SUPERIOR COURT OF THE DISTRICT OF COLUMBIA
CIVIL DIVISION

NATIONAL ASSOCIATION OF STATE FARM AGENTS, INC.	:	Civil Action No. 02CA004089
Plaintiff,	:	Calendar 7
v.	:	
STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY, et al.	:	
Defendants.	:	

FINDINGS OF FACT AND CONCLUSIONS OF LAW

This cause seeking declaratory relief came on for a bench trial on July 26, 2005, proceeded from day to day thereafter with the taking of evidence through July 29 and concluded with the hearing of closing arguments on August 1. The trial commenced with the plaintiff charging that six of defendants' employment practices violated their employment contracts. One of those charges, involving direct sales of insurance by defendants over the Internet, was voluntarily dismissed without prejudice during the course of trial on July 29.

The trial sequence of the presentation of the evidence was somewhat unusual. Each of the employment practices involved was treated as a minitrial, with each side presenting its evidence on a particular practice before taking up the next subject matter. This did not mean that the subject matters were entirely distinct; there was some overlap as will be seen. Instead, the rationale for the trial sequence was to afford the court better comprehension of each subject matter as the trial proceeded. The same sequential presentation will be

followed in these Findings and Conclusions, although some of the implicated practices (particularly the first two) are significantly interrelated.

The court, of course, has had the opportunity to see and hear the witnesses, and the assessments on credibility have assisted in shaping these findings.

Accordingly, on this 16th day of December 2005, the following Findings of Fact and Conclusions of Law are hereby published pursuant to Rule 52(a), Super. Ct. Civ. R.*

* References to the trial transcript are cited by witness, date and "Tr." page. (*e.g.*, Smith, 7/26, Tr. ___.) The Joint Pretrial Statement and Supplemental Joint Pretrial Statement are cited "JPTS" and Supp. JPTS, respectively. Plaintiff's exhibits are cited "PX," defendants' as "DX" and court exhibits as "CX." Multipage documents are cited to exhibit number and page or bates number with prefatory party initials and zeroes omitted. Multi-document exhibits are cited to exhibit number and bates number where necessary. Findings and conclusions will be numbered sequentially throughout, without regard to the employment practice involved.

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Findings of Fact

I. Background

A. *Parties*

1. Plaintiff, National Association of State Farm Agents ("NASFA" or "plaintiff") "is a District of Columbia corporation composed of State Farm Agents in at least 47 states and the District of Columbia. NASFA's principal place of business is Baltimore, Maryland." (JPTS Stip. 1.)

2. "NASFA's members are active or retired State Farm agents." (*Id.* at Stip. 2.)

3. "Defendants State Farm Mutual Automobile Insurance Company, State Farm Fire and Casualty Company and State Farm Life Insurance Company are all corporations formed under Illinois law with their principal place of business in Bloomington, Illinois. [Defendant] State Farm General Insurance Company is a California Company with its principal place of business in California." (*Id.* at Stip. 3.) (Defendants are collectively referred to as "State Farm" or "the Company" as well as "defendants.")

4. "State Farm provides various insurance and financial services products to the public." (*Id.* at Stip. 4.)

5. "State Farm is the largest provider of auto and homeowner's insurance in the United States and makes insurance available to residents throughout the country and in three provinces in Canada." (*Id.* at Stip. 5.)

6. "State Farm provides insurance to the public principally through its network of approximately 16,000 independent contractor Agents located throughout the states and provinces in which it does business." (*Id.* at Stip. 6.)

7. "Although State Farm sells many lines of insurance and financial products to the public, its core business is auto and fire (homeowner) insurance. Consequently, Agents' compensation is dominated by commissions on auto and fire insurance." (*Id.* at Stip. 7.)

B. *The Agent's Agreements*

8. "There are currently over 50 different forms of agreements in effect between State Farm and its Agents (each an Agent's Agreement). With rare exceptions, virtually all Agents operate under one of three basic forms of the Agent Agreement known as the 'AA3,' the 'AA4,' and the 'AA97'." (*Id.* at Stip. 8.)

9. "The AA3 Agreement first came into effect in 1977; the AA4 first came into effect in 1982; and the AA97 first came into effect in 1996." (*Id.* at Stip. 9.) "These three agreements are substantially identical." (*Id.* at Stip. 10.)

10. "As each new agreement went into effect, existing agents had the option to elect to become agents pursuant to the new agreement; new agents could sign up only on the new forms of agreement." (*Id.* at Stip. 10.) "When the AA97 was first introduced, Agents operating on earlier forms of the Agent's Agreement were given the choice of either keeping their then-current agreement, or signing the AA97." (*Id.* at Stip. 11.) Thus, "[a]ll Agents who have joined State Farm since 1997 operate under the AA97 Agreement." (*Id.* at Stip. 12.) "At present, approximately 50 per cent of all active Agents operate under the AA97 Agreement." (*Id.* at Stip. 13.)

11. The commissions vary under the contracts. "Under the AA3 Agreement and the AA4 Agreement, Agents receive a 10% commission on auto policy premiums paid to State Farm, and a 15% commission on fire [or homeowner] policy premiums." (*Id.* at Stip. 14.) "Under the AA97 Agreement, Agents receive an 8% commission on auto policy premiums

paid to State Farm, and a 10% commission on fire policy premiums." (*Id.* at Stip. 15.) "These commission rates apply to 'personally produced' business, that is, to policies for which the Agent . . . has solicited the initial application." (*Id.* at Stip. 16.)

12. "Agents sometimes also receive 'assigned business,' [or 'block assignments'] that is, customers referred to the Agent by State Farm, consisting primarily of customers formerly assigned to another Agent who has retired or passed away. The commission rates applicable to assigned business vary by contract and by product type." (*Id.* at Stip. 17.) The commission rates on such assigned business are lower than on "personally produced" business. (DX 75.)

C. *The Issues Presented*

13. The five remaining employment practices challenged by NASFA as violative of the Agent's Agreements are: (1) The "Partner Agent Program;" (2) the "Select Agent Program;" (3) restrictions on the sale of new insurance policies; (4) refusal to consent to agents brokering insurance for other carriers during the time new business was restricted; and (5) mandating attendance by agents at annual meetings on ethical and legal requirements. The issues will be considered *seriatim*.

II. The Partner Agent Program

A. *Entry Into the Securities Business*

14. For over 65 years, the Glass-Steagall (Banking) Act of 1933, Pub. L. No. 73-66, ch. 89, 48 Stat.162 (1933), imposed reciprocal prohibitions upon the insurance and investment banking businesses forbidding each from engaging in the business of the other.

15. During this period of enforced separation, "State Farm . . . [was] an insurance company[.]" (JPTS Stip. 18.) This separation is reflected in the Agent's Agreement in

"SECTION I – MUTUAL CONDITIONS AND DUTIES," which describes the scope and nature of an agent's duties in paragraph A:

> 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.

(PX3, AA97 Agreement). The prior contracts are substantially identical. (PX 1, 2.) State Farm concedes that the "Agent's Agreement addresses only the sale of insurance; it does not refer to mutual funds or other securities, nor does it provide that Agents will solicit applications for mutual funds or other securities." (Defs.' Prop. Finds. and Concs. ¶ 26 at 10.) At all relevant times State Farm was aware that its agents had no contractual obligation to sell securities. It is fair to infer that agents in general were aware that their contracts were limited to insurance (*See e.g.,* Knapp, 7/29, Tr. 508:8-509:2) and that their expectations were in accordance with that understanding prior to the Partner Agent Program.

16. The names of the State Farm companies who signed the Agreements indicate their sole commitment to "insurance."

17. This enforced separation was repealed in 1999 by the Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999), 12 U.S.C. § § 1811-1835a (2001), and "federal law for the first time permitted financial services companies to provide insurance product to the public. By the same stroke, insurance companies were given broader access to the financial markets." (*Id.* at Stip. 18.)

18. "Faced with competition from increasingly full-service companies, State Farm made the strategic choice to begin providing a broader array of financial services products."

(*Id.* at Stip. 19.) Early efforts by State Farm in the banking and investment fields included establishment of banks and, in its first securities-based product, the marketing of variable life and annuity products in 1998. (CX 2-3, bates 1265; Wright, 7/28, Tr. 315:22-316:1; Sikora, 7/27, Tr. 53:20-25.)

19. State Farm recognized that "State Farm Mutual Funds are not insurance products" in a document entitled "Program to Market Mutual Funds to All Customers" which was presented to its agents. (CX 2-3, bates 1260, 1316.) To underwrite and distribute securities products, State Farm formed State Farm VP Management Corp. ("VP Management"). (CX 2-3, bates 1260.) To sell the securities, State Farm, as we shall see, looked to its insurance agents who were not in privity with VP Management. (PX 1, 2, 3.)

20. In 2000 "State Farm decided to provide ... mutual funds" (JPTS, Stip. 20; CX 2-3, bates 1312), its "second security product offering[.]" (CX 2-2, bates 783.)

21. But the sale of securities presented problems for the Company. "In particular, federal and state securities laws only permit registered securities representatives to solicit mutual fund business from customers." (JPTS Stip. 21.) "Registered representatives are required by federal securities laws to hold a 'Series 6' license; state securities laws require the agents to hold a 'Series 63' license. Because State Farm had not traditionally provided securities to the public, few Agents possessed the requisite licenses." (*Id.* at Stip. 22.) State Farm, therefore, "encouraged all of its Agents to acquire Series 6 and 63 licenses." (*Id.* at Stip. 23.) "At present 60% of State Farm Agents are licensed to" sell securities. (*Id.* at Stip. 24.)

B. *State Farm's Full Commitment to the Securities Market*

22. At its National Convention in 2000 at Dallas, Texas, State Farm stated its full commitment to the sale of securities. The theme of "Grow or Go" was announced. (Killingsworth, 7/26, Tr. 29:6-9.) John Killingsworth, then an Agency Field Executive for State Farm was in attendance, as were agents who worked under his jurisdiction. He testified that they heard an "ultimatum that "they" were being told that if they didn't do certain things, grow, then they would be forced to go." (*Id.* at Tr. 31:14-18.) The primary subject of the theme was the "securities issue[.]" (*Id.* at 31:19-22.) He testified that "grow or go" had a "very negative effect on his agents and they felt at risk[.]" (*Id.* at 30:10-13; 31:13-14.) Killingsworth's testimony on Dallas is consistent with and corroborated in part by a State Farm document that, although published the following year on the then forthcoming Partner Agent Program, makes reference to the Dallas Convention in discussing the "[s]trategy" for inducing "all non-registered agents" to become registered: "Restate 2000 National Convention statement on corporate direction of becoming a leader in [the] financial services arena and intent to market to all customers." (PX 7 at 1, bates 1113.) "All customers" would naturally include customers whose State Farm representatives were not registered to sell securities.[1] No contrary evidence was offered as to the 2000 convention, including the grow or go theme, and I find the foregoing account accurate.

23. We can surmise that the first substantial effort to recruit qualified securities agents from State Farm's insurance agents took place no later than 2000. Besides the earlier sale

[1] Later, in 2001, when the Partner Agent Program was announced, Killingsworth discussed it with his superior, David Dannewitz, who replied, "Urgent that State Farm move forward into the securities products; that agents that did not cooperate and were not involved in that process had to grow or go." (Killingsworth, 7/26, Tr. 28: 15-29: 2.) His superior was not called to dispute this.

of variable products, a pilot offering of retail mutual funds occurred in January 2001, and countrywide marketing began on March 15, 2001. (CX 2-3, bates 1271.) Approximately 56% of all agents then became registered to sell securities. (PX 4.) Agents who became registered entered into a new contract with State Farm's separate entity, VP Management (Finding 19), who is not a defendant.[2] However, as of June 22, 2001, the marketing of mutuals was disappointing. "[O]nly 2,623 or 27.9% of our 9,419 registered agents have sold at least one account." (CX 2-2, bates 784.)

24a. The problem, said Donald Sikora, State Farm's Executive Administrative Assistant who fathered the Partner Agent Program and was brought in, in February 2001 to administer it (Sikora, 7/26, Tr. 224:3-16), stemmed from the fact that

> Roughly 44 per cent of all State Farm agents have chosen for one reason or another, not to become registered representative agents. Thus, a large percentage of our customers do not have the opportunity to learn about the securities products we have available to meet their needs through their local State Farm agent. *This defeats the Company goal to become a leader in the financial services industry.*
>
> It is the goal of the Company to encourage as many agents as possible to become a registered representative *and* to actively market securities products to meet the needs of our customers.

(CX 2-2, bates 784; first emphasis supplied.) (See also PX 7.) [3]

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[2] AA97 agents entered into a slightly different securities contract than AA3/4 agents. The contracts came to light after the case was under advisement, and note was taken of defense counsel's reference to, and incidental testimony about, a "registered representative agreement" that was not in the record. (7/26, Tr. 209:12-210:16.) The agreements were then requested. The AA97 contract is marked CX 5-1 and the AA3/4 contract is CX 5-2. Both contracts are entitled "State Farm Securities Products Agreement."

[3] This important document, entitled "A Program to Market Mutual Funds to All Customers" was sent on June 27, 2001, by Sikora to all of the 13 Senior Vice Presidents, each of whom has several Vice President Agencies under him/her and heads one of the 13 zones into which the country is divided. (Letter dated August 2, 2005, of defense counsel, attached to the Order Supplementing Trial Exhibits, dated August 3, 2005; Wright, 7/26, Tr. 179:14-18; Whitney, 7/27, Tr. 190:1-12; DX 73.) This document and most others that were made court exhibits were not disclosed in discovery but were made available in response to court request during the course of trial. (See 7/27, Tr. 36: 9-38:16, 51: 10-17; Finding 42, *infra*.)

b. To the extent that agents declined registration, "the Company was faced with the question of how to reach customers serviced by agents who chose not to obtain licenses and become registered representatives." (JPTS Stip. 25.)

25. The Sikora solution to the "question," adopted by State Farm, embodied two major tactics to access the customer of the nonregistered State Farm agent, the "good neighbor" gateway through which passage to the customer was best made but who was not permitted by law to discuss securities with customers. The first was the "Second Look": "To provide non-registered agents a **Second Look** at the advantages of being a registered agent – and an opportunity to reverse their original decision not to become registered." (CX 2-2, bates 785; bold in original.) If the Second Look proved unavailing and the agent persisted in not being registered to sell securities, the default tactic to access the nonregistered agent's customers came into play, the Partner Agent Program. (CX 2-3, bates 1261: "The program is designed to encourage all Agents to be registered and actively involved in securities products, but it also creates a system for marketing mutual funds to customers of Agents who choose not to become registered representatives.")

C. *The Substance of the Partner Agent Program*

26a. The general outlines of the Partner Agent Program ("PAP") are again best explained in Sikora's words to the zone vice presidents.[4]

[4] Several words and an acronym require explanation. "Select agent" refers to an agent who has qualified for the status and benefits of a special bonus and award program established by State Farm in 1998. (Finding 31, *infra*.) (That program presents the second issue in this case.) The "call center" is a 24/7 telephone answering service that State Farm provides for customers and prospective customers. (JPTS Stip. 34-36.) "AFE" refers to an Agency Field Executive who heads one of approximately 500 Agency Field Offices (AFOs) located throughout State Farms 13 zones and who are subordinate to the zone officials. (DX 73.) Each AFE supervises 30-40 agents. (Wright, 7/26, Tr. 179:13-180:18, DX 73).

This program provides options for non-registered agents to stay involved in marketing mutual funds through the nomination of a partner agent (a registered Select agent approved by the AFE). This partner agent will handle referrals from the non-registered agent; referrals from call center or Internet contacts *and* market mutual funds to customers of the non-registered agent. For those agents choosing to not become registered, the Partner Agent Program provides them the chance to be proactive and still have a role in securities products.

- The non-registered agent nominates an agent of his or her choice to assist their mutual funds needs
- The non-registered agent will be able to inform their customers that they selected their partner agent
- The non-registered agent will know there is only one agent, and who that agent is, that will be assigned mutual fund accounts from their existing households
- Assurance from their partner agent that no other lines of business will be solicited from customers referred for mutual funds

If a non-registered agent decides to NOT become registered and NOT nominate a Partner Agent the AFE will select one for him or her.

(CX 2-2, bates 785, emphasis in original; CX 2-3, bates 1302.)

b. Accordingly, I find that PAP imposed a "partner" relationship upon the nonregistered agent whether the agent wished it or not and, hence, was involuntary in that respect. Stated otherwise, although agents were free not to choose a partner, they were not free to be without one and, hence, were not free to remain outside the program and stick to insurance only.

27. The PAP procedure contemplated that agents who elected to name their partners would sign a combination document, the Letter of Understanding/Nomination Form. (PX 10.) The Letter contained the commitment by the nonregistered agent to refer ("you refer") to the agent's partner (who was nominated on the reverse side) any customer or prospective customer who requests, inquires about or appears to need information about

"products you don't handle." (*Ibid.*)[5] The name of the partner desired by the nonregistered agent would be filled in on the nomination side of the document, which was to be signed by the nonregistered agent and witnessed by the AFE who was instructed to review the document at the outset with all agents, registered or not: (PX 10; Sikora, 7/27, Tr. 50:8-10.) "Agents may nominate a partner once a year unless the partner agent terminates." (PX 8, bates 1333.)

28a. A nonregistered agent who elected to "partner" did not have the ultimate choice of naming the partner. Instead, the agent was allowed to "nominate" a partner subject to State Farm's approval, exercised through the agent's AFE. (CX 2-3, bates 1257; CX 2-2, bates 786; PX 8, bates 1334, "AFE Role.") AFE approval required that the nominated partner be: (1) a registered, "Select" agent (Finding 31, *infra*); (2) "active" in securities, having sold "both variable products and mutual funds;" (3) willing to provide the same service as for his/her partner's customers and (4) agree not to actively solicit the partner's customers. (CX 2-3, bates 1257; CX 2-2, bates 786; PX8).

b. Sikora's testimony, that nonregistered agents could refer customers to registered agents who were not Select agents (7/27, Tr. 15:16-22), is discounted. Aside from his unpersuasiveness in general (*see, e.g.,* Finding 42, *infra*), his testimony was unconvincing because it was contrary to *all* State Farm literature on PAP, most of which he authored. Further, he responded with a contradictory answer to the question, why AFE approval was required "if the non-registered agents could refer . . . customers to anybody they wanted [?]" He answered, such approval allowed entry of the partner "information on the registered

[5] Thus, the Letter was made applicable to unidentified products yet to come on line. (PX 9, Frequently Asked Questions, Question 17; Sikora, 7/27, Tr. 33:3-24.)

reference database so that if a [customer] contact was made to the company, we would have an approved referral agent available." (*Id.* at Tr. 15:23-16:9.) But if AFE approval could be circumvented, as Sikora testified, there would not be an *approved* referral agent available in the database. Moreover, there would be no reason to promulgate multiple, AFE approval guidelines, some of which are discretionary, if his approval was perfunctory as Sikora's testimony suggests.

29. PAP was presented to the agents in September and October 2001. (Sikora, 7/26, 228:23-229:4, PX 8.) About 79% of the nonregistered agents nominated a partner agent. (Sikora, 7/26, Tr. 234:14-18.) PAP was presented to the public on December 1, 2001. (CX 2-2, bates 786.)

30. The parties have stipulated that "Agents were . . . free to refuse to nominate partners." (JPTS Stip. 28.) I consider that stipulation binding, of course, on this important aspect of the case. Nevertheless, the testimony of Steven Knapp, NASFA's president elect, on his reason for selecting a partner captures the realities of the choice. When asked if he selected a "partner agent" he replied, "knowing that one would be appointed for me if I didn't, yes, I did." (7/26, Tr. 102:15-16.) This rationalization, together with the deprivation of Select-Agent-Program benefits (Finding 31, *infra*) and the prospect of direct mail marketing (Findings 33a, 34, 35, *infra*), may well account for the high percentage of nominations made by nonregistered agents. Still, State Farm made 933 partner appointments for agents who declined to nominate. (CX 1, bates 901.)[6]

[6] We do not know how many AFE appointments were made as a result of AFE disapproval of an agent's choice. (See footnote 9, *infra*.)

D. *PAP Was Boosted by the Select Agent Program*

31. PAP's appeal was enhanced by the Select Agent Program, an incentive program whose substantial rewards were conditioned, among other things, upon the agent being registered or licensed to sell "all products [including securities] and services OR agree[ing] to refer clients to another licensed or certified State Farm agent[.]" (Finding 80(1)d, *infra*; emphasis in original.) Nonregistered agents who declined agreement to refer were thus denied this program's benefits. The two programs were further interlocked by PAP's requirement that the partner agent receiving referrals be a Select agent. (Finding 28a) (The full findings on the Select Agent Program, the next issue in this case, commences on page 43.)

E. *The Effect of Direct Marketing on Agents*

32. President elect Knapp of Belleville, Illinois, a State Farm agent for 23 years, gave up his AA4 contract with its higher commissions for an AA97 contract at State Farm's urgings. (7/29, Tr. 490:7-22, 491:25-493:25; Finding 10.) He declined seeking securities registration because the sale of securities was not in his interest in view of the characteristics of his market and the relative profitability of insurance over mutual funds. (7/26, Tr. 101:11-102:13.) One of his greatest concerns, which I find was typical of nonregistered agents, was the "direct mail" campaign originally contemplated by State Farm.

33. Since the purpose of PAP was to access the nonregistered agent's customers, it was planned at the outset to market those customers, *inter alia*, by direct mail involving the registered partners, including those who were appointed for agents who declined to nominate partner agents:

a. State Farm's "Partner Agent Program Procedures" provided, "The partner agent will become involved with the marketing of retail Mutual Funds to customers in *their* book of business." (CX 2, bates 1333; emphasis added.) To the same effect is the "Power point" presentation. (CX 2-3, bates 1259, 1302.) Since the book of the registered agent was irrelevant, the statement must have been intended to apply only to the "book of business" of the nonregistered agent who elected to partner (the "participating agent") and whose book would disclose the identities and addresses of the customers who were to receive the mail.

b. Nor was the agent who declined to nominate a partner agent (the "nonparticipating agent") exempted from direct mail marketing: "Company will select [a] registered agent to handle marketing and referrals if non-registered agent elects not to nominate a registered agent." (PX 6, "Contacting Policyholder of Non-Securities Registered Agents," last sentence.) The only source of the identities and addresses of the nonparticipating agent's customers for direct mailing purposes would be State Farm.[7]

34. The prospect of mail directed to their customers by another agent stirred great anxiety among nonregistered agents. (Knapp, 7/26 Tr. 98:19-24.) Wright confirmed this agent concern. (Wright, 7/26, Tr. 185:17-186:6.) Again, I find Knapp typical. Though "friendly competitors," agents are "nevertheless competitors among ourselves. One of the most sacred things of State Farm, we do not try to raid the business of other agents." (Knapp, 7/26 Tr. 96: 14-18.) Indeed, all of the Agent's Agreements provide (§ IH), "You will respect the rights and interests of your fellow agents in policies credited to their accounts by

[7] Such customer information is the sole property of State Farm. (§ ID, Agent's Agreement, PX 1, 2, 3.) State Farm denied providing such information.

refraining from raiding or otherwise diverting policies from their accounts to your account." The necessity for a contractual provision evidences that "raiding" is a general concern. Nevertheless, as PAP contemplated, Knapp's AFE explained to her agents that the "partner agent, whoever that was, would be provided with the name, address and phone numbers of my clients, and then he would be able to send letters, direct mail letters, and make phone call follow-ups to those persons." (Knapp, 7/26, Tr. 98:3-11.)[8]

35. Knapp's fear of direct mail was confirmed by David Swift, a past president of NASFA (7/26, Tr. 142:22-23.)[9] His AFE in San Antonio, Texas, told his agents that, in addition to national advertising that would "hurt" nonregistered agents "because people would know that you didn't have a license," State Farm was "going to then send out letters to your policyholders in the name of your partner agent to solicit your business." (7/26, Tr. 143:11-18.) Swift was concerned that "my policyholders receiving letters saying that I didn't qualify to sell mutual funds made me look bad." (*Id.* at 144: 22-25.) In so stating, the AFE was simply echoing State Farm's written policy:

- Emphasize to all agents that advertising and public relations efforts will focus on driving interested customers to agents. **Non-registered agents could experience negative reactions from current customers as well as the general public.**
- Develop ... AFE communication tool for discussion with all non-registered agents.

...

[8] Agents were told that "the company has the ability" to create a letter that "would have my signature on it and it would be encouraging my customers to go to another agent to buy Mutual fund products." (*Id.* at 98:25-100:1.)

[9] Swift had a partner appointed for him when his choice of a registered agent from another district three miles away was rejected. (7/26, Tr. 151:7-9, 153:18-21, 158:24-159:7.) He knows of other agents who made similar choices that were rejected. (*Id.* at 160: 16-22.)

- Review with agent, company supported direct mail campaign for registered agents and heavy national advertising and public relations effort. All State Farm customers will know about mutual funds.
- It would be inappropriate to ignore nearly half of our current customers.

(PX 7; bold letters in original.) State Farm thus intended to stir this anxiety in the nonregistered agents. No evidence was presented that AFEs across the country failed to follow company policy by pressing the same points, as did the AFEs of Knapp and Swift.

36. I find, accordingly, that the presentation of PAP in September and October 2001 by AFEs to agents conformed in all material respects to the presentation made to Knapp and Swift by their AFEs. I have not relied upon the testimony of nonregistered agent Gabriel Nazziola on this branch of the case because he deals with his negative reactions to PAP rather than the presentation of the program by his AFE. (Nazziola, 7/26 Tr. 163:16-165:1.) Nor did I rely on Killingsworth's testimony, but not because of defendant's attack on his credibility. On the contrary, I found him persuasive. I discounted his testimony on this issue because he also did not deal with the manner of his presentation (Killingsworth, 7/26, Tr. 25:5-19) and because the registered agents he dealt with were "new trainee agents" (*Id.* at 23:13-17, 25:5-8), an atypical situation.[10]

37. State Farm's literature attempted to assure the nonregistered agent against

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[10] Defendant argues that the testimony on PAP of Killingsworth (who was fired on October 29, 2001 and is suing State Farm (7/26, Tr. 54:9-10)) is "incredible" since he was physically barred from his office on August 17, 2001, when he was placed on administrative leave, and PAP was not presented to the agents until September, 2001. While presentation to the agents did not occur until September and October, the PAP program was circulated internally before. A four page "Program to Market Mutual Funds to All Customers" was sent to Vice President Agencies on June 27 (CX 2-2, bates 783-786). Presentation kits for Vice Presidents (Zones) and for AFEs were sent to each Vice President Agency on July 29. (CX 2-3, bates 1256-1324.) The Vice Presidents Agencies were to make their presentation to all AFEs between July 31 and August 31, 2001. (CX 2-2, bates 835.) Moreover, although sent home, Killingsworth was given work to do (7/26, Tr. 51:18-21.) He was being paid until October 29, 2001. (*Id.* at 52:12-16.) He had an office at home, "was completely hooked up on e-mail and was responsible for keeping current on issues of e-mail and responding [to his superior] on issues." (*Id.* at 53:5-8.)

raiding. The Partner Agent Program Procedures twice admonishes against this practice (PX 8, bates 1333, 1334), and the Letter of Understanding iterates this admonition. (PX 10.) State Farm went further by providing in "Frequently Asked Questions" that "local agency leadership is charged with managing any recurring activities where this [improper solicitation by the partner agent] appears to be occurring," although such documents were marked "For Agency Leadership Use Only." (PX 9, Question 6.) But there was a caveat to these assurances. The same State Farm literature acknowledged that a customer referred to another agent might prefer that agent over the first for all of his/her business and provided, "Both agents [the referring agent and the partner agent] must give due respect to the customer's preference for which agent should service that customer's business." (PX 10, Letter of Understanding; see also PX 9, Frequently Asked Questions, Question 6: "Sensitivity to customer choice must always remain the primary determinant in who services their insurance needs.") Thus, there was a risk of agents losing clients. There were subtle means by which an agent to whom a customer is referred may stimulate the customer to seek transfer. (Knapp, 7/26, Tr. 105:9-106:16.)[11] Such transfers have occurred. (Knapp, 7/26 Tr. 106:16-108:9; Killingsworth, 7/26, Tr. 26:10-28: 10.) Accordingly, I cannot find that significant raiding did or did not occur.

F. *The Restriction of Direct Mail*

38. The direct mailing campaign, so feared by nonregistered agents, was pilot-tested in May 2003. No direct mailing of substance had yet been undertaken. The test was

[11] The Agent's Agreement (§ I H) gives State Farm the power to transfer an account from one to another agent after notice to the original agent "when the policyholder makes a bona fide request in writing." All contracts have this provision. (PX 1, 2, 3.)

reported by Sikora on August 1, 2003. (PX 17.) Sikora concluded that the test "appears to suggest customers want to deal with their current agent rather than another agent, even if their current agent offers to set up a referral." (*Ibid.)*

39. Relying upon its witnesses, State Farm contends that direct marketing did not occur "because State Farm was responsive to Agents' concerns." (Defs.' Prop. Finding ¶ 57.) The record, however, is to the contrary. The direct-mailing-test report states, "*Because of these [test] results*, there are no plans to *expand* a direct mail marketing effort involving non-registered agents." (PX 17; emphasis added.) I find that, although the concerns of the nonregistered agents were considered, the primary reason for not expanding direct marketing to customers was stated in Sikora's communication of August 1, 2003. I also find, based upon the same Sikora letter, there was a limited direct mail effort by State Farm independent of the pilot test. The agents were never told direct mail was "not going forward." (Sikora, 7/27, Tr. 31:3-6; Wright, 7/26, Tr. 217:6-219:6.)

G. *Agent Reaction to Direct-Mail Nonimplementation*

40. Suit was filed on August 9, 2002, shortly less than a year following presentation of PAP to the agents. In the meantime, no direct marketing of substance occurred. Defendant took the deposition of plaintiff's prospective witnesses and inquired of their perceptions of PAP's implementation. Knapp said "nothing ever happened." (7/26, Tr. 119:15-18.) Swift denied that the program had "gone away" as of the date of his April 2002 deposition (*Id.* at Tr. 155:6-8) but was confronted by his deposition testimony that "since [the] lawsuit" the program "[a]s of now, it's a non-issue." (*Id.* at Tr. 155:24-156:5); and Nazziola, who retired on December 31, 2002 (a year after PAP was operational), bragged in deposition that the program "stopped" because the "blast that . . .we gave against it

immediately in print was enough that they took a step back [.] " (*Id.* at Tr. 167:20-168:13). Further on the issue of mootness, defendant introduced plaintiff's newsletter of July 8, 2003, stating, "although the Partnering Program may not be completely dead, it is clearly in a very deep coma and is not likely to ever be revived." (DX 55.) This evidence, I find, was addressed solely to nonimplementation of the direct mailing feature of the original program (so feared by unregistered agents) and to no other, such as appointment of a partner agent or referral of customers.

H. *The Registered Representative Referral Database*

41. The Registered Representative Referral Database ("3RD") was, according to State Farm, initiated in August 2003, a year after this litigation attacking PAP commenced. (Supp. JPTS ¶ 4 at 4.) State Farm's pretrial version of the 3RD differed from that depicted by the evidence. At pretrial State Farm claimed:

> In place of the . . . [PAP], State Farm has created a . . . [3RD]. The database is used only when a prospective mutual fund purchaser serviced by a non-registered Agent calls State Farm directly and expresses an interest in purchasing mutual funds from the Company . . . State Farm refers the prospective purchaser to one of the registered Agents listed in its database on a rotating basis.

(JPTS ¶ 9 at 13). A Frequently Asked Question supports the rotation position in answer to the question "What happens if I don't participate?": "If a non-registered agent does not submit a selection, the Securities Products department will handle inquiries on a rotation basis." (PX 14, Question 3.)[12] The evidence, however, was otherwise as to its understanding within State Farm and amongst the agents. Further, 3RD never took the place of PAP.

[12] As already stated, Frequently Asked Questions were labeled "For Agency Leadership Use Only." (*e.g.*, PX 9, 14.)

42. Sikora, who also had responsibility for 3RD (7/26, 237:9-14), testified that while the agents were never informed in writing that the 3RD replaced PAP, "the AFEs were instructed to tell the agents that the PAP program had been replaced and was no longer in existence." (7/27, Tr. 51:25-52:9.) The court directed State Farm to produce all documents so stating. (*Id.* at 52:10-17.) That direction supplemented a prior order to produce "any document that was addressed to the AFE on instructions as to what information to impart to the agents" in regard to both PAP and 3RD. (Tr. 7/27, 36:9-38: 16.)[13] None of the documents produced on 3RD instructed AFEs to inform agents that PAP was replaced or ended. In fact, no document even mentioned or advised anyone inside the State Farm organization that PAP was ended. I find the agents were never told PAP was ended and that PAP was never terminated or replaced.

43. When Sikora was asked the "substantive difference between" PAP and the 3RD, he replied:

> There really is none, Your Honor. The non-registered agent is still selecting another registered agent, who would be in a position to accept referrals. And so rather than referring to it as a partner agent, anything like that, we decided let's call it what it is, and that's going to be a referral agent. And that referral agent would receive referrals directly from a non-registered agent or possibly if applications were submitted directly to corporate and it was of a customer currently assigned to that non-registered agent, we would go to that database to find out who that referral agent is.

(7/26, Tr. 244:1-16.) Asked if there was any difference other than that titular difference, Sikora responded:

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[13] Documents produced during trial were marked CX 2, most of which documents related to PAP and had been produced earlier in discovery. After trial, and upon the court noting that CX 2 documents alluded to other, unproduced documents, the court requested supplementation of the record. Documents then produced that related to PAP were marked CX 2-2 and CX 2-3, and documents relating to 3RD were marked CX 3. (Order Supplementing Trial Exhibits, August 3, 2005.)

> The significant difference was that under the new program, the RRRD Program, if a non-registered agent chose not to participate there would be no selection for him as there was durin[g] the partner program.

(*Id.* at 244:17-22.) I find the principal *intent* of 3RD was to modify PAP by abolishing involuntary selection by State Farm of a "referral agent" for nonparticipating agents. The agents were not informed of any change.

44. Again the evidence shows, and I find, the situation in the field was both different from and confusing as compared to the 3RD plan:

a. In the first document initiating the 3RD on August 6, 2003, from Sikora to all vice presidents, it was stated in bold letters, **"The normal assignment process will be used for customers request[s] when the non-registered agents do not select an agent."** (CX 3, bates 4721; emphasis in original.) Since PX 14 (specifying "rotation" selection in answer to question 3 of Frequently Asked Questions) was not "updated" or promulgated until August 20, 2003, (PX 14, bates 4193, Sikora, 7/27, Tr. 20:23-21:1), the "normal assignment process," which Sikora mentioned two weeks *earlier* on August 6, must have been State Farm selection by the AFE under PAP.

b. The document entitled "Registered Representative Referral Database Program Procedures" (PX 13) substantially mimicked Partner Agent Procedures (PX 8) but purged it of all "partner" language, replacing it with the locution "referral agent." The document was created on August 20, 2000, as shown by its "updated" publication date. (PX 13, bates 4192.) It states that, in the case of a nonparticipating agent, "The assignment will be made in accordance with the Policy Assignment Program." (PX 13, bates 4191.) The "Policy Assignment Program," however, was never explained.

c. On August 21, 2003, the day *after* question 3 was updated, Sikora e-mailed the Superintendent Agency Services for the California Zone to engage its help in updating the 3RD database. He said, among other things, "If a non-registered agent chooses not to select a registered agent, that agent should be made aware that [a] local registered agent will be assigned for securities product sales and ongoing services." (CX 3, bates 4717-18.) Substantially the same statement is made in the document Sikora attached to his e-mail, which attachment he instructed the Superintendent to forward to each of his AFEs. (*Id.* at 4719.) Again, no mention is made of rotation, although that matter would have been of interest to nonregistered agents and merited passing on to them. Presumably, the same communication was sent to all the other zones.

45. The presence of PAP persisted notwithstanding its purported replacement by 3RD:

a. The documents presenting 3RD (PX 13 and PX 14) transparently tracked the PAP documents (*e.g.,* PX 8 and PX 9) except (i) "partner" language was scrubbed and "registered representative referral" and "referral agent" language was substituted, (ii) the mode of selecting a referral agent for a nonparticipating agent was theoretically changed but that which replaced it, if anything, was unclear as stated in the immediately preceding Finding, and (iii) references to direct marketing were removed. (Sikora, 7/27, Tr. 8:18-9:11.) Among the other features of PAP carried over to 3RD were the requirements that a participating agent's selection of a referral agent comply with the same PAP criteria (including being a Select agent) and meet with AFE approval. (PX 13.)

b. The 3RD program implies that it is new. In fact the database called "registered representative referral database" was in existence prior to its formal announcement on August

20, 2003. The Sikora communication to all vice presidents on August 6, (Finding 44a) begins, "It is time to update the Registered Representative Referral Database that is used for referring customers to a local Registered State Farm Agent." (CX 3, bates 4721.) And Sikora's attached specimen e-mail to AFEs for use in the updating (Finding 44c) states that "this database is approximately one year old." (CX 3, bates 4719.) It was, therefore, the product of PAP as were prior databases, which would change every year pursuant to State Farm's policy to permit annual partner selections. (PX 8, bates 1333.) Annual selections continued under 3RD (PX 13, bates 4191.)

c. 3RD was not, therefore, "begun on a clean slate," as State Farm contends. (Defs.' Prop. Finding ¶ 66 at 21.) Nor is it correct that the database "did not include appointments made under the Partner Agent Program." (*Ibid.*)[14] In fact, the then database consisted entirely of selections made according to PAP's rules since the database was about a year old. (CX 3, bates 4719.) Therefore, the listings included default selections made by the AFE under PAP for nonparticipating agents. For the purpose of the 2003 updating, listings from the then database were provided by Sikora with his August 6, 2003 e-mail to the Zone Superintendent. (Finding 44c.) The listings were to be distributed to all zone AFEs and indicated the previous referral-agent selections made by and for nonregistered agents in each AFE district. (CX 3, bates 4717.) Sikora instructed that "changes to the selected registered agent can be recorded directly on the list[.]"[15] Further, the 3RD database itself identifies the referral agent as the

[14] Sikora's testimony (7/27, Tr. 53:12-15) is cited in support. But his "no" answer was given to a question that was asked concerning *present* circumstances, not those that prevailed in 2003: " Does the computer database for the triple RD include appointments that were made prior to the triple RD?"

[15] No instructions were given on enlightening the nonparticipating agent on how the selection would be made if the agent persisted in not making a selection.

"Registered Partner." (CX 4.)

d. About 94% of nonregistered agents selected referral agents. (Sikora, 7/27, Tr. 41:25-42:5.)

46. Almost two years after 3RD was announced, the State Farm organization was still confused as to 3RD's meaning and relationship to PAP. On July 1, 2005, just 25 days prior to the commencement of this trial, Home Agency Sales Resources (ASR), which was charged with oversight of the program (Fisher, 7/27, Tr. 75:21-76:7), e-mailed all AFEs to update the 3RD database. DX 68 is a specimen of the communications. For some reason the update was limited to nonparticipating agents.[16] In enclosing a list of such nonregistered agents, the e-mail stated, "The attached is a list of agents who currently do not have a *partnered* registered agent." (*Ibid*; emphasis added.) Thus did the highest administrative level of State Farm's 3RD manifest its understanding, common to that in the field, that the Registered Representative Referral Database was merely the name of the database that was utilized by the Partner Agent Program.

47. The AFEs proceeded to implement the update. A fraction of AFE e-mails fell into the hands of NASFA. Twenty were admitted into evidence. (PX 91.) They show that the confusion from the top administrative level ran down to the AFE field level: 16 of the e-mails referred to "partner" or "partnering" (one used the term "paired up"), two said the AFE would appoint if the agent did not and two more employed both faults by using "partner" and by stating the AFE would select if the agents failed to do so. Fifteen of the e-mails were silent on the agent's option not to select.

[16] State Farm agrees the update was so limited. (Defs.' Prop. Findings ¶ 72 at 23.)

48. NAFSA's counsel turned over the e-mails to State Farm's counsel on or about July 15, the date requested by ASR for the return of agents' selections. (Fisher, 7/27, Tr. 82:18-20, 95:9-17, 114:14-23.) On July 20, Gregory Fisher, an agency vice president, rebuked Brian Preacher, the author of the ASR e-mail for

> incorrectly confusing two different programs. The Representative Registered Referral Database is not the "Partner Agent Program." The "Partner Agent Program" was discontinued in 2003.

(DX 70.) In this emphatic statement, Fisher stated in simple language what State Farm never told its employees before (*i.e.*, that PAP was ended), an event which, in any case, I find never occurred. "To ensure that you [Preacher] understand" the 3RD, Fisher referred Preacher to an intranet location. Significantly, the location's subaddress was "partnerprogram." Fisher's e-mail also advised of the agent's right to decline selection of a referral agent and the method of default selection by rotation. Fisher requested that ASR send a corrective e-mail to all AFEs. (DX 70.) ASR complied. (*Ibid.*) In correcting the e-mail of an AFE who had implemented the update, Fisher likewise referred to State Farm's intranet location, employing the "partnerprogram" subaddress. (DX 69.)

49. Defendant responds that 20 AFE e-mails are minuscule and hardly show confusion in an organization with 500 AFEs. But we do not know how many AFE e-mails there were since ASR only asked AFEs for an update of nonregistered agents in their districts who had *not* selected referral agents; and there may well have been districts with no nonparticipating agents since well over 90% of nonregistered agents had made appointments in 2003. (Finding 45d.) Moreover, we do not know what the other AFEs

said.[17] NASFA did not have access to all AFE e-mails. It learned of the update shortly before trial and had no time to pursue discovery. E-mails were received only from those agents who were cooperative. (Pl.'s Closing Arguments, 8/1, Tr. 656:24-657:16.) State Farm had the capacity to produce others but did not. Finally, State Farm's position does not address the fact that ASR, the highest 3RD administrative echelon of State Farm, was confused. Since it was, it is not unlikely that others were also.

50. In sum, I find that PAP was never ended. A name change does not alter the substance of the program. The only modification of substance *intended* by 3RD was the selection of a referral agent ("partner" under PAP) when the nonregistered agent declined to nominate. (Finding 43.) 3RD was born, in part, because of the felt litigation necessity of dealing with a challenge based upon the imposition of a "partner" on a nonparticipating agent. 3RD's conceptual solution was to await an inquiry by a customer of a nonparticipating agent and make the selection then by rotation. Although the testimonies of Sikora and Fisher, the only State Farm witnesses who testified on selection of referral agent by rotation, were somewhat equivocal as to whether they were addressing the concept as distinguished from its being put into practice (Sikora, 7/27, Tr. 19:22-24, 22:17-25, 29:13-17; Fisher, 7/27, Tr. 85:13-20, 87:6-8, 91:13-92:13), I find that rotation was substantially implemented. This does not gainsay the fact, which I also find, that some AFEs, because of confused instructions, are still appointing referral agents for nonparticipating agents and that those selections appear on the database, thereby diminishing the occasions for rotational selection.

[17] We do know from Mr. Fisher, however, that he received an e-mail from an AFE in Mississippi reporting "confusion on the program on the part of some AFEs." (7/27, Tr. 93:23-94:7.)

I. *Senior Agents and PAP*

51. Shortly after the Dallas convention of 2000, which sounded the grow or go theme (Finding 22), Killingsworth's superior (agency vice president Dannewitz) instructed him to speak monthly to his agents who were ages 55 or older about their retirement plans, including specific dates, and report back. (Killingsworth, 7/26, Tr. 34:12-23.)[18] Retirement of agents in this age bracket would be substantially advantageous to State Farm since it would free the Company from paying the higher commissions under the AA3 and AA4 contracts, which many of these senior agents had, and allow State Farm to make "block assignments" of retiring agents' businesses to AA97 agents. (*Id.* at Tr. 34:24-35:9 ["an enormous windfall"]; Findings 11 and 12.) NASFA contends that State Farm used PAP to "push out" senior, nonregistered agents.

52. To further its position, NASFA alludes to a State Farm document (bates 1339) purporting to be a "study that revealed . . . most of the unregistered agents were age 55 or older." (Pl.'s Prop. Finds. And Concls. ¶ 36 at 7.) The document was not offered in evidence, and I would not consider it but for the fact that NASFA did not gain possession of it until late in the trial of this branch of the case when defendants produced the documents requested by the court. (Finding 42.) Defendants respond that the turnover to plaintiff was mistaken since the document was not within the purview of the court's request for State Farm documents. Hence defendants, while "inadvertently" providing plaintiff with a copy, did not submit it to the court.[19] Even if defendants were correct, I would nevertheless

[18] No evidence was offered that any other AFE received such an instruction or conducted such inquiries of agents.

[19] A copy has been provided at my request.

receive the document in evidence if I determined that defendants improperly withheld it from plaintiff in its pretrial discovery. Rather than resolve this collateral issue after briefing, I will assume the admissibility of the document bates 1339.

53. Nevertheless, the evidence is insufficient to permit the inference that PAP was used to induce retirement of senior unregistered agents. Moreover, assuming, *arguendo*, that State Farm wished to bring about such retirements, the evidence fails to connect PAP as a significant vehicle for accomplishing this objective.

Conclusions of Law

A. *The Issues* [20]

54. Three major issues are before us: (a) whether nonregistered insurance agents were required by PAP, or by PAP as amended by 3RD, to involve themselves in mutual fund activities when their contracts were limited solely to insurance activities; (b) whether their independent contractor status, as protected by section II B of the Agent's Agreements, was violated by either of the programs; and (c) whether either of those programs breached the implied covenant of good faith and fair dealing?

B. *Mootness*

55. A preliminary question is raised as to PAP on the grounds of mootness, for the asserted reasons that PAP was terminated by 3RD and plaintiff's evidence shows the program was morbid. The findings, however, are to the contrary. PAP was never terminated. (Findings 42, 45, 46, 50.) The agents' testimony that the program in 2002

[20] NASFA was held to have representational capacity to bring this lawsuit on behalf of its membership. (Order of October 24, 2002, by Judge Kravitz denying motion to dismiss.)

seemed to be "stopped" and "a non-issue" and the newsletter in 2003, stating the program was "in a very deep coma" and "nothing ever happened," were addressed solely to nonimplementation of the direct mailing feature of the original program. (Finding 40.) The testimony did not deal with the other features, such as appointment of a partner agent or referral of customers. Moreover, subsequent events, including those as recent as July of this year, demonstrate that the "partnered registered agent" (so termed by the agency in charge of the program) and "partner" selections by some AFEs for nonparticipating agents are extant. (Findings 46, 47.) Fisher's self-serving answer "no reason" to the leading question, "Is there any reason to believe that the partner agent program in its original form will be brought back into existence by State Farm?" cannot moot the issue. (7/27, Tr. 75:5-15.) Fisher's testimony was not a "settled and unchallenged policy," as was present in *DeFunis* v. *Odegaard*, 416 U.S. 312, 318 (1974), but an *ad hoc* response to an invitation in the form of a leading question, answered by an official without power to enact the policy. "The burden of demonstrating that a case is moot falls heavily upon the party asserting it." *In re Morris,* 482 A. 2d 369, 371 (D.C. 1984). Defendant has failed to carry that burden.

C. *Conflict of Laws*

56. The AA97 contract provides that Illinois law controls. (§ VI E, PX 3.) About 50% of active agents are subject to the AA97 contract. (JPTS Stip. 13.) AA3 and AA4 contracts are silent as to choice of law. As if to champion their rights, State Farm argues that agents with those contracts must have their rights determined by the law of the state where each agent operates, a somewhat mischievous position since (1) NASFA has members in 47 states and the District (Finding 1), (2) State Farm dictated that Illinois law would govern in its AA97 contract as it has in the State Farm Securities Products Agreement, Article IX,

Section 9.6 (CX 5-1, 5-2; Finding 23), and NASFA has never claimed otherwise; and (3) State Farm's position would allow disparate adjudications on the same facts amongst agents with the same contract language.[21] Under these circumstances, I am satisfied that there has been an effective choice of law by the parties, under RESTATEMENT (SECOND) OF CONFLICTS OF LAWS § 187(1) (1971) and that, apart from that choice, the interests of justice are best served by the application of Illinois law.

D. *The Choice Given Unregistered Agents by PAP*

57. We begin by recognizing, as State Farm concedes, that the Agent's Agreements "address[ ] only the sale of insurance, . . . nor does it provide that Agents will solicit applications for mutual funds or other securities." (Finding 15.) Stated otherwise, nonregistered agents were perfectly within their contractual rights to decline any involvement with securities, and State Farm had no right to compel such activity. State Farm responds that PAP was entirely voluntary, and the parties have stipulated unregistered agents were "free to refuse to nominate partners." (Finding 29.) But there was no choice to remain outside of PAP, with its involvement in securities, and just sell insurance. Unregistered insurance agents were not free under PAP to be without a *securities* partner. If an agent refused to nominate a partner, he/she nevertheless had, by compulsion, a securities partner selected by State Farm, acting through its AFEs, and was thereby involved in securities. (Findings 26, 33b; 67, *infra*.)[22]

58. Moreover, the choice given the agents was a Hobson's choice: a "house" partner

[21] State Farm's conflicts position was not raised in the Joint or Supplemental Pretrial Statements or in its proposed findings or conclusions. It was raised in subsequent briefings.

[22] Although we, of course, are not to take the term "partner" in its legal sense, it is nevertheless ironic to employ the term in a context that negates *delectus personae*, the essential feature of a partnership.

or a partner personally selected by the nonregistered agent (if the nominated partner met State Farm's criteria). (Findings 26, 30.) Indeed, "nonregistered [a]gents were encouraged to select a registered agent," as stipulated by the parties (JPTS Stip. 27), precisely because that meant the agent would sign the Letter of Understanding/Nomination pledging the agent to refer potential securities customers to the partner agent. (PX 10.) The Letter was, after all, the ultimate goal of the program: to give State Farm access to the unregistered agent's potential securities customers by using the agent's goodwill. (Finding 24, PX 7.)

59. State Farm relies upon Wright's testimony to present the program as voluntary:

a. Focusing upon the "non-registered agents . . . who [have a] . . . partner agent . . . appointed for them by the company [*i.e.*, the nonparticipating agent]," Wright replied to a rapid series of leading questions that State Farm did not "require" (1) referral, (2) the sharing of information between nonparticipating agents and partner agents; or (3) any dealing between them. (7/26, Tr. 184:17-185:6.) State Farm did not, according to him, act against nonparticipating agents who said "they would not refer business" because "The program was voluntary. That was their choice as an independent contractor." (*Id.* at Tr. 185:7-16.)

b. The first response to State Farm's "voluntary" contention, as elucidated through Wright's testimony, is that it ignores the plight of participating agents who acceded to nominate only because of the illusory alternative given them, *i.e.*, to have State Farm appoint a partner for them. The second rejoinder is that Wright's testimony erroneously attempts to portray the nonparticipating agent as having the opportunity to opt entirely out of PAP, without any entanglements with PAP or securities. This was accomplished by a leading question calling for a conclusory answer: "Did State Farm require . . . the non-

registered agents to deal in any way with the partner agents who had been matched up with them?" The witness's answer, "No," was incorrect. (7/26, Tr. 185:3-6.)[23]

c. The nonparticipating agent was inextricably involved with securities by the PAP provision that the "Company will select [a] registered agent to handle *marketing* and referrals if [the] non-registered agent elects not to nominate a registered agent." (Finding 33b; emphasis added.) The nonparticipating agent thus was to have his customers courted by his house partner through direct mail. And PAP's "Guiding Principles" (set forth in its "Partner Agent Program Procedures") provided, "Both the non-registered and partner agent will have the opportunity to review and be involved in the direct marketing plans to the customers assigned to the non-registered agent." (CX 2, bates 1336.) Since the agent who declined to nominate a partner was nevertheless assigned a partner, I read the foregoing guiding principle to apply to all nonregistered agents, the agent who nominated a partner and signed the Letter of Understanding as well as the nonparticipating agent. State Farm did not distinguish in the guiding principles on "review and be involved" between the two agents, a distinction which it frequently drew in other respects when it wished to exclude one or the other.

d. Further, review and involvement in direct mail by both participating and non-participating agents was an imperative for State Farm as well as the agents. For State Farm, it was the entire reason for PAP: to use the good will of unregistered agents to market their customers for securities. (Finding 24.) Better for the Company to have some

[23] After persistent leading, the court advised defense counsel: "I'm not going to interrupt you from now on, but I want to warn you that I will make the appropriate discount in judging credibility when leading questions are posed to witnesses. They don't have the same currency in my mind as answers given to questions that are not leading." (7/27, Tr. 213:9-14.)

imprimatur from the nonparticipating agent than have the agent a spoiler. For the agents, especially the ones who had a partner without consent, they dreaded the prospect of direct mail to clients advising them that their agent was not qualified to service their needs in securities but that the "partner" was. (Findings 34, 35.) Review and involvement in the "direct mail marketing plans to customers" was an urgent necessity in order to moderate the language of the communication in an effort to mitigate the risk of losing customers. Thus, the nonparticipating agent and the "partner" agent would inevitably have dealings in the phraseology of the communication, the nonparticipating agent to smooth its raw edges and the "partner" to gain whatever blessings he could. It will not do for State Farm to argue that it did not "require" these dealings. It knowingly put the nonparticipating agent in this predicament where necessity "required" involvement with the "partner" agent.

e. Nor is Wright's testimony of nonaction against the nonparticipating agent in accord with the record for several reasons: (1) State Farm's bonus and award program, the Select Agent Program, was geared, *inter alia*, to participating agents who agreed to refer potential mutual customers; hence its valuable benefits were denied by State Farm to nonparticipating agents in retaliation for the exercise of their contractually protected rights to confine their activities to insurance (Findings 15, *supra*, 80 and 84, *infra*); (2) State Farm dubiously insinuated that a "refusal to refer a client who requests information about a securities product could also result in a potential [client] risk to the non-registered agent." (PX 9, Frequently Asked Questions, Question 22); and (3) State Farm's ire toward nonparticipating agents was displayed in a "Power point" presentation in which the agents were described as "*Undermin[ing]* State Farm's goal to become [a] financial services leader"

and causing "A disconnect between the needs of the customer, the needs of State Farm and the needs of that individual agent." (CX 2-3, bates 1279; emphasis in original.)

f. As respects Wright's volunteered opinion that "The program was voluntary," voluntariness is not to be determined by State Farm's mindset, never disclosed to its agents, to forgo implementation of direct marketing. (*See e.g.,* Finding 39.) Rather, it is the agents' state of mind that is controlling based upon the circumstances known to them. Nevertheless, the testimony is interesting since it is a concession by State Farm's executive that the Company did not have the right to oblige referrals because "That was their choice as an independent contractor agent."[24]

E. *Standing*

60. State Farm asserts that participating agents acted voluntarily and, hence, cannot complain of their involvement in securities. But the only choice they made was the choice of *who* would select their securities partner. There was no voluntary choice to stay out of securities and stick to the insurance contract. Accordingly, the agents who nominated partners have standing to complain and may proceed as the RESTATEMENT (SECOND) OF AGENCY § 385 cmt. sub§ (1)b (1957) states: "If in violation of his agreement, the principal gives an unreasonable order, the agent may have an action against him for loss caused by his obedience to it [.]"[25] *See also*, *Id.* at cmt. sub§ (2)d.

[24] The implications of direct mail not having been substantially implemented are discussed at paragraph 68, *infra.*

[25] Declaratory judgment would, of course, also be available.

F. *PAP and the Scope of Contract*

61. The wedge of PAP that drove the agents to participate and sign the Letter of Understanding/Nomination was involuntary assignment of a securities partner if the agent opted not to choose a partner. I can find no source in any of the Agent's Agreements for such a unilaterally imposed assignment, and I have been cited to none. The rationale for the option (indeed for the entire program) — to maximize the sale of securities — was utterly foreign to the agent's insurance contracts. The question is not, as State Farm contends, whether it has the right to sell securities. The question, instead, is whether its insurance agents had a duty under their contracts to facilitate the sale of securities. A direct company edict requiring agents to refer potential securities customers to a registered agent would have breached the contracts, as State Farm well knew. (Finding 15.) *William Ziegler and Son* v. *Chicago Northwestern Development Co.,* 71 Ill. App. 3d 276, 282, 389 N.E. 2d 195, 199 1979) declares on point: "The . . . [employer] has a right to full and good faith performance of the contractor's promise, but has no right to expand the nature and extent of the contractor's obligation," citing *Castle Concrete Co.* v. *Fleetwood Associates, Inc.*, 131 Ill. App. 2d 289, 293-94, 268 N.E. 2d 474, 476 (1971). Instead of mandating referral, State Farm achieved by indirection through PAP the functional equivalent of such an edict by manipulating almost 4,900 amendments to the contracts in the form of 4,900 Letters of Understanding, all in the first year of PAP.[26] Although not denominated

[26] 6,192 (verified number of nonregistered agents (CX 1, bates 901)) x 79% (the percentage of such agents who selected their own partners and hence signed Letters) (Finding 29) = 4,891 agents. As direct mail was sidelined, the number of letters have risen through the years to 94% unregistered agents. (Finding 45d.)

amendments, they were such in substance for they obliged referral of potential mutual fund customers. (Finding 27.)

62. Accordingly, I hold that PAP was initiated and operated until at least August 2003, under rules of choice that were rigged to produce a huge majority of agents (now virtually unanimous) who amended their contracts so as to involve themselves in securities by agreeing to refer customers potentially interested in securities to a registered partner. A choice to partner (and amend one's contract) cannot be considered voluntary when no choice is given to be free of any partner and adhere to the original contract. It follows that the Letters of Understanding were in breach of contract. Also, all partner selections under PAP must be considered in breach, the ones selected by the agents for the reasons already mentioned and the selections made by State Farm's AFEs for the reason that they had no power to do so.

G. *PAP and Independent Contractor Status of Agents*

63. After contractually assuring the agent, "You are an independent contractor for all purposes," each of the contracts promise, "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." (§ IB, Agent's Agreements, PX 1, 2, 3.)[27]

64. The sense of the Restatement on evaluating the status of an independent contractor as compared with an employee is that, to the extent an "actor's physical activities

[27] Only the AA97 Agreement has any qualification of this robust declaration of independent contactor status: "As a State Farm Agent, you are obliged to follow State Farm procedures and processes," a provision which in no wise diminishes the substantive contents of the agent's rights.

and his time are surrendered to the control of the" employer, the case for independent contractor is diminished. RESTATEMENT (SECOND) OF AGENCY, *supra,* § 220 cmt. e (1958). That is a serviceable yardstick to determine whether an agent's contractually protected independence has been materially diminished, as no Illinois authority directly on point has been cited or found.

1. The Participating Agent

65. By nominating a partner and signing the Letter of Understanding in order to avoid a partner appointed by the Company, the agent undertook to perform for State Farm the following activities:

a. Refer to his partner any customer or prospective customer who "expresses interest in, requests information about or appears in your opinion to need information about products you don't handle" (PX 10), thereby exposing the agent to the risk of losing the customer. (Finding 37.)[28]

b. Inform his partner of the names and addresses of his insurance clients so they may receive direct mail on securities, again incurring the risk of losing his client. (Finding 33a); and

c. "[R]eview and be involved [with the partner] in the direct mail marketing plans to the customers assigned to the non-registered agent" (CX 2, bates 1336), perhaps the most time-consuming activity of all. (Findings 59c, d.) State Farm explicitly acknowledged that the participating agent's activities would transcend insurance when it declared, "this program provides options for non-registerd agents to *stay involved in marketing mutual*

[28] Compensation for the referral is legally prohibited. (PX 10.)

funds . . . [.]" (Finding 26a; emphasis added.) The participating agent was thus made to surrender, *pro tanto,* "full control of . . . [his] daily activities with the right to exercise independent judgment as to time, place and manner of soliciting insurance[.]"

66. The question is not whether these additional, imposed activities transformed the agent's status from an independent contractor to that of an employee. Of course, they did not. The question, instead, is whether the increased activities breached the contractual promises of "full control . . . of duties" and "independent judgment as to time, place and manner of soliciting insurance[.]" Wright was correct: "That [the decision to refer securities clients] was their choice as . . . independent contractor agent[s]." (Conclusions 59a, f.) By giving its independent-contractor agents a Hobson's choice on nomination and referral, State Farm impaired that freedom of choice and "pushed" them into PAP.

2. The Nonparticipating Agent

67. The nonparticipating agent also lost "full" control of his/her activities. The direct mail marketing, featured in the literature and the AFE presentations to agents, contemplated that these agents and their partners would also involve themselves in the direct marketing of mutuals. (Finding 33b; Conclusions 59c, d.) By so doing they would also inevitably involve themselves in critiquing the proposed mutual-fund mailings to their customers and, no doubt, in haggling about the language. This agent's independence and time would also be impaired, albeit to a lesser degree than the participating agent.

3. Nonimplementation of Direct Mail

68. That the direct mail campaign was never launched in any substantial fashion is not relevant to whether PAP violated the independent contractor provision of the contracts. The dispositive facts are that direct mail was an integral part of PAP as it was promulgated, and

State Farm *claimed the right* to conduct it. State Farm did not shelve direct mail until August, 2003, and the primary reason for doing so at that time was the disappointing results of the pilot test. (Findings 38, 39.) If the circumstances were to change and a successful direct mail campaign was devised, it would no doubt be taken off the shelf.

H. *PAP and the Implied Covenant of Good Faith and Fair Dealing*

69. "In Illinois, a covenant of good faith and fair dealing is implied in every contract absent express disavowal," *Interim Health Care of N. Illinois, Inc. v. Interim Health Care, Inc.,* 225 F. 3d 876, 884 (7th Cir. 2000), citing *Martindell v. Lake Shore National Bank,* 15 Ill. 2d 272, 286, 154 N.E. 2d 683, 690 (1958). Understanding "good faith" is aided by a recognition of its converse:

> A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, . . . abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance.

RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d (1981); *See also* cmt. a ("Good faith . . . emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party[.]"). The Seventh Circuit, again applying Illinois law, has stated "'Bad faith' is a term of art in contract law; it refers to one party's manipulation of contractual terms in order to take commercial advantage of another party." *Zeidler v. A & W Restaurants, Inc.,* 301 F.3d 572, 574-75 (7th Cir. 2002) (summary judgment proper in absence of fact issue of bad faith or proximate cause.) Here, State Farm manipulated the contracts of nonregistered agents and induced amendments by imposing on agents a rigged option in order to extract two unjust competitive advantages: (a) depriving agents of their contractual rights and justified expectations to engage solely in insurance; and (b)

using the goodwill the agents enjoyed with their insurance customers so that the Company could effectively access them as potential securities customers notwithstanding the risk of client loss to the agent. (Findings 24, 25, 37.)

70. Illinois law concurs with the RESTATEMENT view condemning "evasion of the spirit of the bargain" and emphasizing the "agreed common purpose." (Conclusion 69.) "Where a party acts with improper motive [by] . . . exercising contractual discretion in a manner inconsistent with the reasonable expectations of the parties, [that party] . . . is acting in bad faith." *Dayan v. McDonald's Corp.*, 125 Ill. App. 3d 972, 991, 466 N.E. 2d 958, 972 (1984) (franchise termination not in bad faith.) State Farm concedes that Illinois law so states: NASFA "must prove that State Farm acted inconsistently with the Parties' reasonable expectations in order to 'take commercial advantage of' Agents."), citing *Zeidler,* 301 F.3d at 574-75. (Defs.' Mem. Resp. to Pl.'s Post T. Subm. at 8.) The agents' expectations prior to PAP were limited to insurance activities. (Finding 15.) When offered the opportunity to become registered in securities, 56% of the agents were willing to forgo their original expectations and take on securities. The remaining agents decided, for one reason or another, to stay with insurance, their original expectations. State Farm's conduct meets the elements it has conceded constitute bad faith in view of the agent's expectations and the commercial advantages State Farm extracted, as stated in Conclusion 69.

71. Under Illinois law, "The [good faith] covenant is only an aid to interpretation, not a source of contractual duties or liability[.]" *Zeidler,* 301 F. 3d at 575. However, "If a party is found to have acted in bad faith, then the other party is relieved of the effects of contractual breaches caused by that bad faith." (*Ibid.*) Accordingly, all partner nominations and Letters of Understanding rendered under PAP are ineffectual.

I. *The Registered Representative Referral Database*

1. Validity of the Concept

72. PAP was not terminated by 3RD. (Finding 42.) Instead, 3RD's principal intent was to amend PAP by doing away with the forced coupling of the nonparticipating agent with a registered agent selected by State Farm. (Finding 43.) As respects the customer of the nonparticipating agent, under 3RD's concept State Farm would make no selection of a referral agent unless and until a customer first contacted State Farm and inquired about mutuals, whereupon the selection would then be made by rotation. (Findings 41, 43; Sikora, 7/27, Tr. 10:15-23).[29]

73. In theory, 3RD cured PAP's infirmities. It gave the unregistered agent the choice that was denied before, to remain an insurance agent with the same contract and with no ties to securities.[30]

74. NASFA contends that rotational selection of a registered agent nevertheless amounts to selecting a "partner" for the unregistered agent whose customer makes inquiry of State Farm about mutuals. But the unregistered agent is not called upon to do anything. And State Farm has no duty to turn away business simply because an unregistered agent previously sold an insurance policy to a potential purchaser of securities. State Farm has a right to pursue its business interests and rotational selection is as fair a way to do it as any other.

2. Implementation of the Concept

[29] Sikora also testified that the plan was changed so that rotational selection would not be triggered by a customer's inquiry but by the customer's application for mutuals. (7/27, Tr. 32:4-33:2.)

[30] There remains for consideration the impact of the Select Agent Program, which will be taken up next.

75. 3RD began with PAP's database. (Findings 45b, c.). Implementation of the rotational system in the case of nonparticipating agents was murky and confused. Multiple official pronouncements from the top of the line (Sikora) to the bottom (AFEs) contradicted and confused rotational selection, a condition which continues to the present. (Findings 44, 46-49.) Since PAP's origin and implementation were clearly established, the burden of proof that it was altered in practice by rotational selection was upon State Farm. Although, the question is close, I have found that 3RD's change has been implemented in substantial part. (Finding 50.) Where implemented, PAP as amended by 3RD is not in violation of contract in any respect. There may still remain, however, some districts where the unregistered agent has not had the choice to opt out of the program as 3RD contemplated. This should be attended to promptly.

III. Select Agent Program

Findings of Facts

A. *Inception*

76. "State Farm has historically had a variety of award programs to reward Agents for meeting objectives the Company deemed important. Examples of other bonus or reward programs include the Inner Circle, Chairman's Circle, Legion of Honor, the Millionaire Club, and the Extended Millionaire Club." (JPTS Stip. 30.)

77. Such bonus or reward programs under the AA97 contract are promulgated pursuant to section II D: "Each Company reserves the right to fix and determine the amount, extent, and conditions of any bonus, awards, prizes and allowances." The provision is identical to section II C of the predecessor contracts. (PX 1, 2, 3.)

78. "Starting in approximately 1998, State Farm instituted a new program known as the 'Select Agent' Program." ("SAP") (*Id.* at Stip. 31.) The program became effective in 2000. (Wright, 7/29, Tr. 550:4-25.)

79. "Although the specific details of the Program have varied somewhat from year to year, its basic structure has remained constant. Agents who meet certain criteria are eligible to receive certain benefits from the Company." (JPTS Stip. 32.)

B. *Summary of Criteria and Benefits*

80. "(1) The current criteria to become a Select Agent are:

a. participation in the Customer Response Center;

b. have at least one LSA-4 or LSA-5 licensed staff member;

c. (i) solicit 40 net paid life insurance policies OR create 25 new life households; (ii) $8,500 in life premium credits; and (iii) 80% or better 2nd year life persistency;

d. licensed or certified in all products and services OR agree to refer clients to another licensed or certified State Farm Agent;

e. create and implement a business plan.

(2) The current benefits and rewards of Select Agent Program include:

a. eligibility to receive coop advertising monies;

b. eligibility to receive block assignments and internet leads concerning new customers;

c. free designation in Yellow Pages block advertisements as a 'Select Agent;'

d. eligibility to participate in additional bonus programs;

e. registered Select Agents are eligible to receive mutual fund referrals."

(Supp. JPTS Stip. A (1) & (2).)[31] "Currently, 76% of Agents nationwide are Select Agents." (JPTS Stip. 33.) I find the rewards and benefits bestowed by SAP were valuable.

81. The fourth criterion of SAP's "current criteria" (Finding 80 (1) (d)) has been referred to as the "product availability criterion." In the context of this case, the product is securities in general and mutual funds in particular. The product availability criterion, in turn, consists of alternative criteria. The first alternative clause ("licensed or certified") contemplates the agent being directly qualified by license or certificate (or, as here, registration) to deal with the product. The second alternative ("agree to refer") assumes the agent is not directly qualified but may yet be eligible for SAP benefits if he "agree[s] to refer[.]" The validity of the "referral criterion" is the issue that concerns us here.

82a. The Customer Response Center ("CRC"), mentioned in SAP's first criterion, is a State Farm facility established in 1997 that "takes calls from policyholders when Agents offices are closed in the evening and during weekends." (JPTS Stips. 34, 35)

b. The second criterion for Select agent eligibility requires the agent have at least one staff member who is a state Licensed Staff Associate ("LSA") of the LSA-4 or 5 level, authorized to solicit applications for insurance. (Wright, 7/29, Tr. 555:19-565:5; Knapp, 7/29, Tr. 495:17-498:10.) The requirement had its origin in the increasing demand of state enforcement authorities that employees of agents who have direct dealings with

[31] The parties dispute whether SAP had additional benefits consisting of entitlement to broker policies for "Phoenix Life and Aon insurance carriers" and "greater underwriting flexibility." (*Id.* at concluding brackets.) Decision of that issue is unnecessary.

agency customers on insurance applications be licensed. (Wright, 7/29, Tr. 555:9-556:11.)

C. *SAP's Connection with PAP*

83a. By hinging SAP's rewards upon, among other things, the unregistered agent's agreement to refer to a registered agent (PAP's ultimate objective), the two programs were significantly linked. A reciprocating link was added by PAP's requirement that the registered agent be a Select agent. (Finding 31.) The last benefit recited in the list of SAP's benefits is that "registered Select agents are eligible to receive mutual fund referral." (Finding 80 (2) e.)[32]

b. State Farm disclaims any connection between the programs. It is true that historically SAP was implemented in 2000, while PAP was instituted a year later. But State Farm was already planning to enter the mutual field in 2000 (Finding 20), and SAP was no doubt shaped with mutuals as well as other product offerings in mind. State Farm declared ambitiously in 2000 its "goal to become a leader in [the] financial services area" (Findings 22, 24.) The achievement of that goal, which included the mutual fund market, was a significant factor in the creation of SAP. It proves nothing that SAP's scope applied to all agents while PAP's focus was on agents unregistered in securities. SAP, it is true, had other goals in addition to financial services. It is enough, however, that one of its main objectives was to gain the cooperation of agents unregistered in financial services.

[32] Wright testified that SAP permits an unregistered agent to "refer the customer to any [registered] agent of his or her own choosing, anybody in the company." (7/26, Tr. 210:22-211:1.) But the final benefit enumerated by SAP, *i.e.*, "registered Select Agents are eligible to receive mutual fund referrals[,]" clearly indicates that a registered agent who is *not* Select is *not* eligible. (Finding 80(2) (e).) This aligns the two programs, as was no doubt intended by State Farm, instead of permitting SAP to undo PAP's policy. (Finding 28a.)

84. The purpose of SAP's referral criterion was to induce unregistered agents to refer by promising substantial rewards. Correspondingly, I find State Farm also purposed retaliation against the nonparticipating agents who, in declining to refer potential mutual clients, were simply exercising their contractual rights to deal solely in insurance. The Company retaliated by discriminatorily denying them SAP's benefits. It is true, as asserted, SAP's benefits were extra-contractual and, hence, State Farm was not denying unobliging agents contractually guaranteed benefits. But, more importantly, SAP's benefits were conditioned upon the unregistered agent surrendering a contractually protected right, an illicit goal which no other rewards program had undertaken. (Knapp, 7/29, Tr. 508:8-509:2; Finding 15.)

85. Although it would not remedy the vice of SAP, I do not credit Wright's testimony that SAP's referral requirement would be satisfied by an agent's verbal, good faith commitment to refer customers to a registered agent. (7/29, Tr. 557:15-558:1, 566:1-567:1.) A verbal commitment would not do for PAP. The referral commitment (Letter of Understanding) was written and the AFE was required to sign as a witness. (PX 10.) The Letter, which also nominated the partner agent, was to be executed in triplicate, and the AFE was to certify that "he or she has covered the guidelines of the program with the agent." (CX 2, bates 1334.) And "One copy should be sent to Agency Resources for Processing." (*Ibid.*) It is difficult to believe that the same Company, so meticulous in prescribing the documentation of the written commitment to refer (PAP), would be so trustful as to rely on an oral promise in handing out financial rewards (SAP) and in seeking the assistance of its nonregistered agents who were undertaking an uncompensated activity which entailed the risk of losing clients. I also note that there

was not a line in State Farm's literature in SAP or PAP to confirm this testimony by so instructing the AFEs or informing the agents, nor was is it corroborated by any other witness.[33]

86. Reliance is also placed upon Wright's testimony, in response to a leading question, that participation in the 3RD program by choosing a referral agent would satisfy SAP's referral criterion. (7/29, 575:25-576:5.) If this testimony were credited, not even an oral promise to refer would be necessary and the entire referral criterion would be eviscerated, contrary to State Farm's stipulation that the referral criterion is among the "current criteria." (Finding 80(1) d.) A reader may search the State Farm literature on SAP or announcing 3RD in vain for any hint that any program was changed so that an agent's appointment of a referral agent would do service for an agreement to refer to that agent. (PX 13, 14.) Nor is any reason apparent why the protocol on a written commitment to refer would be eliminated *sub silentio.* Certainly, the testimony of Sikora, who was in charge of 3RD as well as PAP, refutes Wright. In answer to the court's question whether there was "any substantive difference" between the programs other than their titles, Sikora referred *only* to repeal of State Farm's involuntary assignment of a partner to a nonparticipating agent. (Finding 43.) Finally, there is no reason an agent's appointment would have sufficed under PAP as amended by 3RD and not under PAP in its original form. The answer is that it did not suffice under any program, including SAP.

[33] State Farm's literature on SAP does not show a trustful disposition to rely on an oral assurance to refer. On the contrary, it speaks of "Referral activity be[ing] monitored," of a "Product per Household metric . . . . [that] will become the evolving measure of product penetration in a State Farm household," and states further, "If the agent has not cooperated in making our products available, he/she will only have two years left on their Select Agent certification." (PX 31, bates 516.)

Conclusions of Law

A. *The Validity of the Referral Criterion*

1. The Issues

87. NASFA challenges SAP as breaching the Agent's Agreements in that SAP: (1) creates classes (Select and nonselect agents) and discriminates between them in the allowance of benefits, contrary to section II A; (2) improperly exercises the bonus and awards power by denying benefits contrary to prior custom and premised upon a requirement outside the contracts; (3) breaches the contractual provision on cooperative advertising (section I F); and (4) breaches the implied covenant of good faith and fair dealing by multiple arbitrary determinations. The first issue and cooperative advertising need not be decided; nor need the facts be determined beyond those already stated. It is perhaps sufficient to say on the merits that in as much as SAP's referral criterion was intended to promote and implement PAP, and since PAP in its original form was in breach of contract, the referral criterion is similarly tainted. But SAP's problems are more fundamental than such a derivative taint.

2. Breach of Contract as to PAP

88. Each criterion stipulated by SAP constitutes a condition precedent to Select agent status. In fixing the conditions, State Farm exercised, pursuant to section II C or II D of the Agent's Agreements, its "right to fix and determine the amount, extent, and *conditions* of any bonuses, awards, prizes and allowances." (emphasis added.) There is a critical difference between the first three criteria (each of which relates to insurance, a product which is the sole concern of the agents' contracts) and the referral criterion which, as applied to this case, involves securities, a product which defendant concedes is wholly

foreign to the Agent's Agreements. The right to fix and condition bonuses and awards is a power that is necessarily circumscribed by the subject matter of the contracts. To hold otherwise would unravel the contractual limitation on the activities required of the agents and could turn insurance agents into computer salesmen if State Farm decided to become a conglomerate. The reach of such a power is especially repugnant where the agents are independent contractors. The power to stipulate conditions to the award of benefits, although stated without explicit limitations, must be limited by the outer, subject-matter boundaries of the contract. Hence, it cannot be exercised to award valuable benefits to promote the sale of mutual funds.[34]

89. For want of direct authority dealing with our type of contract, we may turn to the analogous subject of the *ultra vires* exercise of corporate powers.[35] The corporate power to grant bonuses and awards is an incidental power which, like the power to borrow or spend money, is exercised as a means to accomplish a corporate purpose. Fletcher, in his work on corporations, discusses the incidental power to borrow:

> Although a corporation has undoubted power to borrow money needed to accomplish its incorporated purposes and objects, its power does not extend beyond that. It cannot ordinarily borrow money not necessary to its legitimate business and for a purpose foreign to that for which it was created, such as borrowing money to make an ultra vires purchase of property. So a corporation has no implied power to borrow money to use in speculation outside the business for which it was organized[.]

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[34] A hybrid product such as variable life would present a question not now before the court, as mutual funds do not involve any element of insurance. Nor, strictly speaking, does this case present any question regarding any of the other criteria that are insurance related.

[35] We are not concerned with the disfavored aspects of the doctrine of *ultra vires* involving the question of by whom and when it may be raised to challenge a corporation's power under its articles of incorporation. See 805 ILL. COMP. STAT. 5/3.15 (2004). Our concern is *not* whether, in enacting SAP's referral criterion, State Farm exceeded its powers under its *articles of corporation*. The question, instead, is whether the referral criterion breaches the *contracts* State Farm entered into with its agents who seek a declaration of their rights *in futuro* respecting the executory aspects of their contracts. We look to the *ultra vires* doctrine only as an aid, by analogy, to ascertain whether the contracts have been breached.

6 WILLIAM M. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2611 at 677-78 (TIMOTHY P. BJUR *et al.* Perm. ed. 1996) (footnotes omitted.) The same, of course, applies to all incidental powers, including the power to grant bonuses. Illinois is in accord:

> Where acts of a corporation are spoken of as *ultra vires*, it is . . . intended that they are not within the powers conferred upon the corporation by the act of its creation, and are in violation of the trust reposed in the managing board by the shareholders, that the affairs shall be managed and the funds *applied solely by carrying out the object for which the corporation was created.*

Peoria Life Insurance Co. v. *International Life & Annuity Co.*, 246 Ill. App. 38, 44-45 (Ill. App. 1927) (emphasis added); *see also Bradley* v. *Ballard,* 55 Ill. 413, 418 (1870) ("on the application of a stockholder, or of any other person authorized to make the application, a court of chancery would interfere and forbid the execution of a contract *ultra vires.*") State Farm has exercised its bonus and awards power beyond the scope of the contracts and, hence, in breach thereof.

90. State Farm rebuts by claiming its "product availability . . . criterion" is crafted "in order to encourage Agents to facilitate the sale of all the Company's products, including the ones they themselves were not licensed to discuss with potential customers and to better serve customers in purchasing products that their particular Agent could not assist them with." (Defs.' Prop. Concl. Law ¶ 135 at 41.) But laudable objectives do not justify impermissible means or tactics. Some nonregisterd agents were not disposed to refer clients who might be inclined to buy mutuals from registered agents. They wanted nothing to do with mutuals, and their contract concededly gave them that right.

91. It may be argued that, nonparticipating agents aside, unregistered agents who agreed to refer by signing Letters of Understanding cannot complain since they became Select agents and received the advantages of that status. But the answer is those agents

should have enjoyed that status with its benefits without being subjected to a breach of contract. SAP's referral criterion was, therefore, invalid as to all unregistered agents until at least August 2003, when the 3RD modification was promulgated.

3. Breach of Contract as to PAP Amended by 3RD

92. Since PAP as amended by 3RD gave unregistered agents the choice of completely opting out of securities, thus preserving their original contracts, SAP is not tainted derivatively by its application to the underlying program as modified by 3RD. However, as we have seen, SAP's referral criterion considered independently is an improper exercise of the bonus and award power and, therefore, a breach of contract apart from the underlying program of PAP as amended by 3RD. But I need not rest our decision on that ground alone because SAP's referral criterion breaks faith with the implied covenant.

4. Covenant of Good Faith and Fair Dealing

93. Assuming, *arguendo,* State Farm's bonus and awards power somehow extended to products beyond insurance, the question arises whether it was exercised in good faith. The Restatement (as noted in Conclusion 69) condemns as bad faith the "abuse of a power to specify terms[.]" RESTATEMENT (SECOND) OF CONTRACTS, *supra,* § 205 cmt. d. Again, Illinois supports the Restatement:

> In describing the nature of that [good faith] limitation, the courts of this State have held that a party vested with contractual discretion must exercise that discretion reasonably and with proper motive, and may not do so arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectation of the parties. (*Foster Enterprises, Ins.* v. *Germania Federal Savings & Loan Association* (1981), 97 Ill. App. 3d 22, 30-31, 421 N.E. 2d 1375; *Pierce* v. *MacNeal Memorial Hospital Association* (1977), 46 Ill. App. 3d 42, 51, 360 N.E. 2d 551.)

Dayan, 125 Ill. App. 3d at 991, 466 N.E. 2d at 972. (cited cases in original.)

94. The Seventh Circuit has clearly delineated Illinois law on good faith as it applies to the exercise of discretionary power. There was evidence in *Interim Health Care of Northern Illinois, Inc.* v. *Interim Health Care, Inc.,* 225 F. 3d 876 (7th Cir. 2000), that the franchisor who had a duty, subject to a wide discretion, to refer customer leads to its franchisee, withheld leads to weaken the franchisee in anticipation of opening a competing operation (which it had a right to do). In reversing summary judgment, the court held,

> This seems the paradigmatic case of a contract party invoking a reasonable contract term (the discretionary obligation to furnish account leads) dishonestly to achieve a purpose "contrary to that for which the contract had been made." Such manipulation, we have intimated, is the essence of bad faith.

Id. at 886 (citation omitted.) In so holding, the court invoked its prior decision in *The Original Great American Chocolate Chip Cookie Company, Inc.* v. *River Valley Cookies, Lmtd.,* 970 F. 2d 273 (7th Cir. 1992), which declared, "The law [of Illinois] does . . . provide a remedy in the name of good faith against opportunistic behavior designed to change the bargain struck by the parties in favor of the opportunist[.]" *Id.* at 281.

95. This case is stronger than *Interim Health.* SAP's referral criterion was intended to promote the transformation of agency contracts, understood and acted upon by all as being limited to insurance (Finding 15), to agreements that also involved referral of customers interested in securities. The combined tactics to accomplish this were the Partner Agent Program, later modified by 3RD, and the Select Agent Program. The latter program, based upon an exercise of the bonus and awards power, promoted contract change by handsomely rewarding participating agents who agreed to modify their contracts by a Letter of Understanding, which pledged them to refer potential securities clients. Those agents who only wished to sell insurance and declined to refer were SAP's targets for retaliation. In

a bald exercise of discrimination for standing on their contract rights, the agents were denied SAP's largess. (Finding 84.) Moreover, State Farm was aware at all times that its Agent's Agreements imposed no obligation upon its agents as to securities. (Finding 15.)

96. Other Illinois authorities are in accord. *Peterson* v. *H & R Block Tax Services, Inc.* 971 F. Supp. 1204,1211 (N.D. Ill. 1997) (good faith requires "contractual discretion to [be] exercise[d] . . . reasonably, not arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties.") (internal quotation marks omitted); *Bonfield* v. *AAMCO Transmission, Inc.,* 708 F. Supp. 867, 885 (N.D. Ill. 1989) ("So even if the express terms of the Agreement permitted *AAMCO* to alter its policies, it could not change them arbitrarily.") *See also Zeidler,* 301 F. 3d at 574-75 (discussed in Conclusion 70, *supra,* at 41.)

97a. It cannot avail State Farm that SAP's benefits are not contractually promised.[36] The overriding fact is that the denial of benefits to nonreferring agents constitutes retaliatory discrimination because the agents declined to cede their contractual rights and, as such, the denial was prompted by bad faith. It makes no difference that the benefits were gratuitous. To award them discriminatorily, in retaliation for the exercise by agents of their contract rights, is to act in bad faith.

b. This breach of good faith, unlike the breach stemming from misuse of the bonus and award power, affects PAP as amended by 3RD as well as PAP in its original form.

[36] This point was raised by Wright in answer to a leading question (7/26, Tr. 211:5-16), in response to the court's previous questions on discriminatorily withholding SAP benefits from agents who declined to pledge to refer. (*Id.* at 199:23-203:1.)

c. Since the referral criterion's application constitutes bad faith in breach of contract, all agents who suffered the "effects of [these] contractual breaches caused by that bad faith" are entitled to be "relieved" of their consequences. *Id.* at 575. The nonparticipating agent who otherwise qualifies under SAP's criteria would be so aggrieved. And there may yet be others who can make an appropriate showing.

IV. Restrictions on New Business

Findings of Fact

A. *Historical Practice*

98. "Like any Insurance company, State Farm must manage the risks that it is willing to assume by establishing underwriting criteria." (JPTS Stip. 40.) "Unlike many other enterprises, volume and profitability are sometimes at odds with each other in the insurance industry." (*Id.* at Stip. 41.) Every new policy represents additional expense and increased risk of loss. (Wright, 7/28, Tr. 300:2-13; Swift 7/28, Tr. 281:8-16.)

99. "From time to time in the past, State Farm has imposed specific limitations on the number of new applications Agents may submit in order to minimize the Companies risk and exposure." (JPTS Stip. 42.) "Historically, these previous limitations were occasioned by unforeseen or unforeseeable events like natural catastrophes or economic downturns." (*Id.* at Stip. 43.) "For example, State Farm Fire and Casualty Company (the 'Fire Company') limited the production of new business in certain hurricane-prone areas in response to severe losses suffered as a result of Hurricane Andrew in August 1992. By itself, Hurricane Andrew caused policyholder losses of approximately $3.7 billion, more than the entire surplus of the Fire Company at the time." (*Id.* at Stip. 44.)

100. "As a result of these developments, the Fire Company announced limitations on production of new business in 1993 and placed limits on the growth of the Company. The programs involved quantitative limits on new risks the Company was willing to insure in certain areas, including Texas, Florida and Louisiana." (*Id.* at Stip. 45.) "The purpose of the limitations on new business was to reduce the Fire Company's exposure to catastrophic loss so as to guarantee that it would continue to be able to meet its obligations to existing policyholders." (*Id.* at Stip. 46.)

101. "Even as the limitations on new business production were being announced, the Northridge Earthquake occurred in southern California in January 1994. The earthquake itself cost over $3 billion in policyholder losses[ ]" and also resulted in policy restrictions. (*Id.* at Stip. 47.)

B. *Risk Provision of the Contract*

102. Section I L of the AA3 and AA4 contracts provides:

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

(PX 1,2.) The AA97 contract, while containing the same risk-provision language in section I L as the AA3 and AA4 contracts, added the following clause immediately thereafter: "and submissions of applications by individual agents, by market area, by line of coverage, by policy type, and Company, or by other means." (PX 3.)

C. *The Restrictions at Issue*

103. In 2001, the Company lost over $5 billion and lost $2.5 billion in 2002, due principally to "unprecedented" claim severity (average cost per case) caused by precipitous

increases in repair and medical costs, and further due to inadequate rates, reduced investment income and increased costs associated with rapid growth. (Wright, 7/28, Tr. 295:11-298:4.) As a consequence, the Company was downgraded by one insurance rating agency and another issued a warning on the adequacy of the Company's financial resources. (*Id.* at Tr. 300:14-301:19.)

104. To recover its financial health, State Farm undertook in 2002 a number of actions: (1) it "attacked expenses on every front" (*Id.* at Tr. 299:5-10), (2) it raised rates aggressively wherever it could (*Id.* at Tr. 299:9-10), (3) it intensified its reevaluation of existing policyholders to ascertain compliance with its underwriting standards (*Id.* at Tr. 299:10-17) and (4) it placed limits on the writing of new business because it was "absolutely necessary." (*Id.* at Tr. 299:19-300:14-19.)

D. *The Decisional Process Leading to Restrictions*

105. State Farm "targeted . . . [its] actions" to the diverse circumstances "in territories within each state." (*Id.* at Tr. 301:20-302:2; Swift, 7/28, Tr. 282:19-283:1.) Limitations were set in a "collaborative effort" between each zone management team, consisting of its vice president, actuaries and underwriters, and a headquarters team consisting of its actuaries, underwriters and member's of the Chairman's Council, which included Wright. Each zone submitted a plan to the Council with a profit target, and the plan would be refined in a back-and-forth deliberative process. Targets were set based on historical loss trends and rate adequacy in each market. (*Id.* at Tr. 302:3-304:6).

106. Mary Bitzer, State Farm's central zone vice president, testified to the consideration given to restricting new business at least once a year by her executive team. Production reports, claim severity reports and payment reports were considered, although

no document (such as minutes) was generated as a result of the meeting. The review was not conducted according to a written procedure or an exact process. Consideration was given to profitability and growth of product, costs incurred, investment returns and the business and regulatory environment. Each team member made recommendations. (Bitzer, Dep. Tr. 7:24-11:10). Agent concerns were considered but not the effect upon their compensation. (*Id.* at 27:21-29:24.) Wright, speaking for headquarters, stated State Farm was "very concerned" about agents, including their incomes. (7/28, Tr. 305:1-12.) Bitzer confirmed the collaboration with corporate headquarters (Dep. 11:14-12:25.)

107. I do not find, as NASFA does, State Farm's witnesses in material contradiction. The decisional process, although informal, was deliberative, responsible and thorough. It was reasonable in both the manner in which it was conducted as in the result reached.

E. *Impact on Agents*

108. NASFA's evidence, not disputed by State Farm, is that agents suffer an annual attrition rate of 12 to 15% of policyholders. (Swift, 7/28, Tr. 272:4-9.) Collateral losses follow. (*Id.* at 270:2-8, 271:10-19.) On the other hand, State Farm's evidence shows, and NASFA admits, agents incomes rose substantially during the variable restriction periods (Wright, 7/28, Tr. 305:13-306:18; DX 74), primarily because of the rate increases. (*Id.* at Tr. 306:19-24.)

F. *The Current State of Restrictions*

109. By the end of 2004, substantially all of the restrictions were lifted as State Farm's profitability improved. (*Id.* at Tr. 307:5-14.) New business limitations remained at that time only in the hurricane states of Texas, Louisiana and Florida. (*Id.* at Tr. 307:20-308:3.)

Conclusions of Law

A. *Breach of AA3/4 Contracts*

110. While conceding the AA97 amendment to section I L of the contract empowers State Farm to limit new business by types or categories of policies, NASFA denies State Farm had that power under the earlier contract versions and insists that acceptance or rejection of risks was limited to individual policies. (Finding 102.) The question now raised by NASFA as to the AA3/4 risk provision had been raised in prior litigation (Conclusions 111, 112, *infra*), and no doubt State Farm intended to lay the question to rest by the AA97 amendment. "The fact that State Farm subsequently added language to clarify the Risk Provision does not suggest that the explicit language at issue [in the AA3/4 contracts] did not authorize the exposure management program [limiting new business]." *Appling* v. *State Farm Mutual Auto Ins., Co.,* 340 F.3d 769, 779 (9th Cir. 2003). State Farm expressly reserved in the earlier contracts "the right to prescribe . . . rules governing the binding, acceptance, renewal, rejection, or cancellation of risks, and adjustment and payment of loss." The right to promulgate "rules . . . governing the . . . acceptance . . . of risks" clearly denotes the power to regulate by broadly categorizing risks that will be accepted and those that will not. Granted that the categories selected by rule may affect only narrow, individualized risks; yet there is nothing in the contract language authorizing rule making that precludes rules limiting risks by broad types of policies.

111. The case law involving the AA3/4 contracts has sanctioned broad restrictions on the submission of new business. *Hartman* v. *State Farm Mutual Auto. Ins. Co.,* Case No. 93-8084 (S.D. Fla. 1993), *aff'd.,* 77 F. 3d 496 (11th Cir. 1969) (limiting new homeowners and

auto insurance due to hurricane Andrew);[37] *Appling,* 340 F. 3d at 779 (variable limits on new business due to hurricane Andrew and Northridge earthquake; "This provision is patently clear: State Farm has the right to prescribe rules governing risks.") Illinois would, I have no doubt, concur with these cases, especially in the light of the authority cited in the next Conclusion.

112. NASFA further claims that any power to curtail new business must be premised upon risks arising from a natural catastrophe and not purely economic risks. Such a contention is at war with the stipulation on prior usage: "Historically, these previous limitations were occasioned by unforeseen or unforeseeable events like natural catastrophes or economic downturns." (JPTS Stip. 43.) Since every risk of loss that section I L addresses is, at bottom, an economic loss, it makes no sense to restrict gratuitously the economic loss solely to one species, *i.e.,* natural disaster. Illinois has repudiated an attempt to confine section I L to natural disasters. *Jessen* v. *State Farm Mutual Auto. Ins. Co.,* 174 Ill. 2d 564 (Ill. 1997).[38] In that case, summary judgment for State Farm was affirmed, upholding an agent's one year restriction from writing new automobile insurance under the original form of section I L because of the significant, purely *economic* losses incurred by the agent's policyholders. Claims of breaches of contract and bad faith were rejected. *Accord, Henmans* v. *State Farm Ins., Co.,* 653 So. 2d 69 (La. App. 1995) (same facts as *Jessen.*)

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[37] The District Court held, "This language clearly and unambiguously reserves to State Farm the right to control the amount of risk assumed by its companies through their intermediary agents." *Hartman*, Case No. 93-8084 (S.D. Fla. 1993), Final Order of Dismissal With Prejudice at 9.

[38] The lower court's ruling, *Jessen State Farm Mutual Ins. Co.,* No. 1-96-1048 (Ill. App. 1997), is unpublished.

113. NASFA further claims that a *foreseeable* economic slump cannot justify invocation of section I L to restrict new business. The argument rests upon the claim that, "where an insurer enters into a line of business, it is obligated to remain in that business so that agents will not be deprived of the benefits of their contract." (Pl.'s Prop. Find. and Conc. ¶ 157 at 39.) Having thus posited a *contractual* duty owed by State Farm to its agents, NASFA asserts that State Farm can only be "excused from performance by [the contractual defenses of] impossibility or commercial impracticability" which can apply "only when the procuring cause is not occasioned as a result of foreseeable and avoidable events or the . . . [party's] own act." (*Id.* at ¶ 159 at 39.) *Speakman* v. *Allmerica Financial Life Ins. & Annuity Co.,* 367, F. Supp. 2d 122 (D. Mass. 2005), is cited as enunciating this rather singular common law duty to remain in a line of business. *Speakman,* however, falls far short of the mark. The case in fact sounds in fraud. The company induced its agents to give back past commissions paid to them from particular variable annuities in exchange for the company's promise to repay the agents with higher commissions to come from future premiums received from variable annuity policies. Having pocketed the commission moneys given back in reliance upon the company's promise, the company discontinued the product. The general employment contracts in this case are a world apart from the special, post employment contracts in *Speakman,* which defrauded the retired agents. The case can have no application here.

114. Hence, forseeability of an economic downturn has nothing to do with the issue at hand, nor does contributory fault of State Farm's executives. As long as the judgment exercised was in good faith, the agents may not complain. The duty NASFA claims here posits a duty higher than the Company owes to its shareholders.

B. *Good Faith and Fair Dealing*

115. The only attack on the AA97 contract is on the basis of the implied covenant. (Pl.'s Prop. Find. and Conc. ¶ ¶ 165-172 at 41-42.)[39] NASFA faults the decisional process leading up to the decision to suspend new business on the grounds that it was "undirected, without standards, and apparently arbitrary." It further complains that State Farm did not come up with better evidence. I have found that the decisional process meets the standards of good faith. (Finding 107.) The burden of persuasion rested upon the plaintiff making the claim, although the soundness of the process was established by a preponderance of the evidence.

V. Brokering for Other Insurers

Findings of Fact

A. *Contractual Provision*

116. Section I G of all contracts provides:

> The fulfillment of this Agreement will be your principal occupation, 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.

(PX 1, 2, 3.)

B. *Historical Background*

117. "For at least half a century, State Farm agents have been exclusive agents who, except in rare circumstances, solicit business only for State Farm. There are no insurance

[39] The arguments that section I L applies only to natural disasters and that, if it is applicable to purely economic slumps they must be unforeseeable, are not directed to the AA97 contract.

agents other than State Farm exclusive Agents who solicit business for and receive commissions from the Company." (JPTS Stip. 48.)

118. "The Company invests resources nurturing its brand identity through Agents, including State Farm's frequent national television advertisement highlighting the qualities of its 'good neighbor' Agents. The exclusive relationship between State Farm and its Agents benefits the Agents as well as State Farm." (*Id.* at Stip. 49.)

119. "State Farm has given consent to Agents who have signed a separate Agreement with a State Farm subsidiary known as IPSI (the IPSI Agreement) to solicit applications for Fortis Insurance Company and Phoenix Mutual Life Insurance Company thru IPSI." (*Id.* at Stip. 50.) State Farm entered into alliance[s] with Fortis and Phoenix contemplating such activities by its agents. (Fisher, 7/27, Tr. 222:2-12, 24-25.) "Each of these companies provides products that State Farm does not provide. Fortis, for instance, provides health products that State Farm does not, including short term medical and student health policies. Phoenix Mutual provides high-end life insurance products State Farm does not provide." (JPTS Stip. 51.) "In addition, in very rare circumstances, such as where no state FAIR plan or industry association plan is available, the Company has allowed agents to write business for other private insurance companies." (JPTS § G, Defs.' Req. Stip. (26) at 47, as agreed to in Pretrial Order July 11, 2005, § (4) at 2.)

C. *State Farm Policy on Consent to Broker*

120. The foregoing instances of consent brokering were exceptions to State Farm's general policy of not permitting brokering. (Fisher, 7/27, Tr. 206:18-23.) Asked when there "might . . . be an exception to the no-brokering policy[,]" Fisher replied, "In a circumstance in which we are not in a market, a product market, we have no plans to enter or reenter it,

and we don't feel like we are competing with the company that is in the market." (*Id.* at Tr. 216:4-9.) State Farm's view of a competitor includes a small company that sells only one type of insurance that State Farm also sells under the rationale,

> [W]e sell policies one at a time. And for everyone that our competitors get is one that we don't have a chance to compete for potentially. It's not the size. It's the fact that we would be their competitors in the marketplace.

(*Id.* at 218:7-15.)[40] The *reasons* for State Farm's overall policy of "no-brokering subject to the no-competition exception" involve nine "factors" that have been set forth in letters denying consent to broker:

> In deciding whether to grant its consent, State Farm considers the following factors: the 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 Farm or a partnered company, and the potential for strained Agent loyalty.

(PX 45.) State Farm erred in describing the recited circumstances as "factors" it considers "[i]n deciding whether to grant consent." Rather, they were factors that shaped the standard used in deciding whether to consent. But there is no evidence that this mischaracterization, seized upon by NASFA, occurred in bad faith.

D. *Agent Request to Broker*

121. The restrictions on new business instituted in 2002 (section IV, *supra*), brought

[40] The intensity of State Farm's spirit of competitiveness with other carriers was probably matched by the agents' rivalries with each other; yet neither State Farm nor its agents could accommodate the other until State Farm receded with the 3RD modification of PAP.

a number of requests by agents to broker. Only the denials of the requests of David Swift and Clifford Mueller are in issue. "The following State Farm Agents [also] submitted written requests to State Farm for permission to write business for other insurers: Terry McManus (April 9, 2003), Jim Moore (April 10, 2003), Alan Shultz (June 4, 2003), Patricia Adkins (April 9, 2003), Frank Dutto (April 23, 2003)." (Supp. JPTS Stip. A(9) at 3.) "State Farm sent letters denying their requests." (*Id.* Stip. A(10) at 3.)

1. Request of David Swift

122. "On November 25, 2002, NASFA President David Swift wrote State Farm asking the Company to permit Agents subject to limitations on their production of new business to solicit business for all other insurers, including competitors of State Farm." (JPTS Stip. 52.) "In his letter to State Farm, Mr. Swift asked the Company to solicit for any other insurer because the then-existing limitations on new business production

> have drastically disabled, or entirely eliminated, the ability of Agents to operate profitably. Without the ability to service the needs of new customers, the ability of each Agent's business is severely impaired."

(*Id.* at Stip. 53; DX 79.)

2. Request of Clifford Mueller

123. Mueller, a State Farm agent for 30 years in Amosville, Virginia, requested leave to broker because State Farm had suspended writing fire insurance in Virginia. (7/27, Tr. 151:3-10, 152:1-9; PX 92.)[41] Such insurance was being requested by his clients, prospective clients and "centers of influence," whom he developed over 25 years, and "it was very embarrassing for one who purports to be everybody's good neighbor not to be

[41] Fire insurance and homeowner insurance are used interchangeably.

able to take care of their needs." (*Id.* at Tr. 156:11-16.) His e-mail request on October 24, 2002 did not specify an insurer. (*Id.* at Tr. 170:13-18; PX 92.)

124. State Farm's fire insurance suspension in Virginia had been in place since August, 2002. (*Id.* at Tr. 171:22-24; Whitney, 7/27, Tr. 197:3-5.) It's intent was to lift the suspension as soon as possible and, when Mueller's request was received, zone management was in receipt of market report evaluations on State Farm's position which found the "trends very favorable." State Farm planned to reenter the fire insurance market as early as December 2002, and it ultimately did so. (Whitney, 7/27, Tr. 204:22-205:6; Mueller, 7/27, Tr. 171:18-21).

125. Mueller's request to broker was referred to William Whitney, the Agency Vice President for Virginia. (Whitney, 7/27, Tr. 189:25-190:5.) Whitney was aware during his discussions with Mueller of State Farm's plans to reenter the Virginia fire insurance market as early as December 2002. (*Id.* at Tr. 204:11-21.) Before speaking with Mueller, Whitney called State Farm's headquarters and verified that State Farm's policy remained, to deny brokering where the other company was deemed a competitor. (*Id.* at Tr. 191:23-192:4, 201:19-202:6.)

126. Whitney then called Mueller and denied the brokering request. (Mueller, 7/27, Tr. 153:17-24; Whitney, 7/27, Tr. 194:5-6.) At Mueller's request, Whitney e-mailed a confirmation of the denial. (Mueller, 7/27, Tr. 154:4-9; PX 92.) The Whitney e-mail evidences a wide difference between the two accounts of the telephone conversations. The e-mail denied a request to broker for Allstate or Nationwide, full-line companies who compete nationally with State Farm in virtually every line of insurance. (PX 92.) Mueller denies ever mentioning those companies. (7/27, Tr. 155:13-15.) Instead, he says that he

mentioned brokering for two small regional companies, Loudon County Mutual and Northern Neck Insurance. (*Id.* at Tr. 155:12-18.) Whitney denied the mentioning of those companies. (7/27, Tr. 192:18-193:6.)

127. It was stipulated by counsel that during the period August 2002 to December 2002, both Loudon Mutual Insurance Company and Northern Neck Insurance Company were regional, limited-line insurance companies, each engaged in writing fire (including homeowners) insurance. Loudon also wrote personal umbrella insurance, a product that State Farm had never suspended in Virginia. (7/29, 485:11-488:8). State Farm policy would have required that brokering for either Loudon or Northern be denied since each was viewed to be a competitor. (Whitney, 7/27, Tr. 197:23-198:9; Fisher, 7/27, Tr. 218:17-219:5.)

Conclusions of Law

A. *NASFA's Claims*

128. NASFA contends State Farm violated the implied covenant of good faith and fair dealing because: (a) "its refusals to [permit brokering] were not in accord with its stated reasons;" (b) "State Farm failed to show it gave any reasonable consideration to the Agent's requests[;]" and (c) "State Farm's reasoning—that allowing agents to broker would amount to turning its clients over to the competition—is illogical and unsupported." (Pl.'s Post T. Mem. at 14.)

B. *Good Faith and Fair Dealing*

1. Consistency of Refusals and Reasons

129. The apparent lack of consistency was due, as I have found (Finding 120), to State Farm's mischaracterization of the nine factors as guides in the decisional process

rather than as factors that shaped the standard used to determine whether to consent. The error was inadvertent and not the product of bad faith.

2. Consideration of Broker Requests

130. NASFA's contention, that State Farm failed to show it gave reasonable consideration to the requests for brokering, inverts the burden of persuasion. Having brought this action and made the bad faith claim, the burden, of course, is upon NASFA. Nevertheless, Swift's application for "all Agents" to solicit "automobile and homeowner insurance" on behalf of "all other insurance carriers where State Farm has limited, in any capacity, an Agent's ability to sell new insurance policies[ ]" was hopelessly overbroad on its face and properly rejected. Mueller's e-mail application was sent three months into State Farm's Virginia limitation on new fire policies. The e-mail did not proffer any specific carrier for whom he wished to broker. This defect was cured, he says, when he told Whitney on the telephone that he wished to broker for Loudon and Northern Neck.[42] Since Whitney knew that the limitation on fire coverage might well be lifted in two months and since both Loudon and Northern Neck were competitors in that very line of business, I cannot hold that State Farm's denial of consent was unreasonable.

3. Fear of Losing Clients

131. Nor can I conclude that State Farm's fear of losing clients by brokering is "illogical and unsupported," as NASFA claims. Fisher's discourse on protecting trade

[42] State Farm overstretches the record in attributing to Mueller the words "such as" in asking to broker for Loudon and Northern Neck. No transcript citation is supplied. (Defs.' Prop. Find. and Conc. ¶ 221 at 80.) Further, Mueller's testimony was not "directly contradicted" by Whitney who, although stating that "the only companies mentioned in the conversation were Allstate and Nationwide," could not say whether he or Mueller mentioned them. (*Ibid.*)

secrets, the sixth "factor" in shaping State Farm's policy standard on broker consent, is compelling evidence that the fear is not groundless and arbitrary. (7/27, Tr. 210:19-211:24.)

VI. Mandatory Meetings

Findings of Fact

A. *Inception of Policy*

132. "During the 1990's, the insurance industry endured a considerable amount of adverse publicity[ ]" regarding ethical practices of insurers and agents. (JPTS Stip. 56; Wright, 7/29, Tr. 631:5-18.)

133. "In response to these developments, a number of insurers came together and formed 'IMSA,' the Insurance Marketing Standards Association." (JPTS Stip. 57.) "As part of its mission, IMSA offers certification that member insurers are 'compliant' organizations if they can demonstrate their commitment to ethical business practices." (*Id.* at Stip. 58.) "In approximately 1998, State Farm sought IMSA certification for the first time." (*Id.* at Stip. 59.)

134. IMSA leaves it to the applicant to decide the particulars of the ethical showing it will make in order to demonstrate compliance. (Wright, 7/29, Tr. 632:12-633:15.) "As part of its effort to demonstrate its commitment to ethical business practices, and more generally to make sure that all Agents were fully informed about recent legal and regulatory developments in the industry, State Farm instituted a mandatory, once-yearly ethics/compliance program for Agents." (JPTS Stip. 60.)

135. "The first such program was conducted in 1998; it has been held every year since." (*Id.* at Stip. 61.) "The program lasts for half a day, typically the morning hours." (*Id.*

at Stip. 62.) "Personal attendance by all Agents is required. Agents who do not attend risk having State Farm terminate their contracts." (*Id.* at Stip. 63.) "According to . . . Wright, the Company decided that matters of ethical, legal and regulatory compliance are of sufficient importance to require Agents' attendance (once a year, and for half a day) in this exceptional case." (*Id.* at 64.)

136. Meetings are held at an agent's AFO and, if unable to attend, the agent may attend a meeting held in another AFO in the same state. (Wright, 7/29, Tr. 630:16-18; Knapp 7/29, Tr. 619:5-11.)

B. *Agendas*

137. "The topics covered [at the annual meetings] vary from year-to-year." (JPTS Stip. 61.) Topics in the past have included theft, money laundering, privacy, claims handling, managing trade secrets and information security. (Wright, 7/29, Tr. 636:20-637:3.) In 2005, the agenda included solicitation guidelines, policyholder signature practices and management of premium fund accounts. (DX 41.)

C. Alternatives Considered

138. State Farm considered alternatives other than agent meetings for providing continuing ethical and legal education as they impact insurance. The option of self-study programs was discarded by State Farm because of the inability effectively to monitor intake of the materials and the necessity "to make a strong statement" in view of the exposure to class action suits that would "provide us a defense against a pattern and practice type of suit indicating that we were lax in the area of compliance[.]" (Wright, 7/29, Tr. 633:2-15, 637:4-20.) Knapp, perhaps the ultimate independent contractor, asserted that State Farm "does not have the right to administer a test to me at all[,]" thus confirming that monitoring a

self-study program would be ineffectual. (7/29, Tr. 627:9-22.) The meeting alternative also had the advantage of permitting agents to share their views. (Wright, 7/29, Tr. 634:23-635:7.)

Conclusions of Law

A. *Contractual Provisions*

139. In addition to section I B, the independent contractor provision of the contracts (Conclusion 64), plaintiff relies upon the fourth preamble paragraph of each of the contracts which, after alluding to the assistance and guidance State Farm will provide its agents, states:

> In turn, we will *invite* you to attend such meetings as may be called by the Companies for the purpose of introducing new products, ideas, services and procedures, promoting sales, and furnishing you with assistance, guidance, and consultation to better enable you to achieve your potential.[43]

(PX 1, 2, 3; emphasis added.)

140. Defendants cite the first two preambles: (1) "It is to our mutual interest to serve the insuring public [and] to comply with all applicable laws . . . "and (2) "The Companies and the agents must deal equitably with policyholders as to rates and claims, be trustworthy in handling money, avoid false advertising and unfair practices, and otherwise act in a lawful manner." State Farm contends these policy declarations are implemented in section I A's declaration that "[T]he Agent will . . . *comply with all laws and regulations,* and cooperate with and advance the interests of the Companies, the agent, and the policyholders." (PX 3; emphasis added.)[44]

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[43] The AA97 contract omits the last eight words.

[44] The italicized language, which is of key significance in the quotation, is not found in either the AA3 or AA4 contracts, a circumstance that defendant was duty bound (but did not) reveal.

141. The AA97 contract has another significant operative provision not found in the earlier contracts. In section I B, just before the independent contractor language, the first sentence provides, "As a State Farm agent, you are obliged to follow State Farm procedures and processes and to provide prompt, friendly, accurate and cost effective services." A grudging construction of "procedure" and "process" might confine the words to solicitation and service, thus avoiding a more expansive view that takes into account the process that prepares the agent for the ethical and legal responsibilities involved in soliciting and servicing. Rather than have half of the agents bound by one provision and the remainder by another, I will not rest my opinion on section I B.

B. *The Preamble and its Implementation*

142. While it is said preambles do not generally create affirmative obligations but, instead, throw light on the operative terms of a contract, *Atlantic Mutual Ins.* v. *Metron Engineering*, 83 F.3d 897, 899 (7th Cir. 1996), citing *Illinois Housing Development Authority* v. *M-Z Const. Corp.,* 110 Ill. App. 3d 129, 145 (Ill. App. 1982), the proposition somewhat oversimplifies the matter. While preamble language typically is hortatory and expressive of purpose or policy,[45] some preamble expressions speak unequivocally of duties and could just as soon be placed in the body of the contract.[46] Such a substantive expression, instinct with obligation, is the second preamble's enjoinder, "The Companies and agents must deal

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[45] *E.g.,* in the first preamble paragraph: "The purpose of this Agreement . . . ; the third paragraph: "independent contractors . . . are best able to provide . . . ;" and the last: "The companies and the Agent expect . . . ."

[46] *E.g.,* in the fourth preamble: "We [the Company] will provide you . . . 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."

equitably with policyholders as to rates and claims, ..." To relegate this imperative to the benign but empty introduction of an agreement is to elevate form over substance. Treating the provision as a substantive duty, it would certainly justify the post contractual mandate of an annual, half day meeting.

143. Alternatively, if the "must deal equitably" provision is considered pure preamble, it should still be a sufficient contractual presence to support subsequent implementation by the meeting rule. After all, the Company's need for the rule is compelling while the agent's burden is nominal. With 16,000 agents, the Company's exposure to liability for an agent-independent contractor misstep is formidable in view of the liability theories involving its personal negligence ("pattern and practice") and the many exceptions that riddle the nonimputation-of-liability rule of independent contractors. PROSSER and KEETON on THE LAW of TORTS § 71 (W. PAGE KEETON *et al.* 5th ed. 1984). Also, as the Company says, "good ethics is good business." The agents, on the other hand, forgo several morning hours once a year. They will, however, receive valuable instruction in return on avoiding financial liability on their own part. *Samson* v. *Harvey's Lake Borough*, 881 F. Supp. 138, 143 (M.D. Pa. 1995) (monthly meeting attendance and preparation of reports "do[ ] not indicate . . . [employer] supervision or control of . . . [independent contractor's] daily work activity.")

144. Accordingly, I hold that the preamble's enjoinder that "agents must deal equitably with policyholders" was a sufficient contractual basis for the annual ethics meetings.

C. *Common Law Duty of Agent to Principal*

145. State Farm claims alternatively that the agency component of its independent contractor relationship with its agents enables it, under the common law of agency, "to issue

reasonable directions to agents . . . [which] agents must obey, whether or not there is a written contract between the parties." The Restatement is cited:

> Even specific agreements, however, must be interpreted in the light of the principles which are applicable to the relation of principal and agent. The existence of the fiduciary relation between the parties, and the duty of the agent not *to act for the principal* contrary to orders, modify all agency agreements and create rules which are *sui generis* and which do not apply to contracts in which one party is not an agent for the other.

RESTATEMENT (SECOND) OF AGENCY, *supra* Intro. Note, Ch. 13, Topic 1. (first emphasis added.)

146. But the Restatement discussion is not concerned with general orders given by the principal to an agent. Rather, it is confined to orders directed to the agent when "act[ing] for the principal[.]" Stated otherwise, the Restatement discussion concerns the representative actions of an agent with third parties and, in that regard, the Restatement declares that the fiduciary relationship imposes a "duty of the agent not to act for the principal contrary to orders[.]" We are here concerned with a principal's order whose immediate concern is the attendance by the agent at intramural meetings involving other agents, not interacting with third parties.

147. But this would be a crimped view of both State Farm's meeting rule and the Restatement rule. The sole purpose of State Farm's meeting rule looks forward to the agent's capability in "acting for" State Farm with third parties. Looked at otherwise, the common law rules on agency dealing with third party transactions are sufficiently adaptive to

require compliance by the agent with orders that contemplate being reasonably informed in the demands of law and equity in dealing with third parties.[47]

148. The Restatement rule was cited with approval and applied in *Hanover Insurance Co.* v. *St. Paul Fire & Marine Insurance, Co.* 359 F. Supp. 591 (W.D. La. 1973), a case in which the underlying agency contract reserved to the insurance company the right to cancel policies and was silent on agent cancellation. The agency was held liable for losses that ensued after it failed to cancel a policy when ordered by its principal to do so. In positing the issue, the court stated, "The fact that the principal reserves the right to directly cancel a policy does not relieve the agent of its obligation to effect cancellation when so requested by the company, if such is the duty of the agent." *Id.* at 594. The Restatement introductory note was quoted and relied upon in deciding that the "assertion . . . the Agency was under no duty to cancel the policies as requested by plaintiff is totally devoid of merit." *Ibid.*

149. That the Company said it would "invite" agents to meetings does not forswear its power to require nominal appearances for matters of compelling importance for all concerned.

Plaintiff is to prepare a declaratory judgment on the Partner Agent and Select Agent Programs. Defendant is to prepare a judgment on the remaining issues.

12-16-05
Date

Leonard Braman
Senior Judge Leonard Braman
(Signed in Chambers)

[47] RESTATEMENT (SECOND) OF AGENCY, *supra*, § 14 cmt. b, also cited by State Farm, begs the question of whether the principal's subsequent order is a breach of contract by stating conditionally that the agent must obey "if he continues to act as such." I have found no such breach here.

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