

**IN THE SUPERIOR COURT FOR THE DISTRICT OF COLUMBIA
CIVIL DIVISION**

NATIONAL ASSOCIATION OF)	
STATE FARM AGENTS, INC.,)	
)	
Plaintiff,)	C.A. No. 02ca0004089
)	Calendar 7
vs.)	Judge Neal E. Kravitz
)	
STATE FARM MUTUAL)	
AUTOMOBILE INSURANCE)	
COMPANY, et al.,)	
)	
Defendants.)	

**PLAINTIFF’S MEMORANDUM OF LAW IN OPPOSITION TO
STATE FARM’S MOTION FOR SUMMARY JUDGMENT AND
IN SUPPORT OF NASFA’S MOTION FOR SUMMARY JUDGMENT**

**W. Michael Garner
Jennifer L. Gehrig
DADY & GARNER, P.A.
4000 IDS Center
80 South Eighth Street
Minneapolis, MN 55402
(612)359-3515**

**Allan Hillman
Thomas M. Wood, IV
D.C. Bar No. 426879
NEUBERGER, QUINN, GIELEN,
RUBIN & GIBBER, P.A.
27th Floor
One South Street
Baltimore, MD 21202-3282
(410) 332-8550**

ATTORNEYS FOR PLAINTIFF

TABLE OF CONTENTS

	<u>Page</u>
INTRODUCTION	1
STATEMENT OF THE FACTS	3
A. Parties.....	3
B. Background.....	3
C. Requirements To Become A State Farm Agent.....	5
D. The Sale And Distribution Of Insurance.	8
E. The Agent Agreement.....	11
F. State Farm’s Wrongdoing.....	14
1. Partnering Program	14
2. Select Agent Program	21
3. Mandatory Meetings.....	25
4. Internet Sales.....	26
G. Curtailment Of Product Sales and Denial of Brokering	27
ARGUMENT.....	36
A. The State Farm Agreement Is A Franchise And State Farm Has Violated Franchise Statutes	36
B. The Decisions Cited By State Farm Do Not And Should Not Preclude This Court From Holding That State Farm Agents Are Franchisees Under The State Franchise Laws	41
1. The Three Decisions Involving State Farm Are Not Dispositive	41
2. State Farm’s Other Franchise Cases Are Even Less Viable As Precedents Than The Three State Farm Decisions	44
C. The Agent Agreements Are Franchises Under The Statutes Of The Fifteen Franchise States At Issue	47
1. The Franchise Statutes	47
2. The Trademark And Community Of Interest/ Marketing System Requirements Are Uncontested And, In Any Event, Satisfied	52
3. State Farm Agents Offer, Sell, Distribute, Market Or Dispense Insurance And Insurance Services	53

	<u>Page</u>
a. The Agent Agreement’s Provision that Agents Deliver Policies and Render Services Satisfies the Requirements that they “Offer, Sell or Distribute,” “Market” or “Dispense” Insurance	53
b. State Farm Agents Sell Insurance	56
4. State Farm Agents Pay Franchise Fees	60
a. Payments for the Premium Fund Account Are Franchise Fees.....	67
b. Payments for Required Signage are Franchise Fees	69
c. Expenses for Computers are Franchise Fees	70
d. Payments for Advertising Expenses and Sales Brochures Are Franchise Fees	71
e. Payments for Sales Materials Are Franchise Fees	74
f. Reduced Commissions to Trainee Agents Are Franchise Fees.....	75
D. State Farm Has Violated State Franchise Statutes.....	77
1. State Farm’s Agreements Violate State Franchise Statute Prohibitions on Termination Without Cause and Its Curtailments of Sales Violate State Franchise Statute Prohibitions on Discrimination, Freedom of Sourcing And Changes in Competitive Circumstances	78
a. State Farm’s Agreement Permits Termination Without Cause.....	78
b. State Farm’s Curtailment of Sales of Insurance is a De Facto Termination of the Franchisees’ Agreements	78
c. State Farm’s Curtailment of Sales Violates Wisconsin’s Prohibition on Changes in Competitive Circumstances	81
d. State Farm’s Refusal to Permit Agents to Sell Insurance Of Other Companies, Even Those That Are Not Full-Line Competitors of State Farm, Violates Statutory Sourcing Rights	82
e. State Farm’s Restrictions on Selling Are Unlawfully Discriminatory	84

	<u>Page</u>
2. The Select Agent and Partner-Agent Programs Discriminate Between Agents and Impose Unfair Standards Upon Them.....	85
E. State Farm’s Practices Breach The Agent Agreements And The Implied Covenant Of Good Faith And Fair Dealing	86
1. State Farm’s Refusal to Grant Permission to the Agents to Sell Insurance, as well as State Farm’s Refusal to Permit Agents to Broker Business of Other Companies Constitute Breaches of Contract and the Implied Covenant of Good Faith and Fair Dealing	87
a. State Farm’s Curtailment of Sales in Virtually Every State is a Breach of Contract	87
b. State Farm’s Curtailment of Sales of Policies Violates the Implied Covenant of Good Faith	90
c. State Farm’s Refusal to Permit Brokering Violates the Implied Covenant of Good Faith And Fair Dealing.....	93
2. The “Partnering” Program Breaches the Agents’ Contracts and the Implied Covenant.....	98
3. The “Select Agent” Program Breaches The Agent Agreement.....	105
F. State Farm May Not Compel Agents to Attend Mandatory “Compliance” Meetings	108
G. State Farm’s Internet Sales Unlawfully Encroach On The Agents’ Territories.....	110
CONCLUSION.....	112

TABLE OF AUTHORITIES

<u>Cases</u>	<u>Page(s)</u>
<u>American Bus. Interiors, Inc. v. Haworth, Inc.</u> , 798 F.2d 1135 (8 th Cir. 1986).....	79
<u>Beilowitz v. General Motors Corp.</u> , 233 F. Supp.2d 631 (D.N.J. 2002).....	79-80
<u>Blankenship v. Dialist Int’l Corp.</u> , 568 N.E.2d 503 (Ill. Ct. App. 1994).....	53
<u>Boat & Motor Mart v. Sea Ray Boats, Inc.</u> , 825 F.2d 1285 (9 th Cir. 1987).....	61-62, 64, 67, 71, 73 74
<u>Borberly v. Nationwide Mut. Ins. Co.</u> , 547 F. Supp. 959 (D. N.J. 1981).....	44-45
<u>Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp.</u> , 139 F.3d 1396 (11 th Cir. 1998)	111
<u>Carlos. v. Philips. Bus. Systems, Inc.</u> , 556 F. Supp. 769 (E.D.N.Y. 1983).....	79
<u>Carmichael v. Adirondack Bottled Gas Corp. of Vermont</u> , 635 A.2d 1211 (Vt. 1993).....	91
<u>Carvel Corp. v. James Baker</u> , 79 F. Supp.2d 53 (D. Conn. 1997).....	91, 92, 111-12
<u>Cassidy Podell Lynch, Inc. v. Snyder Gen. Corp.</u> , 944 F.2d 1131 (3 rd Cir. 1991).....	52
<u>Childs v. Adams</u> , 909 S.W.2d 641, 646 (Ark. 1995).....	89
<u>Coelho & Bachetti, Inc. v. Ford New Holland, Inc.</u> , Bus. Franchise Guide (CCH) ¶ 10,923 (A.A.A. 1996)	81
<u>Cooper Distrib. Co. v. Amana Refrigeration, Inc.</u> , 63 F.3d 262 (3 rd Cir. 1995).....	52
<u>Cromeens Holloman, Sibert, Inc. v. AB Volvo, Inc.</u> , 349 F.3d 376 (7 th Cir. 2003).....	40
<u>Emerick v. Mutual Benefit Life Ins. Co.</u> , 756 S.W.2d 513 (Sup. Ct. Mo. 1988)	45
<u>Erdmann v. Preferred Research, Inc. of Georgia</u> , 852 F.2d 788 (4 th Cir. 1988).....	45-46
<u>Federal Baseball Club of Balto. V. National League of Professional Baseball Clubs</u> , 259 U.S. 200 (1922).....	43
<u>33 Flavors of Greater Delaware Valley, Inc. v. Bresler’s 33 Flavors, Inc.</u> , 475 F. Supp. 217 (D. Del. 1979).....	61
<u>Foodmaker v. Quershi</u> , Bus.Franchise Guide (CCH) ¶ 11,780 (Sup. Ct. Ca., San Diego Co. 1999).....	112
<u>Forester, Inc. v. Alas Metal Parts</u> , 313 N.W.2d 60 (Wis. 1981).....	59-60

	<u>Page(s)</u>
<u>Gentis v. Safeguard Business Systems, Inc.</u> , 71 Cal.Rptr.2d 122 (Cal. App. 2 nd Dist. 1998).....	39, 54-56, 60
<u>Grammar v. Evans</u> , 1998 WL 181998 (Ark Ct. App. 1998).....	89
<u>Hansen v. Johnston</u> , 249 N.E.2d 133 (Ill. App. 1969).....	108
<u>Harper v. Cedar Rapids Television Co.</u> , 244 N.W.2d 782 (Iowa 1976).....	89
<u>Hartland Computer Leasing Corp. v. Insurance Man, Inc.</u> , 770 S.W.2d 525 (Mo. Ct. App. 1989).....	89
<u>Hartman v. State Farm Mutual Auto. Ins. Co.</u> , Case No. 93-8084 (S.D. Fla. 1993), <i>aff'd mem.</i> (table), 77 F.3d 496 (11 th Cir. 1996).....	41, 42-43
<u>Interim Healthcare of Illinois v. Interim Healthcare</u> , 225 F.3d 876 (7 th Cir. 2000).....	90-91, 93, 97
<u>John B. Comonos Inc. v. Sun Co.</u> , 831 A.2d 696 (Pa. Super 2003).....	2
<u>Jungbluth v. Hometown, Inc.</u> , 201 Wis.2d 320, 548 N.W.2d 519 (1996).....	82
<u>Kealey Pharmacy and Home Care Servs., Inc. v. Walgreen Co.</u> , 761 F.2d 345 (7 th Cir. 1985).....	81
<u>Keeney v. Kemper Nat'l Ins. Co.</u> , 960 F. Supp. 617 (E.D.N.Y. 1997).....	46
<u>Koellen v. Snap-on Tools Corp.</u> , Bus. Franchise Guide (CCH) ¶11,426 (E.D. Wash. 1998).....	76
<u>Lobdell v. Sugar 'N Spice</u> , 658 P.2d 1267 (Wash. Ct. App. 1983).....	52, 53
<u>Luzim v. Phillips</u> , Bus. Franchise Guide (CCH) ¶ 9020 (E.D.N.Y. 1987).....	74
<u>Lakeshore Machinery, Inc. v. Thermwood Corp.</u> , 117 F.R.D. 429 (E.D. Wis. 1987).....	53
<u>Maryland Supreme Corp. v. Blake Co.</u> , 369 A.2d 1017 (Md. Ct. App. 1977).....	89
<u>Marx & Co., Inc. v. Diner's Club, Inc.</u> , 550 F.2d 505 (2d Cir. 1997).....	2
<u>Mazziotti v. State Farm Indemnity</u> , No. C-333-98 (N.J. Super. Ch. Div. 2002).....	41, 43-44
<u>Meade v. Prudential Ins. Co. of America</u> , 477 A.2d 726 (D.C. 1984).....	1
<u>Mathis v. Daines</u> , 639 P.2d 503, 505 (Mont. 1981).....	89
<u>Newman v. Hinky Dinky Omaha-Lincoln, Inc.</u> , 427 N.W.2d 50 (Neb. 1988).....	91
<u>People v. Kline</u> , 100 Cal.App.3d 587, 168 Cal.Rptr. 185 (1980).....	52
<u>Perlman v. Westin Hotel Co.</u> , 506 N.E.2d 1318 (Ill. App. 1987).....	108

	<u>Page(s)</u>
<u>Peter v. Stone Park Enters., LLC</u> , 1999 U.S. Dist. LEXIS 11385 (N.D. Ill. 1999).....	38
<u>Petereit v. S.B. Thomas</u> , 63 F.3d 1169 (2d Cir. 1995).....	79, 81
<u>Satellite Receivers, Ltd. v. Household Bank (Illinois) N.A.</u> , 922 F. Supp. 174 (E.D. Wis. 1996).....	80
<u>Sims Wholesale Co., Inc. v. Brown-Forman Corp.</u> , 468 S.E.2d 905 (Va. 1996)	80
<u>Southworth v. Oliver</u> , 587 P.2d 994 (Or. 1978).....	89
<u>Steinberg v. Arnold</u> , 402 A.2d 1302 (Md. Ct. App. 1979)	89
<u>Stockton v. Sentry Insurance</u> , 989 S.W.2d 914 (Ark. Sup. Ct. 1999)	46
<u>To-Am Equipment Co. v. Mitsubishi Caterpillar Forklift Am., Inc.</u> , 953 F. Supp. 987 (N.D. Ill. 1997), <u>aff'd</u> , 152 F.3d 658 (7 th Cir. 1998).....	64-66, 71, 74, 76
<u>Tractor and Farm Supply, Inc. v. Ford New Holland, Inc.</u> , Bus. Franchise Guide (CCH) ¶ 10,643 (W.D. Ky. 1995)	66-67, 68, 74
<u>Van v. Mobil Oil Co.</u> , 515 F. Supp. 487 (E.D. Wis. 1981)	82
<u>Vitkauskas v. State Farm Mutual Auto. Ins. Co.</u> , 157 Ill. App.3d 317, 509 N.E.2d 1385 (Ill.App.3d 1987)	41, 56, 59
<u>Wright-Moore Corp. v. Ricoh Corp.</u> , 908 F.2d 128 (7 th Cir. 1990).....	80
<u>Zentner v. Farmer’s Group, Inc.</u> , No. B-133011 (Cal.App.2d 2000) (Unpublished)	46
 <u>Statutes</u>	
Arkansas Code Am. § 4-72-201 et seq.	37, 47, 78
California Franchise Investment Law, Cal. Corp. Code § 31000, et seq.....	36, 37, 47, 60
California Franchise Relations Act, Cal. Bus. & Prof. Code § 20000, et seq.	36, 37, 78
Delaware Franchise Security Law, Del. Code Ann. tit. 6, §§ 2551 et seq.	36, 37, 48, 78
Federal Trade Commission Trade Regulation Rule on Franchising, 16 C.F.R. Part 436.....	69-70
Florida Franchise Misrepresentation Act, Fla. Stat. § 817.416	43

	<u>Page(s)</u>
Hawaii Franchise Investment Law, Haw. Rev. Stat. §§ 482 et seq.	36, 37, 48, 60, 78, 82, 84
Illinois Franchise Disclosure Act of 1987, Ill. Comp. Stat. §§ 705/3, et seq.	36, 37, 48, 60, 64, 78, 84
Indiana Franchise Act, Ind. Code §§ 23-2, et seq.	36, 37, 49, 60, 78, 82, 84
Maryland Franchise Registration and Disclosure Law, Md. Code Ann., Bus. Reg. §§ 14-201, et seq.	36, 37, 49, 60
Michigan Franchise Investment Law, Mich. Comp. L. §§ 445.1501, et seq.	36, 37, 49, 60, 78
Minnesota Franchise Act, Minn. Stat. §§ 80 C.01, et seq.	36, 37, 49, 60, 78, 84
Nebraska Franchise Act, Neb. Rev. Stat. §§ 87-401 et seq.	36, 37, 49-50, 78
New Jersey Franchise Practices Act, N.J. Stat. Ann. §§ 56:10-1, et seq.	36, 37, 50, 78
New York Franchise Sales Act, N.Y. Gen. Bus. Law §§ 680, et seq.	36, 37, 50, 60
Oregon Franchise Act, Or. Rev. Stat. §§ 650.005 et seq.	36, 50-51, 60
Virginia Retail Franchising Act, Va. Code Ann. §§ 13.1-557, et seq.	36, 37, 51, 78
Wisconsin Franchise Investment Law, Wis. Stat. §§ 553.01, et seq.	36, 37, 51, 60
Wisconsin Fair Dealership Act, Wis. Stat. §§ 133.01, et seq.	36, 37, 51, 78

Other Authorities

California Dept. of Corps, “Guidelines for Determining Whether an Agreement Constitutes A Franchise,” Release 3-F.	62-63, 68
3 Corbin on Contracts, § 554 (1960)	2
Federal Trade Commission, “Interpretive Guides to Franchising and Business Opportunity Ventures Trade Regulation Rule (1979)	70
W.M. Garner, <u>Franchise and Distribution Law and Practice</u> (2003)	42
Ill. Admin. Code, Title 14, § 200.105	64
McCormick on Evidence, § 12	2
<u>Merriam-Webster’s Collegiate Dictionary</u> , 10 th Ed.	40, 51-52, 54, 56
RESTATEMENT (SECOND) OF CONTRACTS § 305, cmt. d.	91
RESTATEMENT (SECOND) OF CONTRACTS § 223 at 157-58	89
VII Wigmore on Evidence, § 1952	2

INTRODUCTION

Plaintiff, National Association of State Farm Agents, Inc. (“NASFA” or the “Agents”), submits this memorandum in opposition to the motion of defendants for summary judgment and in support of its motion for summary judgment on its claims against Defendants State Farm Mutual Automobile Insurance Company, State Farm General Insurance Company, State Farm Fire and Casualty Company, and State Farm Life Insurance Company (hereinafter collectively referred to as “State Farm”).

NASFA’s motion should be granted and State Farm’s should be denied. At its roots, this case is about State Farm’s effort unilaterally to change the rights and obligations between it and its agents, to the detriment of the Agents, without their consent. The undisputed facts lead to the conclusion that the relationship between State Farm and its agents is one of franchisor and franchisee under the laws of 15 states. Under those statutes, State Farm may not change its relationships with the Agents in the ways it has attempted. Additionally, summary judgment is appropriate for NASFA on its contract claims because it is the Court which construes the contracts as a matter of law; and to the extent there is ambiguity, the evidence adduced in discovery demonstrates that the ambiguities should be resolved in the Agents’ favor.¹

State Farm’s motion must be denied also because the premise upon which it rests—that “the deposition testimony of Plaintiffs’ own officers and directors” has “demolished” NASFA’s position—is just wrong as a matter of both fact and law. State Farm quotes very selectively from testimony of NASFA’s Board members, in an effort to convince the Court that its programs under challenge are lawful. The first observation to make is that the testimony proves no such thing; nor could it prove that. State Farm’s counsel recognized that repeatedly in depositions.

¹ In addition, the rule of contra preferentem applies; if there is ambiguity, the contract is construed against the drafter, State Farm. Meade v. Prudential Ins. Co. of America, 477 A.2d 726 (D.C. 1984).

His clearest statement was made to Board Member Steven Knapp:

Let's be very clear. I'm not asking you for a legal opinion. You are not giving a legal opinion that's binding on anybody.

(Knapp Depo. p. 101; Garner Aff., Ex. 11.) Comments by NASFA's members, all lay persons, about whether State Farm was (or was not) violating the Agent Agreements are not admissible as admissions, neither evidentiary nor, of course, judicial. Testimony on whether the law has been violated, or as to the interpretation of a contract or the legal significance of various facts is excluded because such a determination is within the special legal knowledge of the Judge. 3 Corbin on Contracts, § 554 (1960); see concerning even exclusion of expert evidence, VII Wigmore on Evidence, § 1952, and Marx & Co., Inc. v. Diner's Club, Inc., 550 F.2d 505, 509-10 (2d Cir. 1977) (same); see also, John B. Comonos, Inc. v. Sun Co., 831 A.2d 696, 714 (Pa. Super 2003). Testimony concerning the witness' general belief in this regard is properly excludible as usurping the province of the Court. McCormick on Evidence, § 12 at 26-27. And the "abolition of the ultimate issue rule does not lower the bar" to admit such "legal" testimony. Marx, 550 F.2d at 511 n.17. State Farm's aggressive stance here is seriously undercut by its almost total failure to consider the primary evidence – undisputed evidence about the agreements and the programs themselves.

The second observation concerning State Farm's citation to the testimony of NASFA's Board Members is that their factual testimony, viewed in its entirety, is quite adverse to State Farm's position. In this Memorandum, we quote substantially from that testimony to demonstrate that point. Finally, it is noteworthy that, while State Farm has cited with approval the deposition of its prior managerial employee, John Killingsworth, in fact Mr. Killingsworth's testimony is also distinctly harmful to it.

STATEMENT OF THE FACTS

A. PARTIES

NASFA is a District of Columbia corporation composed of State Farm Agents throughout the United States. NASFA's principal place of business is in Baltimore, Maryland. (Plaintiff's Statement of Undisputed Facts in Support of its Motion for Summary Judgment ["PSOF"] ¶ 1.)

The Defendants are related insurance companies that do business as "State Farm" and that have their principal places of business in Bloomington, Illinois. (PSOF ¶¶ 2-5.) The term "State Farm" shall be used throughout this document to refer to all defendants.

B. BACKGROUND

State Farm and each of NASFA's member Agents are parties to written agreements denominated the "AA3," the "AA4," or the "AA97" (the "Agent Agreements") pursuant to which the Agents are appointed by State Farm to market its insurance products. (PSOF ¶ 7.) The three forms of agreement were put into effect successively by State Farm in approximately 1977, 1982 and 1997. (PSOF ¶ 8.) As each new agreement went into effect, existing agents had the option to elect to become agents pursuant to the new agreements; new agents could sign up only on the new forms of agreement. These three agreements are substantially identical for purposes of this motion. (PSOF ¶ 9.)

State Farm's Agents have always been the prime and principal vehicle of State Farm to sell insurance policies. State Farm Agents sell automobile insurance, fire (i.e., homeowners') insurance, life insurance and health insurance, among other types of insurance. Agents are required to conduct field underwriting, solicit insurance, collect premiums and assist with insurance claims. (PSOF ¶¶ 10, 11 and 12.)

Agents have protected territories. The Agreement AA3 and AA 4 provide:

We will leave in your account all automobile policies credited to your account so long as the policyholder resides within a 25-mile radius of your principal place of business and within a state in which you are duly licensed, except that we may, after prior written notice to you, transfer any automobile policy to the account of another State Farm Agent when the policyholder makes a bona fide request in writing. You will respect the rights and interests of your fellow agents and policies credited to their accounts by refraining from writing or otherwise diverting policies from their accounts to your account.

(PSOF ¶¶ 13, 14.)

The AA97 Agreement provides:

We will leave in your account all policies credited to you account as long as the policyholder resides within a 75-mile radius of your principal place of business and within a state in which you are duly licensed, except that we may, after prior written notice to you, transfer any policy to the account of another State Farm Agent when the policyholder makes a bona fide request in writing. You will respect the rights and interests of your fellow agents and policies credited to their accounts by refraining from raiding or otherwise diverting policies from their accounts to your account. You shall neither directly nor indirectly attempt to divert policies to your account from unassigned accounts or from those of other State Farm Agents, or from your own account to the accounts of other State Farm Agents.

(PSOF ¶ 15.)

Agents receive commissions for every policy they sell. (PSOF ¶ 16.)

Agents invest considerable time, effort, and resources into marketing, advertising, networking, record keeping, and selling State Farm insurance policies (PSOF ¶ 18), and it takes years for Agents to build and establish their clientele and reputations within their communities.

(PSOF ¶ 17.)

Prior to the advent of government regulation of franchising in the 1970's, State Farm openly referred to—indeed advocated—its Agents Agreements as a “franchise.” (PSOF ¶ 19.)

When the Federal Trade Commission and certain states began regulating the sale of franchises in

the 1970's, State Farm directed its employees to stop using that nomenclature, (PSOF ¶ 20) but made no substantive change in its arrangements with agents. (PSOF ¶ 21.)

Nonetheless, after this directive, State Farm recruiters continued to refer to the State Farm agency as a "franchise." (PSOF ¶ 22.) Steven Knapp, a State Farm agent, testified:

I think I can say from day one that I always thought it to be a franchise. My manager talked about it. He made comparisons to a McDonald's or other similar, perhaps, more well-known types of franchise organizations. You know, "you are going to be your own boss, you are an independent contractor, this is your franchise. I think the word "franchise" was even used as a comparable term. "You are getting a State Farm franchise." I can almost hear him say the words.

(PSOF ¶ 22.)

C. REQUIREMENTS TO BECOME A STATE FARM AGENT

In order to become a State Farm agent, an applicant must make certain payments to State Farm. (PSOF ¶ 23.)

Before becoming an independent contractor, agents are required to complete a two-year training program, during which they are State Farm employees pursuant to Trainee Agent agreements. (PSOF ¶¶ 24 and 25.) Trainees are supervised and trained by either a manager or an AFE (Area Field Executive) and are required to take several classes on how to sell insurance. (PSOF ¶ 26.) Trainee agents are paid a certain "draw" by State Farm. Trainee agents must then generate commissions sufficient to cover the draw that State Farm pays them. If agents do not generate commissions in this amount, they are liable for the deficiency and must make it up to State Farm in order to become an independent contractor agent. (PSOF ¶ 27.)

Trainee agents, though they do the same work as an independent contractor, receive commissions that are substantially less than those of an independent contractor. For example, the trainee agent agreements for the time period 1954-2004, reveal the following:

**Auto and Fire Commissions Earned by Trainees
Compared to Commissions Earned by Independent Contractor Agents**

**Auto and Fire Commissions Earned by Trainees
Compared to Commissions Earned by Independent Contractor Agents**

Time Period	Personally Produced <u>Auto</u>	Assigned <u>Auto</u>	As Compared To ICA <u>Commissions</u>	Personally Produced <u>Fire</u>	First Year Assigned <u>Fire</u>	2nd Year Assigned <u>Fire</u>	As Compared To ICA <u>Commissions</u>
1954-1985	0%	0%	10% - 7%	15%	0%	0%	15% - 10%
1985-1990	5%	0%	10%-7%	7.5%	0%	0%	15% - 10%
1990-1991	5%	0%	10% - 7%	7.5%	0%)%	15% - 10%
1991 - 1995	5%	3.5%	10% - 7%	7.5%	0%	0%	15% - 10%
1995-2004	5%	0%	10% - 7%	7.5%	0%	0%	15% - 10%

(PSOF ¶ 28.)

The trainee agents must forego all commissions on auto policies and give up a portion of their commissions on other types of policies such as homeowners or life insurance. (PSOF ¶ 29.) The amount of forgone commissions exceeds \$500 per year. (PSOF ¶ 32.)

Once the State Farm Agent becomes an independent contractor agent, he or she, as a practical matter, must purchase promotional items from State Farm, such as calendars, golf balls, cards, signs, stationery and other items, the cost of which exceeds \$500 per year. State Farm makes it clear to agents that they should obtain these items in order to fulfill their obligations to policyholders. (PSOF ¶ 30.)

Upon becoming independent agents, the Agents are provided with a list of start-up

expenses, which include the purchase and installation of an exterior sign with an expected cost of \$1,300. (PSOF ¶ 31.) For no less than 35 years, as a matter of custom and practice, State Farm has requested agents to have signs. Agents need to have signs as a practical necessity in order to serve their policyholders. (PSOF ¶ 31.)

Additionally, agents must, as a matter of practical necessity, purchase sales brochures from State Farm, because State Farm prohibits agents from producing their own sales brochures. These sales brochures summarize the benefits of the products that agents sell, and agents typically spend at least \$25.00 per month on these brochures. (PSOF ¶ 33.)

Until 1996, State Farm agents were required to lease computer equipment from State Farm. Since 1996, State Farm has provided agents with a standard package of computer equipment. Agents are specifically prohibited from attaching any of their own equipment to that required to be purchased by State Farm. Agents are also prohibited from installing any of their own software on computers required by State Farm. Agents typically require more equipment and software than is provided by State Farm and thus, must purchase or lease additional equipment from it themselves. (PSOF ¶ 35.)

State Farm agents also must establish what are known as Premium Fund Accounts. These accounts, required by contract, are bank accounts into which agents must deposit premiums that they collect from customers. (PSOF ¶ 36.) The funds belong to State Farm, and the accounts are maintained solely for the benefit of State Farm, but the cost of maintaining them must be borne by the agents – a cost that can easily exceed \$500 over the course of the relationship. Agents are required to pay monthly fees to maintain these accounts for the benefit of State Farm. (PSOF 37.) NASFA Board Member Adams testified:

. . . I have a premium – I assume we all have premium fund accounts where we deposit money that the customers bring in either to write

insurance or to pay their bills, and it's a trust account in our name, but it's State Farm's money, and the majority of the agents in the country are charged a service fee just to hold that account open at each bank. I mean, I know some agents who pay \$30 a month. I know several agents who pay \$70 a month.

(PSOF ¶ 38.) President Swift testified similarly that it is a contractual requirement that agents, as trustees, pay the service charges on the premium fund account, and that monthly fees can be considerable:

Q. What are those fees, by the way?

A. Probably \$70, \$80 a month. They could be more. I mean, that's my own personal fees. Some guys who do a lot of transactions, they could be in the hundreds of dollars a month, you know.

(PSOF ¶ 38.)

State Farm agents, in the course of selling insurance, must advertise as State Farm agents (as opposed to holding themselves out as independent agents); they must use State Farm terms, advertising must follow State Farm procedures and they must otherwise conduct themselves as State Farm agents. (PSOF ¶ 39.) Agents are authorized to use, and in fact must use, the State Farm name and mark, and in fact do use it through signs, stationery and advertising. (PSOF ¶ 40.)

D. THE SALE AND DISTRIBUTION OF INSURANCE

State Farm Agents sell and distribute insurance. The Agent Agreement provides that agents shall, among other things, "deliver policies" to policyholders. (PSOF ¶ 66.)

James Gregory Fisher, State Farm's designated witness on the subject of insurance sales, testified that agents sell insurance and clients purchase it from them. (PSOF ¶ 42.) He stood by his testimony in a prior, unrelated case in which he confirmed that agents sell insurance:

Q. Do you recall testifying in a case called "State Farm Mutual Automobile Insurance Company against John W. Weir"?

A. Yes.

Q. And do you recall that you were asked a question “so in a particular community, if they can’t get the agent or agents in that community to actively market and sell a new set of products, they really don’t have any way to push it forward in that community, do they?” And you gave the answer “assuming that the people who live in that community want to purchase insurance from that particular agent who is selling the products that would be right.”

* * *

Q. Okay. And do you disagree with that testimony, in any respect today?

A. No.

Q. Do you recall testifying, in that case, that it’s the agent that sells the product?

* * *

Q. Okay, I’ll show you a question and answer and see if it refreshes your recollection. The question was, “but in terms of who it is that actually meets the prospect and sells the product to the policy holder, that’s the agent in the community; right? “Answer: Typically, yes.”

* * *

Q. So that was the answer that you gave under oath; is that right?

A. That’s correct.

Q. Okay. And is there anything that was inaccurate or untruthful about that?

A. No.

(PSOF ¶ 43) (emphasis added).

John Killingsworth, a former State Farm employee who was responsible for supervising

agents, confirmed that the principal duty of agents was to “sell policies.” (PSOF ¶ 44.)

State Farm requires numerous training programs that explicitly teach agents how to *sell* insurance. For instance, the agents are required to take a class entitled “Client Centered Selling” offers a concept referred to by State Farm as the “Need Satisfaction Selling Process. (PSOF ¶¶ 45 and 46.)

State Farm has an expense reimbursement policy for trainee agents. State Farm’s stated purpose of the policy is:

Expense reimbursement attempts to put all Trainee Agents on a level playing field. This reduces their financial worries and allows them to concentrate on what they were selected to do: sell State Farm products and services to meet customer needs and operate profitable, multi-line agencies.

(PSOF ¶ 47.)

State Farm has published a magazine for its agents entitled “The Reflector.” In that magazine, State Farm, and particularly its Vice President for Agency, Charles Wright, repeatedly refers to State Farm agents “selling” insurance. (PSOF ¶¶ 48-57.)

Most significantly, in order to confirm that agents are not employees for tax purposes, State Farm submits a form to the IRS confirming each agent is an independent contractor, which states among other things:

He (the worker) receives training from your firm via product and sales seminars, continuing education, and motivational seminars. Your firm offers him training dealing with a range of topics such as sales, service, ethics, and market conduct.

You [State Farm] concur that he sells and distributes your firm’s insurance . . . products . . .

(PSOF ¶ 57.)

When a State Farm agent is contacted by an applicant for insurance, the agent has the

authority to close the sale of that insurance. A State Farm agent has the authority to bind coverage – i.e., a customer may come to the agent’s office, complete an application and pay a premium and receive coverage on the spot. (PSOF ¶ 58.) State Farm’s Chief Operating Officer, Vincent Trosino, confirmed that agents are authorized to bind coverage. (PSOF ¶ 58.) Once coverage is “bound,” State Farm is obligated to assume the risk of loss to the extent of coverage. (PSOF ¶¶ 59-60.)

E. THE AGENT AGREEMENT

The Agent Agreement contains a number of provisions that are relevant to this motion. The preamble stresses that the purpose of the Agreement is to, among other things, “increase business on a profitable basis.” (PSOF ¶ 63.)

It is to our mutual interest to serve the insuring public, to comply with all applicable laws, to increase business on a profitable basis, and to maintain the Companies’ financial strength to protect policyholders’ interests.

The Agreements recognize that the agents are independent contractors, and that the Company does not assert control over their daily activities:

The Companies’ agents operating as independent contractors, within the scope of their authority, are best able to provide the creative selling, professional counseling, and prompt and skillful service essential to the creation and maintenance of successful multiple-line Companies and agencies. We do not seek, and will not assert, control of your daily activities, but expect you to exercise your own judgment as to the time, place, and manner of soliciting insurance, servicing policyholders, and otherwise carrying out the provisions of this Agreement.

(PSOF ¶ 64.)

The Company agrees to provide guidance and states that it will invite agents to attend meetings:

State Farm makes available to all agents the experience and

technical knowledge acquired and developed over the years with respect to selling, underwriting, and servicing insurance. We will provide you, through our personnel, with information and guidance as to the operation, conduct, and financial management of your agency; and from time to time we will designate specific employees to advise you regarding your activities. In turn, we will invite you to attend meetings for the purpose of introducing new products, ideas, services and procedures, promoting sales, and furnishing you with assistance, guidance, and consultation.

(PSOF ¶ 65.)

The agents' duties are described in broad terms:

The Agent will solicit applications for insurance, collect premiums, fees and charges, countersign and deliver policies, reinstate and transfer insurance, assist policyholders and cooperate with adjusters in reporting and handling claims, avoid conflicts of interest, comply with all laws and regulations, and cooperate with and advance the interests of the Companies, the agents, and the policyholders.

(PSOF ¶ 66.)

While the agent is obligated to follow procedures, the agreement reiterates that he is an independent contractor “for all purposes” with “full control” of daily activities.

As a State Farm agent, you are obliged to follow State Farm procedures and processes and to provide prompt, friendly, accurate, and cost effective service. You are an independent contractor for all purposes. You have full control of your daily activities, with the right to exercise independent judgment as to time, place, and manner of soliciting insurance, servicing policyholders, and otherwise carrying out the provisions of this Agreement.

(PSOF ¶ 67.)

The Agreement further recognizes that agents have exclusive territories:

You agree that in the location or relocation of your office you will not unduly infringe on the established office locations of any other agent.

(PSOF ¶ 68.)

State Farm maintains control over its advertising, name and trademark:

We will advertise, provide promotional materials, and participate in the cost of your advertising, in accordance with policies determined from time to time by us. You will not use any advertisements referring to us or identifying us, directly or indirectly, without our prior approval.

(PSOF ¶ 69.)

The Agreement also states that while the agent will not directly or indirectly write insurance for another company, State Farm may authorize it to do so:

The fulfillment of this Agreement will be your principal occupation and requires your personal services, and you will not directly or indirectly write or service insurance for any other company, other than a State Farm subsidiary or affiliate or through any governmental or insurance industry plan or facility, or for any agent or broker, except in accordance with the terms of any written consent we may give you.

(PSOF ¶ 70.)

The agent must collect premiums on behalf of the company and deposit them into a premium fund account that holds interest for State Farm and that it must pay to maintain. (PSOF ¶ 71.)

State Farm retains the right to prescribe policy forms and provisions and other procedures:

We retain the right to prescribe: all policy forms and provisions; premiums, fees, and charges for insurance and services; rules governing the binding, acceptance, renewal rejection, or cancellation of risks, and adjustment and payment of losses; and limitations on the submissions of applications by individual agent, by market area, by line of coverage, by policy type, by Company, or by other means.

(PSOF ¶ 72.)

Significantly, in the AA3 and AA4 forms of Agreement, central to this case, the last

clause, purporting to give the company the right to prescribe limitations on the submission of applications, does not appear. (PSOF ¶ 73.)

State Farm purports to retain the right to control agent compensation:

Each Company reserves the right to fix and determine the amount, extent, and conditions of any bonuses, awards, prizes, and allowances.

(PSOF ¶ 74.)

The Agreement provides that it will terminate upon the death of the agent or upon notice:

This Agreement will terminate upon your death. Either you or State Farm have the right to terminate this Agreement by written notice delivered to the other or mailed to the other's last known address.

(PSOF ¶ 75.)

However, upon termination, an agent is entitled to a termination review:

In the event we terminate this Agreement, you are entitled upon request to a review in accordance with the termination review procedures approved by the Boards of Directors of the Companies, as amended from time to time.

(PSOF ¶ 76.)

With respect to this provision, State Farm's designated witness with knowledge, Gregory Fisher, testified that State Farm never terminates anyone arbitrarily or capriciously; it always does so for a reason. In other words, State Farm terminates only for cause. (PSOF ¶ 77.)

D. STATE FARM'S WRONGDOING

Over the past several years, State Farm has engaged in or implemented a number of practices inconsistent with the Agent Agreement. These include the following:

1. Partnering Program

The "Partnering Program" or "Partner-Agent" program, is a State Farm program pursuant

to which agents who are not registered to sell non-insurance products (i.e., mutual funds) are paired with those who are; the ostensible purpose is to put clients of the non-licensed agents in touch with an agent who can sell them mutual funds. The principal problem with the program is that the registered agents then have access to the unregistered agents' books of business, which threatens the non-registered agent with loss of his insurance business.

Some years ago State Farm decided to go into the business of selling mutual funds and other financial products ("financial products"). Under NASD regulations, people who sell mutual funds must be licensed to do so, and State Farm embarked upon a campaign to have its insurance agents obtain licenses to sell mutual funds. (PSOF ¶ 78.) While many agents became so qualified, a substantial number – about 40% – did not ("non-registered Agents"). (PSOF ¶ 79.)

In order to attempt to market financial products to customers of non-registered agents, State Farm implemented a "partnering" program under which a non-registered agent was paired with a registered agent to whom the non-registered agent could refer inquiries from persons interested in buying mutual funds. (PSOF ¶ 80.)

John Killingsworth, an employee of State Farm for nearly twenty-five years, serving as both an Agency Field Manager and an Agency Field Executive, described the Partner-Agent program as follows:

- Q.** Are you familiar with something called the partner agent program?
- A.** Yes.
- Q.** Can you describe what that is, please?
- A.** Agents that would not or did not get their securities licenses were asked to select or were given a partner agent that was securities-licensed. The lion's share of those agents – and

it was my experience that all of them, in my particular case, were new agents with little or no book – and the partnering agent was to refer anybody that had a securities policy that they wanted to buy to the partnering agent that had the securities license.

Q. How is it that State Farm agents – Well, strike that. How did you – If you did, how did you present the partner agent program to the agents under your jurisdiction?

A. I resisted it.

Q. Why?

A. The vice president that I had had already selected the agents. They were all trainee agents. And they were to be assigned to these large agents who had these large books of business, very lucrative, very wealthy clients. If the senior agent was not going to get the securities license, they were – the VP was very, very adamant that we are going to write these security products on our clients. They're going to get a chance for them. And they will be referred to this list of trainee agents.

(PSOF ¶ 81.)

Although it was held out as a voluntary program, non-registered agents had no choice but be paired with a partner agent. First, non-registered agents were asked to select or name a partner agent. That nominee had to be approved by the agent's AFE (Area Field Executive). If the non-registered agent refused to nominate a partner, or if the AFE refused to approve of the nominee, then State Farm selected a partner agent for the non-registered partner. This is confirmed by State Farm's own Partner Agent Program document, which states:

If a non-registered agent chooses not to nominate a fellow State Farm agent to be his or her partner, the AFE will be asked to select an agent that will function as the non-registered agent's partner.

(PSOF ¶ 83.)

Don Sikora, an Executive Administrative Assistance, for State Farm, stated:

Choosing not to become registered, they'll be given the chance to nominate a local select registered agent for securities marketing, sales and service of their current customers, thus providing them with some involvement in this process and products and as an extension of their service to their customers. However, if they should choose not to nominate a partnering agent, the company will appoint a select registered agent for marketing and sales within the non registered agent's customer base.

(PSOF ¶ 82.)

State Farm maintains a "Registered Representative Data Base," which allows State Farm to select a registered agent if a customer should call State Farm directly and refer the customer to that agent. (PSOF ¶ 84.) The non-registered agent, in turn, would have to share the identities and key personal and financial information about his or her clients with the registered agents.

(PSOF ¶ 85.)

Non-registered agents were and are understandably concerned that registered agents would, upon receiving these referrals, "raid" their books of business, resulting in a loss to the non-registered agents. As Board Member Stephen Adams testified:

. So I felt like if they did that and someone decided finally to buy one of the mutual funds or a variable life product and they went to that partnering agent, they would just on their own want to gravitate all their business to that one place, because they are paying me money to cover them for insurance. With this agent over here, if the stock market goes, might make them some money. So I felt the perception from the customer standpoint was going to be set me up to [have] my business stolen. I don't know the exact term for it. But it just didn't seem ethical.

(PSOF ¶ 89.)

NASFA President Swift echoed this concern:

. [Y]our business, and if the client went – the concern here is that . you're paying me for car insurance, okay, and you're paying me for home insurance but you're not getting – you don't see you're getting any benefit because, guess what, you're not having any claims but you're just paying out money. But over here, you're putting money into this mutual fund as an example, and let's say it starts making money, which it isn't now. But

let's say it starts making money, so then the client says well, wait a second. You know, [the "partner"-agent] is making me money and you're costing me money. Then maybe I'll just transfer all my autos and homes over to [the "partner" agent]. Then through no fault of [the "partner"-agent], my client transfers over to him because he thinks he's making him money, and I'm costing him money.

(PSOF ¶ 90.)

State Farm agent Gabe Nazziola put his finger precisely on the problem caused by this involuntary "voluntary" program:

. . . So some dreamboat went and talked to some consultant and came up with this Partner Agent Program. Well, this is going to work in one of two ways. It's a sword that has a very sharp blade on both sides. Either you're going to stimulate this guy to start selling [the new product] because he doesn't want anybody else – not Jesus Christ, not the disciples, nobody else – in his business writing in his households, confusing the allegiance, disturbing the relationship, which is the whole success of State Farm – that's how he know this had to come from outside brain-dead to have the Partner Agent Program where some other agent, some AK is going to come in. You're going to give him access to all your files and all your records, and he's going to solicit your policyholder. Now, if he never did another thing, you've immediately undermined the relationship. You've immediately created: Oh, Jesus, who the hell's my agent here? Why can't my agent sell me this [other product]? Why doesn't this guy? Not a good thing, not well-thought-out by anybody from any stretch of the imagination. So you knew that this had to [aggravate] every State Farm agent in creation. Nobody wanted anybody else into their book of business. "I'm an independent businessman. You hired me to be an entrepreneur to select, the time, the place and the method." What's all that mean? You keep saying that they reserve to themselves the right to do this; they reserve themselves the right to do that. Do you really think that they reserved that right to come into my business when you told me it was going to be mine? You went to the heart of every agent. Anybody that was on your side, you put them against you when you came out with this idea. So we know it couldn't have been an insurance person who had this idea. Anybody that has any idea of truly what the relationship is between an agent and a policyholder could never ever have suggested something so damaging.

(PSOF ¶ 90.)

Former State Farm Manager John Killingsworth testified about how raiding would take

place:

Q. Okay. Let me ask the question this way. I'm asking you to identify any registered State Farm agent who, through or because of the partner agent program, had or made contact with policyholders who were part of the book of business of a non-registered agent, and, as a result of that contact, wrote business for State Farm products other than mutual funds.

* * *

A. I don't know how to answer that, because the only way – unless there was some aggressive marketing program which would not be allowed – that a non – that a registered agent is because the existing agent was forced to make a referral. I am aware of cases that have been transferred --- where the entire File was transferred to the securities [registered] agent, because you can't comment on a securities product without knowing everything about that client. In that process, the client would become the client of the securities [registered] agent.

Q. Okay. And who transferred the file to whom?

A. Well, the securities [registered] agent would simply get a letter signed by the policyholder. The company would then be required to transfer the file.

Q. And give me the names of the registered agents who received such letters from policyholders which transferred the entire book of business to the registered agent.

A. I didn't say the entire book of business. I said the client.

Q. Okay. Now – Okay. I am asking you to tell me the names of registered agents who, because of the partner agent program, were able to write P&C business, either auto or fire –

A. I didn't say they wrote the P&C business. I said it was transferred.

Q. What was transferred, the P&C business or the mutual fund business?

A. Well, the mutual fund business couldn't be transferred because the prior agent was not securities-licensed.

Q. So you are aware of cases –

A. Yes.

Q. -- by name where the P&C business was transferred to – from a nonregistered agent to a registered agent?

A. I am aware of agents where this was alleged to have gone down.

Q. Ah-hah. Alleged by whom?

A. By the agents, by the losing agents.

Q. Okay. And which – So – All right. And how many losing agents were there who made these allegations? Were these allegations made to you? Let me ask that first.

A. Yes.

Q. By the losing agents?

A. Yes.

Q. How many losing agents made these allegations to you?

A. Three.

(PSOF ¶ 91.)

Killingsworth testified that as a result of the Partner-Agent Program, agents “felt betrayed. They felt forced. They felt that a lifetime of work had come at risk.” (PSOF ¶ 92.)

State Farm has claimed that the sale of mutual funds and the Partnering Program were justified by customer demand. (PSOF ¶ 86.) In fact, however, State Farm conducted no studies that showed its customers were demanding to buy mutual funds from it, and the only study done on the Partnering Program showed that customers were not interested in dealing with State Farm agents other than their own agents. (PSOF ¶ 87.)

Jerry Beauchamp, NASFA's incoming president, testified that the partner-agent programs' concept of having "two agents for the policyholder" was unprecedented "in 40 years that I have been with State Farm." (PSOF ¶ 93.)

State Farm claims that such raiding is against its procedures, but, during depositions of its witnesses with knowledge of these practices, they testified that there is, in fact, no disciplinary procedure in place to discipline registered agents who would raid the business of a non-registered agent. (PSOF ¶ 94.) State Farm never announced that it was discontinuing the Partner-Agent program. (PSOF ¶ 93.)

2. Select Agent Program

State Farm has unilaterally appointed certain agents as "select agents," giving them rights and privileges not extended to or reasonably available to other agents. (PSOF ¶ 95.)

In order to become "Select" Agents, agents must achieve certain "profitability" goals – i.e., claims of their clients cannot exceed a certain level; they must submit so-called "business plans"; and they must achieve certain levels of "production" – i.e., sell a certain amount of insurance. (PSOF ¶ 96.)

State Farm admits that the designation of "Select Agent" creates a distinction between Select Agents and non-Select Agents. (PSOF ¶ 98.)

Select Agents enjoy benefits that other agents do not, such as:

- Select Agents have a higher level of compensation.
- Select Agents are singled out by State Farm (*e.g.*, in the Yellow Pages) to the public as "Select" Agents (as distinguished from others who are not so designated).
- Select Agents' customers may use the company's 24-hour Customer Response Center ("CRC") without charge to the Select Agent, whereas Agents who are not Select Agents must pay \$1.75 per household in order to make this service available to their customers.

- Select Agents may participate in co-op advertising with State Farm, but non-Select Agents may not.
- Select Agents are eligible to receive “block” assignments while others are not. (A block assignment is an assignment of existing business that usually belonged to another agent that is re-assigned upon retirement of that agent.)
- Select Agents are entitled to earn any of the bonuses originally made available to all agents, but which are now conditioned on first being a Select Agent.

(PSOF ¶ 97.)

State Farm, however, has not done any studies to determine whether the Select Agent program would accomplish its goals, (PSOF ¶ 99) nor has State Farm determined that all agents would be capable of becoming Select Agents. (PSOF ¶ 100.)

As a practical matter, agents in certain locations (i.e., inner city or other high-risk locations) cannot achieve the profitability goals for becoming Select Agents because their clients naturally experience high incidents of loss. (PSOF ¶ 101.)

Likewise, the requirement to have a business plan is not at all realistic because it is administered in an arbitrary and capricious manner. Additionally, John Killingsworth explained that the business plan element was both unnecessary and unfairly evaluated:

- Q.** Did you have any problem with the business plan element of the requirement?
- A.** I had enormous problems with it, because there was no standards to it. It was all over the board.. Some turned in a one-pager. It was not well administered at all. And my really high quality agents that produced large volumes of quality business did not want to take time sitting around writing a business plan with a group of people. They knew what they were doing. They knew how to do it. They were very intuitive. They just did the business at a very high level. But they couldn't get the benefits without writing this plan.

(PSOF ¶ 102.) Additionally, Steven Knapp, shared his reason for why submission of a business plan could, in fact, undermine his business:

I didn't think that it was appropriate for me to share the specific techniques that I have learned over my career as to how I secure business with anybody else. In my particular town, I have six other State Farm agents that, although we are friendly competitors, we are competitors. Why would I want to submit a plan as to how I succeed to an AFE who might share it with them.

(PSOF ¶ 102.)

After the Select Agent program was implemented, agents who were not select agents were penalized by the loss of contractual rights they possessed even before the advent of the Select Agent Program. NASFA Board Member Mueller testified:

Q. Have there been any reprisals against you by the company for your decision not to participate in the CRC [part of the Select Agent program]?

A. Yes.

Q. What are they?

A. By not participating in the CRC, when a life specialist became available in my agency group, I received an e-mail that stated that the life specialist could only be sent to select agents and registered representatives so I did not receive assistance with the life insurance because I was not on the CRC.

Q. What was the position you said that became available?

A. A Life specialist. The company employed certain people and gave them certain types of training to assist agents in increasing their life insurance production and these life specialists, as they were called, were sent around to the different agents as the agents requested but prior to being able to make the request, we received written notification from our area field executive, Ginger Corell, that unless you were a select agent and a registered representative, they could not send this life specialist to our office.

Q. So that the life specialist was somebody who State Farm went out and hired?

A. Yes.

Q. As a resource that the company made available to certain agents?

A. To certain agents.

Q. Free of charge?

A. I believe it was free of charge.

Q. And the company decided that these life specialists would be made available only to select agents?

A. That is correct.

* * *

A. . [T]hat but, also, in the preamble of the contract, it says, paragraph 4, "We will provide you through our personnel with information and guidance as to the operation, conduct and financial management of your agency and from time to time we will designate specific employees to advise you regarding your activities." Well, they are saying that they will give me employees to advise me in my activities. One of my activities for which I have contracted is the sale of life insurance. And by not allowing me access to that specialist, given what I have just read you, I feel like the company has violated the contract in that regard.

(PSOF ¶ 103.)

Former State Farm Manager Killingsworth testified as follows about the Select Agent program:

Q. What was your view, if any, as to the appropriateness of the Select Agent Program?

A. I did not like it at all.

Q. Why?

- A. Agents should not be, in my judgment, differentiated against. The achievers should be rewarded, but not issues like this, to divide and differentiate. It was very – in my judgment, a very divisive policy. Created a lot of hostility. Greatly diminished the relationships. On the heels of the Grow .

(PSOF ¶ 104.)

3. Mandatory Meetings

State Farm has required Agents to attend meetings, when there is no contractual provision requiring such attendance. The Agreements state only that the independent contractor agents will be “invited” to meetings, not that they must attend. (PSOF ¶ 105.) Beginning in the late 1990s, State Farm has required its agents to attend certain “compliance” meetings in person.

(PSOF ¶ 106.)

The mandatory nature of these meetings was confirmed by Chuck Wright, as follows:

Q. And does that involve a meeting between somebody from the agency field and the agent?

A. It could.

Q. Okay. Is that a required meeting?

A. Well, required in what sense?

* * *

Q. If the agent doesn't want to participate, the agent doesn't have to?

A. If the agent doesn't want to participate in the program, we might have to reevaluate our relationship with the agent.

(PSOF ¶ 107.)

State Farm has considered terminating agents who do not attend these mandatory meetings. NASFA Board Member Clifford Mueller testified:

A. It would be one way. Were it not for the contract saying that I will be invited to meetings, okay? Now, invitation under termination is not much of an invitation, as far as I can understand that. And there are LUTC [continuing educational] courses that are taught by competent professionals for which agents would receive continuing education credits, okay, so there are many more ways to guarantee the ethics of your agency force rather than forcing them to go to a meeting or be terminated. I had a health condition at one point in time that made it difficult for me to get to a meeting and I was told flat out, “You don’t go to the meeting, you will be terminated.”

Q. Who told you that?

A. Ralph Brittain [State Farm Manager]. Real simple.

(PSOF ¶ 108.)

This is further evidenced in an email from Ralph Bolt to Chuck Wright, on August 22, 1997, which stated “[a]n open issue is how to assure 100% attendance by Independent Contractor[s]. We have some ideas on license renewal we’ll be checking out. (PSOF ¶ 109.)

Mandatory meetings cut into the agent’s working day, when other methods of conveying the same information, such as home study, are available. (PSOF ¶ 110.) Moreover, not even State Farm executives attend such “compliance” meetings. (PSOF ¶ 111.)

State Farm admits that the Agent Agreement contains no language that says the Company can require agents to attend meetings. State Farm further understands the contract to mean that the company is not going to direct agents on how to conduct day-to-day business. (PSOF ¶ 112.)

4. Internet Sales

State Farm is selling insurance over the Internet, violating the agents’ rights to be free from encroachment and to enjoy unencumbered relations with their policyholders. (PSOF ¶ 114-115.)

As of just May 16, 2004, a customer can log onto State Farm’s website, statefarm.com,

and purchase an automobile or renter's insurance policy if they live in the states of California, Illinois, Missouri, Ohio, Oregon, Tennessee, and Washington. (PSOF ¶ 108.) Agents in the states enumerated above were asked to sign an amendment to their Agent Agreements, commonly-referred to as the alternate access points amendment. (PSOF ¶ 116.)

An agent must sign the amendment in order to be assigned policies sold directly by State Farm over the Internet. The Amendment also provides for a reduced rate of commission. As such State Farm is competing with its agents for business because agents are not getting the business they would otherwise get, but rather, they receive reduced commissions. Agents receive just 3 percent commission on referred Internet sales, compared to a normal commission of 8-10 percent on automobile policy sales and a normal commission of 10-15 percent on homeowner's sales. (PSOF ¶ 117-118.) State Farm does not allow agents to have their own web sites. (PSOF ¶ 118.)

E. CURTAILMENT OF PRODUCT SALES AND DENIAL OF BROKERING

Until 2001 there was a well established custom and practice that agents were to sell as much insurance as possible; this is what the Agent Agreement meant by requiring the Agents to make fulfillment of the agreement their full-time occupation; and accordingly, there was a corresponding understanding and custom and practice on State Farm's part that it would make available to State Farm agents all of the products that they could sell. (PSOF ¶ 11.)

Beginning in late 2001 or early 2002, in contravention of this well established custom and practice, State Farm unilaterally discontinued selling certain insurance products through agents, curtailed product lines that agents could sell, imposed new and onerous requirements upon agents as a condition to their selling certain lines of insurance, reduced commissions and otherwise made the business and profession of being a State Farm agent more burdensome,

expensive and oppressive. (PSOF ¶ 119.) State Farm curtailed sales of products in 43 jurisdictions and as of January 2003, in 25 jurisdictions. (PSOF ¶ 119.)

Mary Bitzer, a Senior Vice President for State Farm's Central Zone, was offered by State Farm as a witness to testify on the subject of market restrictions. (PSOF ¶ 120.) Ms. Bitzer has authority within the five-state area that she represents to restrict business. (PSOF ¶ 121.) She described the process of deciding to restrict sales of insurance as not involving any regular compilation of information or regular list of reports. For example:

Q. Is there any kind of written procedure that dictates how you go about making the decision with respect to restricting business?

A. No.

Q. Okay. How do you know what the procedure is?

A. There is no procedure.

(PSOF ¶ 122.)

Similarly, she testified that there was no particular standard or criterion with respect to the effect on State Farm agents that the Company takes into account when making a decision on restrictions of new business. (PSOF ¶ 123.)

Restrictions on business result in significant decreases in the number of new policies an agent may sell. For instance, for the area of South Texas, the result of restrictions on the number of new fire policies that an agent could sell was severe.

Year	Average Book of Business of Agents
1998	143
1999	156
2000	166

2001	180
	95
2002	(year that restrictions were imposed)

(PSOF ¶ 124.)

State Farm’s curtailment of business would not have an unmitigated effect on Agents if they had the ability to sell alternative products—*i.e.*, if they could broker selected products of other insurance companies—products that State Farm itself has withdrawn from the marketplace.

The Agent Agreement, in fact, contemplates that such permission will be given:

The fulfillment of this Agreement will be your principal occupation and requires your personal services, and you will not directly or indirectly write or service insurance for any other company, other than a State Farm subsidiary or affiliate or through any governmental or insurance industry plan or facility, or for any agent or broker, except in accordance with the terms of any written consent we may give you.

In fact, however, State Farm’s “consent” is illusory. Even though the Agent Agreement contemplates that State Farm may allow agents to broker the products of other companies, State Farm has refused to allow its agents to market insurance offered by other carriers as replacement products for the ones it has prohibited them from selling, even where the other carriers are not full line competitors of State Farm. (PSOF ¶ 125.)

In considering agent requests to broker, State Farm looks at no documents that pertain specifically to agents, to the effect of any restriction on agent compensation; and there is no discussion of agent compensation. (PSOF ¶ 126.)

Vince Trosino, State Farm’s COO, testified:

Q. Is there a general policy that State Farm follows with respect to giving agents permission on soliciting the products of other companies?

A. It’s extremely limited .

(PSOF ¶ 126.)

State Farm claimed in discovery that in evaluating agent requests to broker other lines of insurance, it considered a number of factors:

[t]he general market situation, the potential for conflicts of interest, the possibility of customer confusion, the potential for claim handling complications, the potential liability to State Farm in the event that the other insurer fails to perform to the client's satisfaction, the difficulty in protecting trade secrets, the protection of the State Farm brand, the value of the training and support provided to the Agent and staff, the long term potential to market the line of business through State Far or a partnered company, and the potential for strained Agency loyalty.

(PSOF ¶ 127.)

In fact, however, State Farm's witnesses were unable to provide specific documentation, studies or examples to show that those factors were in fact applied or that they ever related to the objectives State Farm sought to accomplish:

Q. Let me ask the witness with respect to State Farm agents' solicitation of business with these insurance companies that we've named earlier, and if you want me to rename them I'll do that. Do you know if it has experienced any confusion on the part of its policyholders as to who is insuring them?

A. I don't know.

* * *

Q. Do you know whether State Farm has experienced any difficulty protecting its trade secrets with respect to business done with these other companies?

A. I don't know.

Q. Do you know if any of these other companies have unfairly competed with State Farm because of State Farm doing business with them?

A. I don't know of any particular instances.

Q. Has State Farm ever undertaken any study to determine that doing business with other insurance companies would have an adverse effect on it, competitively?

* * *

A. I've never heard of any task force or study group, no.

Q. Okay, and where did the information about other companies' E&O insurance come from?

A. It came from the gentleman with whom I work who is our E&O contact.

Q. Did he survey other companies' E&O insurance?

A. I have no idea.

* * *

Q. What study, if any, has State Farm ever done on the possibility of confusing policyholders if State Farm authorized its agents to solicit the products of other companies?

A. I don't know what study.

Q. Has it done any study or review of any potential complications with respect to claims handling?

A. I don't know.

Q. Has it studied or looked into any potential liability that State Farm or its agents might have if business was placed with a company that didn't pay on claims?

* * *

A. I don't know about a study.

Q. Other than a lawsuit, do you have any information?

A. I would assume, we would simply ask our own underwriting and claims what complications that would

present. I don't know of any study. I don't know who asked who. I don't know. That's not my area.

Q. You don't know of any particular questions that were asked of anyone?

A. No.

(PSOF ¶ 129.)

Rather, State Farm has simply denied those requests, without giving any particular reasons.

State Farm's arbitrary exercise of its discretion is exemplified in the experience of NASFA Board member Clifford Mueller. He testified:

Q. So it was your intention, if State Farm had given consent to you to place fire insurance with Northern Neck or Loudoun --

A. Loudoun County Mutual.

Q. --Loudoun County Mutual, it was your intent to provide that insurance to them from those companies but then switch them over to State Farm down the road when State Farm authorized you to --

A. If and when --

Q. -- increase production again on fire insurance?

A. If and when State Farm got back in the fire insurance business, that would be a reasonable assumption to make.

Q. Okay. Reasonable assumption being that you would then switch them over to State Farm from whatever you had provided them or sold them before?

A. Yes. Yes. That's why I was so incensed at Mr. Whitney's [State Farm's] e-mail stating that I had talked about Allstate and Nationwide, who are direct competitors of State Farm, whereas Loudoun County Mutual and Northern Neck only write fire insurance and he knew that.

- Q. So on October 24th, 2002, you sent this e-mail requesting permission to place fire insurance with a company other than State Farm.
- A. Yes, sir.
- Q. So after the e-mail, you had a conversation with Mr. Whitney?
- A. Yes, sir.
- Q. And what is Mr. Whitney's position?
- A. He is regional – well, he would be analogous to a regional deputy vice president. He is a vice president in charge of agency for Virginia in the zone.
- Q. And what did he say to you in the conversation, I'm not talking about the e-mail yet?
- A. I would refer you to item 11, which is some notes that I took on a 5-by-7 steno pad. He first informed me that brokering business was against the contract and I referred him to the contract telling him that it wasn't against the contract if I had written permission of State Farm and his response to me was that it was not in our mutual interest to have me have the authority to broker. Of course, it was no money out of his pocket, the money was coming out of my pocket.
- Q. That's your comments to me now, right? I just want to distinguish.
- A. No, I did not say that to Mr. Whitney at the time, no.
- Q. I'll let you say whatever you want but let's just get clear what was in the conversation and what wasn't.
- A. Then I asked Mr. Whitney, as has been a problem in the past on occasion, if he had the full authority of the company to grant or deny such a request. And his response was Mr. Thompson would refer any such requests to him and, "I have full authority to grant or deny such a request." So it would appear that you don't have to go very far up the

corporate ladder to get that permission. “Just wanted to make sure what you were asking for.” Oh, his phone call – his comments to me was that he wanted – he was making the phone call in order to be certain what I was asking for and then he stated emphatically, “You can’t broker business.” I said since the contract required me to put my request in writing, I was asking for him to put his denial in writing and he said, “Sure, I’ll put it in writing,” and then his answer, which was not accurate, I responded to stating that he must have misheard what I said.

Q. Okay. And on item 11, which you referred to, which is your contemporaneous notes of what you and Mr. Whitney said to each other –

A. Yes, sir.

Q. -- you wrote, “I did not say Allstate or Nationwide and said – I said Loudoun County Mutual or Northern Neck.” You went back and wrote this later, I guess, after you saw his return e-mail?

A. Yes, after I saw his return e-mail. That’s why there is a line there.

Q. Okay. So the next thing that happened, I guess, and it is all on the same day, October 24th, you got this return e-mail from Mr. Whitney, and it speaks for itself, I don’t have to ask you to read it but what did you do after you got this return e-mail from Mr. Whitney?

A. There was nothing to do. I can’t broker so boom.

Q. So did you call him back and say, “You got it wrong. I never said Allstate or Nationwide, I said Northern Neck and Loudoun County”?

A. I have a draft – let me read it here. Item 14. Now, this is a draft of the e-mail I sent on 10/29/02 at 10:20 a.m., stating that he must have misheard me and that – “You must have misheard the companies I named as examples/possibilities for such brokerage. They were Loudoun County Mutual or the Northern Neck, both of which write nothing but fire insurance. Allstate and/or Nationwide never passed my lips as a company with which I ever considered a business relationship.”

- Q. And it is your testimony that you sent this as an e-mail to Mr. Whitney?
- A. 10/29/02 at 10:20 a.m.
- Q. Did you get any response?
- A. Not that I am aware of.
- Q. But, nevertheless, you sent him this e-mail on October 29th?
- A. Yes, because I thought it was incumbent upon him to be infinitely more accurate with what his agents had requested. I could see a vice president of agency not wanting a State Farm agent to broker with Allstate or Nationwide, as they are multi-line companies, but what we were discussing was fire insurance and the two companies that I picked write only fire insurance, which State Farm was not writing at the time so there would be no conflict of interest as there would be with Nationwide and Allstate.
- Q. This is item 15, if you will take a look at it. I take it you had this document in your files?
- A. Yes.
- Q. Okay.
- A. I'm also chairman of the Northern Virginia Agents Association and send out a newsletter once a month and this was one of the items that I had put in that newsletter.
- Q. Does this relate at all to your request to broker business?
- A. I had – I thought it related, in that State Farm allows very selective brokering of business when it suits their purpose and this AON association with State Farm was merely an example of that to my counsel. I know that in Alabama they allow brokering of certain types of insurance, there is in Northern Virginia a brokering of health insurance with Fortis, there is brokering of life insurance with a company called Phoenix, I think it is Phoenix Mutual, I'm not sure, and it was merely to bolster my case that the rejection of my request to broker insurance was arbitrary and capricious in the extreme.

(PSOF ¶ 131.)

The idea behind allowing agents to broker lines of insurance not presently offered by State Farm is that when State Farm commences again to offer the coverage, the State Farm agent (whose AA3 or AA4 contract provides for retirement based on his last year of earnings) has every incentive to move the policyholder to the State Farm policy. As NASFA President Swift testified:

Sure. Because at the time, State Farm was not in the market, and if they allowed us to broker the business, we could write the business for a period of time, being able to save the business without losing the entire book of business. And then we would put it back in State Farm when State Farm will take it, if they want it, because our retirement is based on our book of business.

* * *

I would like to say right here, I don't think – what we're trying to establish here is that we're not trying to take the business away from State Farm and do something else with it. We're only trying to be able to sell that business so we can keep the total book of business we have and then put it back with State Farm when they're ready to write again.

(PSOF ¶ 133.)

ARGUMENT

A. THE STATE FARM AGENT AGREEMENT IS A FRANCHISE AND STATE FARM HAS VIOLATED FRANCHISE STATUTES

SUMMARY OF ARGUMENT

The State Farm Agent Agreement is a franchise under the laws of states pleaded in the Complaint that regulate the conduct of franchisors,² and State Farm's conduct in this case has

²California Franchise Investment Law and California Franchise Relations Act (Count V); Hawaii Franchise Investment Act (Count VI); Indiana Franchise Act and Indiana Deceptive Franchise Practices Act (Count VII); Virginia Retail Franchising Act (Count VIII); Minnesota Franchise Act (Count IX); Wisconsin Franchise Investment Law and Wisconsin Fair Dealership Law (Count X); Nebraska Franchise Practices Act (Count XI); New Jersey Franchise Practices Act (Count XII); Oregon Franchise Act (Count XIII); Arkansas Franchise Practices Act (Count XIV); Delaware Franchise Security Law (Count XV); New York Franchise Sales Act (Count XVI); Michigan Franchise Investment Law (Count XVII); Maryland Franchise Registration and Disclosure Law (Count XVIII); and Illinois Franchise Disclosure Act of 1987 (Count XIX).

violated those statutes, which, among other things, make it unlawful for franchisors to terminate or refuse to renew franchise agreements without good cause; to discriminate among franchisees, to impose unreasonable standards of performance, or to change the competitive circumstances of franchisees without good cause. All of the state statutes define a franchise in terms of a combination of some of the following elements:

1. One party (the franchisor) grants to another party (the franchisee) the right to offer, sell or distribute a product or service;³
2. The franchisee uses the franchisor's trademark or trade name;⁴
3. The franchisee pays the franchisor a fee for the right to enter into the business;⁵ and
4. The franchisor either (a) prescribes a marketing plan or system for use by the franchisee or (b) there is a "community of interest" between the franchisor and franchisee in the marketing or selling of the goods or services of the franchisor.⁶

³Ark. Code Ann. § 4-72-202(1); Cal. Corp. Code § 31005(a)(1); Cal. Bus. & Prof. Code § 20001(a); Del. Code Ann. Tit. 6, § 2551(3); Haw. Rev. Stat. § 482E-2; 815 Ill. Comp. Stat. § 705/3(1)(a); Ind. Code § 23-2-2.5-1(a)(1); Mich. Comp. L. § 445.1502 (3)(a); Md. Code Ann. § 14-211 (e)(1)(i); Minn. Stat. § 80C.01, subd. 4(a)(1); Neb. Rev. Stat. § 87-402(1)(a); N.J. Stat. § 56:10-3(a); N.Y. Gen. Bus. L. § 681(3)(a) or (b); Or. Rev. Stat. § 650.005(4)(a); Va. Code § 13.1-559(a)(1); Wis. Stat. § 553.03(4)(a)(1); Wis. Stat. § 135.02(3).

⁴Ark. Code Ann. § 4-72-202(1); Cal. Corp. Code § 31005(a)(2); Cal. Bus. & Prof. Code § 20001(b); Del. Code Ann. tit. 6, § 2551(1)(2); Haw. Rev. Stat. § 482E-2; 815 Ill. Comp. Stat. § 705/3(1)(b); Ind. Code § 23-2-2.5-1(a)(2); Mich. Comp. L. § 445.1502(3)(b); Md. Code Ann. § 14-201(e)(1)(ii); Minn. Stat. § 80C.01, subd. 4(a)(1); Neb. Rev. Stat. § 87-402(1)(a); N.J. Stat. § 56:10-3(a); N.Y. Gen. Bus. L. § 681(3)(b); Or. Rev. Stat. § 650.005(4)(b); Va. Code § 13.1-559(a)(2); Wis. Stat. § 553.03(4)(a)(2); Wis. Stat. § 135.02(3).

⁵Ark. Code Ann. § 4-72-202(1); Cal. Corp. Code § 31005(a)(3); Cal. Corp. Code § 31011; Cal. Bus. & Prof. Code § 20001(c); Cal. Bus. & Prof. Code § 20007; Del. Code Ann. tit. 6, § 2551(3); Haw. Rev. Stat. § 482E-2; 815 Ill. Comp. Stat. § 705/3(1)(c); Ind. Code § 23-2-2.5-1(a)(3); Md. Code Ann. § 14-201(e)(1)(iii); Mich. Comp. L. § 445.1502(3)(c); Minn. Stat. § 80C.01, subd. 4(a)(3); N.Y. Gen. Bus. L. § 681(3)(a) or (b); Or. Rev. Stat. § 650.005(4)(c); Va. Code § 13.1-559(a)(3); Wis. Stat. § 553.03(4)(2)(3). The Nebraska Franchise Practices Act, New Jersey Franchise Practices Act, Wisconsin Fair Dealership Law, and the Arkansas Franchise Practices Act do not require payment of a "franchise fee" to satisfy the definition of a "franchise."

⁶ Cal. Corp. Code § 31005(a)(1) (marketing plan); Cal. Bus. & Prof. Code § 20001(a); Haw. Rev. Stat. § 482E-2 (community of interest); 815 Ill. Comp. Stat. § 705/3(1)(a); Ind. Code § 23-2-2.5-1(a)(1) (marketing plan); Md. Code Ann. § 14-201(e)(1)(i); Mich. Comp. L. § 445.1502(3)(a) (marketing plan); Minn. Stat. § 80C.01, subd. 4(a)(2) (community of interest); Neb. Rev. Stat. § 87-402(1)(a) (community of interest); N.J. Stat. § 56:10-3(a) (community of interest); N.Y. Gen. Bus. L. § 681(3)(a) or (b); Or. Rev. Stat. § 650.005(4)(a) (marketing plan); Va. Code § 13.1-559(a)(1) (marketing plan); Wis. Stat. § 553.03(4)(a)(1) (marketing plan); Wis. Stat. § 135.02(1) and (3) (community of interest). The Arkansas Franchise Practices Act and Delaware Franchise Security Law require neither a marketing plan nor a community of interest.

As shown below, State Farm satisfies all of these elements.

At the outset, however, it is significant that State Farm, in the past, acknowledged that its relationships with agents were franchises – in fact, that was a major selling point in recruiting agents. (PSOF ¶ 19.) Even though State Farm ceased calling its agencies “franchises” after federal and state governments began regulating the sale of franchises in the late 1970s, State Farm continued to use the term. Its recruiters told prospective agents that it was “like a McDonald’s.” Agent Stephen Adams testified:

The way it was outlined to me and my wife was that I was buying the equivalent of a McDonald’s franchise and I didn’t have to ever worry about inventory, because we could never run out, and that I could make as much money as I wanted and I didn’t have to buy the franchise outright upfront, that they had a finance program in lieu of me giving them the funds upfront for the business that they would withhold commissions on me for two years during the trainee period, and then by them doing that, that my expenses to run the office would exceed any income that I would make, that I would have to have sufficient funds to fund the operation for the first two years.

(PSOF ¶ 22.) Although State Farm will contend now that it has repudiated these admissions, “a party cannot avoid a franchise relationship merely by disclaiming its existence” Peter v. Stone Park Enters., LLC, 1999 U.S. Dist. LEXIS 11385 at 19, Bus. Franchise Guide (CCH) ¶ 11,750 (N.D. Ill. 1999). Most importantly, the State Farm Agent Agreement satisfies the requirements for a franchise.

State Farm argues that no court has held that insurance agents are franchisees, and urges this Court not to depart from those decisions. While NASFA recognizes the decisions rendered previously, three of which relate to State Farm agents, we respectfully submit that the Court

should so depart, because, as a matter of law, that is the correct holding.⁷

As we demonstrate below:

- certain prior decisions (including one of those involving State Farm) are irrelevant because they were based upon employer-employee relationships, or on insurance relationships which do not involve retail sales or services;
- the other prior decisions, including the remaining two involving State Farm, are also irrelevant because evidence, which is present in the record in this case concerning sales by State Farm agents and fees paid by them, was not presented by plaintiffs in those cases; and/or
- several prior decisions also did not even fully evaluate the definition of “franchisee,” and instead focused on only one of three alternate definitions.

The state franchise statutes embrace the relationship between the independent contractor State Farm agents and State Farm; only an incomplete reading of those statutes could lead to a different conclusion. And, there is no preemption of the field by state insurance statutes, nor does State Farm expressly argue preemption.

Finally, while there is substantial evidence cited in NASFA’s undisputed facts and in this Memorandum (notably from the writings of State Farm executives) that State Farm agents do sell insurance, State Farm’s focus on the “selling” element as the sine qua non of every franchise relationship is a red herring. As discussed below, all of the franchise statutes require only that a party have the right to either offer or sell or distribute the products or services of the franchisor.⁸

⁷ It is undisputed – in fact it is not even discussed by State Farm – that its independent contractor agents have the right to use the State Farm trademark and/or name. It is undisputed – in fact, it is not even discussed by State Farm – that its independent contractor agents are subject to marketing plan or system prescribed by State Farm or that there is a community of interest. It is agreed that those elements of a franchise exist.

⁸ Most instructive, and directly supporting the conclusion that State Farm independent contractor agents qualify as franchisees if they either offer or sell or distribute State Farm’s products or services, is the Court’s extensive study of that language in interpreting the California Franchise Investment Law, the forerunner of all state franchise laws, and the model for many, see Gentis v. Safeguard Business Systems, Inc., 71 Cal. Rptr. 2d 122 (Cal. App. 2nd Dist. 1998), which is discussed later in this Memorandum.

Indeed, the “sale” point can be readily disposed of here: Eleven of the fifteen state franchise statutes at issue provide that a franchise exists when the franchisee has the right to “distribute” a product or service and the other elements are satisfied. The term “distribute” means “to give out or deliver.” Merriam-Webster’s Collegiate Dictionary, 10th Ed. at 338. All these forms of the Agent Agreement provide that Agents shall “deliver policies.” (PSOF ¶ 66.) Hence, the Agents deliver – i.e., distribute—policies and services. On this element, therefore, there should be no dispute.

The second, and sole, remaining franchise issue is the existence of a “franchise fee.” Most, but not all, of the franchise statutes require that some sort of minimum fee be paid to obtain the status of a franchisee. The evidence presented in NASFA’s undisputed facts and in this Memorandum proves that there are such fees paid by State Farm agents. And even if there were an issue of fact on this point, the Agent Agreement would still indisputably be a franchise in the three jurisdictions where a fee is not required.

The real issue here is not whether State Farm agents are franchisees under various state franchise statutes; it is whether they are franchisees under all or merely most of the franchise statutes. We submit that the coverage is total.⁹

⁹ State Farm, without citation, observes (State Farm Memorandum, p. 53 n.8) incorrectly that, because the new State Farm Agents’ Agreement, version AA97, has a choice of law designating Illinois, the Court need look only to Illinois law to determine if the group of agents who are signatory to that particular contract (as opposed to the still popular AA3 and AA4 contracts) are “franchisees.” While we submit that, under Illinois law, they are franchisees, State Farm is incorrect. That issue was expressly considered and decided in Cromeens, Holloman, Sibert, Inc. v. AB Volvo, Inc., 349 F.3d 376, 384-87 (7th Cir. 2003). There, the Court held that the reach of the Illinois Franchise Law was only to the territorial limits of Illinois, and a choice of law provision could not extend it. Hence, the Illinois law applies only to Illinois agents.

B. THE DECISIONS CITED BY STATE FARM DO NOT AND SHOULD NOT PRECLUDE THIS COURT FROM HOLDING THAT STATE FARM AGENTS ARE FRANCHISEES UNDER THE STATE FRANCHISE LAWS

1. The Three Decisions Involving State Farm Are Not Dispositive

State Farm cites Vitkauskas v. State Farm Mutual Auto. Ins. Co., 157 Ill. App. 3d 317, 509 N.E.2d 1385 (Ill. App. 3d 1987); the unpublished decision in Hartman v. State Farm Mutual Auto. Ins. Co., Case No. 93-8084 (S.D. Fla. 1993), *aff'd mem.* (table), 77 F.3d 496 (11th Cir. 1996); and the unpublished decision in Mazziotti v. State Farm Indemnity, No. C-333-98 (N.J. Super. Ch. Div. 2002), for the proposition that State Farm independent contractor agents are not franchisees. We respectfully disagree.

The crucial distinction which renders the Vitkauskas decision irrelevant here is apparent at the outset: The Court stated plaintiff Vitkauskas was a “trainee agent,” making him an “employee” of State Farm. 509 N.E.2d at 1387. Employees cannot be franchisees, and no one contends otherwise. The Court stated correctly that “[u]nder the [Illinois Franchise Disclosure] Act, an employee and a franchisee are not synonymous.[i]t is impossible to conclude that IFDA was intended to regulate [the] employer and employee relationship.” Id. at 1390-91.

The present case is not about whether trainee (employee) agents are franchisees, but whether, when they attain a new status, that of independent contractor State Farm agents, they are franchisees.

The Illinois Franchise Disclosure Act defines a franchise as:

a contract or agreement by which (1) a franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed by a franchisor; (2) the operation of the franchisee's business is substantially associated with the franchisor's trademark, service mark; and (3) the franchisee is required to pay, directly or indirectly, a franchise fee of \$500.

(In 1987, the minimum fee was \$100.) Oddly, the Court did not consider the offering or distributing prongs of the definition, and simply stated that the plaintiff (employee) did not sell insurance. That is not apposite here, because, as discussed above and at length below, (a) plaintiffs here do “sell” and (b) they do “offer” or “distribute” State Farm insurance.

Finally, Vitkauskas states that the plaintiff did not present evidence that there was a franchise fee paid. Id. at 1391. Here, however, as described in NASFA’s undisputed facts and this Memorandum, here there is such evidence.

Following the teachings of the Book of Job,¹⁰ State Farm cites to the treatise Franchise and Distribution Law and Practice, by Plaintiffs’ lead counsel W. Michael Garner. While Mr. Garner may appreciate this implicit nod to his expertise in franchising, State Farm misses the point. Mr. Garner’s work is, as stated, a treatise; it presents a description of cases and authorities, and does not necessarily advocate one position or another. To claim that Mr. Garner approves of the Vitkauskas decision merely because he cited it (with thousands of other authorities cited in his multi-volume work) is akin to claiming that Professors Wright and Miller or Professor Moore agreed with all of the cases they cited in their encyclopedic treatises. The Court knows better.

Thus, Vitkauskas is wholly unavailing to State Farm.

Next is Hartman v. State Farm, a 1993 decision affirmed without opinion (in the table) by the Eleventh Circuit. The Hartman case was decided under Florida law. In ruling on Count V, the Court declined to be bound by several of the cases cited by State Farm in its Memorandum. It held instead that whether the plaintiff was a franchisee depended not on another court’s analysis of the law (of Missouri, Illinois or Virginia), but on an analysis of the Florida franchise

¹⁰ “My desire is that mine adversary had written a book.” Job, XXXI, 35.

statute, a statute not even at issue in this case.

The Florida Franchise Misrepresentation Act, Fla. Stat. § 817.416, defines a franchise as (1) a contract that establishes a commercial relationship, (2) under which the franchisee is granted the right to offer, sell or distribute goods or services of another [this language is consistent with the original statute, California’s], (3) the franchise is a component of the franchisor’s distribution system, and (4) the franchise is “substantially reliant” on the franchisor for its basic supply of goods.

First, evaluating the existence of a “commercial relationship,” the Court, in a conclusion reminiscent of the ancient holding that professional baseball is not part of interstate commerce,¹¹ cited a 1934 Florida case for the proposition that an insurance agent’s business does not involve a “commercial relationship.” Such a curious conclusion does not lend credibility to the court’s analysis. Second, the Court stated that agents do not provide a “service,” a conclusion expressly refuted by State Farm’s own agent agreements; moreover, anyone who has ever sought insurance or made a claim could take judicial notice that agents provide a “service.” Finally, the Court cited Vitkauskas for the proposition that agents do not “sell” insurance – a proposition which is not dispositive, given the fact that the Agent Agreement expressly states that agents deliver – *i.e.*, “distribute” insurance policies. Moreover, given the sworn admissions and writings of State Farm executives that they do sell (see argument below), Hartman is inapposite. In sum, Hartman defaults on the obligation to seriously analyze the franchise issue. And – again – what it says about Florida is applicable only to Florida.

Lastly, State Farm cites Mazziotti Ins. Agency v. State Farm Indemnity, a New Jersey Chancery Division opinion. The Court determined that the New Jersey Franchise Practices Act

¹¹ Federal Baseball Club of Balto. v. National League of Professional Baseball Clubs, 259 U.S. 200 (1922).

“Act”) did not govern the relationship between an insurance agent and the insurance company. That Act – unlike many other franchise statutes – expressly requires that there be “sales” by the franchisee, see Slip. Op. at 18, citing N.J.S.A. 56:10-4. The Court decided that the agents do not “sell” (Slip Op. at 24-25), but apparently it was not furnished with any of the substantial evidence in the record here – from the mouths and pens of State Farm itself – that agents do sell. (PSOF ¶¶ 42-57.)

Actually, Mazziotti is helpful to NASFA. There State Farm argued (as it does in the present case) that there is already a “comprehensive legislative scheme” concerning insurance relationships. The Court however, refused to oust the New Jersey Franchise Practices Act on the basis of New Jersey’s insurance law. Instead, it cited the plaintiff’s argument that “on numerous occasions our courts have recognized that overlapping regulatory schemes are compatible.” (Slip Op. at 19). Thus, while State Farm prevailed on the franchise issue on the ground (not available given the evidence in this case) that agents do not sell, it did not prevail on its argument that the existence of a regulatory scheme governing insurance agents and insurers ipso facto prohibits franchise law coverage.

Reduced to their essentials, the gravamen of the three State Farm cases is that there is no franchise relationship because agents do not “sell” insurance. Two of those cases ignored the disjunctive language (offer or sell or distribute) of the statutes; here, there is no dispute that agents “distribute” insurance, and in this case, the evidence of sales is substantial, and cannot be glossed over – most certainly not on summary judgment.

2. State Farm’s Other Franchise Cases Are Even Less Viable As A Precedents Than The Three *State Farm* Decisions

State Farm’s other citations to cases holding the agent-insurer relationship is not a franchise are readily distinguished. Borberly v. Nationwide Mut. Ins. Co., 547 F. Supp. 959 (D.

N.J. 1981), another New Jersey case, is the earliest such decision. It appears that the plaintiff did not even argue that the New Jersey Franchise Practices Act applied. The Court states in a footnote that the plaintiff sought to rely “by analogy” on a case which was not decided under the Act. The Court then observes, in dictum in that same footnote, that the Act “does not govern the contractual relationships existing here,” Id. at 973 n.23, but there is no indication that the plaintiff even raised the Act as an issue; indeed, the point was not even thought worthy of a headnote.

Emerick v. Mutual Benefit Life Ins. Co., 756 S.W.2d 513 (Sup. Ct. Mo. 1988) (en banc) was next. The Court dealt there with a “general agent,” and made findings that the relationship between the parties, both when Emerick was a general agent and when he worked at the Home Office, constituted an “employment contract,” Id. at 526-27 (“it is clear that either by reason of the terms of the employment contract . there are items for which respondent is entitled to compensation [including] renewal commissions as they come due.” Id. at 527). Of course, given that “employment” relationship, there was no franchise, and the Court’s brief holding that the “trial court did not err” in finding no franchise existed was correct – but inapposite here.

In Erdmann v. Preferred Research, Inc. of Georgia, 852 F.2d 788 (4th Cir. 1988), the Court held only that a title insurance business was not a franchise under Virginia law. Examination of this case reveals that it has nothing to do with NASFA v. State Farm. The Virginia Retail Franchise Act requires sales at retail to the ultimate consumer; as a title insurer, Erdman simply did not qualify. The Court explained:

To find that Erdmann’s relationship with Preferred falls within this section would be to strain the language of the statute. Black’s Law Dictionary defines “retail” as “a sale for final consumption a sale to the ultimate consumer.” Black’s Law Dictionary (5th Ed. 1979). Erdmann’s title insurance service did not fall within this definition. His services were performed for professional mortgage lenders and

attorneys. Such professionals were not ultimate consumers of a retail sale, but, rather, passed such services on, in some form, to the purchasers of the property.

Id. at 790 (emphasis added). State Farm agents, by contrast, deal with the “ultimate consumer.” Erdman is therefore helpful to NASFA.

In Keeney v. Kemper Nat’l Ins. Co., 960 F. Supp. 617 (E.D.N.Y. 1997), the Court gave even less consideration to the franchise issue than did the previous cases. Without addressing any of the required elements of the New York Franchise Sales Act, it merely stated, with respect to Counts VIII-IX of the Complaint, that “[n]one of the relevant elements which create a franchise arrangement were pled by the plaintiffs . [and] the Agreement is merely a “garden variety commercial contract.” Id. at 625. This observation is hardly worthy of citation, must less reliance.

Stockton v. Sentry Insurance, 989 S.W.2d 914 (Ark. Sup. Ct. 1999), held the relationship between the parties was an employment relation, based upon the parties “Sales Representative Employment Contract.” Id. at 916-17. Plainly, *Stockton* has no bearing here, where it is undisputed that, as recited in the Agents’ Agreements, State Farm agents are “independent contractors.”

Finally, the unpublished California opinion in Zentner v. Farmer’s Group, Inc., adds nothing to State Farm’s argument. Zentner was not even an agent; he was a District Manager of Farmers, who “recruited insurance sales agents.” (Slip Op. at 3.)

In fact, Zentner, like Erdmann, is helpful to NASFA, not State Farm. The California Court observed that “[u]nlike a franchisee, Zentner did not receive funds from customers and pay a percentage of his gross to Farmers.” Id. at 13. State Farm agents do receive the funds and, in the end, a percentage of the gross is paid to State Farm, and a percentage goes to the agent.

In sum, State Farm’s citations do not establish that State Farm agents are not franchisees. To the extent that they rely on whether an agent “sells” or not, they are inapposite since almost all of the state statutes provide that franchisees may “offer” or “distribute” a product or service. Moreover, if the evidence cited in NASFA’s undisputed facts and in this Memorandum makes anything clear, it is that State Farm agents sell insurance.

C. THE AGENT AGREEMENTS ARE FRANCHISES UNDER THE STATUTES OF THE FIFTEEN FRANCHISE STATES AT ISSUE

With the above in mind (and with the evidence cited herein that State Farm agents do pay a “franchise fee”) we now review the state franchise statutes referred to in the Complaint, to demonstrate that, under each, State Farm agents are franchisees.

1. The Franchise Statutes

The state franchise laws are largely similar to each other and to most of the statutes discussed above. They are:

The Arkansas Franchise Practices Act, Ark. Code Ann. § 4-72-202(1) defines a franchise as a written or oral agreement for a definite or indefinite period in which a person grants another a license to use a trade name or to sell or distribute goods or services at wholesale or retail.

The California Franchise Investment Law, Cal. Corp. Code § 31000, et seq. and the California Franchise Relations Act, Cal. Bus. & Prof. Code § 20000 define a franchise as a contract or agreement, express or implied, by which (1) a franchisee is granted the right to engage in the business of offering, or selling or distributing goods or services; (2) under a marketing plan or system prescribed in substantial part by a franchisor; (3) the operation of the franchisee’s business is substantially associated with the franchisor’s trademark or name; and (4) the franchisee is required to pay a franchise fee. Cal. Corp. Code § 31005(a); Cal. Bus. & Prof. Code § 2001(a)-(c).

The Delaware Franchise Security Law (“DFSL”), Del. Code Ann. tit. 6, §§ 2551, et seq. defines a franchise as a contract governing the business relationship within the State of Delaware between a franchised distributor and a franchisor where the franchised distributor is required to pay more than \$100 to enter into the contract. Del. Code Ann. tit. 6, § 2551(3). No time limit is imposed on the payment requirement.

The DFSL defines a “franchised distributor” as a person with a place of business within the State of Delaware, engaged in the business of (a) purchasing or consigning products which bear the trademark of a manufacturer for the primary purpose of selling such products to retail outlets; (b) making retail sales of products which bear the trademark of no more than 3 manufacturers; (c) selling books, magazines, journals, newspapers, or other publications at retail outlets; or (d) operating a service station or other place of business for the sale of motor fuel. Del. Code Ann. tit. 6, § 2551(1).

The Hawaii Franchise Investment Law, Haw. Rev. Stat. §§ 482E-1, et seq., defines a franchise as a contract or agreement, express or implied, in which a person is granted a (1) license to use a trade name and in which (2) there is a community interest in the business of offering, selling, or distributing goods or services, and in which (3) the franchisee is required to pay a franchise fee. Haw. Rev. Stat. § 482E-2.

The Illinois Franchise Disclosure Act of 1987 defines a franchise as an implied or express contract by which (1) a franchisee is granted the right to engage in the business of offering, selling or distributing goods or services; (2) under a marketing plan or system prescribed or suggested by the franchisor; (3) the operation of the franchisee’s business is substantially associated with the franchisor’s trademark; and (4) the franchisee is required to pay a franchise fee of \$500 or more. 815 Ill. Comp. Stat. § 705/3-(1).

The Indiana Franchise Act, Ind. Code §§ 23-2-2.5-1, *et seq.*, and the Indiana Deceptive Franchise Protections Act, Ind. Code § 23-2-2.7, *et seq.*, both define a franchise as (1) a grant of a right to engage in business of dispensing goods or services under a marketing plan or system; (2) the operation of the business is substantially associated with the franchisor's trademarks; and (3) the franchisee is required to pay a franchise fee.

The Maryland Franchise Registration and Disclosure Law, Md. Code Ann., Bus. Reg. §§ 14-201, *et seq.*, defines a franchise as an agreement in which (1) a purchaser is granted the right to engage in the business of selling or distributing goods or services under a marketing plan or system prescribed in substantial part by the franchisor, (2) the business is associated substantially with the trademark of the franchisor, and (3) the purchaser must pay a franchise fee. Md. Code Ann., Bus. Reg. § 14-201(e).

Under the Michigan Franchise Investment Law, Mich. Comp. L. §§ 445.1501, *et seq.*, a franchise is defined as a contract by which a franchisee is granted (1) the right to engage in the business of selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor, (2) the business is substantially associated with the franchisor's trademark, and (3) the franchisee is required to pay a franchise fee. Mich. Comp. L. § 445.1502(3).

The Minnesota Franchise Act, Minn. Stat. §§ 80C.01, *et seq.*, defines a franchise as a contract between two or more persons by which (1) a franchisee is granted the right to engage in the business of distributing goods or services using the franchisor's trademark, (2) in which the franchisor and franchisee have a community of interest in the marketing of goods or services, and (3) for which the franchisee pays a franchise fee. Minn. Stat. § 80C.01, Subd. 4.

The Nebraska Franchise Act, Neb. Rev. Stat. § 87-401, *et seq.*, defines a franchise as (1)

a written arrangement under which the franchisor grants a license to use a trademark, (2) in which there is a community of interest in the marketing of goods or services and for which the (3) the franchisee pays a franchise fee. Neb. Rev. Stat. 87-402(1).

The New Jersey Franchise Practices Act, N.J. Stat. Ann. § 56:10-1, et seq., defines a franchise as a written agreement for a definite or indefinite period, in which a person grants to another person a license to use a trade name, trademark, service mark, or related characteristics, and in which there is a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement, or otherwise. There is no fee requirement. N.J. Stat. Ann. § 56:10-3(a).

The New York Franchise Sales Act, N.Y. Gen. Bus. Law § 680, et seq., defines a franchise as a contract or agreement, either expressed or implied, by which: (a) franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor, and the franchisee is required to pay, directly or indirectly, a franchise fee, or (b) franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate, and the franchisee is required to pay, directly or indirectly, a franchise fee. N.Y. Gen. Bus. Law § 681(3).

The Oregon Franchise Act, Or. Rev. Stat. §§ 650.005, et seq., defines a franchise as a contract by which a franchisee is (1) granted the right to engage in the business of selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; (2) the franchisee's business is substantially associated with the franchisor's

trademark; and (3) the franchisee is required to give to the franchisor valuable consideration. Or. Rev. Stat. § 650.005(4).

The Virginia Retail Franchising Act, Va. Code Ann. § 13.1-557, et seq., defines a franchise as a written contract or agreement between two or more persons, by which: (1) franchisee is granted the right to engage in the business of offering, selling or distributing goods or services at retail under a marketing plan or system prescribed in substantial part by a franchisor; (2) the operation of the franchisee's business is substantially associated with the franchisor's trademark or other commercial symbol; and (3) the franchisee is required to pay, directly or indirectly, a franchise fee of \$500 or more. Va. Code Ann. § 13.1-559(b).

The Wisconsin Franchise Investment Law, Wis. Stat. §§ 553.01, et seq., defines a franchise as an agreement by which (1) a franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor, (2) the operation of the franchisee's business is substantially associated with the franchisor's business and trademark, and (3) the franchisee is required to pay a franchise fee. Wis. Stat. § 553.03(4).¹²

There are, therefore, 15 states whose statutes are at issue. In only one, Delaware, is there a requirement that the franchisee sell; in eleven, a franchise may “sell, offer, or distribute goods or services.”¹³ In Nebraska and New Jersey, the franchisee must “market” goods or services – a term that means to “expose for sale.” Merriam-Webster's Collegiate Dictionary, 10th Ed. at 712.

¹²The Wisconsin Fair Dealership Law, Wis. Stat. §§ 135.01, et seq., defines a dealership as an agreement by which a person is granted the right to sell or distribute goods or services, or use a trade name or trademark, in which there is a community of interest in the business. Wis. Stat. § 135.02(3). Under the Fair Dealership Law, no fee is necessary, and good cause is needed for termination of the relationship.

¹³ Arkansas, California, Hawaii, Illinois, Maryland, Michigan, Minnesota, New York, Oregon, Virginia and Wisconsin.

In Indiana, a franchisee “dispenses” goods or services of the franchisor. “Dispense” means “distribute.” Merriam-Webster’s Collegiate Dictionary, 10th Ed. at 335. Indiana has no “sell” requirement. As shown below, the Agent Agreements satisfy the statutory definition of a franchise.

2. The Trademark and Community of Interest/Marketing System Requirements Are Uncontested and, In Any Event, Satisfied

State Farm does not even contest that its agreements with the Agents satisfy the trademark and the community of interest/marketing system elements of the franchise definition, so we will only touch on those requirements briefly.

The Agents are authorized to use the State Farm name and mark and in fact do use it through signs, stationery and advertising. See Cassidy Podell Lynch, Inc. v. Snyder Gen. Corp., 944 F.2d 1131, 1139-40 (3rd Cir. 1991); Cooper Distrib. Co. v. Amana Refrigeration, Inc., 63 F.3d 262, 272-73 (3rd Cir. 1995); Lobdell v. Sugar ‘N Spice, 658 P.2d 1267 (Wash. Ct. App. 1983).

The “marketing plan” requirement is generally satisfied by the franchisor’s specification of prices, pricing systems, sales requirements, sales techniques or advertising. See, e.g., People v. Kline, 100 Cal. App. 3d 587, 168 Cal. Rptr. 185 (1980) (marketing plan is satisfied by franchisor’s promise of “total and continuing support” and assistance with advertising). State Farm has extensive requirements concerning advertising and marketing. The Agreement provides:

We retain the right to prescribe all policy forms and provisions; premiums, fees, and charges for insurance; and rules governing the binding, acceptance, renewal, rejection, or cancellation of risks, and adjustment and payment of losses.

(PSOF ¶ 72.) Additionally, State Farm furnishes the Agents with manuals, forms and records;

advertises for the Agents; and provides them with promotional materials. Id. at Section I, ¶ F. Indeed, even a franchisor’s advice or suggestion satisfies the “marketing plan” requirement of the franchise statutes. Blankenship v. Dialist Int’l Corp., 568 N.E.2d 503, 507 (Ill. Ct. App. 1994).

The “community of interest” element, which replaces the “marketing plan” element in some state statutes, simply requires that the franchisee be dependent upon the franchisor; that is, if the relationship were terminated, the franchisee’s business would cease to exist. See Lobdell v. Sugar ‘N Spice, Inc., 658 P.2d 1267 (Wash. Ct. App. 1983); Lakeshore Machinery, Inc. v. Thermwood Corp., 117 F.R.D. 429 (E.D. Wis. 1987). Here, there is no question that termination of the Agency Agreement would destroy the agent’s business.

3. State Farm Agents Offer, Sell, Distribute, Market or Dispense Insurance and Insurance Services

State Farm does contend that its agents do not “sell” insurance, and therefore, the Agent Agreements are not franchisees. State Farm shamelessly misleads this Court on both the facts and law.

(a) The Agent Agreement’s Provision that Agents Deliver Policies and Render Services Satisfies the Requirement that They “Offer, Sell or Distribute,” “Market” or “Dispense” Insurance

First, State Farm’s argument is predicated upon the premise that “the franchise statutes of all but one of the states mentioned in the Complaint require that the would-be franchisees “sell” the franchisor’s goods or services.” (Def. Mem. at 77.) This, in fact, is not the law. As noted, all of the statutes except one state that a franchise exists if the franchisee “offers, sells or distributes,” “markets” or “dispenses” a product or service. The Agent Agreement itself states that agents shall “deliver” policies and render services such as collection of premiums,

reinstating and transferring insurance, assisting policyholders and the like. (PSOF ¶ 66.) “Distribute” means “deliver;” “dispense” means “distribute.” “Market” means to “expose for sale.” Merriam Webster’s Collegiate Dictionary, 10th Ed. at pp. 338, 335, 712. The Agreement, therefore, on this basis alone, satisfies this element of the franchise statutes for all state statutes except the one that expressly requires a “sale”--Delaware.

This conclusion is confirmed in Gentis v. Safeguard Business Systems, Inc., 71 Cal. Rptr. 2d 122 (Cal. App. 2nd Dist. 1998). We will allow the Court’s opinion to speak eloquently for itself:

The CFIL [California Franchise Investment Law] defines a franchise in section 31005. The statute provides, in pertinent part: “(a) ‘Franchise’ means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which: [¶] (1) A franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; and [¶] (2) The operation of the franchisee’s business pursuant to such plan or system is substantially associated with the franchisor’s trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and [¶] (3) The franchisee is required to pay, directly or indirectly, a franchise fee,” (§31005, italics added.).

[Defendants] point to the “offering, selling or distributing goods or services” language of subdivision (a)(1) of section 31005, a portion of the marketing plan or system prong of the statute.

Defendants contend the trial court erred as a matter of law in holding Safeguard was a franchisor under the CFIL because persons who solicit orders, but lack the authority to enter into binding sales contracts, do not offer, sell or distribute goods or services. Plaintiffs concede they cannot enter into binding contracts or pass title to goods. Nevertheless, they assert, the trial court properly determined they were franchisees. We agree. .

As a general matter, remedial or protective statutes such as the [CFIL] are liberally construed to effect their object and quell the mischief at which they are directed. With regard to the statutory definition of ‘franchise,’ this means each element should

be construed liberally to broaden the group of investors protected by the law and to carry out the legislative intent.”

The Legislative history of section 31005 reveals great care was taken in defining a “franchise” because of the countless and varied relationships that could qualify as such.

We turn to the words of the statute as enacted by the Legislature, giving the language its usual, ordinary meaning. Significantly, the statutory language at issue is stated in the disjunctive: “offering, selling or distributing goods or services,” (§31005, subd. (a)(1), italics added.) By using the word “or,” the Legislature intentionally broadened the scope of the statute. The double use of the disjunctive recognizes a distinction between: offering goods; selling goods; distributing goods; offering services; selling services; and distributing services.

The usual, ordinary meaning of “offering” is: “the act of making an offer” (Webster’s New World Dict. (3d College ed. 1991) p. 941), “the act of one who offers” or “something offered for sale.” (Merriam Webster’s Collegiate Dict. (10th ed. 1995) p. 807). “Offer” is defined, inter alia, as “to bring before, present, show,” or “to present for consideration; suggest; propose.” (Webster’s New World Dict., supra, p. 940.) It is synonymous with extend, present, proffer, tender, afford, or provide. (Roget’s II: The New Thesaurus (Houghton Mifflin Company 1984) p. 320.) The usual, ordinary meaning of “distribute” or “distributing” is to give out or deliver.” (Merriam Webster’s Collegiate Dict., supra, p. 338.) It is synonymous with disburse, dispense, or dole out. (Roget’s II: The New Thesaurus, supra, p. 142.).

“[T]he language “offering, selling or distributing goods or services” (§31005, subd. (a)(1) encompassed the arrangement at issue here as found to exist by the trial court. Plaintiffs offered Safeguard’s goods for sale to customers by: contacting existing customers and recruiting new business; calling on customers; demonstrating products; installing Safeguard systems; solving customer problems; providing ongoing service; and soliciting orders for goods subject to Safeguard’s approval. By presenting and demonstrating its products, installing its systems, and providing ongoing service, plaintiffs ensured the distribution and sale of Safeguard’s goods. An integral part of their function was to offer Safeguard’s goods and services to customers. Plaintiffs participated in the direct distribution of Safeguard’s goods by, on occasion, picking products up and delivering them to customers. Also, plaintiffs received goods from Safeguard to be picked up by

customers.

Defendants cite decisional authority from other jurisdictions in support of their contention Safeguard is not a franchisor because plaintiffs: were authorized to solicit orders for goods at prices set by Safeguard, but lacked the authority to enter into binding sales contracts; did not maintain any inventory; did not pass title to products; did not bill customers; and did not ordinarily deliver goods to customers. Several of those decisions hold there is no right to sell goods or services absent authority to enter into a binding contract. [citing, inter alia, *Vitkauskas v. State Farm*]

Those cases did not address the right to offer or distribute goods or services. As discussed above, the CFIL defines a franchisee as one “granted the right to engage in the business of offering, selling or distributing goods or services.” (§31005, subd. (a)(1), italics added.)

71 Cal. Rptr.2d at 123-27 (emphasis added; citations omitted).

(b) State Farm Agents Sell Insurance

Even if most of the franchise statutes did not contain expansive definitions that obviated the need to satisfy the “sell” requirement, the record is replete with evidence that agents in fact do sell insurance.

State Farm takes as its touchstone for the definition of a sale the Vitkauskas decision, supra, which in turn defined “sale” of insurance as the power to make a binding contract of insurance: “to transfer a product at the point and moment of agreement.” 157 Ill. App. 3d 317, 326, 509 N.E.2d 1385, 1391 (Ill. App. 1987). The record demonstrates that in fact, State Farm agents do make binding contracts of insurance – unlike the trainee agent in Vitkauskas, agents may “transfer the product at the point and moment of agreement.” This is consistent with the ordinary meaning of sell: “to give up (property) to another for something of value.” Merriam-Webster’s Collegiate Dictionary, 10th Ed., p. 1062.

Specifically, when an applicant submits an application and premium to an agent, the

agent may “bind” the coverage—that is, the agent is authorized to accept the application and premium, at which point State Farm provides coverage. This was vividly illustrated in the testimony of Vincent Trosino, State Farm’s Chief Operating Officer:

- Q.** Do you know what – Do you know what the term “binder” means?
- A.** I’m generally familiar with that yes.
- Q.** What does it mean?
- A.** It means a temporary commitment by State Farm to – Let’s take auto insurance as an example –
- Q.** Mm-hmm.
- A.** --if that’s okay – temporary commitment for a limited period of time that we would way we would stand behind coverage for that person as we consider the application for acceptance and sale.
- Q.** Okay. Is a binder issued at – at some point?
- A.** I believe it is.
- Q.** Okay. At what point in the process is that binder used?
- A.** I believe at the point of application.
- Q.** Okay. Now, what – what—At the point of application what contact does the applicant have with State Farm itself?
- A.** their contact I with a State farm independent contractor agent who we have a contract with to – to handle that kind of process.
- Q.** Okay. And so the – the independent agent is authorized at this point to bind the coverage?
- A.** Unless there’s been some reason to take away the binding authority of that agent –
- Q.** Mm-hmm.
- A.** -- yes.

(PSOF ¶ 58.)

Charles Wright, State Farm's Vice President for Agency, acknowledged that when the agent accepts the binder, State Farm provides coverage:

Q. But isn't it true that if all those conditions you talked about are met, you know, the application, the premium, that it is an accurate application, the underwriting requirements are met and the agent issues a binder, say, on this home, and the next day before the policy has reached State Farm, the house burns down, doesn't State Farm cover that loss?

A. In most instances, that loss would be covered.

(PSOF ¶¶ 59-60.)

Barry Thomas, State Farm's Director of Underwriting and a designated 30(b)(6) witness, expressly recognized that the company was contractually bound to provide coverage when the binder was issued:

Q. Well, at what point, in your view, does State Farm become contractually committed to provide coverage to a person or entity?

A. When the company has made the decision to accept or reject the requested coverage for – requested application for coverage.

Q. Okay. And, and that's after – that's sometime after a binder is issued; is that correct?

MR. REICHLER: Well –

A. No. The company has – the company has accepted the coverage when the binder is issued on an interim basis.

(PSOF ¶ 59.)

What these gentlemen describe is precisely a sale: when the applicant pays the premium, the agent gives up something – coverage – for value: money.

Beyond this legal reality – but consistent with it – State Farm has admitted, time and again, that its agents sell insurance:

- The Agent Agreement states that agents provide “creative selling”

and that State Farm provides technical knowledge to agents with respect to selling. (Exs. 1-3.)

- Gregory Fisher, State Farm’s 30(b)(6) witness, testified in unrelated litigation that “who it is that actually meets the prospect and sells the product to the policyholder, that’s the agent . . .” When asked what the principal duty of the agent was, he said, it was to “sell policies.” (PSOF ¶ 41.)
- Agents attend classes entitled “Client Centered Selling,” (PSOF ¶¶ 45-46.)
- Vice President for Agency Chuck Wright has written articles for or been quoted in State Farm’s magazine, The Reflector, as saying “selling insurance . . . through agents is the way we do business;” “It takes the agent to stimulate sales;” “You [agents] are still the greatest sales force anywhere;” “Develop and practice you sales interview strategy;” “Don’t give up if you don’t make a sale to your first prospects.” (PSOF ¶¶ 48-57.)
- State Farm submits a form to the IRS in which it confirms that the agent “sells and distributes your firm’s insurance and financial products and services” and “sells other types of insurance.” (PSOF ¶ 57.)

State Farm contends that Agents do not “sell” or “offer” policies for sale because they do not have authority to set rates or the terms of the policies; they do not “own” the policies; they do not approve the application of the customer. (Def. Mem. at 82-83.) These factors are not determinative, and State Farm cites absolutely no legal authority to support its position. Franchisees usually do not have authority to set the terms or conditions of the products or services they sell. A McDonald’s franchisee cannot change the recipe for a Big Mac; does not own that recipe; and cannot even purchase meat or buns from anyone except approved suppliers. Franchised real estate brokers—Century 21, Coldwell Banker, Re/Max—sell houses that are not theirs, pursuant to terms they do not set and for prices that they do not control. Yet no one contests that they “sell” houses.

State Farm relies on Vitkauskas and Forester, Inc. v. Alas Metal Parts, 313 N.W.2d 60

(Wis. 1981) for authority that agents to not sell. As discussed at length above, Vitkauskas involved a trainee agent under a trainee agreement; the agreements involved here were not at issue. Moreover, Vitkauskas did not even consider the “offer” or “distribute” language of the Illinois statute. Thus, it can hardly be considered dispositive. Forester involved a manufacturer’s representative who expressly had no authority to sell. Id. It has no relevance to this case whatsoever. See Gentis v. Safeguard Business Sys., 60 Cal. App. 4th 1294 (Cal. Ct. App. 1998), supra.

In the last analysis, then, State Farm agents are franchisees because the distribute insurance products; they also sell insurance products, in every sense of the word: they have authority to deliver coverage for money, and State Farm’s highest officers have repeatedly verified and written that agents “sell” insurance. Finally, State Farm tells the IRS that its agents sell insurance.

4. State Farm Agents Pay Franchise Fees

In three states – Arkansas, New Jersey and Wisconsin (with respect to its Fair Dealership Law) – NASFA has already shown that the Agent Agreement is a franchise, because there is no requirement in those states that it prove the existence of a franchise fee. In the remaining twelve states, it has satisfied that requirement. State Farm agents have to pay a number of fees to become an agent. Franchise statutes typically define franchise fees inclusively: they are “*any fee or charge that a franchisee is required to pay directly or indirectly*” to enter into the franchised business “*including, but not limited to, any such payment for goods or services.* Ill. Comp. Stat. § 705/3(14)).¹⁴

¹⁴ Cal. Corp. Code § 31011; Haw. Rev. Stat. § 482E-2; Ill. Rev. Stat. ch. 121 ½, par 703; Ind. Code § 23-2-2.5-1; Md. Code Ann. Bus. Reg. § 14-201; Mich. Comp. L. § 445.1503; Minn. Stat. § 80C.01; NY Gen. Bus. Law § 681; Or. Rev. Stat. § 650.005; Wis. Stat. § 553.03.

While there are minor differences in the specific definition of “franchise fee,” the general approach is to define the fee as *any fee or charge* that the franchisee has to pay to enter into the business; the statutes then provide for specific exceptions – such as the payment of a bona fide wholesale price for inventory. But unless it is *specifically excepted*, any fee or payment is a franchise fee. Moreover, in all states at issue except Delaware and Illinois, there is no threshold for the amount of fee – it can be de minimis. Finally, in five of the states, *the burden is on the putative franchisor, not the franchisee, to show any specific exception from the definition*—a task State Farm has not even purported to undertake. Cal. Corp. Code Ann. § 31153 (stating that in any proceeding under this law, the burden of proving an exemption or an exception from a definition is upon the person claiming it); Delaware – the party seeking to invoke the Delaware Franchise Security Law has the burden to prove that the Act actually applies. 33 Flavors of Greater Delaware Valley, Inc. v. Bresler’s 33 Flavors, Inc., 475 F. Supp. 217, 228 (D. Del. 1979); 815 Ill. Comp. Stat. § 705/42 (stating that in any proceeding under this Act, the burden of proving an exemption or an exception from a definition is upon the person claiming it); Mich. Comp. Laws § 445.1503(10) (stating that in any proceeding under this act, the burden of proving an exemption or an exception from a definition is upon the person claiming it); Wis. Stat. § 553.24(5) (stating that in any proceeding under this chapter, the burden of proving an exemption or an exception from a definition is upon the person claiming it).

There are three key cases that merit extended discussion here because of their landmark status and guidance in determining what is a franchise fee.

In Boat & Motor Mart v. Sea Ray Boats, Inc., 825 F.2d 1285 (9th Cir. 1987), the Ninth Circuit considered whether a dealer in pleasure boats was a “franchisee” under the California Franchise Relations Act. With respect to the franchise fee issue, the Court observed:

The Act itself defines such a fee as “any fee or charge that a franchisee or sub-franchisor is required to pay or agrees to pay for the right to enter a business under a franchise agreement, including, but not limited to any such payments for such goods and services” Cal. Bus. & Prof. Code, 20007. The charge can be required “directly or indirectly.” Id. 200001. The Guidelines further specify that “a payment by a franchisee, though nominally optional, may in reality be a required one, if the article for which the payment is made is essential, or if the franchisor intimates or suggests that it is essential, for the successful operation of the business.

825 F. 2d at 1289.

The Court went on to observe that the dealer’s purchases of

video cassettes, films, floats, banners, posters, and brochures arguably constituted a fee in terms of the Act. All of these purchases from Sea Ray were at the behest of Sea Ray. The purchases occurred because Sea Ray asked that they be made. The purchases were all suggested by Sea Ray as essential and certainly the purchase of the brochures was essential.

Id. at 1290.

The Sea Ray court did not, ultimately, decide whether the dealer had paid a franchise fee. The Court’s observations, however, were based upon guidelines promulgated by the California Department of Corporations, the agency vested with responsibility for administering California’s franchise acts. The Department’s “Guidelines for Determining Whether an Agreement Constitutes a Franchise, California Department of Corporations, Release 3-F,” available at www.corp.ca.gov/commiss/ref3f/htm and annexed as Exhibit 50, contains the definitive statement on what constitutes a franchise fee under California law. Among other things, the Guidelines make clear that a franchise fee encompasses any fee paid by the franchisee *for the account of the franchisor, on behalf of the franchisor or that benefits the franchisor:*

Payments which the franchisee is required to make under the franchise agreement for the account of the franchisor are equivalent to payments made to the franchisor. Thus, it makes no

difference whether payments for the rental of premises are required to be made by the franchisee to the franchisor as the owner and lessor of the premises, or to a third-party owner where the franchisor is the lessee and the franchisee the sublessee. Also, payments required in the franchise agreement to be made by the franchisee for advertising and promotion to enhance the good will of the franchisor's business, even though the advertising and promotion also benefit the franchisee's business, may be deemed made for the account of the franchisor, especially where the agreement gives the franchisor discretion to determine the manner and content of the publicity. (PL/38F, PL/43F.)

* * *

(i) Some Examples

The Commissioner's opinions have considered the following types of payments as constituting a "franchise fee":

Performance guarantee or deposit (Comm. Op. Nos. 72/25F, 73/10F, 75/6F);

Deposit of money (Comm. Op. Nos. 73/15F, 74/3F, 74/5F, 74/6F);

An initial or set-up fee (Comm. Op. Nos. 72/23F, 73/15F);

Fee for advertising (Comm. Op. Nos. 72/11F, 73/17F);

Nonrefundable bookkeeping charge (Comm. Op. No. 72/13F);

A payment for training and school expenses (Comm. Op. Nos. 71/60F, 73/39F);

Royalty or percentage of gross receipts (Comm. Op. Nos. 72/47F, 73/23F, 73/24F);

Charges for sales kits, brochures, programs, forms, decals, shirts, displays and announcements (Comm. Op. Nos. 71/49F, 73/29F, 82/1F);

Rental or lease fee (Comm. Op. Nos. 73/26F, 73/50F);

Payment for services, such as consulting or management fees (Comm. Op. Nos. 73/25F, 73/41F, 77/1F, 79/2F).

Garner Aff., Ex. 50 (Emphasis added). As Sea Ray and the Guidelines make clear, then, a franchise fee encompasses any fee paid to or on behalf of the franchisor unless it is specifically excluded.

The second case, from State Farm's home state, Illinois, provides perhaps the most vivid illustration of the broad sweep of the definition of "franchise fees." The Illinois statute defines a franchise fee as "any fee or charge that a franchisee is required to pay directly or indirectly for the right to enter into a business" 815 Ill. Comp. Stat. § 705/3(14), but it must be in the amount of \$500 or more. 815 Ill. Comp. Stat. § 705/3(1)(e). The statute goes on to provide that the Attorney General may define "franchise fee" further. And, indeed, the Illinois Attorney General did so:

"Any payment(s) in excess of \$500 that is required to be paid by a franchisee to the franchisor or an affiliate of the franchisor constitutes a franchise fee unless specifically excluded by Section 3(14) of the Act."

Ill. Admin. Code. Tit. 14, § 200.105.¹⁵ In To-Am Equipment Co. v. Mitsubishi Caterpillar Forklift Am., Inc., 953 F. Supp. 987 (N.D. Ill. 1997), aff'd, 152 F.3d 658 (7th Cir. 1998), the Court considered whether payments made by a heavy equipment dealer to the manufacturer for parts and repair manuals were franchise fees within the meaning of the Illinois Franchise Act. The dealer showed that (1) it was required to do warranty work on the equipment; (2) in order to do such work, it needed the manuals; (3) it had to buy the manuals from the manufacturer; (4) while individual manuals were inexpensive, in the aggregate, the dealer had paid a total of \$1,658 to the manufacturer for manuals over a period of several years. A jury found that it had

¹⁵Note that while the Illinois regulations define a franchise fee as including any fee paid to the franchisor or an affiliate, they do not exclude fees paid to others on behalf of the franchisor.

paid a franchise fee – i.e., more than \$500 for the right to enter into the business. The District Court upheld the verdict and denied the manufacturer’s motion for judgment n.o.v.

The District Court – in virtually the only decision nationwide to consider these questions – addressed two issues that are on point here: the first is whether the purchase of “manuals” was a franchise fee even though the dealer received manuals that had a value equal to his payment; the second is whether the expenditure of an amount in excess of \$500 that was spread over several years satisfied the statute’s threshold for a \$500 fee.

The Court rejected the manufacturer’s arguments that the payments for the manuals were ordinary business expenses to the dealer and that they were not fees because the payment did not exceed the manufacturer’s cost of the manuals:

[A]ll rules make some rough cuts. The Attorney General of Illinois – by promulgating a regulation under explicit statutory rulemaking authority – has confined the exceptions to those in the statute. [Citation omitted] The statute in turn says that all required payments to a manufacturer are franchise fees, unless covered by an exception. It uses opportunity to resell, rather than some relation between price and cost (or value) as the device to identify implicit franchise fees. In many cases, the proxy will be a good one. Another of the exclusions from the definition of franchise fees – “the payment for fixtures necessary to operate the business” (815 ILCS 705/3(14)(d)—implies that payments for consumables are included as franchise fees if they do not meet the retail-sale exclusion in sec. 705/3(14)(f). No state court has held or even suggested that the regulation confining the exceptions to those in the statute is invalid..

953 F. Supp. at 992. (Emphasis added.)

[The manufacturer’s] argument—that the price for required purchases is not a fee “for the right to enter into [the] business” if the dealer can use the purchased goods to recoup what it pays for them – does not hang together. That the purchases may be worth the asking price may show that the price is not a disguised “fee” has nothing to do with whether the payment is “for the right to enter into [the] business.” .

* * *

Understood in the light most favorable to the verdict, the evidence shows that To-Am paid \$1,658.75 for parts and service manuals that MCFA commanded it to possess. The requirement came from the part of the dealership agreement that obliges each dealer to maintain an adequate supply of manuals, so that it can repair the fork-lift trucks as it promised MCFA it would do.

Id. (Emphasis added.)

The Seventh Circuit affirmed:

[T]he Illinois legislature and the designated Administrator, the Attorney General, could not have been more clear. They wanted to protect a wide class of dealers, distributors, and other “franchisees” from specified acts, such as terminations of their distributorships (franchises) for anything less than “good cause.” They might have done so because it is hard to quantify the level of a franchisee’s investment in the products or services of the franchisor, and easy for the franchisor to reap the benefits of those investments without full compensation if it can terminate the relationship essentially at will. Or they might have done so based on an empirical assumption . . . that franchisees tend to be weak and in need of a legislative boost in bargaining power. Or the legislature and the Attorney General might have been engaged in wealth distribution. The reasons do not matter. What does matter to this case is that these definitions under Illinois law were binding on the district court and they are binding on us.

152 F.3d at 662.

Yet another court reached a similar conclusion under Michigan law, which defines a franchise fee as “a fee or charge that a franchisee or sub-franchisor is required to pay or agrees to pay for the right to enter into a business under a franchise agreement, including but not limited to payments for goods and services.” Mich. Comp. L. § 445.1503. § 3(1). The statute, like the Illinois statute, goes on to create specific exceptions for purchases of goods, equipment or fixtures at a bona fide wholesale price, as well as certain other specific exceptions not relevant here. In Tractor and Farm Supply, Inc. v. Ford New Holland, Inc., Bus. Franchise Guide (CCH)

¶ 10,643 (W.D. Ky. 1995) (attached as Garner Aff., Ex. 51), the Court, construing Michigan law, observed that the Michigan Attorney General had promulgated regulations defining “fee or charge” as including payments for services, which were “presumed to be in part for the right granted to the franchisee to engage in the franchise business.” Mich. Admin. Code Rule 445.101(2)(c). Therefore:

The Court finds this is a logical interpretation of the Franchise Law. Plaintiffs’ payments for employee training, an on-line computer service, and their required payments for, and use of, Defendant’s advertising, promotion, and sales materials, therefore, constitute a franchise fee.

Id. (Emphasis added.)

These cases, therefore, provide the following guidance: Consistent with the broad, remedial purposes of franchise statutes, a “franchise fee” is any fee the franchisee pays to the franchisor that is required for the business unless it is specifically exempted. The fact that the franchisee might obtain something of value in exchange for the fee – indeed, even something of equivalent value – does not remove it from the scope of a franchise fee. Payments on behalf of the franchisor, and payments that benefit the franchisor, such as payments for advertising, are also franchise fees.

In light of their teachings, we will consider the specific payments made by State Farm agents.

(a) Payments for the Premium Fund Account Are Franchise Fees

At the outset, State Farm overstates the law with its contention that fees paid to third parties are not franchise fees. The statutes at issue do not require that the fees be paid to the franchisor; they only require that the fee be paid in order for the franchisee to enter in to the business. Sea Ray, which State Farm cites for the proposition that franchisees must pay a fee to

the franchisor, does not stand for that principle. Rather, California has expressly recognized that a fee may be paid to a third party on behalf of a franchisor. California Guidelines, supra.

It is undisputed that agents must maintain a separate bank account for the benefit of State Farm, into which they deposit premium payments and other monies that belong to State Farm. The Agent Agreement acknowledges that these funds are held by the agent in trust for State Farm; the account, moreover, is “for State Farm’s benefit.” (PSOF ¶ 71.) It is undisputed that agents’ banks generally charge for maintaining this account (DSOF ¶ 77) in the amount of \$30 to \$70 a month or more. (PSOF ¶ 38.)

Under every state definition of a franchise, the bank charges for a premium fund account are a fee that the franchisee pays and that is required in order to enter into the business of being a State Farm agent; it is mandated by the Agent Agreement. As noted, the state statutes do not require that franchise fees be paid directly to the franchisor; they can be paid on behalf of the franchisor. Here, there is no dispute that they are paid on behalf of State Farm; the Agreement expressly states that the account is for State Farm’s benefit. The only way in which the agents benefit from the payment of the fee is that it permits them to be in the business of being State Farm agents. They have no access to the account; they have no control over the account. The maintenance of the account, therefore, in accordance with the teachings of the California Corporation Commissioner’s Guidelines, is that it is a fee paid “on behalf of” the franchisor and is therefore a franchise fee.

A second ground on which the Premium Fund Account constitutes a franchise fee is that it is a fee that benefits the franchisor. Thus, for example, under Tractor and Farm Supply, it is akin to the required payments for advertising, promotion and sales materials, or to advertising that benefits the franchisor, as explicitly recognized by the California Commissioner of

Corporations.

Finally, State Farm has not carried its burden, as it must in at least five states, of showing an exemption or exception from the definition *–i.e.*, that the fees are not “fees paid by the franchisee to enter into the business.” Rather, its memorandum rests on the thin reed that secondary authority, Mr. Garner’s treatise, refers to the requirement that franchise fees be paid to the franchisor, and the statement of a single franchisee witness that he had negotiated for no fees from his bank.

For all of these reasons, the fees franchisees pay to maintain the premium fund account are franchise fees.

(b) Payments for Required Signage are Franchise Fees

As a practical necessity, agents must purchase signs with the State Farm logo to advertise their business. For over 35 years, State Farm has required its agents to have signs; indeed agents cannot serve the interests of their policyholders without signs—how would policyholders find them? (PSOF ¶ 31.) State Farm provides agents with a list of start-up expenses that include a sign costing \$1,300. (PSOF ¶ 31.)

Payment for a sign therefore is a payment that the Agent makes in order to enter into the business of being a State Farm agent. Payment for a sign is like the advertising payments that the California Corporations Commissioner recognized as payments for advertising and promotion “to enhance the goodwill of the franchisor’s business.” It is in the same category as charges for sales kits, brochures, programs, forms, decals, shirts, displays, and announcements that the Commissioner has expressly recognized as within the definition of a franchise under California law.

The Federal Trade Commission in its Trade Regulation Rule on Franchising, 16 C.F.R.

Part 436 – the federal counterpart to state laws – recognizes that a franchise fee need not be mandated by contract. Rather, the FTC looks to whether the franchisee must make the payment as a “practical necessity.”

Payments made by practical necessity include, among others, those for equipment that can only be obtained, in fact, from the franchisor or its affiliate.

“Interpretive Guides to Franchising and Business Opportunity Ventures Trade Regulation Rule,” Bus. Franchise Guide (CCH) ¶ 6201 et seq. at ¶ 6207 (attached as Garner Aff., Ex. 52). Here, while there may be no literal contractual requirement that an agent have a sign, it is necessary as a practical matter to do so. The state statutes, moreover, do not require that the contract mandate the payment.

Finally, once again, State Farm has not shown that the payment for a sign falls within the scope of any exception to the broad definition of a franchise fee. In this regard, it has failed to carry its burden of proof of showing that the franchise law does not apply to it. Payments for signs are franchise fees.

(c) Expenses for Computers are Franchise Fees

Until 1996, State Farm agents were required to lease computer equipment from State Farm. Since 1996, State Farm has provided agents with a standard package of computer equipment. DSOF at ¶ 80. Agents are specifically prohibited from attaching any of their own equipment to the equipment required to be purchased from State Farm. (PSOF ¶ 35.) Agents are also prohibited from installing any of their own software on computers required by State Farm. Id. Agents typically require more equipment and software than is provided by State Farm and thus must purchase additional equipment themselves. Id.; DSOF at ¶ 83.

State Farm’s reliance upon the testimony of a single agent—Steve Adams—with respect

to the lease of computer equipment (See Def. Mem. at 65) is just that: The testimony of one witness, and it does not stand for the proposition that all agents do the same.

Under the teachings of To-Am and Sea Ray, payments for equipment that a putative franchisee must purchase or lease from a franchisor are franchise fees. Indeed, required payments for such equipment fall squarely into the definition of payments that are required for the franchisee to enter into the business. Clearly then, agents who signed up with State Farm prior to 1996 and had to make payments for computer equipment and software are franchisees. Those who, as a practical matter, had to lease or purchase additional equipment from State Farm after 1996, also have paid a franchise fee.

(d) Payments for Advertising Expenses and Sales Brochures are Franchise Fees

The Agent Agreement requires that agents advertise:

The expense of any office, including . . . advertising . . . shall be incurred at your discretion and paid by you.

* * *

We will advertise, provide promotional materials, and participate in the cost of your advertising, in accordance with policies determined from time-to-time by us. You will not use any advertisements referring to us or identifying us, directly or indirectly, without our prior approval.

(PSOF ¶ 69.)

As a practical necessity, agents must advertise; this requirement includes actual placement of advertising as well as distribution of advertising materials and sales brochures. Additionally, as State Farm recognizes (DSOF ¶ 87), monies are paid to State Farm for advertising as part of cooperative advertising programs. Advertising expenses exceed \$500 per year to agents.

State Farm argues that advertising expenses are confined to Yellow Pages advertising. In fact, agents do much more advertising than merely the Yellow Pages, and the evidence with respect to Yellow Pages is hardly dispositive. (Def. Mem. at 65-66.)

Additionally, State Farm requires that agents purchase sales brochures from it. (PSOF ¶ 33.) Agents typically spend at least \$25 per month, or \$300 per year, on sales brochures. Id. Agent Steve Knapp explained why agents must purchase these brochures from State Farm and why (in the words of the FTC Rule interpretation) they are a practical necessity for a State Farm agent:

Q. And are you obligated by State Farm to obtain those or –

A. In reality, yes. As part of the sales process, you have to explain the benefits and coverages of a policy. Absent taking out a copy of the contract itself, which is very cumbersome and printed on very small paper, you would defer to a professionally prepared sales brochure which would highlight the major provisions of the contract. So if you are really going to sell product, you have to have access to something that provides those benefits.

* * *

Q. If you did not purchase them and decided to use something else of your own creation, State Farm would not say “you must purchase our sales brochures”?

A. State Farm says that if I’m going to use sales brochures, I must purchase them from them.

Q. but you are free not to use sales brochures? It may be a wise decision or not, but you are free to make the decision not to use sales brochures?

A. I guess I would be free not to have running water in my office, but I choose not to. To say that you don’t have sales brochures in an insurance sales business, you just may as well throw away the applications too. It is hard to separate the sales brochure from the sales process. In fact, you can get in trouble with ethical problems if you don’t disclose at least the basic items that are in the contract. You want to provide that information to the customer.

- Q. Could you take a sales brochure, look through it and make a list of things that you want to talk to the customer about?
- A. No, I couldn't do that. State Farm would prohibit me from doing that. We are admonished to not even take a highlighter and highlight a sentence or a word on any of the illustrations that they provide us. That would be emphasizing one part of the contract or one part of the sales information as opposed to another. So we are not even allowed to do it. We are told we can't even write on the things. I can't circle something and write a little note and say "this is really important."
- Q. You didn't let me finish my question. You said the sales brochure is important because there are items that you need to talk about to the customer when you explain the policy.
- A. Yes, correct.
- Q. It's possible for you to do that without the sales brochure itself, isn't it? You know what those items are now. You have been doing this for 20-some-odd years. You could make your own checklist of what things you feel you need to tell your customer. They would all be honest and accurate things. You don't need to look at the sales brochure to know what to tell the customer, do you?
- A. Realistically it is not possible.
- Q. Why not?
- A. Realistically I could have walked from Belleville to here today. It is not practical to have done that. I flew on an airplane and got here in a timely manner. If you are conscientious about what you do, conscientious about what you tell your customers and wishing to limit liability for a customer coming back and saying "well, I didn't know that was in there" or "I didn't know that was available, you sold me this and you didn't tell me that this and this and this were available," no prudent agent in this day and age would ever not provide the information, the basic information about the policy. And the company wants us to do that, for all sorts of very good reasons.

As discussed above, the Ninth Circuit recognized that advertising and purchases of promotional materials may constitute franchise fees in Sea Ray; the California Corporations Commissioner has expressly held that advertising expenditures are franchise fees. California Guidelines, Garner Aff., Ex. 50. Michigan law holds that advertising expenses are franchise

fees. Tractor and Farm Supply, Inc. v. Ford New Holland, Bus. Franchise Guide (CCH) ¶ 10,643 (D. Ky. 1995) (attached as Garner Aff., Ex. 51). Similarly, advertising fees paid to a franchisor can constitute a franchise fee under New York Law. Luzim v. Phillips, Bus. Franchise Guide (CCH) ¶ 9020 (E.D.N.Y. 1987) (attached as Garner Aff., Ex. 53).

State Farm has failed to carry its burden of showing that these expenses are not franchise fees or that they fall within any statutory exception under any statute. Expenses for advertising are franchise fees.

(e) Payments for Sales Materials are Franchise Fees

Agents must pay State Farm for promotional materials, such as golf balls, calendars, road maps, greeting cards and the like that bear State Farm's logo. Like advertising, agents need to use these materials in order to promote their businesses; as a practical necessity, agents must purchase them if they want to do business as State Farm agents.

Although Robert Lamphier testified that he was not obligated to obtain promotional materials such as golf balls, road atlases and calendars from the company (Lamphier Depo. 76/20 – 77/17) (Def. Mem. at 67), that testimony reflects only Mr. Lamphier's particular circumstances. As a practical matter, however, agents must purchase the materials.

Sea Ray is directly on point; there, the dealer had to buy such materials from the manufacturer, and the Ninth Circuit held that these very well could constitute a franchise fee. The California Commissioner of Corporations, moreover, has opined that payments for advertising materials that benefit the franchisor – in this case, State Farm concedes that the materials bear the State Farm logo – are franchise fees. The decisions in both To-Am and Tractor and Farm Supply also support the conclusion that payments for these materials are franchise fees.

The fact that the Agent Agreement does not contain an express requirement that agents purchase these materials is not determinative on the question whether they are required. In To-Am, the court held that the jury was entitled to infer that purchase of the materials was required because the dealer was required to perform warranty work and could not do so without the manuals. The court, moreover, rejected the manufacturer's contention that it did not have to purchase manuals because it could have photocopied them. Here, the agreement requires that the agent "solicit applications for insurance" and "advance the interests of the companies, the agents, and the policy holders." The agent is required to "provide prompt, friendly, accurate and cost effective service." The agreement states that State Farm will furnish certain material without charge, but it goes on to say that "State Farm will offer at your expense, additional equipment, materials, supplies and services." The implication is that such additional materials, at the agent's expense, are also specified by the company. The agreement goes on to state that the expense of any advertising "shall be incurred at your discretion and paid by you." Certainly a finder of fact can infer from this that such payments are required.

As agent Swift has testified, the cost of these materials alone exceeds \$500. (PSOF ¶ 32.) And once again, State Farm has failed to show why they should be treated as an exception or exemption.

(f) Reduced Commissions to Trainee Agents are Franchise Fees

It is undisputed that in order to become an independent State Farm agent, an individual must start out as a trainee agent. For a period of approximately two years, trainees are employees of State Farm. (DSOF ¶ 59.) During this time, State Farm pays trainees a draw against commissions and certain expenses. The trainees sell insurance, but they receive reduced commissions: in particular, they must forego all commissions on auto policies and give up a

portion of their commissions on other types of policies such as homeowners or life insurance (PSOF ¶ 27.) Additionally, if the compensation the trainee agents make does not equal the draw that they receive, then they must make up that payment up to the company in order to become independent agents. (PSOF ¶ 27.) Therefore, it is undisputed that (1) in order to become a State Farm agent, an agent must accept reduced commissions for a period of two years; (2) the amount by which commissions are reduced exceeds \$500 over a six-month period; and (3) if agents do not generate commissions sufficient to equal their payments, they must make up the difference.

It has been recognized that reduced commissions may constitute franchise fees. In Koellen v. Snap-on Tools Corp., Bus. Franchise Guide (CCH) ¶11,426 (E.D. Wash. 1998) (attached as Garner Aff., Ex. 54), a commissioned salesman contended that a manufacturer's withholding of portions of his sales commission constituted a franchise fee. The court observed, "in other words, he submits that he was forced to pay part of his sales proceeds to [the manufacturer] for the privilege of selling its products. If he can prove that allegation, he will have established the existence of a franchise fee." In that case, however, the manufacturer (unlike State Farm) carried its burden of proof and demonstrated that its reduced commissions were for lost accounts, not for the right to enter into the business, and therefore were not franchise fees. Nonetheless, as the court pointed out, if the manufacturer had not shown this, its contention that foregone commissions franchise fees would have been sustained.

Here, the reduced commissions of trainee agents are required in order for them to become agents. The fact that State Farm pays a salary or draw against commissions, or expenses does not make a difference. See To-Am, 953 F. Supp. 987 ("All required payments . . . are franchise fees, unless covered by an exception. It uses an opportunity to resell, rather than some relation between price and cost (or value) as the device to identify implicit franchise fees.") In other

words, To-Am expressly rejects the theory that State Farm advances in its papers – that the franchisor’s provision of something of value – manuals, expense payments, a draw – nullifies the fee. It does not.

As is true with every other argument that State Farm makes against the existence of a franchise fee, it ignores the burden that the state statutes place upon it: It must show the existence of an exception to the general rule that a franchise fee is any fee that the franchisee pays to the franchisor. It has shown no such exception here and therefore has failed to meet its burden. The reduced commissions are a franchise fee, and this Court should so hold.

For these reasons, the State Farm Agent Agreement is a franchise and should be treated as such. As shown below, State Farm has violated these franchise statutes.

D. STATE FARM HAS VIOLATED STATE FRANCHISE STATUTES

Franchise laws were enacted to curb certain abuses of franchisees by their franchisors; these abuses arose, in large part, from the disparity in size and bargaining power between immense franchisors and small franchisees. State legislatures imposed these restrictions in order to prevent franchisors from using franchisees to build up the market for the franchisees’ products and then taking it away from them or changing it. Accordingly, these statutes contain, among other things, the following prohibitions:

- Prohibitions against termination or “non-renewal” of franchise agreements without notice, “good cause” (meaning the franchisees’ failure to perform the agreement) and an opportunity to cure.
- Prohibitions against “changes in competitive circumstances” without notice, good cause and an opportunity to cure. A change in competitive circumstances means a material change in the way that the franchisor does business, a reduction or change in product lines, a change in compensation or the like.
- Prohibitions on discrimination between similarly situated franchisees.

- Prohibitions on unreasonable standards of conduct.
- Prohibitions on restricting the franchisee’s sources of supply.

Certain of State Farm’s policies and practices violate these statutory requirements.

1. State Farm’s Agreements Violate State Franchise Statute Prohibitions on Termination Without Cause, and its Curtailments of Sales Violate State Franchise Statute Prohibitions on Discrimination, Freedom of Sourcing and Changes in Competitive Circumstances

(a) State Farm’s Agreement Permits Termination Without Cause

It is undisputed that State Farm’s Agent Agreements are all terminable without cause. (PSOF 22-A.) State Farm may – and does – assert that it never avails itself of that right, but it does not dispute that the Agreements allow it to exercise that right. Requiring termination only with cause is a right provided by twelve of the franchise statutes,¹⁶ and in those jurisdictions, State Farm’s contracts are illegal on that score.

(b) State Farm’s Curtailment of Sales of Insurance is a *De Facto* Termination of the Franchisees’ Agreements

State Farm’s limitations on the sales of its own policies, and concomitant refusal to permit agents to sell policies of other insurers, even those which do not compete with State Farm in any additional lines, violates franchise law prohibitions on termination without reasonable notice and good cause because they destroy the agents’ ability to successfully operate their businesses. Decisions under these statutes recognize that a franchisor need not send a franchisee an express notice terminating the relationship in order to violate the statute. Rather, the franchisor may violate it through a “*de facto*” or “constructive” termination. Because State Farm

¹⁶Ark. Code Ann. § 4-72-204(a)(1); Cal. Bus. & Prof. Code § 20020(b); Del. Code Ann. tit. 6, § 2552; Haw. Rev. Stat. § 482E-(H); 815 Ill. Comp. Stat. § 705/19; Ind. Code § 23-2-2.71(7)&7-3; Mich. Comp. L. § 445.1527(c); Minn. Stat. § 80C.14, subd. 3; Neb. Rev. Stat. § 87-404; N.J. Stat. § 56:10-5; Va. Code § 13.1-564; Wis. Stat. § 135.03.

has violated these statutes, and because it threatens to continue to do so, the Agents are entitled to a declaration that State Farm may not terminate them directly or indirectly without good cause.

For example, in Carlos. v. Philips. Bus. Systems, Inc., 556 F. Supp. 769 (E.D.N.Y. 1983), a manufacturer of dictation equipment undertook to “reorganize” its channels of distribution so as to convert the plaintiff from an exclusive distributor to a “dealer.” As a dealer, the plaintiff would lose “significant competitive advantages with respect to price, terms and advertising.” The Court rejected the manufacturer’s argument that this was merely a change in its distribution system:

The clear intent behind [the Manufacturer’s] new dealer arrangement is to streamline its marketing system by eliminating exclusive distributors such as D & S in order to more profitably exist in a changing marketplace. Any argument that the new agreement merely works a “change” is, in the court’s opinion, nothing more than a poorly disguised euphemism for what is essentially a termination or failure to renew this distribution agreement.

The Court held that the manufacturer had violated the New Jersey Franchise Practices Act and enjoined the termination.

Similarly, in American Bus. Interiors, Inc. v. Haworth, Inc., 798 F.2d 1135 (8th Cir. 1986), the Court held that a manufacturer’s refusal to provide information to a dealer that was essential for a dealer to conduct business amounted to a de-facto termination. As in Carlos, there was no express termination or announcement of termination.

In Petereit v. S.B. Thomas, 63 F.3d 1169 (2d Cir. 1995), the Second Circuit recognized that re-alignment of distributors’ territories, *which deprived them of customers that they had had*, could constitute a constructive termination in violation of the Connecticut franchise statute; similarly, in Beilowitz v. General Motors Corp., 233 F. Supp. 2d, 631 (D.N.J. 2002), the court

held that cutting back a franchisee's territory could constitute a de-facto termination in violation of the New Jersey Franchise Practices Act.

What these cases have in common is the principle that applies here: where a franchisor makes a change in distribution of its product or service line that cuts off the franchisee's source of supply, or otherwise changes the terms under which it does business so as to materially and adversely affect the franchisee's ability to do business, it constitutes a de-facto termination in violation of state franchise statutes that prohibit termination or non-renewal without good cause. The franchise statutes at issue provide that termination may only be for good cause, and then only upon reasonable notice. See supra n.16.

State Farm's withdrawal of its agents' rights to sell insurance was without good cause. Good cause is generally defined as failure of the franchisee to meet performance criteria. Wright-Moore Corp. v. Ricoh Corp., 908 F.2d 128, 137 (7th Cir. 1990). Here, State Farm has not limited the number of new insurance policies that Agents can sell due to deficiencies in the performance of its Agents. Rather, State Farm's new "no-new-business" policy is completely unrelated to the Agents' performance. State Farm has not withdrawn from the business of selling insurance policies at all, but instead has selectively (and in discriminatory fashion) limited the ability of some Agents to sell new insurance policies. This does not amount to good cause. See, e.g., Wright-Moore Corp., 908 F.2d at 137 (internal economic reasons for the franchisor are not, by themselves, good cause for termination or non-renewal of a franchise"); Satellite Receivers, Ltd. v. Household Bank (Illinois) N.A., 922 F. Supp. 174 (E.D. Wis. 1996) ("The purely economic concerns [that is, unrelated to the performance of a particular dealer] of a grantor who remains in the marketplace cannot provide good cause for termination as a matter of law"); Sims Wholesale Co., Inc. v. Brown-Forman Corp., 468 S.E.2d 905, 909 (Va. 1996) (holding that

manufacturer's desire "to consolidate its brands into fewer wholesalers over broader geographic areas" was not "good cause" within Virginia's Wine Franchising Act); Coelho & Bachetti, Inc. v. Ford New Holland, Inc., Bus. Franchise Guide (CCH) ¶ 10,923 (A.A.A. 1996) (holding that the manufacturer's elimination of a specific brand did not constitute good cause for termination of dealers associated with that brand); Kealey Pharmacy and Home Care Servs., Inc. v. Walgreen Co., 761 F.2d 345 (7th Cir. 1985) (holding there was no good cause for a termination due to manufacturer's withdrawal from the market); Petereit, 853 F. Supp. at 60 (franchisor enjoined from reallocating store assignments even though franchisor asserted it was good for business because "to permit defendant to find cause in purportedly sound business judgment is to make the relationships illusory," and as there was no failure to perform by franchisees, no good cause for termination could be found).

It is not disputed that State Farm has drastically reduced the policies available for franchisees to sell in many states (PSOF ¶ 119), and that this has had a significant negative impact upon the Agents and their ability to conduct and continue their businesses. (PSOF ¶ 124.)

The fact that State Farm may have restored business in some of these jurisdictions does not lessen the gravity of the wrong that State Farm has committed; the sale of policies is the lifeblood of the agency. Without policies to sell, agents cannot survive. Taking away policies terminates the franchisees' ability to do business and effectively terminates their franchises.

A holding that State Farm may not terminate except for good cause is completely consistent with what State Farm claims as its policy: That it in fact terminates agents' contracts only for good cause. (PSOF ¶ 77.) Hence, a judicial declaration that State Farm must do what it claims it already does should not be an undue burden.

(c) State Farm's Curtailment of Sales Violates Wisconsin's Prohibition on Changes in Competitive Circumstances

For similar reasons, State Farm’s withdrawal of business violates Wisconsin’s prohibition on changes in competitive circumstances without good cause. Wis. Stat. § 135.03. Changes in competitive circumstances have included changes that affected the dealer’s ability to do business, Jungbluth v. Hometown, Inc., 201 Wis. 2d 320, 548 N.W.2d 519 (1996) as well as a change in credit terms, Van v. Mobil Oil Co., 515 F. Supp. 487 (E.D. Wis. 1981). Here, State Farm’s withdrawal of product to its agents amounts to a very substantial change in competitive circumstances. There has been no showing that the agents failed to perform or that State Farm had good cause for the changes.

(d) State Farm’s Refusal to Permit Agents to Sell Insurance of Other Companies, Even Those That Are Not Full-Line Competitors Of State Farm, Violates Statutory Sourcing Rights

State Farm’s refusal to permit agents to sell insurance products of other companies is a violation of the prohibition in two states on a franchisor’s restriction of the source of supply to franchisees.¹⁷ Those statutes provide that it is unlawful for the franchisor to restrict the franchisee’s sources of supply unless they are reasonably necessary for a lawful purpose and justified on business grounds. State Farm has refused to permit agents to sell insurance of companies other than itself, but it has not shown that this refusal was “reasonably necessary for a lawful purpose” or justified on “business grounds.” To the contrary, State Farm claimed in discovery that in evaluating agent requests to broker other lines of insurance, it considered seven different factors:

[t]he general market situation, the potential for conflicts of interest, the possibility of customer confusion, the potential for claim

¹⁷Haw. Rev. Stat. §482E-6(2)(B) (unlawful to restrict sources of supply unless reasonably necessary for a lawful purpose justified on business grounds; suppliers who meet franchisor’s statutes are not considered designated sources covered by this section); Ind. Code § 23-2-2.7-1(1) (unlawful to restrict sources of supply unless restriction is publication of list of specifications; does not apply to trademarked goods sold by the franchisor).

handling complications, the potential liability to State Farm in the event that the other insurer fails to perform to the client's satisfaction, the difficulty in protecting trade secrets, the protection of the State Farm brand, the value of the training and support provided to the Agent and staff, the long term potential to market the line of business through State Far[sic] or a partnered company, and the potential for strained Agency loyalty.

(PSOF ¶ 127.)

Yet, its witnesses were unable to provide any specific documentation, studies or examples to back up how those factors were applied in practice. Gregory Fisher, State Farm's designated 30(b)(6) witness on this topic, knew of no confusion on the part of policy holders as to who was insuring them; he knew of no difficulty protecting trade secrets; he was unaware of any unfair competition from other companies; he had never heard of any study on whether doing business with other companies would have an adverse effect on State Farm; he knew of no study of difficulties in handling claims, liability or confusing policyholders if State Farm allowed agents to handle other lines of insurance. (PSOF ¶ 129.) In short, despite the fact that State Farm enumerated factors it claimed to consider in determining not to allow agents to broker other companies' products – there was no evidence to support those factors. Hence, there is no showing of a necessity or any lawful purpose for these restrictions, nor is there any showing of business grounds.

State Farm's citation of the testimony of Agent Mueller (Mueller Depo. 126/8-22; 152/11 – 153/4) for the proposition that there is a risk that policyholders will be confused as to which company is actually insuring them when State Farm agents write business for other companies (Def. Mem. at 39) says no such thing. Mr. Mueller testified that policyholders often do not know which company is insuring them or who is handling their insurance. This is a far cry from State Farm's stated concern—that it, State Farm, would have problems if policyholders were confused

about who was insuring them.

On this record, then, State Farm has failed to carry its burden of justifying the sourcing restrictions, and the Agents should be entitled to a declaration that they may sell other lines of insurance.

(e) State Farm’s Restrictions on Selling are Unlawfully Discriminatory

Finally, State Farm has imposed its limitations in a discriminatory manner. Four states – Hawaii, Illinois, Indiana and Minnesota – prohibit a franchisor from discriminating between franchisees. The Minnesota regulation is representative:

It shall be unfair and inequitable for any person to: discriminate between franchisees in the charges offered or made for royalties, goods, services, equipment, rentals, advertising services, or in any business dealing, unless any classification of or discrimination between franchisees is based on franchises granted at different times, geographic, market, volume, or size differences, costs incurred by the franchisor, or other reasonable grounds considering the purposes of Minnesota Statutes 1973 Supplement, sections 80C.01 to 80C.22.

Other statutes are similar. See Haw. Rev. Stat. § 482E-6(2)(c) (unlawful to discriminate in charges or “other business dealings” unless based on franchises granted at different times, based on local or regional experimentation in product lines, or is based on other “reasonable distinctions considering purposes of the franchise law and is not arbitrary”); 815 Ill. Comp. Stat. § 705/18 (virtually identical to Hawaii statute); Ind. Code § 23-2-2.7-2(5) (“unlawful to discriminate unfairly among franchisees”).

While there has been virtually no case law interpreting these statutes, their thrust is clear: a franchisor cannot treat franchisees differently with respect to “any business dealing” unless the differential in treatment is reasonable and related to the purposes of the franchise statute.

In this case, as has been demonstrated, State Farm has discriminated against franchisees

in different states by withdrawing completely from certain markets and by severely cutting back in others. As Exhibit 56 demonstrates, since 2002, the variation in types of policies available to Agents in different jurisdictions has been immense.

While State Farm would have us believe that these differences are based upon carefully considered assessments of business realities and prospects in the respective jurisdictions, that is simply not the case. The decision to restrict business is not based upon any particular standard or criterion; the Company does not take the interests of the agents into account when they make these decisions; and there is no procedure followed for determining how to restrict business. (PSOF ¶¶ 122-123.)

Accordingly, State Farm has failed to produce evidence that its decisions to restrict business in any given state is (a) reasonable; (b) based upon criteria related to the purposes of the franchise laws – *i.e.*, to preserve and enhance the value of franchisees’ businesses; and (c) not arbitrary. In fact, the evidence points to the contrary, and this Court should grant this branch of the Agents’ motion for summary judgment.

2. The Select Agent and Partner-Agent Programs Discriminate Between Agents and Impose Unfair Standards Upon Them

As demonstrated above, the Select Agent program creates two classes of agents: “Select” agents and all others: Select Agents are admittedly singled out for favorable treatment by State Farm; they have privileges to use the State Farm logo that non-Select agents do not; they have the benefit of receiving block assignments and co-op advertising, which non-select agents do not. They may avail themselves of the Customer Response Center without charge; non-select agents must pay. Select Agents are treated differently and preferentially.

Although State Farm executives attempted to characterize the Select Agent Program as “voluntary” and “available to all,” that is not the case. The requirements to become a select

agent include requirements that an agent be “profitable” – that is, that the claims arising from an agent’s pool of clients not exceed certain levels. As a practical matter, this objective is impossible for an agent in an inner-city setting to achieve; similarly, agents whose clients are devastated by natural disasters will fall short. Additionally, State Farm’s administration of the requirements to become select agents has been inconsistent, if not capricious, thereby making access to the Select Agent program discriminatory.

The Select Agent Program is discriminatory against non-Select agents under the same statutes State Farm’s curtailment of business is discriminatory. As noted above, those statutes broadly proscribe differential treatment of franchisees when they are not similarly situated unless the differential treatment is reasonable and based upon criteria related to the purposes of franchise laws.

Not only has State Farm failed to show any such reasonable, non-arbitrary distinctions, but also the evidence demonstrates that the Select Agent program is not based upon any meaningful distinctions. State Farm has not made any determination that it is available to all agents. Nor has State Farm determined that it would accomplish its goals. On this record, there is no business justification for the Select Agent program or for penalizing agents who participate in it.

E. STATE FARM’S PRACTICES BREACH THE AGENT AGREEMENTS AND THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

State Farm has breached the Agent Agreements through the practices that it has imposed unilaterally upon the agents, and has breached the implied covenant of good faith and fair dealing. We will consider these practices in turn.

1. STATE FARM’S REFUSAL TO GRANT PERMISSION TO THE AGENTS TO SELL INSURANCE, AS WELL AS STATE FARM’S REFUNSA TO PERMIT AGENTS TO BROKER BUSINESS OF OTHER COMPANIES CONSTITUTE BREACHES OF CONTRACT AND THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

a. State Farm’s Curtailment of Sales in Virtually Every State is a Breach of Contract

State Farm’s curtailment of agents’ sales of new insurance policies breaches the Agent Agreements. Those Agreements are specifically premised on the notion that the agents are to increase business and sell as many new insurance policies as they can, and the Agreements do not limit the number of insurance policies an agent may sell. The Preamble to the agreements states:

It is to our mutual interest to satisfactorily serve the insuring public, to comply with all applicable laws, to increase business commensurate with the available potential, and to maintain the Companies’ operations on a profitable basis in order to assure the necessary financial strength to protect the policyholders’ interests.

Agents Agreements at Preamble (emphasis added). The Agent Agreement goes on to state, at Section I, which describes the duties of the Agent:

The Agent will solicit applications for insurance, collect premiums, fees and charges, countersign and deliver policiesassist policyholders and cooperate with adjustersand advance the interests of the Companies, the agents and the policyholders.

(PSOF ¶ 66.)

As a State Farm agent, you are obliged to follow State Farm procedures and processes and to provide prompt, friendly, accurate and cost effective service.

(PSOF ¶ 67.)

The fulfillment of this Agreement will be your principal occupation and requires your personal services.

(PSOF ¶ 70.)

State Farm relies upon Section I.L. of the Agent Agreement, which states that the Company retains the right to prescribe “policy forms and provisions” and “limitations on the submissions of applications by individual agent, market area, line of coverage . . . or other means.” The meaning of this provision, however, is limited by custom and usage.

As explained by agent David Swift, for over 30 years, and until it began imposing limits on sales two years ago, State Farm consistently construed these provisions as requiring agents to sell as much insurance as possible of every kind that the company offered. Indeed, this was the custom and practice of State Farm for years, and the way that State Farm and its agents construed these agreements. The ability to sell as many insurance policies as possible is the essence of the bargain between the agents and State Farm. (PSOF ¶ 11.) The manner in which the agents are compensated -- *i.e.*, via commissions -- strongly supports the position that the agents are contractually entitled to sell new insurance policies without limitation. Agent’s Agreements at Attachments.

Furthermore, since at least 1977, State Farm has never limited the number of policies that agents may sell. *Id.* at ¶ 22. Thus, the Agent Agreement, as confirmed by the parties’ course of

dealing over several decades,¹⁸ is that the agents may sell new insurance policies without limitation.

Since 2001, State Farm has imposed drastic limitations on the Agents' abilities to sell insurance. These restrictions have included, for example, limitations on sales of auto insurance—a bread and butter item—in virtually every state, and on homeowners' insurance in virtually every state. These limitations have made it virtually impossible for the agents to function. (PSOF ¶ 119.)

State Farm's restrictions on Agents' abilities to sell breaches the Agent Agreement. First, State Farm has, essentially, taken away the subject matter of the Agent Agreement – insurance policies. How is the agent to “solicit applications for insurance, collect premiums, fees and charges, countersign and deliver policies” or to make the discharge of these duties his or her “principal occupation” when there are no policies to sell? State Farm now pleads the excuse that

¹⁸See RESTATEMENT (SECOND) OF CONTRACTS § 223 at 157-58 (a course of dealing is a sequence of previous conduct between the parties to an agreement which is to be fairly regarded as establishing a common basis of understanding for interpreting their expressions and other conduct; unless otherwise agreed, a course of dealing between the parties gives meaning to or supplement or qualifies their agreement); Childs v. Adams, 909 S.W.2d 641, 646 (Ark. 1995) (formation of a contract is “made wholly by spoken words or by conduct”) (citations omitted); Mathis v. Daines, 639 P.2d 503, 505 (Mont. 1981) (holding that a contract may be explained by reference to the circumstances under which it was made and the matter to which it relates); Southworth v. Oliver, 587 P.2d 994, 998 (Or. 1978) (holding that in order to determine the terms of contract “the definiteness or indefiniteness of the words used in opening the negotiation must be considered, as well as the usages of business, and indeed all accompanying circumstances”) (citations omitted); Harper v. Cedar Rapids Television Co., 244 N.W.2d 782, 789 (Iowa 1976) (holding that “manifestation [to the terms of the contract] may be wholly or partly by written or spoken word or by other acts or failure to act”); Grammar v. Evans, 1998 WL 181998 *2 (Ark Ct. App. 1998) (“The courts may look to the conduct of the parties to determine their intent”) (citations omitted); Hartland Computer Leasing Corp. v. Insurance Man, Inc., 770 S.W.2d 525, 527 (Mo. Ct. App. 1989) (“As with all contracts, the court seeks to enforce the reasonable expectations of the parties garnered not only from the words of a standardized form imposed by its proponent, but from the totality of the circumstances surrounding the transaction[s]uch provisions of the standardized form which fail to comport with such reasonable expectations [of the parties] or which are unexpected and unconscionably unfair are held to be unenforceable”) (citations omitted); Steinberg v. Arnold, 402 A.2d 1302, 1305-06 (Md. Ct. App. 1979) (“Another rule long recognized by the courts in Maryland is to admit extrinsic evidence of the negotiations leading up to the formulation of a contract, of the circumstances of the parties at the time of entering into the contract and of the parties own construction of the contract in order to discern their intention”) (citations omitted); Maryland Supreme Corp. v. Blake Co., 369 A.2d 1017, 1026 (Md. Ct. App. 1977) (holding that “where the contract for sale involves repeated occasions for performance by either party with knowledge of the nature of the performance and opportunity for objection by the other, any course of performance accepted or acquiesced without objection shall be relevant to determine the meaning of the agreement.)

this issue is “moot” because most of the restrictions have been lifted. The symptoms have abated, perhaps, but the disease is merely in remission. State Farm has, by curtailing sales, essentially made performance of the agreement impossible and it claims to power to do so in the future. It has breached the contract, and the agents are entitled to a declaration that State Farm may not do so going forward.

b. State Farm’s Curtailment of Sales of Policies Violates the Implied Covenant of Good Faith

Under the implied covenant of good faith and fair dealing, State Farm must administer its policies, and must exercise its discretionary is power to “prescribe” policy forms and provisions . . . and limitations on the submissions of applications . . . by “market area” in a reasonable manner.

There is no dispute between the parties that, given such discretion, State Farm must exercise it under Illinois law (the choice in the AA97 agreement), fairly and reasonably. As the Seventh Circuit held, relying on Illinois law, in Interim Healthcare of Illinois v. Interim Healthcare, 225 F.3d 876 (7th Cir. 2000):

In Illinois, a covenant of good faith and fair dealing is implied in every contract absent express disapproval. (Citation omitted.) Problems relating to good faith performance are most common where one party to an agreement is given wide discretion, and the other party must hope the discretion is exercised fairly. (Citation omitted.) When one party to a contract is vested with contractual discretion, it must exercise that discretion reasonably and with proper motive, and may not do so

arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties. (Citation omitted.)

Id. at 884 (emphasis added).¹⁹

State Farm's abuse of its discretionary power is analogous to that of the franchisor in Carvel Corp. v. James Baker, 79 F. Supp. 2d 53 (D. Conn. 1997). In Carvel, a franchisor of ice cream parlors, Carvel, sold exclusively to franchisees for many years. Carvel then promulgated a new contract that gave it the right to sell its ice cream through other channels of trade, and, particularly harmful to its franchisees, to supermarkets that competed with franchisees. Id. at 56-59. The franchisees sued. Id. The court rejected the franchisor's contention that the integrated franchise agreement gave the franchisor immunity from liability in selling to supermarkets. The court stated:

[A]t the time the parties executed the . . . agreement, Carvel had, for decades, conducted its business exclusively through its company-owned stores and its franchisees. . . . It is therefore reasonable that the parties expected that the benefit accruing to the [franchisees] would include an unique relationship with Carvel, to the exclusion of supermarkets. . . . Under this construction, the supermarket program deprives the defendants of their right to receive the benefits of the agreement.

Id. at 62. The court when on to hold:

While Carvel has the discretion to institute an alternative distribution program, the [franchisees] could have reasonably expected, at the time of contracting, that Carvel would not use such a system to compete directly against them, especially since distribution to supermarkets and other retail outlets was not a

¹⁹See RESTATEMENT (SECOND) OF CONTRACTS § 305, cmt. d. (the implied covenant of good faith and fair dealing protects a party from “evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party’s performance”); Carmichael v. Adirondack Bottled Gas Corp. of Vermont, 635 A.2d 1211 (Vt. 1993) (finding that the implied duty of good faith and fair dealing continues after termination of a distribution agreement where the supplier failed to negotiate with its distributor for a new arrangement or to allow its distributor sufficient time to sell to another party); Newman v. Hinky Dinky Omaha-Lincoln, Inc., 427 N.W.2d 50, 54 (Neb. 1988) (“Where a contract confers one party a discretionary power affecting the rights of the other, a duty is imposed to exercise that discretion in good faith”).

practice that existed prior to the agreement. While the [franchisees] are not entitled to abrogate Carvel's right to "sell or license to sell products under Carvel's trademarks ..." the [franchisees] are entitled to expect that Carvel will not act to destroy the right of the [franchisees] to enjoy the fruits of the contract.

Id. at 66.

Here, as in Carvel, State Farm, despite a historical course of dealing granting the Agents the right to sell new insurance policies without limitation, has decided that it no longer wants to undertake the risks associated with underwriting new insurance policies.

State Farm's decision to restrict agents from selling insurance in various territories is not based upon any standards, criteria, regular procedure or other ascertainable standard of reasonableness. Mary Bitzer, a Senior Vice President for State Farm's Central Zone, was offered by State Farm as a witness to testify on the subject of market restrictions. (PSOF ¶ 120.) Ms. Bitzer has authority within the five-state area that she represents to restrict business. She described the process of deciding to restrict sales of insurance as not involving any regular compilation of information or regular list of reports (PSOF ¶ 122.) For example:

Q. Is there any kind of written procedure that dictates how you go about making the decision with respect to restricting business?

A. No.

Q. Okay. How do you know what the procedure is?

A. There is no procedure.

(PSOF ¶ 122.) Similarly, she testified that there was no particular standard or criterion with respect to the effect on State Farm agents that the Company takes into account when making a decision on restrictions of new business. (PSOF ¶ 123.) State Farm looks at no documents that pertain specifically to agents, to the effect of any restriction on agent compensation; and there is

no discussion of agent compensation. (PSOF ¶ 123.) State Farm’s conduct is unreasonable and unjustified; the Agents are entitled to a declaration that it has breached the implied covenant of good faith and fair dealing.

c. State Farm’s Refusal to Permit Brokering Violates The Implied Covenant of Good Faith and Fair Dealing

State Farm sets up a strawman, attempting to convince the Court that NASFA seeks blanket permission for State Farm agents to write insurance for their policyholders with other companies (to “broker” insurance), whenever State Farm declines to allow them to write such business for State Farm. Such is not the case. In fact, the request is far more limited. NASFA seeks only a court order that State Farm must administer reasonably and fairly (in “good faith,” see Interim Healthcare, supra) the provision in its agents’ agreements that allows agents to broker if State Farm provides them permission.

State Farm’s discretion is broad; agents do not seek to eliminate that. They recognize that, even where State Farm has temporarily withdrawn from selling, e.g., fire or auto insurance in a market, there may be justification for it to decline to allow an agent to broker a client’s new policy to a full line competitor such as Nationwide or Allstate. NASFA witnesses have so testified. (PSOF ¶¶ 131, 133.) The problem is that, as NASFA’s Jerry Beauchamp testified: “well, I think I asked him [his State Farm Manager], I said, well, does it look like that you all would even consider it [allowing brokering]? And he said, “No, Never.” (PSOF ¶ 130.)

The brokering sought here is an effort to retain the customer’s State Farm business while placing, with a non-full line company, one part of the business which State Farm is not writing. The goal and result of this would be to retain a State Farm customer, and the assurance that the customer, who cannot obtain all of his needs from State Farm, will not leave the State Farm agent and transfer all his business to another full service company, e.g., AllState or Nationwide

or The Hartford. Further, the concept is that, when State Farm commences again to offer the coverage, the State Farm agent (whose AA3 or AA4 contract provides for retirement based on his last year of earnings) has every incentive to move the policyholder to the State Farm policy.

As NASFA President Swift testified:

- A. Sure. Because at the time, State Farm was not in the market, and if they allowed us to broker the business, we could write the business for a period of time, being able to save the business without losing the entire book of business. And then we would put it back in State Farm when State Farm will take it, if they want it, because our retirement is based on our book of business.

(PSOF ¶ 133.) And:

- A. . I would like to say right here, I don't think – what we're trying to establish here is that we're not trying to take the business away from State Farm and do something else with it. We're only trying to be able to sell that business so we can keep the total book of business we have and then put it back with State Farm when they're ready to write again.

(Id.)

State Farm's unfair and unreasonable (i.e., illegal) arbitrary exercise of its discretion is exemplified in the experience of NASFA Board Member Mueller. We reiterate here this testimony, already cited earlier:

- Q. So it was your intention, if State Farm had given consent to you to place fire insurance with Northern Neck or Loudoun –
- A. Loudoun County Mutual.
- Q. --Loudoun County Mutual, it was your intent to provide that insurance to them from those companies but then switch them over to State Farm down the road when State Farm authorized you to –
- A. If and when --
- Q. -- increase production again on fire insurance?
- A. If and when State Farm got back in the fire insurance business, that would be a reasonable assumption to make.

- Q. Okay. Reasonable assumption being that you would then switch them over to State Farm from whatever you had provided them or sold them before?
- A. Yes. Yes. That's why I was so incensed at Mr. Whitney's [State Farm's] e-mail stating that I had talked about Allstate and Nationwide, who are direct competitors of State Farm, whereas Loudoun County Mutual and Northern Neck only write fire insurance and he knew that.

- Q. So on October 24th, 2002, you sent this e-mail requesting permission to place fire insurance with a company other than State Farm.
- A. Yes, sir.
- Q. So after the e-mail, you had a conversation with Mr. Whitney?
- A. Yes, sir.
- Q. And what is Mr. Whitney's position?
- A. He is regional – well, he would be analogous to a regional deputy vice president. He is a vice president in charge of agency for Virginia in the zone.
- Q. And what did he say to you in the conversation, I'm not talking about the e-mail yet?
- A. I would refer you to item 11, which is some notes that I took on a 5-by-7 steno pad. He first informed me that brokering business was against the contract and I referred him to the contract telling him that it wasn't against the contract if I had written permission of State Farm and his response to me was that it was not in our mutual interest to have me have the authority to broker. Of course, it was no money out of his pocket, the money was coming out of my pocket.
- Q. That's your comments to me now, right? I just want to distinguish.
- A. No, I did not say that to Mr. Whitney at the time, no.
- Q. I'll let you say whatever you want but let's just get clear what was in the conversation and what wasn't.

- A. Then I asked Mr. Whitney, as has been a problem in the past on occasion, if he had the full authority of the company to grant or deny such a request. And his response was Mr. Thompson would refer any such requests to him and, "I have full authority to grant or deny such a request." So it would appear that you don't have to go very far up the corporate ladder to get that permission. "Just wanted to make sure what you were asking for." Oh, his phone call – his comments to me was that he wanted – he was making the phone call in order to be certain what I was asking for and then he stated emphatically, "You can't broker business." I said since the contract required me to put my request in writing, I was asking for him to put his denial in writing and he said, "Sure, I'll put it in writing," and then his answer, which was not accurate, I responded to stating that he must have misheard what I said.
- Q. Okay. And on item 11, which you referred to, which is your contemporaneous notes of what you and Mr. Whitney said to each other –
- A. Yes, sir.
- Q. -- you wrote, "I did not say Allstate or Nationwide and said – I said Loudoun County Mutual or Northern Neck." You went back and wrote this later, I guess, after you saw his return e-mail?
- A. Yes, after I saw his return e-mail. That's why there is a line there.
- Q. Okay. So the next thing that happened, I guess, and it is all on the same day, October 24th, you got this return e-mail from Mr. Whitney, and it speaks for itself, I don't have to ask you to read it but what did you do after you got this return e-mail from Mr. Whitney?
- A. There was nothing to do. I can't broker so boom.
- Q. So did you call him back and say, "You got it wrong. I never said Allstate or Nationwide, I said Northern Neck and Loudoun County"?
- A. I have a draft – let me read it here. Item 14. Now, this is a draft of the e-mail I sent on 10/29/02 at 10:20 a.m., stating that he must have misheard me and that – "You must have misheard the companies I named as examples/possibilities for such brokerage. They were Loudoun County Mutual or the Northern Neck, both of which write nothing but fire insurance. Allstate and/or Nationwide never passed my lips as a company with which I ever considered a business relationship."
- Q. And it is your testimony that you sent this as an e-mail to Mr. Whitney?
- A. 10/29/02 at 10:20 a.m.

- Q. Did you get any response?
- A. Not that I am aware of.
- Q. But, nevertheless, you sent him this e-mail on October 29th?
- A. Yes, because I thought it was incumbent upon him to be infinitely more accurate with what his agents had requested. I could see a vice president of agency not wanting a State Farm agent to broker with Allstate or Nationwide, as they are multi-line companies, but what we were discussing was fire insurance and the two companies that I picked write only fire insurance, which State Farm was not writing at the time so there would be no conflict of interest as there would be with Nationwide and Allstate.
- Q. This is item 15, if you will take a look at it. I take it you had this document in your files?
- A. Yes.
- Q. Okay.
- A. I'm also chairman of the Northern Virginia Agents Association and send out a newsletter once a month and this was one of the items that I had put in that newsletter.
- Q. Does this relate at all to your request to broker business?
- A. I had – I thought it related, in that State Farm allows very selective brokering of business when it suits their purpose and this AON association with State Farm was merely an example of that to my counsel. I know that in Alabama they allow brokering of certain types of insurance, there is in Northern Virginia a brokering of health insurance with Fortis, there is brokering of life insurance with a company called Phoenix, I think it is Phoenix Mutual, I'm not sure, and it was merely to bolster my case that the rejection of my request to broker insurance was arbitrary and capricious in the extreme.

(PSOF ¶ 131.)

Underscoring the absence of good faith in State Farm's decision to refuse to allow brokering is the demonstrated absence of any reasonable basis for its decisions. As admitted by Greg Fisher, State Farm's designated witness on the subject of brokering, even though State

Farm purports to take into account seven factors in evaluating agent requests to broker, there is, in fact, virtually no basis for those factors. (PSOF ¶ 129.) State Farm never assessed whether handling other companies' insurance would impact those factors in the least.

State Farm's blanket refusal to exercise its discretion to allow any brokering requested by agents violates the duty of good faith under Illinois law to exercise such discretion "reasonably" and "fairly." Interim Health, supra. The Court should declare that State Farm has violated that legal obligation.

2. THE "PARTNERING" PROGRAM BREACHES THE AGENTS' CONTRACTS AND THE IMPLIED COVENANT

The "partnering" program violates the essence of the agents' Agreement. The Agreement recognizes that agents are "best able to provide the creative selling, professional counsel and prompt and skillful service" essential to the Company's business and it goes on to provide that State Farm will not seek "and will not assert, control of your daily activities, but expect you to exercise your own judgment as to the time, place, and manner of soliciting insurance, servicing policyholders and otherwise carrying out the provisions of this Agreement." (PSOF ¶ 64.) This emphasis upon the independence of the agent is reiterated in Section I.B.: "You have full control of your daily activities, with the right to exercise independent judgment as to time, place, and manner of soliciting insurance, servicing policyholders and otherwise carrying out the provisions of this Agreement." The Agreement further provides that agents will be compensated in accordance with attached commission schedules, thereby recognizing that the agent's compensation depends upon the business that it generates with its customers.

By requiring agents to refer portions of their business to other agents, State Farm interferes with the agent's status as an independent contractor and ability to exercise independent judgment as to the manner in which it will serve customers. How can an agent independently

serve his clients if another agent is serving them? Additionally, the Agreement provides that an agent will “respect the rights and interests of your fellow agents in policies credited to their accounts by refraining from raiding or otherwise diverting policies from their accounts to your account.”

State Farm’s principal excuse for the Partner-Agent program is that it is “voluntary.” This characterization is misleading, because of the serious adverse consequences to an agent who “elects” not to participate. As such, the program – which is nowhere authorized in the agents’ agreements – cannot simply be justified as a voluntary program which (therefore) need have no contractual authorization.

State Farm cites the depositions of Robert Lamphier (Lamphier Depo. 67/11-13); Steven Knapp (Knapp Depo. 51/12-17); and Gabe Nazziolla (Nazziolla Depo. 156/11-17) for the proposition that the partnering program is “voluntary.” What those witnesses testified to, however, was that they had chosen not to participate in the program; their testimony does not address the point that for agents who do not participate, State Farm assigns a “partner” to a non-registered agent. In that sense, it is not voluntary.

John Killingworth was a State Farm employee for nearly a quarter of a century, rising to Agency Field Manager and Agency Field Executive positions. (PSOF ¶ 81.) Mr. Killingworth also pastored churches in the Arizona and New Mexico, as a community-minded State Farm representative. (PSOF ¶ 81.) He described the partner-agent program devised by State Farm:

Q. Are you familiar with something called the partner agent program?

A. Yes.

Q. Can you describe what that is, please?

A. Agents that would not or did not get their securities licenses were asked to select or were given a partner agent that was securities-licensed. The

lion's share of those agents – and it was my experience that all of them, in my particular case, were new agents with little or no book – and the partnering agent was to refer anybody that had a securities policy that they wanted to buy to the partnering agent that had the securities license.

Q. How is it that State Farm agents – Well, strike that. How did you – If you did, how did you present the partner agent program to the agents under your jurisdiction?

A. I resisted it.

Q. Why?

A. The vice president that I had had already selected the agents. They were all trainee agents. And they were to be assigned to these large agents who had these large books of business, very lucrative, very wealthy clients. If the senior agent was not going to get the securities license, they were – the VP was very, very adamant that we are going to write these security products on our clients. They're going to get a chance for them. And they will be referred to this list of trainee agents.

(PSOF ¶ 81.)

Killingsworth testified as to his reaction to the program in light of his responsibilities to the agents in his geographic area:

BY THE WITNESS:

At the time it was announced, I had a very visceral reaction to it, because it is impossible for an agent to advise a client on a financial services product without knowing all of the business that agent has. The high propensity of those agents, of the new agents, becoming the agent for the existing book of business was extremely high. Very deep concern with me. One of my responsibilities, relationships with agents. Agents with large books of business being diminished in this way was very troublesome for me.

BY MR. HILLMAN:

Q. Did you express that view to anyone in State Farm management?

A. Yes. To Mike Dannewitz.

Q. And who was Mike Dannewitz?

A. He was my agency vice president.

Q. What, if anything, did Mr. Dannewitz say in response to that?

A. We have got to meet the corporate objectives. We have got to become a financial services organization. These agents chose not to go with us. We have to go without them.

(PSOF ¶ 81.)

Killingsworth's apprehensions were shared by State Farm agents. NASFA's Board Members (all testifying before Killingsworth) expressed their well-founded apprehensions. The concern was not so much that the "partner" agents would deliberately "raid" the non-participating agents' client bases; the concern was more sophisticated, yet no less real. As Board Member Stephan Adams testified:

. So I felt like if they did that and someone decided finally to buy one of the mutual funds or a variable life product and they went to that partnering agent, they would just on their own want to gravitate all their business to that one place, because they are paying me money to cover them for insurance. With this agent over here, if the stock market goes, might make them some money. So I felt the perception from the customer standpoint was going to be set me up to [have] my business stolen. I don't know the exact term for it. But it just didn't seem ethical.

(PSOF ¶ 88.)

NASFA President Swift echoed this:

. [Y]our business, and if the client went – the concern here is that . you're paying me for car insurance, okay, and you're paying me for home insurance but you're not getting – you don't see you're getting any benefit because, guess what, you're not having any claims but you're just paying out money. But over here, you're putting money into this mutual fund as an example, and let's say it starts making money, which it isn't now. But let's say it starts making money, so then the client says well, wait a second. You know, [the "partner"-agent] is making me money and you're costing me money. Then maybe I'll just transfer all my autos and homes over to [the "partner" agent]. Then through no fault of [the "partner"-agent], my client transfers over to him because he thinks he's making him money, and I'm costing him money.

(PSOF ¶ 89.)

More colorfully, former State Farm agent Gabe Nazziola put his finger precisely on the

problem caused by this involuntary “voluntary” program:

... So some dreamboat went and talked to some consultant and came up with this Partner Agent Program. Well, this is going to work in one of two ways. It's a sword that has a very sharp blade on both sides. Either you're going to stimulate this guy to start selling [the new product] because he doesn't want anybody else – not Jesus Christ, not the disciples, nobody else – in his business writing in his households, confusing the allegiance, disturbing the relationship, which is the whole success of State Farm – that's how he know this had to come from outside brain-dead to have the Partner Agent Program where some other agent, some AK is going to come in. You're going to give him access to all your files and all your records, and he's going to solicit your policyholder. Now, if he never did another thing, you've immediately undermined the relationship. You've immediately created: Oh, Jesus, who the hell's my agent here? Why can't my agent sell me this [other product]? Why doesn't this guy? Not a good thing, not well-thought-out by anybody from any stretch of the imagination. So you knew that this had to [aggravate] every State Farm agent in creation. Nobody wanted anybody else into their book of business. “I'm an independent businessman. You hired me to be an entrepreneur to select, the time, the place and the method.” What's all that mean? You keep saying that they reserve to themselves the right to do this; they reserve themselves the right to do that. Do you really think that they reserved that right to come into my business when you told me it was going to be mine? You went to the heart of every agent. Anybody that was on your side, you put them against you when you came out with this idea. So we know it couldn't have been an insurance person who had this idea. Anybody that has any idea of truly what the relationship is between an agent and a policyholder could never ever have suggested something so damaging.

(PSOF ¶ 90.)

The partner-agent program was started, placed on hold, and now apparently rejuvenated. It has not had the half life, as yet, to have fulfilled the dire predictions made for it. Yet, while it was active, such predictions were not ephemeral. As former State Farm Manager Killingsworth testified:

Q. Okay. Let me ask the question this way: I'm asking you to identify any registered State Farm agent who, through or because of the partner agent program, had or made contact with policyholders who were part of the book of business of a nonregistered agent and, as a result of that contact, wrote business for State Farm products other than mutual funds.

BY THE WITNESS:

A. I don't know how to answer that, because the only way – unless there was some aggressive marketing program which would not be allowed – that a non – that a registered agent would write a registered product on an existing agent is because the existing agent was forced to make a referral. I am aware of cases that have been transferred – where the entire file was transferred to the securities agent, because you can't comment on a securities product without knowing everything about that client. In that process, that client would become the client of the securities agent.

BY MR. REICHLER:

Q. Okay. And who transferred the file to whom?

A. Well, the securities agent would simply get a letter assigned by the policyholder. The company would then be required to transfer the file.

Q. And give me the names of the registered agents who received such letters from policyholders which transferred the entire book of business to the registered agent.

A. I didn't say the entire book of business. I said the client.

Q. Okay. Now – Okay. I am asking you to tell me the names of registered agents who, because of the partner agent program, were able to write P&C business, either auto or fire –

A. I didn't say they wrote the P&C business. I said it was transferred.

Q. What was transferred, the P&C business or the mutual fund business?

A. Well, the mutual fund business couldn't be transferred because the prior agent was not securities-licensed.

Q. So you are aware of cases –

A. Yes.

Q. -- by name where the P&C business was transferred to – from a nonregistered agent to a registered agent?

A. I am aware of agents where this was alleged to have gone down.

Q. Ah-hah. Alleged by whom?

A. By the agents, by the losing agents.

Q. Okay. And which – So – All right. And how many losing agents were there who made these allegations? Were these allegations made to you? Let me ask that first.

A. Yes.

Q. By the losing agents?

A. Yes.

Q. How many losing agents made these allegations to you?

A. Three.

(PSOF ¶ 91.) Killingsworth testified as follows about the state of mind of his agents concerning the “partner-agent” program:

A. They felt betrayed. They felt forced. They felt that a lifetime of work had come at risk.

(PSOF ¶ 92.)

NASFA’s incoming President, Jerry Beauchamp, testified that such a thing – “two agents for the policyholder” – was unprecedented “in 40 years that I have been with State Farm.” As he concluded, “it’s just not right.” (PSOF ¶ 93.)

State Farm cites the equivocal testimony of President Swift that the partner-agent program has “kind of gone away” and “now it’s a non-issue” for the proposition that the agents “no longer have any dispute with State Farm about the Partner Agent Program.” (Def. Mem. at 17.) Nothing could be farther from the truth. What State Farm has not produced is any evidence that it has discontinued the program. Rather, State Farm’s evidence points to the fact that State Farm will appoint an agent without the non-registered agent’s consent if contacted by a policyholder. (DSOF ¶¶ 111, 119-20.)

The partner-agent program is not only “just not right”; it is just not authorized by the Agent Agreements, it is just not voluntary in any genuine sense, and it is just not lawful. The

Court should so declare.

3. THE “SELECT AGENT” PROGRAM BREACHES THE AGENT AGREEMENT

The “Select Agent” program is nowhere referred to in the agents’ agreements. State Farm seeks to bring it under the alleged contractual umbrella of a “bonus” that State Farm may institute. Apart from the fact that is hard to shoehorn that entire program into the concept of a “bonus,” State Farm’s premise is that, if an agent wants to achieve that status, she or he can do so. If not, the agent will not obtain the additional benefits from the program – but will not suffer the loss of contractual rights previously existing.

State Farm’s premise is false, however. CRC, the Customer Response Center, is a service that is furnished free to “Select Agents” but for which other agents must pay. Even assuming, merely for the sake of argument, that the agents’ agreements actually permit the Select Agent program, the further problem is that, as Mr. Mueller testified, by refusing to pay for CRC, he was penalized by the loss of contractual rights he possessed even before the advent of the Select Agent Program. Thus:

- Q.** Have there been any reprisals against you by the company for your decision not to participate in the CRC?
- A.** Yes.
- Q.** What are they?
- A.** By not participating in the CRC, when a life specialist became available in my agency group, I received an e-mail that stated that the life specialist could only be sent to select agents and registered representatives so I did not receive assistance with the life insurance because I was not on the CRC.
- Q.** What was the position you said that became available?
- A.** A Life specialist. The company employed certain people and gave them certain types of training to assist agents in increasing their life insurance

production and these life specialists, as they were called, were sent around to the different agents as the agents requested but prior to being able to make the request, we received written notification from our area field executive, Ginger Corell, that unless you were a select agent and a registered representative, they could not send this life specialist to our office.

Q. So that the life specialist was somebody who State Farm went out and hired?

A. Yes.

Q. As a resource that the company made available to certain agents?

A. To certain agents.

Q. Free of charge?

A. I believe it was free of charge.

Q. And the company decided that these life specialists would be made available only to select agents?

A. That is correct.

* * * *

A. . [T]hat but, also, in the preamble of the contract, it says, paragraph 4, “We will provide you through our personnel with information and guidance as to the operation, conduct and financial management of your agency and from time to time we will designate specific employees to advise you regarding your activities.” Well, they are saying that they will give me employees to advise me in my activities. One of my activities for which I have contracted is the sale of life insurance. And by not allowing me access to that specialist, given what I have just read you, I feel like the company has violated the contract in that regard.

(PSOF ¶ 103.)

Former State Farm Manager Killingsworth testified as follows about the Select Agent Program:

Q. What was your view, if any, as to the appropriateness of the Select Agent Program?

A. I did not like it at all.

Q. Why?

A. Agents should not be, in my judgment, differentiated against. The achievers should be rewarded, but not issues like this, to divide and differentiate. It was very – in my judgment, a very divisive policy. Created a lot of hostility. Greatly diminished the relationships. On the heels of the Grow .

(PSOF ¶ 105.)

Killingsworth’s negative evaluation of the program does not render it unlawful, but it is instructive. And State Farm’s administration of the program has taken that final step, across the Rubicon into illegality.

State Farm’s contention that the Select Agent programs is “voluntary” is—as has been shown—false. The program is not administered in an even handed way; what may pass as a “business plan” for one agent may not for another. And, as a practical matter, not all agents are able to satisfy the requirements for keeping loss ratios low because they are located in territories where achieving low loss ratios is not, as a practical matter, possible.

State Farm quotes the testimony of President Swift (Swift Depo. 230/9 - 231/16) in which counsel for State Farm cross examined him on whether State Farm was “violating your rights” by giving “bonuses to others” in connection with the Select Agent Program. This sort of unvarnished bullying of a lay witness by a lawyer on the subject of legal rights has, of course, no probative value on the issue for which it has proffered. Similarly, Mr. Mueller’s testimony (Mueller Depo. 35/22 - 36/20 (Martin Ex. 9)) and the testimony of Mr. Beauchamp (Beauchamp Depo. 151/20 – 152/1 (Martin Ex. 7)) that the Select Agent Program is “some sort of bonus or award program” and “supposing” that it was “kind of a reward” is of no probative value. The fact that some of Plaintiff’s officers testified that they chose not to meet the conditions of the

Select Agent Program does not mean that it is not a violation of contract. See Def. Mem. at 22.

It is well established that a party may not take action that interferes with another party's obligation and ability to perform a contract. Hansen v. Johnston, 249 N.E.2d 133 (Ill. App. 1969)(where party renders performance impossible, it has breached contract). In Perlman v. Westin Hotel Co., 506 N.E.2d 1318 (Ill. App. 1987), the owner of a dining club that had two restaurants closed one of them. A member sued upon the ground that the owner had, in essence, destroyed the subject matter of the contract – the right to dine at either or both of two restaurants – and therefore was entitled to damages. The court upheld the complaint upon the ground that the owner had in fact made performance impossible by destroying the subject matter. The same reasoning applies here. By creating two classes of agent, State Farm has interfered with the non-select agents' ability to perform their contractual obligations. The Agent Agreement provides that agents and the Company will work together to “serve the insuring public and to increase business.” The Agreement requires Agents to solicit insurance and to exercise their independent judgment as to the time, place and manner of carrying out their duties. By denying certain agents all of the benefits and privileges that other agents receive, State Farm interferes with the ability of the agents to perform their duties to solicit insurance and exercise their independent judgment.

F. STATE FARM MAY NOT COMPEL AGENTS TO ATTEND MANDATORY “COMPLIANCE” MEETINGS

State Farm has undertaken to require its agents to attend mandatory “ethics” or “compliance” programs – specifically, it has required them to attend these meetings at times that State Farm dictates during the business day.

The Agent Agreement quite specifically provides that agents are independent contractors that have “full control” of their daily activities and with the right to exercise independent

judgment “as to the time, place, and manner of soliciting insurance, serving policyholders, and otherwise carrying out the provisions of this Agreement.”

State Farm’s agents’ agreements state that agents will be “invited” to meetings, not that they must attend – much less that they can be terminated for a failure to attend. While State Farm may attempt to rely on the general provisions of the Agreement pursuant to which it may establish general policies or procedures, the very specific language with respect to agents being independent contractors overrides that more general language. In addition, no State Farm witness was able to reconcile the language providing that agents who are independent contractors with State Farm’s imposition of the mandatory meetings upon them.

State Farm seeks to metamorphasize NASFA’s contractual objection to agents being required to attend meetings called by State Farm, upon pain of termination, into a disinclination by agents to be schooled periodically in ethical obligations. Hence, the dispute, as framed by State Farm, is between flag, mom, and apple pie (State Farm) and the agents. This is clever but disingenuous in the extreme. Apart from the fact that State Farm executives have no such requirement to attend annual ethics meetings (PSOF ¶ 111), the fact is that the agents simply ask to be treated in accordance with their contracts. This State Farm declines to do. As NASFA Board Member Mueller testified:

A. It would be one way. Were it not for the contract saying that I will be invited to meetings, okay? Now, invitation under termination is not much of an invitation, as far as I can understand that. And there are LUTC [continuing educational] courses that are taught by competent professionals for which agents would receive continuing education credits, okay, so there are many more ways to guarantee the ethics of your agency force rather than forcing them to go to a meeting or be terminated. I had a health condition at one point in time that made it difficult for me to get to a meeting and I was told flat out, “You don’t go to the meeting, you will be terminated.”

Q. Who told you that?

A. Ralph Brittain [State Farm Manager]. Real simple.

(PSOF ¶ 108.)

G. STATE FARM'S INTERNET SALES UNLAWFULLY ENCROACH ON THE AGENTS' TERRITORIES

State Farm's sales of insurance over the Internet unlawfully infringe upon the Agents' territorial rights. The Agent Agreement recognizes that Agents need to have territories in which to develop and maintain their businesses: they expressly provide that the Company will leave in the Agent's account all policies so long as the policy holder is within a 75-mile radius of the Agent. (PSOF ¶¶13-15.) The Agreement further provides that the Agent agrees "that in the location or relocation of your office you will not unduly infringe on the established office locations of any other agent." Additionally, the Agreement provides that an agent will "respect the rights and interests of your fellow agents in policies credited to their accounts by refraining from raiding or otherwise diverting policies from their accounts to your account." Additionally, the agent has been the only vehicle for sales of insurance throughout State Farm's history; the very first sentence of the Agent Agreement recognizes that Agents are "best able" to provide sales of insurance.

Now, in a wholly unprecedented move, without consultation with the Agents, State Farm has begun selling insurance over the Internet. Moreover, far from what State Farm would have us believe, its sales are not de minimis offerings of minor products, but mainstream insurance products such as auto and homeowners' insurance in certain territories.

State Farm's Internet encroachment into Agent territories is a violation both of the Agent Agreement and of the implied covenant of good faith and fair dealing. Such sales are in direct contravention to the Agreement's undertaking that agents are best able to sell insurance; that they

must make the sale of insurance their principal occupation; and that they enjoy territorial protection.

Perhaps more significantly, the Internet sales violate the implied covenant of good faith and fair dealing. The Eleventh Circuit has summarized the recent case law concerning encroachment on franchised territories:

The great weight of authority on applying the implied covenant of good faith and fair dealing to cases of encroachment converges around two fairly simple propositions: (1) when the parties include contract language on the issue of competing franchises the implied covenant will not defeat those terms; [footnote omitted] and (2) when there is no such language the franchisor may not capitalize upon the franchisee's business in bad faith. [Footnote omitted]"

Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp., 139 F.3d 1396, 1403 (11th Cir. 1998). Thus, it held that where a franchise agreement did not reserve to the franchisor the right to establish competing outlets itself near a franchised outlet, an issue of fact was presented as to whether the franchisor's placement of such an outlet violated the implied covenant of good faith. Here, State Farm made no reservation of the right to sell into Agents' territories. Carvel Corp. v. James Baker, 79 F. Supp.2d 53 (D. Conn. 1997), discussed earlier, recognized that when Carvel sold ice cream through supermarkets, it infringed the territories that the franchisees claimed as their own.

One form of Carvel agreement, the "Type B" agreement, *specifically reserved to Carvel the right to pursue alternative channels of distributions*. Nonetheless, the Court denied summary judgment to Carvel:

While Carvel has the discretion to institute an alternative distribution program, the defendants could have reasonably expected, at the time of contracting, that Carvel would not use such a system to compete directly against them, especially since distribution to supermarkets and other retail outlets was not a practice that existed prior to the agreement. While the [franchisees] are not entitled to abrogate Carvel's right to "sell or license to sell products under Carvel trademarks...." the [franchisees] are entitled to expect that Carvel will not act to destroy the right of

the [franchisees] to enjoy the fruits of the contract.

Id. at 66.

The same considerations apply here as in Carvel. The Agents have a legitimate expectation that State Farm would not sell directly into their territories, based upon, among other things, the absence of Internet commerce at the time the agreements were made and the absence of any reservation of rights in the agreements. In Foodmaker v. Quershi, Bus. Franchise Guide (CCH) ¶ 11,780 (Sup. Ct. Ca., San Diego Co. 1999), the court rejected a franchisor's contention that a franchise agreement's statement that the franchise was "non exclusive" and "does not in any way grant to or confer upon the Franchisee any proprietary rights or goodwill rights to the Marks or any . . . area, market or territory" entitled the franchisor to place additional franchisees nearby as a matter of law:

However, the express denial of territorial interest to the franchisee herein does not necessarily imply a right to Foodmaker to open franchises at will regardless of their effect on the operations of franchisees. Though the franchisees herein are not entitled to exclusive territory, they are entitled to expect that Foodmaker will not act to impair or destroy their franchisee interest.

Significantly, in all of the foregoing good faith cases, the franchise agreements contained either language expressly limiting the franchisee's rights or granting the franchisor rights to develop. Here, there is no such language; thus the Agents' rights under the implied covenant are even stronger; State Farm's direct sales into the territory encroach unlawfully into their territories. The Agents are entitled to a declaration to that effect and an injunction preventing State Farm from continuing its encroachment.

CONCLUSION

For all of the reasons set forth above, NASFA's motion for summary judgment should be granted and State Farm's should be denied.

RESPECTFULLY SUBMITTED,

DATED: June ____, 2004.

NEUBERGER, QUINN, GIELEN,
RUBIN & GIBBER, P.A.

By _____

Thomas M. Wood, IV

D.C. Bar No. 426879

Allan Hillman

One South Street, 27th Floor

Baltimore, MD 21202-3282

(410) 332-8550

(410) 332-8594 FAX

-and-

W. Michael Garner (MN ID#0274914)

Jennifer L. Gehrig (MN ID#285596)

DADY & GARNER, P.A.

4000 IDS Center, 80 South Eighth Street

Minneapolis, MN 55402-2204

(612) 359-9000

(612) 359-3507 FAX

ATTORNEYS FOR PLAINTIFF