lead to a substantial overstatement of the net revenue impact of the proposal. The Commission assumed an unrealistically low responsiveness of cigarette consumers to changes in the price of cigarettes. The Commission also ignored the tendency for consumer responsiveness to increase with time. Furthermore, the Commission ignored the long-run decline in per-capita cigarette consumption observed in Alaska and in the United States in general. Finally, the Commission misstates the revenue potential of a fixed, per unit tax in the context of inflation. Each of these considerations contributes to an overstatement of potential revenue gains from the tax proposal.

In summary, KPMG Barents found that the Commission overstated the revenue potential of the proposed tax by almost $10 million (29 percent) in FY 1996, and by $25 million (146 percent) in FY 2000. Consequently, the proposed tax would play a much smaller role in closing Alaska's growing fiscal gap than claimed by the Commission. The tax would also increase the bootlegging of cigarettes in Alaska, in connection with military installations, Indian reservations, or other nontaxed alternatives. Finally, as a result of declining cigarette demand, the State increase would reduce local tax collections in Anchorage, Juneau, and Fairbanks by a total of $5 million over the 5-year period.

I. INTRODUCTION

The State of Alaska Long-Range Financial Planning Commission ("the Commission") has proposed a $1 per package increase in the State cigarette tax. The reason for this tax increase is to help close a widening deficit in State finances for fiscal year 1996 (FY 1996) and beyond. The Commission estimates a deficit of $513 million for FY 1995 and forecasts a deficit of over $1.3 billion by FY 2000 without changes in current State fiscal policy.[1]

A 345 percent increase in the State cigarette tax from $0.29 to $1.29 will have a number of unintended effects in the State. These effects include: (1) continued shortfalls in state government revenues; (2) a loss in revenue to major municipal governments; (3) increased illegal activity because of the bootlegging of tax-free cigarettes from jurisdictions not covered by the state's taxing authority, military bases for example; and (4) deterioration in the distribution of income due to the regressive nature of the tax.

The Commission estimates that a $1 per package increase in the cigarette tax will raise an additional $42 million per year (in constant 1996 dollars) during the period FY 1996 through FY 2000[2]. These estimates, however, are based upon several questionable assumptions that overstate the revenue potential of the tax, and will result in the State's revenue goals not being met.

First, the Commission believes that consumers would be unlikely to materially adjust their purchasing behavior in response to significantly higher cigarette prices caused by the tax increase. In other words, the Commission assumes a "demand elasticity" much lower than reported in most peer reviewed professional journals. The scientific evidence suggests that following the proposed tax increase, cigarette sales, and, hence, tobacco tax revenues, would fall much more than the Commission believes.

Second, the Commission makes no reference to the long-run decline in smoking per capita in Alaska and nationwide. Taking this into account further lowers the revenue potential of a tax increase.

Third, the Commission ignores long-run factors specific to Alaska that are likely to further erode potential tax revenue gains. Tax-free cigarette sales at military installations are likely to rise substantially, through legitimate sales and through bootlegging, if the proposed tax increase becomes law. Even under the existing tax regime, an extraordinarily large share of cigarette sales in the State already occur through military bases.

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[1] See State of Alaska Long-Range Financial Planning Commission, 1995, p. 1. These amounts are expressed in FY 1996 dollars.

[2] See State of Alaska Long-Range Financial Planning commission, 1995, p. 3 and p. 26.

Finally, the Commission misstates the revenue potential of a fixed, per-unit tax in an inflationary environment, which also contributes to an overestimation of potential new tax revenue.

In addition to the impact on State tax collections, we also find that the proposed tax increase will directly reduce the tax collections of Anchorage, Fairbanks, and Juneau. This reduction will result from the tax-induced decline in demand for cigarettes that are subject to local taxation in these jurisdictions.

Interest in the distributional consequences of taxes has historically been a major concern in tax policy debates. The concern is particularly acute for lower-income taxpayers, for whom even relatively small dollar increases in tax burden can require disproportionately large sacrifices. The 345-percent increase in cigarette taxes will represent a much larger percentage of income for lower income residents than for wealthier residents. This will adversely affect the distribution of income within the State and make the tax system more regressive.

In summary, we find that the Commission overstates potential revenue gains of the proposed tax increase by 29 percent in FY 1996, and by FY 2000, overstates potential revenue gains by 146 percent. In addition, the decline in local tax revenues collected by Anchorage, Juneau, and Fairbanks, which the Commission does not discuss, will be approximately $1 million per year. Indeed, revenues may be even lower due to increased bootlegging. Finally, the tax increase will fall most heavily on the lower-income portion of the State's population.