

The cases treat the corporation franchise tax as a privilege tax or as a condition for doing business as a corporation within the state, whether the corporation be domestic or foreign. The tax need have no relation to the property held nor to the business done nor to the value of the stock or the amount paid for it. Only some relation to the privilege granted or exercised must be shown to render the tax constitutional.<sup>39</sup> And the relation of the tax to the privilege, required for equal protection, need not be to the value of the privilege; for the franchise is not assessed or evaluated as by a business man. As regards classification of corporations, it is sufficient if legal distinctions<sup>40</sup> are made, based, for example, upon freedom in fixing the price of the stock with the attendant ease and facility in its issue and marketing.

The result of these cases seems clear. Taxes on the number of shares or based on an arbitrary valuation are constitutional under the equal protection clause, on either authorized or issued stock of domestic corporations, and on the issued stock of foreign corporations. Only the authorized stock not yet issued by foreign corporations is exempt, partly because of the operation of the commerce clause of the Federal Constitution. But the constitutionality of the taxes does not imply fairness or expediency which now become the main questions for the tax making bodies. The unequal results of a fixed method regardless of actual value have been pointed out, so arbitrary value or tax on the number of shares have been disapproved. And the *Latrobe* case observed that even taxation on par or the consideration received brought some serious discrepancies. This leaves us with the possibility of Mr. Wickersham's second method of those that have been tried, that of taxing according to a fixed value until the actual value is shown. The expense of collecting the tax is an element in determining expediency. Assessing is more expensive than an arbitrary method, and it is difficult to determine the value of the property or franchise of a large corporation. This hindrance is alleviated by causing the overtaxed corporation to present to the court a schedule of assets before the assessment may be changed. The practical difficulties have weight, but should not outweigh the consideration of what is fair and equitable.

ROBERT J. HARDING, '30.

#### DETERMINING PROFITS OF FIRE INSURANCE COMPANIES FOR RATE REGULATION

Administrative control over the rates and premiums of insurers is a recent development. The people, having brought the

<sup>39</sup> *Southwestern Oil Co. v. Texas* (1909) 217 U. S. 114 at 126.

<sup>40</sup> *Quaker City Cab Co. v. Pennsylvania* (1928) 277 U. S. 389; (1929) 27 MICH. L. REV. 800.

railroads and other public utilities within bounds, quite naturally turned to the organizations most fraught with public interest outside of the field of public utilities. The fixing of insurance rates is a problem far more difficult than determining rates for other public services. Progress is necessarily slow; but there has been a definite advancement since a Kansas statute authorizing the superintendent of insurance to fix fire insurance rates was declared constitutional by the United States Supreme Court in 1914.<sup>1</sup>

The usual means of control is the insurance commissioner or superintendent, appointed by the governor and given certain powers by statute. With regard to the altering and fixing of fire insurance rates, the commissioner usually has the power of approval or disapproval of rates proposed by the companies, his approval being necessary for the schedules to go into effect. Another power, and one very popular with the commissioners, is that of ordering in rates, where they are excessive, a blanket reduction. The statutes lay down but few guides to the commissioner in the exercise of this important power. One class of provisions for his guidance comprises principally such vague phrases as "discriminates unfairly,"<sup>2</sup> "increase is justifiable,"<sup>3</sup> and "methods employed shall be reasonable."<sup>4</sup> A more effective type of guide is one providing that the commissioner shall determine the excessiveness of a rate or class of rates by reference to the profits derived therefrom over a period of years immediately preceding the adjustment.<sup>5</sup> Provisions of this sort at least require consideration of the data over a substantial period of years and prevent reductions because of one or two abnormal years. But at best these statutes give the commissioner very meager directions as to the method of determining rates.

It is fortunate, in view of the meager directions given the commissioner, that the statutes usually provide for judicial review of his decisions. The provisions usually indicate more or less clearly that the court is authorized to investigate and decide *de novo* the questions passed upon by the commissioner.<sup>6</sup> Many of the legislatures have provided simply for a "review" or "appeal." Such provisions have been interpreted as authorizing a full judicial review on the merits.

---

<sup>1</sup> German Alliance Insurance Co. v. Lewis (1914) 223 U. S. 389 (suit to enjoin enforcement).

<sup>2</sup> N. Y. Laws 1922, c. 660, sec. 1; Colo. Laws 1919, c. 138, sec. 9; Pa. Stat. (1922) sec. 12221; Wis. Stat. (1927) sec. 203.38.

<sup>3</sup> Ohio Laws 1919, sec. 9592.

<sup>4</sup> N. Y. Laws 1922, c. 666, sec. 2; Vt. Laws 1919, No. 148; Wis. Stat. (1927) sec. 203.38.

<sup>5</sup> N. Y. Laws 1922, c. 660, sec. 2; S. C. Laws 1917, No. 183, sec. 14; S. D. Laws 1920, c. 66; Wyo. Laws 1921, c. 142, sec. 17; Mo. Laws 1915, p. 313.

<sup>6</sup> Mo. Laws 1915, p. 313.

The commissioner, as we have seen, usually has the power to determine the excessiveness of a rate or class of rates by reference to the profits derived therefrom. Whether or not rates are excessive depends upon whether the premium collected over a considerable period provides not only adequate protection but also a fair profit to the underwriter. The fixing of reasonable fire insurance rates involves applying very technical standards to a mass of data. Statutes never set out the method to be employed by the commissioner in determining profits with a view to ascertaining their reasonableness. Yet everything depends upon the particular method employed. Let us see what the courts, particularly the Missouri courts, in the exercise of their power of review over the commissioner's decisions, have said about the method of determining the profits of fire insurance companies.

In determining whether or not there has been a "reasonable" profit, it is necessary first to find out what the profit is. This naturally represents the difference between income and expenditures. The bases of income and expenditures present the controverted questions. Before entering on a discussion of the decisions of the courts regarding the proper method of determining profits, it is advisable to give a working definition of the necessary technical terms used in the fire insurance business. The business is not one dealing in commodities but in service, indemnity from loss by fire. The service is rendered under contracts by which the insurer assumes the obligation to indemnify. The consideration for this obligation is a payment by the insured called a premium. Premium is referred to as "earned" and "unearned." As soon as a premium is paid it becomes the absolute property of the insurer as compensation paid for the contract of indemnity. It is "earned" in the usual sense of the word. For that reason the terms "earned" and "unearned" when applied to premiums are not accurate unless the sense in which they are used is understood. The terms are used in two connections, with the cancellation of the policies and also with the protective reserve.

Policies provide for cancellation by either party during the life of the policy. As cancellation ends liability before the end of the term for which the insured has paid, there is provision for repayment of that portion of the premium paid for the term remaining after cancellation. The portion of the premium paid which must be returned is designated "unearned," while premium for the term before cancellation is "earned."

The reserve has to do with losses under the policies. The insurer must always be financially able to pay such losses promptly. Sound and honest business acumen requires the maintenance of a liquid fund proportioned to the outstanding risks. To pro-

tect policyholders by assuring a sufficient reservation, the states have enacted laws with the idea, usually, of securing such protection through reinsurance. A fund sufficient to reinsure is required. As premium rates are the same for all companies—by law or by business necessity—the premium for the unexpired terms of the policies is sufficient. This amount is called the “unearned” premium. The balance of the premium is “earned.” It is obvious from the foregoing that whether “unearned” premium be defined as the portion necessary for reinsurance in a solvent company in case of the insolvency of the insurer, or as the sum to be repaid to the insured on cancellation of the policy, the nature and amount are the same.

R. S. Mo. (1919) sec. 6283 authorizes the superintendent of insurance to reduce rates of stock fire insurance companies whenever the earnings of such companies over a five year period show “an aggregate profit therein in excess of what is reasonable,” so as to limit “aggregate collections of insurance companies in this state to not more than a reasonable profit.” Sec. 6284 provides for a review of such order “by a proper action in the courts” wherein “the entire matter shall be treated and determined *de novo*.”

On Oct. 9, 1922, Hyde, then superintendent of insurance, issued an order reducing rates on insurance offered by stock fire insurance companies ten per cent. One hundred and sixty companies filed a petition in the Circuit Court of Cole County praying the court to review the findings and order of the commissioner and set it aside.<sup>7</sup> The Supreme Court, taking the case on appeal from a decision canceling the order, was faced with the problem of determining whether the aggregate profits of the companies for 1917, 1918, 1919, 1920 and 1921 were in excess of what is reasonable. The plaintiffs and the defendant, using practically identical figures, the superintendent being largely dependent in his findings on the data furnished by the companies, reached diametrically opposite results. According to the plaintiffs' calculations the underwriting business in the State of Missouri was operated at a loss over the five year period. The findings of the superintendent, on the other hand, showed an enormous profit. The secret lay in what Justice White termed “the unexplored mysteries of bookkeeping.” The plaintiffs contended that income should be based on “earned” premiums, and that no account should be taken of “unearned” premiums. The defendant insisted that all paid premiums, “earned” and “unearned,” should be included in income, together with interest on investments representing the “unearned” premiums. The two real points of difference, then, were whether “unearned”

---

<sup>7</sup> *Aetna Insurance Co. v. Hyde* (1926) 315 Mo. 113, 285 S. W. 65.

premiums should be included in income, and whether the interest on the invested "unearned" premiums should be so included. The companies argued that the "unearned" premiums were not theirs and might never become theirs. But the court answered that while it was true that the fund might, in case of insolvency, be used for reinsurance, and be lost to the company, the nature of the business made the fund necessary and meanwhile it was earning the same income as the other investments.

The methods of determining the profits contended for by the parties also differed as the basis for calculating losses, whether it should be losses actually paid during the test period, or the losses "incurred," the "incurred" losses being the losses as originally claimed, running from ten per cent to twelve and one half per cent more than the losses actually paid.

The Missouri Supreme Court upheld the order of the superintendent of insurance in declaring that the reasonable profit permitted the companies under sec. 6283 is properly determined on the underwriting business done and not the capital invested. And the proper method to ascertain profit is to deduct losses paid during that period from the premiums received, including the interest on "unearned" premiums.

The companies, having lost in the state courts, were anxious to obtain the opinion of the United States Supreme Court on the matter. However the Supreme Court dismissed a writ of certiorari on the ground that no federal question was presented since the facts brought forward were not sufficient to raise the question whether the law and the superintendent's order were repugnant to the due process clause of the Fourteenth Amendment to the Constitution.<sup>8</sup> This decision forced the companies to start off on a new tack. They filed suit in a United States district court, each company taking the position that sec. 6283, as construed and as applied to it, in the light of its separate experience, was unreasonable and confiscatory, and therefore the order reducing rates was void as to it.<sup>9</sup> The court, after concluding as a preliminary matter that the statute was not invalid simply because it used the aggregate method, but that any company affected by a reduction order thereunder had a right to test the validity of the order as applied to it, on the ground that the effect was confiscatory as to it, and if such contention be sustained to be released therefrom, went on to uphold the order of the superintendent in what is perhaps the most lucid opinion in the books on the subject. It agreed with the Missouri Supreme Court that premiums and losses should be taken on the paid basis. In holding that "unearned" premiums were a part

---

<sup>8</sup> *Aetna Insurance Co. v. Hyde* (1928) 275 U. S. 440.

<sup>9</sup> *Aetna Insurance Co. v. Hyde* (1929) 34 F. (2d) 185.

of income, the judge remarked, "If 'unearned' premiums are to be excluded from the calculation of income and profits, there is the anomalous result of an increasingly prosperous business in fact, and an increasingly unprosperous one in theory." However, the court disagreed with the Missouri court in regard to interest on the investment of the "unearned" premiums, saying, "Because the premium when paid is the property of the company, because the interest arises from the investment of such property, because there is no basis for such result in the fact that a reserve must be maintained (measured by the premium required to reinsure), and because it is conceded that the income from the investment part of the business should not be considered in a rate making base under the statute, we think there is no ground for holding that interest from 'unearned' premiums should be included as income for rate making purposes in these cases." The court further found that the profits determined in this manner over the five year period were unreasonable, that the order of the superintendent reducing rates on certain classes of insurance ten per cent was justified, and not confiscatory as to any of the companies.

Thus, seven years of litigation in Missouri have resulted in victories for the state in every particular except that of interest on the invested "unearned" premiums, on which point there has been some disagreement. The courts have agreed that both premiums and losses should be determined on the paid basis.

There is but one other American case on the subject of the method of determining profit.<sup>10</sup> In that case the Kansas Supreme Court held that "all premiums should be regarded as receipts, which, together with other receipts, if any, of the underwriting business, constitute income for the period under consideration. From the amount of such income should be deducted actual losses and expenses, the difference representing gains or profits." There being an equal division, the court made no decision on the question whether rates should be fixed so as to yield a fair return upon the amount of capital and surplus, allocated by some proper method. The court was also equally divided on whether investment earnings should be considered as a part of the income, that too being left undecided.

American courts seem to agree that all of the premiums received shall enter into the computation of income, while losses shall be taken on the "paid" rather than the "incurred" basis; that, although on this point there is some doubt, investment earnings, even earnings on invested "unearned" premiums, shall not be considered as income in the rate basis.

---

<sup>10</sup> *Aetna Insurance Co. v. Travis* (1926) 121 Kan. 802, 257 Pac. 337, *aff'd* 124 Kan. 350, 259 Pac. 1068.

The question of the method of determining profits of fire insurance companies has come up in England in a different connection, being involved in ascertaining proper assessments for the purposes of the Income Tax Acts. In *McGowan's* case three methods were presented to the House of Lords.<sup>11</sup> The companies contended that they were entitled to deduct from the total premium income, on yearly policies, the estimated or probable losses on risks unexpired at the end of each year. According to their figures the losses on such risks would be equal to one-third in each year of the total premiums. The method employed by the surveyor of taxes was the familiar one of deducting losses and expenses paid from gross receipts. A third suggestion made was that each policy be considered separately. If it had expired, then the result, profit or loss, should be taken. If it had not expired, then an estimate should be made, having regard to the degree of risk during the period unexpired. The House of Lords adopted the method of the surveyor. Loreburn, L. C., admitted that the method was not scientifically unassailable since it obviously proceeded on the assumption that unexpired risks at the beginning and end of a given period are the same, but said, "No method is scientifically unassailable that does not enter into an analysis of the contracts made and the contracts current in each year so minutely that it is in a business sense impracticable." He went on to explain that if in any particular the rule was shown to work hardship it should be modified.

In 1912 the question again came before the House of Lords, and it saw fit to explain and modify its decision in the *McGowan* case.<sup>12</sup> It held that the question as to what are the gains or profits of an insurance company for a given period is a question of fact, and where there is a controversy as to which of two or more methods should be used, that method should be used that shows the true gains or profits. The company in that case explained that under its method of transacting business, paying losses, and keeping books, it carried forward each year forty per cent of the premiums received during that year as a premium reserve to pay losses on policies written during that year which might accrue under the terms of the policies in future years. The government conceded that this was a fair estimate of the amount necessary to pay such losses, but called the attention of the court to its decision in the *McGowan* case and the method used there. The court held that since the method of the company was conceded to be correct on the facts, it should be allowed, and that the method used in the *McGowan* case was not announced as a rule of law, but was

---

<sup>11</sup> (1908) A. C. 207.

<sup>12</sup> *Sun Insurance Office v. Clark* (1912) A. C. 443.

adopted in that case because it was the one found to produce the most accurate results.

The foregoing review of the decisions of the courts regarding the correct method of determining profits of fire insurance companies shows that, with few exceptions, the method contended for by the government, as represented by the commissioner in America and the surveyor of taxes in England, was adopted. It is interesting to note that in two-thirds of the cases involving the application of technical standards of any sort the commissioner's decision was sustained by the court.<sup>13</sup> This situation is due probably more to the unreasonableness of the methods presented by the insurance companies than to any antipathy toward them on the part of the courts. No doubt the courts' inexperience in the mazes of the insurance business is a strong factor. Judges are not qualified for original thought on methods of determining profits. They are forced to adopt what appears to them to be the most reasonable of the methods presented, and this is usually the commissioner's method.

There can be no doubt that the courts reached a correct result in their decisions that "unearned" premiums are a part of income. The commission and other expenses of procuring the business amount to more than the "earned" premiums on policies written for three and five years, and consume a large part of them on policies written for one year. If "earned" premiums alone are income, the underwriting business is being conducted at an actual loss, and the more policies written and the greater the business the greater the loss. Yet at the same time the insurance companies in Missouri were presenting figures telling this story, they were paying dividends of twenty-four per cent, and adding annually to their surpluses. Their explanation of this inconsistency, that all of the profits resulted from the investment side of the business, does not ring true. The safe investments which are the only kind possible where the invested capital is needed for protection yield only a two or three per cent return. And if the underwriting business is such a losing venture, why not abandon it? The contention of the companies on this point presents what a Kansas judge termed "a *non-sequitur* of extraordinary value."<sup>14</sup>

Whether interest on the "unearned" premium is properly considered in the rate basis is a more difficult question. If it is decided that the investment business is separate and distinct from the underwriting business, and is not to be considered in the fix-

---

<sup>13</sup> Patterson, *THE INSURANCE COMMISSION IN THE UNITED STATES* (1927) p. 497.

<sup>14</sup> *Aetna Insurance Co. v. Travis*, n. 10, above.



ing of rates, as the companies have always contended, and as the Missouri statute indicated, then it is inconsistent to maintain that investment of "unearned" premium should be considered, besides being practically impossible to separate it from the protective reserve fund, which always includes a surplus over the amount required to reinsure. Missouri has solved this problem by an amended statute which provides specifically for the consideration of all investment earnings.<sup>15</sup>

The process of determining what is a reasonable rate in the case of unstandardized fire rates is best described in the words of Holmes, as "an intuition of experience which outruns analysis and sums up many unnamed and tangled impressions . . ."<sup>16</sup> The method of determining profits as a basis for rates adopted by the American courts probably reaches a fairly accurate result in the majority of cases. But this does not mean that it is the only proper method, nor that a more accurate one will not be found. The proper attitude for our courts to assume is that of the English House of Lords, that the question of what are the profits is a question of fact, and that that method should be used which produces the most accurate results.

PHILIP S. ALEXANDER, '31.

---

<sup>15</sup> Mo. Laws 1923, p. 234.

<sup>16</sup> Holmes, J., in *C. B. & Q. Ry. Co. v. Babcock* (1907) 204 U. S. 585. Patterson, *op. cit.* 280.