

NO. 10-0245

In the Supreme Court of Texas

PATRICK O. OJO, on Behalf of Himself and All Others Similarly Situated,
Plaintiff-Appellant,

v.

**FARMERS GROUP, INC., FIRE UNDERWRITERS ASSOCIATION, FIRE
INSURANCE EXCHANGE, FARMERS UNDERWRITERS ASSOCIATION, and
FARMERS INSURANCE EXCHANGE,**
Defendants-Appellees.

On Certification From
The United States Court of Appeals
For the Ninth Circuit
No. 06-55522

***AMICI CURIAE BRIEF ON THE CERTIFIED QUESTION FOR
PROPERTY CASUALTY INSURERS ASS'N OF AMERICA,
AMERICAN INSURANCE ASS'N, NATIONAL ASS'N OF MUTUAL
INSURANCE COMPANIES, INSURANCE COUNCIL OF TEXAS, and TEXAS
COALITION FOR AFFORDABLE INSURANCE SOLUTIONS***

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DISCLOSURE OF INTEREST

Credit information has historically proven to be a valuable underwriting and rating tool for insurers and an economic benefit to many insureds. Most states, like Texas, recognize credit-based insurance scoring appropriately helps set rates based on risk. As such, the issue before the Court on a certified question about the use of credit-based scoring to set rates is of widespread interest to the insurance industry. Amici offer this brief to aid the Court in analyzing the Texas Legislature's words and deeds over many decades regulating insurance rates, including its statutory enactments in 2003 regulating the use of credit scoring.

This amici brief is presented by five insurance trade groups representing nearly all of the property and casualty insurance companies writing insurance in Texas and the United States. The Amici are Property Casualty Insurers Association ("PCI"), American Insurance Association ("AIA"), National Association of Mutual Insurance Companies ("NAMIC"), Insurance Council of Texas ("ICT"), and Texas Coalition for Affordable Insurance Solutions ("TCAIS"). PCI represents more than 1,000 property and casualty insurance companies. Its members are domiciled and transact business in all the states. PCI member companies write over 37 percent of all property and casualty insurance in the United States. AIA represents some 350 major property and casualty insurance companies, based in Texas and most other states, that collectively underwrote over \$11 billion in property and casualty insurance premiums in Texas in 2008 (comprising over 30 percent of the market in Texas). NAMIC's more than 1,400 member companies, domiciled and transacting business in all the states, write over 40 percent of the property

and casualty insurance premium in the United States. ICT represents nearly 500 property and casualty insurers writing business in Texas. Among other functions, ICT follows the legislative process and reports to its members on important legislative initiatives and changes in insurance law. TCAIS is made up of major property and casualty insurers writing business in Texas. Its mission is to work with Texas state legislators, regulators, and consumers to find policy solutions that will improve insurance affordability and accessibility.

The Amici will pay all fees and expenses for this brief.

STATEMENT OF THE CASE

- Nature of the Case:** Plaintiff Ojo, an African-American resident of Houston, claims Farmers' use of race-neutral credit-scoring factors to determine premium rates has a disparate impact on minorities in violation of the federal Fair Housing Act ("FHA"). Plaintiff Ojo brought suit against Farmers in the U.S. District Court for the Central District of California on behalf of himself and other minorities.
- Trial Court Proceedings:** The federal District Court dismissed Plaintiff Ojo's complaint as reverse preempted under the McCarran-Ferguson Act, concluding that to allow Plaintiff Ojo's claim would "invalidate, impair, or supersede" Texas' credit scoring statute.¹ The District Court found the Texas statute allows insurers to set insurance rates using credit scoring models so long as the models are actuarially sound and do not use race as a factor.²
- Court of Appeals:** United States Court of Appeals for the Ninth Circuit.
- Appellate Disposition:** Plaintiff Ojo appealed, and a divided three-judge panel initially reversed the District Court, holding that Texas law does not reverse-preempt Ojo's FHA claim.³ But the Ninth circuit granted rehearing *en banc* and has stayed further proceedings pending resolution of its certified question to the Texas Supreme Court. In essence, the Ninth Circuit asks this Court to determine what the Texas Legislature meant when it required as part of its insurance regulatory system, that rates not be "unfairly discriminatory," specifically in the context of credit scoring.⁴
- Certified Question:** This Court accepted the certified question from the Ninth Circuit on April 16, 2010.

¹ *Ojo v. Farmers Group, Inc.*, 2006 WL 4552707 at *20 (C.D. Cal. Mar. 7, 2006).

² *Id.*

³ *Ojo v. Farmers Group, Inc.*, 565 F.3d 1175, 1189 (9th Cir. 2009), *reh'g en banc granted*, 586 F.3d 1108 (9th Cir. 2009).

⁴ *Ojo v. Farmers Group, Inc.*, 600 F.3d 1205 (9th Cir. 2010).

SUMMARY

The Texas Legislature has enacted a comprehensive approach to the regulation of the business of insurance, including specific provisions identifying prohibited discrimination and delegating strong enforcement powers to the Texas Insurance Commissioner. Early on, the Texas Legislature recognized that setting rates based on actuarial principles to predict the costs of risks and hazards was the appropriate way for insurers to price insurance. Sound actuarial principles require any underwriting or rating factor to accurately distinguish individuals on the basis of differences in expected costs associated with the transfer of risk. That is to say, an insurer must differentiate among individuals based on differences in expected or actual costs and hazards. But as no two insureds have identical cost characteristics or face identical hazards, Texas regulatory system permits insurers to group insureds according to differences in actual or probable loss costs. And through the Texas Insurance Code, the Legislature defined “unfair discrimination” as treating individuals in the same class and facing essentially the same hazard unequally. The Texas Legislature’s design for insurance regulation has remained constant over the years.

In 2003, the Texas Legislature expressly brought credit scoring within the Texas insurance regulatory framework. Credit scoring is one of several methods insurers use to classify individuals in order to determine rates.⁵ The Legislature permitted the use of

⁵ Individual insureds within a particular classification may also have individual risk variations and hazards even though classified similarly with others as to other risks and hazards.

credit scoring as long as insurers did not use “unfairly discriminatory”⁶ factors in their credit models, which are factors not tied to risk or that use prohibited characteristics such as an individual’s race. Also at that time, the Legislature directed the Texas Insurance Commissioner to study Texas’ use of credit scoring and report back in January 2005.⁷ The Insurance Commissioner completed his study and reported “credit scoring is not unfairly discriminatory as defined in current law because credit scoring is not based on race, nor is it a precise indicator of one’s race. Further, its use is justified actuarially.”⁸

Finally, most states’ insurance codes ensure persons with similar risk characteristics are treated similarly and prohibit discrimination based on their race. State statutes and case law validate insurers use of actuarially sound factors in grouping persons into classes based on sound actuarial principles, while prohibiting intentional discrimination against individuals.

Texas regulatory design is to make insurance rates as risk-related and accurate as possible and because credit scoring has been shown to be not “unfairly discriminatory,” Plaintiff Ojo’s disparate impact claim under the FHA unquestionably impairs Texas’

⁶ “Unfair discrimination”, as more fully discussed below in Section III, is a term of art in the insurance industry.

⁷ TEX. INS. CODE ANN. art. 21.49-2U § 15 (5) and (6) (Vernon Supp. 2003).

⁸ SUPPLEMENTAL REPORT TO THE 79TH LEGISLATURE: USE OF CREDIT INFO. BY INSURERS IN TEX.: THE MULTIVARIATE ANALYSIS (Jan. 2005), <http://www.tid.state.tx.us/reports/credit3.html>; then follow “Supplement Report” hyperlink. *Accord*, The Federal Trade Commission, *Credit-Based Insurance Scores: Impacts on Consumer of Automobile Insurance* (July 2007), www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf

regulation of the insurance industry. Ojo’s claim is necessarily reverse-preempted under the McCarran-Ferguson Act.⁹

ANALYSIS AND AUTHORITIES

I. Credit Scoring Is Actuarially Sound and Assists In Differentiating Classes Of Risk, And Thus Properly Setting Insurance Rates.¹⁰

In determining insurance rates, property and casualty insurers rely on actuarial standards to set rates that most accurately reflect the costs associated with the risks assumed under an insurance policy. The ability to accurately assess risk is crucial to both the insurers’ financial viability and to well-functioning insurance markets for consumers. If risk is underestimated, an insurer will not charge a premium adequate to cover the losses. The low premium may also attract an imbalance of high-risk insureds, compounding the problem. Alternatively, if risk is overestimated, then an insurer may charge a higher premium than necessary. That would either drive well-informed low-risk insureds to seek policies from competing companies offering lower premiums or leave

⁹ Though the Ninth U.S. Circuit Court of Appeals, in this case, has held the Federal Housing Act applies to homeowners insurance, it acknowledges a split among the Circuits on this point. *Ojo*, 600 F.3d at 1208. Further, the original Ninth Circuit panel considering Plaintiff Ojo’s claim debated whether Plaintiff Ojo’s complaint was based on discriminatory treatment or non-discriminatory conduct that caused disparate impact. *Ojo*, 565 F.3d at 1193 n.2 (Bea, J., dissenting). In reconsidering the panel decision *en banc*, the Ninth Circuit appears to have concluded that Ojo’s claim under the FHA is based on disparate impact. As a result, the Circuit Court asks only whether Ojo’s claim of disparate impact under the FHA, as it pertains to homeowners insurance, is reverse-preempted. While Amici believe a claim predicated on disparate impact is not viable under the FHA in relation to the sale of homeowners insurance (neither any U.S. Circuit Court nor the United States Supreme Court has held so), it is apparent the Ninth Circuit has determined it need not reach that question if, depending on this Court’s decision, the McCarran-Ferguson Act reverse-preempts Ojo’s action.

¹⁰ Texas Insurance Code, Chapter 559, refers to Credit Score, it then defines the terms “credit score” and “insurance score” in Section 559.001(8). It is clear the Chapter, though using interchangeably “credit score” and “insurance score”, explicitly governs what is known in the insurance industry as credit-based insurance scoring.

less well-informed insureds subsidizing through their higher premiums the costs of high-risk insureds. Insurers use actuarial principles to determine appropriate rates by finding relationships between factors and risk of loss and then allocating costs accordingly. This is the essence of risk-based pricing, which ultimately leads to accurate pricing.

Risk-based pricing requires making distinctions among insureds using a number of factors that are relevant to placing individuals expected to have similar risks into pricing groups. The more specific and the greater the number of risk levels used, the more likely insureds are placed with other insureds with similar risk profiles. And the more accurate the grouping of individuals with similar risk profiles, the more accurate the price, which in turn benefits consumers because it improves competition, affordability, and availability of insurance. Texas, along with a number of other states, has embraced risk-based pricing of insurance through legislation. In Texas, an insurer is prohibited from using a rate that is not based on sound actuarial principles or that does not bear a reasonable relationship to the expected loss and cost experience.¹¹

Credit-based insurance scoring, which uses select information from an individual's credit history to measure cost, is in keeping with, and makes more accurate, risk-based rate setting.¹² Over the last two decades insurers have increasingly used credit scoring because their experience has revealed it to be an effective predictor of risk, allowing insurers to more accurately rate policies. In fact, numerous studies conducted by private research firms, public universities, and government agencies have repeatedly confirmed

¹¹ TEX. INS. CODE ANN. § 2251.051 (Vernon 2010).

¹² With respect to credit, generally, the Fair Credit Reporting Act, for decades, has specifically authorized insurer use of credit scores. *See*, 15 USC § 1681b(a)(3)(C).

the positive correlation between credit-based insurance scores and actual loss experience. A few of those reports are noted here.

EPIC Actuaries, in 2003, completed the largest and most comprehensive study undertaken at the time, after reviewing more than 2.7 million automobile policies. The study found that a consumer's credit-based insurance score is directly connected to an insured's likelihood of filing a claim, and that the use of the scores added significant accuracy to the risk assessment process. Further, the study found that the scores measured risk not previously measured by other known rating factors and that they were among the top predictors of risk, outperforming more traditional underwriting factors.¹³ Notably, the study demonstrated that credit-based insurance scores were among the three most important risk factors for each of the six automobile coverages.

The Federal Trade Commission, in 2007, published its study, *Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance*. The study found that scores effectively predict the number of claims consumers file and the total costs of those claims. To reach that conclusion the Federal Trade Commission examined more than two million auto policies.¹⁴

Other studies report similar, significant findings. For example, a report issued by the McCombs School of Business at The University of Texas at Austin concludes:

The correlation between credit score and relative loss ratio is .95, which is extremely high and statistically significant. The lower a named insured's credit score, the higher the probability that the insured will incur losses on

¹³ www.ask-epic.com/Publications/Relationship%20of%20Credit%20Scores_062003.pdf

¹⁴ www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf

an automobile insurance policy, and the higher the expected loss on the policy.¹⁵

The Michigan Supreme Court recently examined this body of evidence and found it persuasive, agreeing that “‘actual and credible loss’ statistics indicate that insurance scoring may be used to establish a ‘system designed to group individuals or risks with similar characteristics which are likely to identify significant differences in mean anticipated losses or expenses, or both, between the groups.’”¹⁶

II. Texas Expressly Permits and Regulates the Use of Credit Scoring.

In 2003, the Texas Legislature expressly recognized the “use [of] credit scoring” in setting insurance rates.¹⁷ Consistent with Texas’ established regimen for all underwriting and rating tools, no credit score could be used that was computed using “factors that

¹⁵ BUREAU OF BUSINESS RESEARCH, McCombs School of Business, The University of Texas at Austin, *A Statistical Analysis of the Relationship Between Credit History and Insurance Losses*, 13 (2003) http://www.ic2.utexas.edu/publications/bbr_creditstudy.pdf.

Other examples are:

- “The data reviewed in this study produced clear evidence of a strong correlation between credit history and future loss performance.” James E. Monaghan, *The Impact of Personal Credit History on Loss Performance in Personal Lines*, 103 (2000). <http://www.casact.org/pubs/forum/00wforum/00wf079.pdf>
- “The distributions from these scoring models show a downward sloping relationship between loss ratio relativities and insurance bureau scores: the lower the score, the higher the loss ratio relativities, and the higher the score, the lower the loss ratio relativities. Were there no relationship, there would *be* no downward or upward sloping observed.” And, “Insurance bureau scores based on credit data enable insurers of all sizes to improve the speed, objectivity and consistency of their underwriting.” Fair, Isaac & Co., *Predictiveness of Credit History for Insurance Loss Ratio Relativities*, 23, 31 (1999). <http://www.mdinsurance.state.md.us/sa/documents/Ex10-FairIsaacStudy.pdf>

¹⁶ *Insurance Institute of Michigan v. Commissioner*, 486 Mich. 370, ___ N.W.2d ___, 2010 Mich. LEXIS 1445 *52 (2010).

¹⁷ TEX. INS. CODE ANN. art. 21.49-2U § 7(a) (Vernon Supp. 2003); Act of June 11, 2003, 78th Leg., ch. 206, § 3.01.

constitute unfair discrimination.”¹⁸ While drafting the credit scoring regulation, the Texas Legislature was urged to outright “ban the practice of credit scoring altogether.”¹⁹ Opponents appeared before the House Committee on Insurance and testified that credit scoring as an underwriting tool should be disallowed, claiming it would have a disproportionate impact on certain groups: “[c]redit scoring is discriminatory, especially against women, minorities, low-income consumers, and consumers who conduct all of their personal business on a cash basis.”²⁰

But credit scoring was not banned. Instead, the Legislature enacted, among other requirements, regulatory protections on the use of credit information. For example, an insurer cannot deny, cancel or non-renew a policy solely on the basis of credit information nor can it deny coverage solely because the consumer does not have a credit card account.²¹ The Legislature also identified information to be disallowed as a negative factor in an insurer’s scoring methodology. Insurers, for example, may not use as a negative factor a collection account with a medical industry code.²² The Legislature further outlined the procedures for informing consumers of the effects credit information may have on their insurance premiums.²³ The Legislature also required insurers to file

¹⁸ TEX. INS. CODE ANN. art. 21.49-2U § 7(a) (Vernon Supp. 2003).

¹⁹ House Research Org., Bill Analysis at p. 20, Tex. S.B. 14, 78 Leg., R.S. (2003).

²⁰ *Id.*

²¹ TEX. INS. CODE ANN. art. 21.49-2U § 3 (Vernon Supp. 2003)

²² *Id.* at § 4.

²³ *Id.* at § 7.

their scoring models or other scoring processes with the Texas Department of Insurance (TDI).²⁴

Finally, the Legislature directed TDI to study the effect credit scoring may have on certain consumers. In particular, section 15 of the credit scoring statute (article 21.49-2U) required the Insurance Commissioner to submit a report to State officials and the Legislature before January 1, 2005, on:

- a description of favorable and unfavorable effects on consumers related to the use of credit scoring;
- ***“any disproportionate impact on any class of individuals, including classes based on income, race, or ethnicity;”*** and
- recommendations from TDI to the Legislature regarding the use of credit information by insurers.

(emphasis added.)

Insurance Commissioner Jose Montemayor completed his credit scoring study and issued his findings in December 2004,²⁵ which was supplemented with a report to the Legislature in January 2005. The Texas study employed multivariate analysis, used data obtained from six leading insurer groups for approximately two million automobile and homeowner policies, with six personal auto and three homeowners credit scoring models represented in the data collection, supplemental information from the Texas Department of Public Safety, including individual information on race, and information from the

²⁴ *Id.* at § 9.

²⁵ TEX. DEP’T OF INS., REPORT TO THE 79TH LEGISLATURE: USE OF CREDIT INFO. BY INSURERS IN TEX. (Dec. 2004), <http://www.tdi.state.tx.us/reports/credit3.html>; then follow “Use of Credit Information by Insurers” hyperlink

Texas Office of the Secretary of State to try to identify individuals of Hispanic origin.²⁶ For the study, TDI also obtained credit scores and the related input variables (*e.g.* number of credit cards, number of collections, etc.) in the credit models from credit vendors, and reviewed insurer rate filings regarding the use of credit scoring and consumer complaints.

The Commissioner found that the use of credit scores “significantly increased pricing accuracy in predicting risk when combined with other ratings variables.”²⁷ He also reported that the use of credit scoring produced an actuarially supported result that was not “*unfairly or intentionally discriminatory*.”²⁸ Notably, he further wrote that “credit scoring is not unfairly discriminatory as defined in current law because credit scoring is not based on race, nor is it a precise indicator of one’s race.”²⁹ And he advised the Legislature that “to ban the use of all risk-related factors based solely on disproportionate impact,” would homogenize the risk and essentially charge everyone the same price and “would be a set-back to all Texans, of all races, especially those of moderate to lower income whose risk remains low.”³⁰

The Commissioner’s findings are significant to the issues in this case. The Legislature expressly directed the Commissioner to study and report back on these issues in anticipation of its next legislative session. And it was during that session the

²⁶ Credit scores are inherently blind to ethnicity.

²⁷ SUPPLEMENTAL REPORT TO THE 79TH LEGISLATURE: USE OF CREDIT INFO. BY INSURERS IN TEX.: THE MULTIVARIATE ANALYSIS (Jan. 2005), <http://www.tid.state.tx.us/reports/credit3.html>; then follow “Supplement Report” hyperlink.

²⁸ *Id.* at p. 2 (emphasis added).

²⁹ *Id.*

³⁰ *Id.*

Legislature re-codified various provisions of the Insurance Code, including Texas' credit scoring statute as Insurance Code, section 559.051, to which it made no relevant changes. Under similar circumstances, this Court has presumed the Legislatures has accepted the state agency's view.³¹

Because Ojo's complaint about credit scoring impairs Texas' regulatory design to ensure rates are appropriate for the risk being insured, McCarran-Ferguson preempts his action.

III. Texas' Regulatory Design — Unfair Discrimination.

The Ninth Circuit's original panel opinion discusses Texas regulatory enactments and concludes Plaintiff Ojo's disparate impact claim, in fact, is consistent with (and therefore not an impairment of) Texas' prohibition of "unfair discrimination."³² In its *en banc* opinion, however, the Ninth Circuit wrote that this is a question first to be decided by this Court. And contrary to the Ninth Circuit panel's conclusion, a more focused review of Texas statutory enactments demonstrates Plaintiff Ojo's disparate impact claim would impair Texas' comprehensive insurance regulatory regime and is inconsistent with Texas' prohibition of "unfair discrimination."

³¹ Two bills banning credit scoring (H.B. 23 and S.B. 167), which were introduced by members of the 79th Legislature before Commissioner Montemayor's January 2005 report was released, died in committee after the report was released.

Tex. H.B. 23, 79th Leg., R.S. (2005),
<http://www/capitol.state.tx.us/BillLookup/History.aspx?LegSess=79R&Bill=HB23>;
Tex. S.B. 167, 79th Leg., R.S. (2005),
<http://www/capitol.state.tx.us/BillLookup/History.aspx?LegSess=79R&Bill=SB167>

³² *Ojo*, 565 F.3d at 1184.

First, it is important to recognize that in public discourse, the word “discrimination” almost always carries a negative connotation. The act of discriminating among individuals or groups is typically seen as inherently unfair, and to say “unfair discrimination” seems redundant. But “unfair discrimination” has a precise meaning for the insurance industry. Insurers and insureds alike have a legitimate need for insurers to differentiate based on the level of risk an individual presents. As a leading textbook on insurance regulation points out: “For insurance, fair discrimination is not only permitted, but necessary.”³³ “Fair discrimination,” the authors go on to explain, is discrimination based on risk. It follows that “unfair discrimination” involves treating individuals differently based on factors unrelated to risk.

Texas’ first statute concerning unfair discrimination dates back to at least 1909, with legislation prohibiting life insurance companies from “discriminating” between insureds “of the *same class and of equal expectation* of life in the amount of, or payment of, premiums or rates charged for policies of life or endowment insurance”³⁴ This statute was placed in Texas Revised Statutes of 1911, as Article 4954; included in Texas Revised Civil Statutes of 1925 as Article 5053; and amended in 1929.³⁵ The original Texas Insurance Code, enacted in 1951, contained a provision virtually identical to the 1909 statute. Article 21.21 of the new Code provided: “No insurance company of any kind doing business in this State shall make or permit any distinction or discrimination in

³³ Kathleen Heald Ettlinger, *State Insurance Regulation*, pp. 29-30 (1995).

³⁴ Act of March 22, 1909, 31st Leg., R.S., ch.108, 1909 TEX. GEN. LAWS 192, 198.

³⁵ Act of May 17, 1929, 41st Leg., 1st C.S., ch. 3, § 1, 1929 TEX. GEN. LAWS 5-6.

favor of individuals between the insureds of the same class and of equal expectation of life in the amount of, or payment of, premiums or rates”³⁶

In 1957, the Texas Legislature broadened the scope of Insurance Code article 21.21, adding section 4(7). Section 4(7) listed “unfair discrimination” as an unfair method of competition and defined the term as:

(7) ***Unfair Discrimination.***

- (a) Making or permitting any unfair ***discrimination between individuals of the same class and equal expectation of life*** in the rates charged for any ***contract of life insurance*** or of life annuity or in the dividends or other benefits payable thereon, or in any other of the terms and conditions of such contract;
- (b) Making or permitting any unfair ***discrimination between individuals of the same class and of essentially the same hazard*** in the amount of premium, policy fees, or rates charged for any policy or ***contract of accident or health insurance*** or in the benefits payable thereunder, or in any of the terms or conditions of such contract, or in any other manner whatsoever.³⁷

In 1987, the Legislature further amended article 21.21, section 4(7) to prohibit unfair discrimination in property and casualty insurance.³⁸ Throughout Texas’ regulatory history, its design has been to assure persons subject to similar risks were charged similar rates.

In 1991, the Texas Legislature enacted Insurance Code article 21.21-5, making it “unfair” to discriminate “on the basis of race, color, religion, or national origin, and to the extent not justified by sound actuarial principles, on the basis of geographical location,

³⁶ Act of June 28, 1951, 52nd Leg., R.S., ch. 491, § 1, 1951 TEX. GEN. LAWS 868, 1075.

³⁷ Act of May 8, 1957, 55th Leg., R.S., ch. 198, § 1, sec. 4(7) 1957 TEX. GEN. LAWS 401, 403.

³⁸ Act of June 20, 1987, 70th Leg., R.S., ch. 761, § 1, 1987 TEX. GEN. LAWS 2713, 2714.

disability, sex, or age, in the setting or use of rates or rating manuals and in the nonrenewal of policies.”³⁹ TDI adopted Rule 21.7,⁴⁰ which elaborated on article 21.21-5’s prohibitions to include not only activity that had the “purpose” of discriminating, but the “*effect*” of discriminating . . . on the basis of race, color, religion, or national origin.” Because TDI over reached its administrative authority, Rule 21.7 was declared unenforceable.⁴¹ Then, in 1994, TDI proposed two rules, later adopted as 28 Tex. Admin. Code §§ 21.1002 and 21.1004.⁴² TDI, first, made clear the rules squarely implemented the Legislature’s risk-based rate setting directive and prohibition of classifications based on an individual’s race, color, religion, or national origin. TDI explained:

Underwriting guidelines are inherently unfair if they are inconsistent with public policy expressions of social and economic fairness. Underwriting guidelines are also unfair if the guideline does not actually distinguish consumers of different expected costs associated with the transfer of risk. If there is no sound actuarial basis for the discrimination among consumers based upon a particular underwriting guideline, consumers of similar risk are being treated differently and, for at least one class of consumers, unfairly.⁴³

Rule 21.1002 defined an underwriting guideline as “unfair” if it was actuarially unsound. And TDI explained, “[a]s a standard, sound actuarial principles means that the underwriting guideline or rating factor in question accurately distinguishes consumers on

³⁹ Act of August 30, 1991, 72d Leg., 2d C.S., ch. 12, § 17.01, 1991 TEX. GEN. LAWS 252, 336-37.

⁴⁰ 18 Tex. Reg. 6135-6240 (Sept. 14, 1993).

⁴¹ 21 Tex. Reg. 10218 (Oct. 15, 1996).

⁴² 20 Tex. Reg. 436-478 (Jan. 27, 1995) (adopted with revisions).

⁴³ 20 Tex. Reg. 440 (Jan. 27, 1995).

the basis of differences in expected costs associated with the transfer of risk.”⁴⁴ Thus, a “class of consumers should be treated differently from another class of consumers only if the costs associated with the transfer of risk for the first class are different than for the second class.”⁴⁵ TDI also noted the “Legislature has recognized that certain risk classifications are inherently unfair, regardless of differences in the expected costs associated with the transfer of risk.”⁴⁶ “For instance, it has prohibited risk classifications based on race, color, religion and national origin. Insurance Code, Article 21.21-5.”⁴⁷

Rule 21.1004 “prohibit[ed] discrimination on the basis of race, color, religion, or national origin” and, if not justified actuarially, on the basis of “geographic location, disability, sex, or age” in all aspects of insurance — “whether to bind, accept, reject, renew, nonrenew, cancel or limit coverage.”⁴⁸ Rule 21.1004 was necessary because, while TDI considered article 21.21-5 to prohibit the refusal to sell insurance based on the protected classes, insurers had argued that the statute left uncovered the refusal to sell a policy. TDI announced:

Because [article 21.21-5] is subject to different interpretations and is not a clear prohibition against all types of *intentional* discrimination based on these factors, it is necessary for the Department to promulgate a rule which provides a comprehensive and unequivocal prohibition against these types of discrimination.⁴⁹

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ 20 Tex. Reg. 441 (Jan. 27, 1995).

⁴⁷ *Id.*

⁴⁸ 20 Tex. Reg. 458 (Jan. 27, 1995).

⁴⁹ 20 Tex. Reg. 465 (Jan. 27, 1995).

And in response to a comment that “the proposed rule would place restrictions on the discrimination which occurs as a natural part of the underwriting process,” TDI explained:

To the extent that the intentional discrimination which is prohibited by this rule occurs in the underwriting process, the Department believes this comment supports the need for this rule. ***Intentional discrimination based on the characteristics identified in this rule should have no place in the underwriting process.*** This comment, which implies that intentional discrimination does occur in the underwriting process, shows that the prohibitions in this rule are necessary to eliminate this unfair practice in the business of insurance. ***If the commenter intended to mean that underwriting actions create an unintended disparate impact against minorities, the rule does not apply to that situation.*** The word “intentional” was added to clarify that the rule only applies to instances of intentional discrimination and not to instances of non-intentional disparate impact. ***If the commenter intended to mean the fair discrimination associated with fair underwriting guidelines and rating factors, the rule creates no restrictions on the use of fair activities in the underwriting process.***⁵⁰

TDI Rules 21.1002 and 21.1004 substantively foreshadowed two statutes the Texas Legislature enacted in 1995. During the 1995 Legislative Session, the “unfair discrimination” prohibition was extended to all types of insurance, to anyone in the business of insurance, and to all aspects of the insurance transaction. Specifically, article 21.21-6 replaced article 21.21-5⁵¹ and article 21.21-8 replaced and expanded article 21.21 section 4(7).

Article 21.21-6 provided that “no person” shall engage in unfair discrimination and defined “unfair discrimination” to mean “refusing to insure; refusing to continue to insure; limiting the amount, extent, or kind of coverage available; or charging an

⁵⁰ 20 Tex. Reg. 467 (Jan. 27, 1995) (emphasis added).

⁵¹ Act of June 8, 1995, 74th Leg., R.S., ch. 415, §§ 1, 9, 1995 TEX. GEN. LAWS 3005, 3015.

individual a different rate for the same coverage because of race, color, religion, or national origin.” Notably, H.B. 1367, enacting article 21.21-6, was originally drafted to prohibit discrimination “based in purpose *or effect* on race, color, religion, or national origin.”⁵² But “in purpose or effect” was removed early in the Legislative process and “solely based on” was substituted.⁵³ The May 1995 House Research Organization Bill Analysis on the final version of H.B. 1367 highlighted that the new statute “deter[s] unfair discrimination *while also allowing the insurance industry reasonable means to assess risk and make decisions based on risk.*”⁵⁴ Article 21.21-8, as explained by its Legislative sponsors, made the unfair discrimination principle applicable to all types of insurance.⁵⁵ At that same time, the Texas Legislature further differentiated risk-based underwriting from the prohibition of the use of an individual's race, color, religion, or national origin. TDI was charged with enforcing the unfair discrimination provisions under article 21.21-6. In contrast, a private cause of action was authorized to redress unfair discrimination under article 21.21-8.

With the enactment of articles 21.21-6 and 21.21-8, TDI repealed Rule 21.1004, explaining the “standards, requirements, and prohibitions set out” in Rule 21.1004 have

⁵² Tex. H.B. 1367 (introduced version) 74th Leg., R.S. (1995), <http://www.capitol.state.tx.us/tlodocs/74R/billtex/html/HB01367I.htm>.

⁵³ House Insurance Comm., Bill Analysis, Tex. H.B. 1367, 74th Leg. R.S. (1995), <http://www.capitol.state.tx.us/tlodocs/74R/analysis/html/HB01367H.htm>.

⁵⁴ House Research Org., Bill Analysis at p. 10, Tex. H.B. 1367, 74th Leg., R.S. (1995), <http://www.hro.house.state.tx.us/pdf/ba78r/sb0014.pdf#navpanes=0>

⁵⁵ H.J. of Tex., 74th Leg., R.S. 3118 (1995) (Statement of Legislative Intent by Representatives Duncan, Hunter, and Junell) (quoted in Teel Bivens, John T. Monford, Todd A. Hunter, Rob Junell, Robert L. Dunan, and Brian D. Shannon, *The 1995 Revisions to the DTPA: Altering the Landscape*, 27 TEXAS TECH. L. REV. 1441, 1447 (1996)).

been “addressed by the 74th Legislature in two enactments” — articles 21.21-6 and 21.21-8.⁵⁶ Later, effective April 1, 2005, the Texas Legislature re-codified article 21.21-6 as sections 544.002 and 544.003⁵⁷ and article 21.21-8 as sections 544.052 and 544.053 of the Insurance Code.⁵⁸ And in re-codifying article 21.21-6, the Legislature inserted the words “the individual’s”. Section 544.002’s prohibition now reads “*because of the individual’s* [] race, color, religion, or national origin.” The change provided clarity about the Legislature’s intent to prohibit discrimination because of “the individual’s” identity irrespective of any actuarially sound requirement.⁵⁹

Considering Texas’ insurance regulatory history, it is clear the Legislature intends insurance rates to reflect risk as accurately as possible and that the insurance industry is prohibited from intentionally discriminating against individuals because of their race. Plaintiff Ojo’s disparate impact complaint impairs Texas’ regulatory design that mandates accurate risk-based rate-setting and prohibits intentional discrimination.

⁵⁶ 20 TEX. REG. 5614 (July 28, 1995)

⁵⁷ Tex. H.B. 2922, 78th Leg., R.S. ch. 1274 § 26(a)(10) (2003).

⁵⁸ *Id.*

⁵⁹ In that same legislative session, Texas added article 21.21.-6A to the Insurance Code. *See* Acts 2003, 78 Leg., ch. 206 §12.02, eff. June 11, 2003. Like article 21.21-6, article 21.21-6A furthered the Legislature’s commitment to eliminating classifications in insurance “*because of*” race. Article 21.21-6A introduced a criminal penalty in the Legislature’s regimen of prohibiting unfair discrimination. Article 21.21-6A made it a state jail felony for life insurers to offer insurance coverage or collect premium based on a rate “*because of*” race, color, religion, ethnicity, or national origin that was different from another rate for the same coverage or premium. Also, the statute provided an affirmative defense for “classifications applied alike to persons of every race, color, religion, ethnicity, or national origin.” This affirmative defense would be meaningless if non-intentional and merely disparate result was all that was necessary for a violation. Certainly, to support a criminal penalty, “*because of*” must refer to intentional conduct. Former article 21.21-6A was re-codified as section 544.401 of the Texas Insurance Code in 2005.

IV. Texas' Approach To The Regulation Of Unfair Discrimination Is Similar To The Regulation Found In The Majority Of States.

Texas' definition of unfairly discriminatory insurance rates is similar to the definition found in the majority of states. Like Texas, the centerpiece of every state's definition of "unfair discrimination" in insurance rates is charging different rates to persons with similar risks of loss and hazards. That is to say, proper insurance rates are dependent on underwriting based on risk and hazards and like risks and hazards being treated alike.

The uniformity among the states in the concept of unfair discrimination in insurance rates stems, in part, from one of the first model laws drafted in 1946 by the National Association of Insurance Commissioners ("NAIC"),⁶⁰ "An Act Relating to Unfair Methods of Competition and Unfair and Practices in the Business of Insurance." This Model Act was drafted by the NAIC on the heels of McCarran-Ferguson to demonstrate that the states were actively regulating insurance, that there was no need for federal intervention, and to justify the preemption in McCarran-Ferguson.⁶¹

⁶⁰ The NAIC is a voluntary association of the insurance commissioners from each of the fifty states, the District of Columbia, and the U.S. territories. State regulators formed the NAIC to further what they viewed as necessary uniformity in insurance regulation. Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U. L. REV. 625, 630 (1998-1999).

⁶¹ RANDALL, *supra* at 633-34. In 1944, the Supreme Court in *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533, 552-53 (1944), held that insurance is interstate commerce subject to federal regulation under the Commerce Clause. The decision was viewed as an assault on state regulatory and tax authority over the insurance industry. The NAIC responded quickly by proposing a bill which was introduced by Senators McCarran (D-Nev.) and Ferguson (R-Mich.) and signed into law on March 9, 1945. The new law – known as the McCarran-Ferguson Act – declared congressional deference to the states' regulation and taxation of the business of insurance.

The provisions of the NAIC Model Act, among other things, prohibit an insurer from engaging in an unfair method of competition or unfair or deceptive act or practice.

Among the acts and practices defined as unfair are:

Making or permitting any unfair *discrimination between individuals of the same class and equal expectation of life* in the rates charged for any *contract of life insurance* or of life annuity or in the dividends or other benefits payable thereon, or in any other of the terms and conditions of such contract;

Making or permitting any unfair *discrimination between individuals of the same class and of essentially the same hazard* in the amount of premium, policy fees, or rates charged for any policy or *contract of accident or health insurance* or in the benefits payable thereunder, or in any of the terms or conditions of such contract, or in any other manner whatsoever.⁶²

This language from the Model Act was adopted by the Texas Legislature in 1957 when it broadened the scope of article 21.21. By 1960, the Model Act was enacted in all states and the District of Columbia, in its model form or in some variation.⁶³

The Model Act has developed and correspondingly been amended by the NAIC over the years. In the early 1990s the Model Act was amended to prohibit an insurer's conduct based on the race, religion or national origin of the individual.⁶⁴ This same prohibition came into Texas law about the same time. As highlighted earlier, the Texas

⁶² Herman T. Bailey, Theodore M. Hutchison & Gregg R. Narber, *The Regulatory Challenge to Life Insurance Classification*, 25 DRAKE LAW REV. INS. LAW ANNUAL 779, 782-83 (1976). See also NAIC Unfair Trade Practices Act, section 4G(1) and (2), NAIC Model Regulation Service, p. 880-4 (Jan. 2004).

⁶³ BAILEY, HUTCHISON & NARBER, *supra* at 782-83.

⁶⁴ NAIC Model Regulation Service (July 2009), Unfair Trade Practices Act, Legislative History at p. 880-49, *Cited to the Proceedings of the NAIC* (2009). "A consumer advocate raised the issue regarding the failure of the Unfair Trade Practices Act to specify race, religion and national origin in Section 4G(5). There was a general consensus that Paragraph (5) should be amended. **1992 Proc. IIA 149.**"

Legislature first enacted this prohibition in 1991 with the enactment of article 21.21-5. Today the Model Act defines “unfair discrimination” at section 4G. Subsection 4G(5) provides:

Refusing to insure, refusing to continue to insure, or limiting the amount of coverage available to an individual because of the sex, marital status, race, religion or national origin *of the individual*⁶⁵

The Model Act’s use of the words “of the individual,” similar to Texas section 544.002’s use of the words, underscores the Act’s prohibition against discrimination because of a characteristic of the individual without regard to any actuarially sound factors. The NAIC compendium of state laws adopting the NAIC Model Act shows that the vast majority of the states have adopted the Model Act in substantially similar form.⁶⁶

Like the development of state regulation of unfair discrimination in insurance rates, the states’ regulation of credit-based insurance scoring has also followed a model act. In that regard, most of the regulation addressing the use of consumer credit information in insurance underwriting and rating is based on the National Conference of Insurance Legislators’ (“NCOIL”) “Model Act Regarding Use of Credit Information in Personal Insurance,” which was released in 2002 and updated in 2005 and 2009. Twenty-seven states have adopted the NCOIL model or restrictions that are very similar in scope and nature to those in the NCOIL model.⁶⁷ And many other states have adopted at least

⁶⁵ NAIC Unfair Trade Practices Act, section 4G(5), NAIC Model Regulation Service, p. 880-4 (Jan. 2004).

⁶⁶ *Id.* at 880-4 (Jan. 2004).

⁶⁷ <http://www.ncoil.org/other/MLRpc.html>; then follow “State Enactment of the NCOIL Credit Information Model Act” hyperlink; *see also* Federal Trade Commission, *Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance* (July 2007), pp. 18-19,

some of the types of restrictions included in the NCOIL model.⁶⁸

The NCOIL model imposes specific restrictions on how insurers use credit information in underwriting or rating risks. In particular, the model prohibits insurers from using an insurance score that is calculated using income, gender, address, zip code, race, ethnicity, religion, marital status, or an individual's nationality.⁶⁹ The model also prohibits an insurer from denying, canceling, or non-renewing a personal insurance policy solely on the basis of credit information.⁷⁰ An insurer cannot deny insurance coverage solely on the ground that the consumer does not have a credit account.⁷¹ Under the NCOIL model, insurance companies must notify an applicant for insurance if credit information will be used in underwriting or rating and insurers must notify and explain to consumers any adverse action based on credit information.⁷² Further, insurance companies must file its scoring models with the applicable state department of insurance.⁷³

Texas has substantially followed NCOIL's model act. Consequently, any conclusion by this Court that Plaintiff Ojo's complaint about credit scoring does not impair Texas' insurance regulatory design could be used to call into question the insurance regulatory framework in a majority of other states.

⁶⁸ www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf
Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance, pp. 18-19,
www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf

⁶⁹ NCOIL Model Act Regarding Use of Credit Information in Personal Insurance, section 5 A.

⁷⁰ *Id.*, section 5B.

⁷¹ *Id.*, section 5E.

⁷² *Id.*, sections 7 and 8.

⁷³ *Id.*, section 9.

CONCLUSION

The Texas Legislature has implemented insurance regulations that mandate underwriting and rates be based on risk and hazard factors. The Legislature has determined that allowing insurers to accurately classify and price risks is the most appropriate way to determine insurance coverages and rates, assuring persons with higher risks and facing greater hazards pay higher rates and concomitantly persons with lower risks and facing lesser hazards pay lower rates. In that regard, it is undisputed the more accurate the risk-based factors, the more accurate the rate set will be. It is this need for accuracy that has driven the increased use of credit-based insurance scoring by the insurance industry and its acceptance by state legislatures. Further, the Texas Legislature expressly added the use of credit scoring to its insurance regulatory framework. And the Legislature has declared it “unfair discrimination” for an insurer to make insurance decisions on factors other than risk, excepting only “the individual’s race, color, religion, or national origin.” This approach is consistent with the majority of other states’ insurance antidiscrimination laws, which safeguard consumers from being treated differently, though their risks are the same, and prohibit the use of an individual’s race, color, religion, or national origin in the setting of rates.

Plaintiff Ojo asserts the federal Fair Housing Act restricts the use of credit scoring for homeowners insurance if the neutral factors, including credit data, disparately impact protected minority groups. The Ninth Circuit has asked this Court to consider whether Plaintiff Ojo’s claim impairs Texas’ insurance regulatory design. Because Texas comprehensively regulates insurance rates both to assure persons with similar risks are

treated similarly and to prohibit intentional discrimination based on an individuals race, color, religion, or national origin, Plaintiff Ojo’s attack on credit scoring substantially impairs Texas’ regulatory design to assure accurate, risk-based insurance rates. It is therefore preempted under the McCarran-Ferguson Act.

Respectfully submitted,

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