



Legal Beat

By MICHAEL SEAN QUINN

Car Wrecks and Car Parts

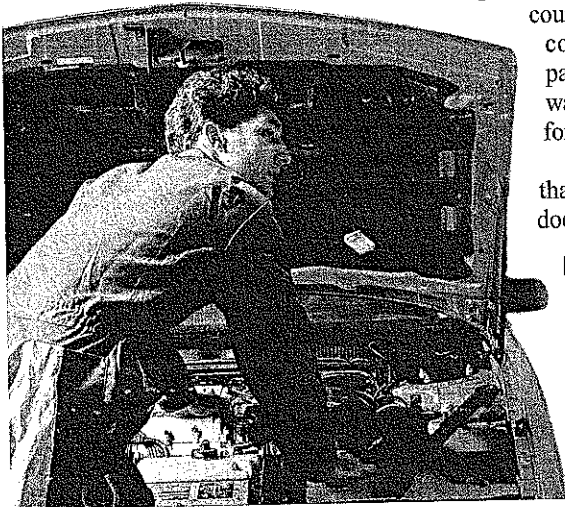
Debate over the use of non-original equipment manufactured (non-OEM) parts has been near the forefront of national

discussion. A January 6 court decision by the Austin Court of Appeals, *Berry v. State Farm*, touched on a small portion of the problem, a tributary to the raging river. The court said that insurers do not have to compute their losses using OEM parts. It's often useful to look backwards and at other lines of insurance for guidance.

Consider the first-party insurer that covers tangible property. What does it pay if the property is damaged?

Property Insurance

This is not a hard question, at least in theory. It is answered by reference to the Principle of Indemnity—an ancient and honorable axiom of insurance theory and law. The point of insurance is to restore the insured to where he



or she was before sustaining a loss, at least insofar as money can do that. Insureds are not supposed to make money on losses, nor are they supposed to lose it. Thus, in property insurance for real property, items are insured at "actual cash value."

Insurance companies like to think that ACV means purchase price minus depreciation, while insureds would like to think that ACV means the price of a new and identical item. This phrase is often not defined in property policies but insurers argue that it is not ambiguous. Many courts adopt the so-called "broad evidence rule" and simply let ACV be whatever the jury says it is—at least within reason.

There are exceptions to these observations. So-called "valued policies" insure items for specific values, at least in the case of total losses. Also, many property policies have replacement cost endorsements. Sometimes this is called appreciation insurance. Obviously, both types of insurance contracts violate the Principle of Indemnity.

Auto insurance theory

These concepts apply to first-party auto insurance—mostly. Suppose that a car has been damaged but is not a total loss. As a general rule, the insurer tries to figure out how much it will cost to repair the covered loss and pay that amount minus the deductible. Obviously, the price of repairs includes the price of the parts plus labor.

Now, a perfectly efficient insurer will try to pay losses in the cheapest possible manner. There is a good chance that this would involve specifying the type of parts to be used as replacement parts and specifying the identity of those who may perform the labor. Presumably, the insurance company will get special deals on the parts and special deals on labor. Insurers may employ mechanics in the legal sense. For example, insurance companies might set up and administer repair facilities. More likely, because of all the headaches involved, not to mention potential liability, insurers will use independent contractors.

Moreover, if an insurance company is really hell-bent to be efficient, it will apply the concept of ACV to the parts. This suggests that it will think about paying as policy benefits only that sum which would be required to purchase used parts. The Principle of Indemnity requires no less. It will require used parts, however, only if that is the least-cost method of contract administration. It isn't.

Auto insurance economic realities

It turns out that it is more expensive to apply the Principle of Indemnity rigorously. First, finding, obtaining, grading, storing and mar-

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keting used parts is an expensive proposition. Second, it must be administratively easy to find used parts similar to those that have been damaged. That's not so easy. Finally, applying the Principle of Indemnity to parts would defeat the overall social goal of financing loss quickly through mechanistic risk-spreading and clock-work claims administration.

The reasons are quite simple. For one thing, haggling over whether two parts were sufficiently similar in quality to be inter-substitutable would take time and therefore money. For another thing, many people don't have the money to make up the difference

between what an insurance company would pay for a loss if damaged parts were priced after they had been properly depreciated. There are simply too many automobile accidents that happen to people who are on tight budgets or who are genuinely poor.

Auto politics

In fact, although auto insurers have never gone so far as vigorously applying the Principle of Indemnity, they have tried to do so in half measures. Some years ago, for example, insurers tried to specify which repair shops insureds could use. The reason

was that the insurance companies had special, discounted deals. In addition, the insurers tried to specify what new parts insureds could use.

There was a grassroots uprising. The insureds didn't like it. Do-gooders protecting the public interest were outraged. Coalitions of repair shops that were not on preferred lists lost business and were irate. Some parts manufacturers that were frozen out joined repair shop coalitions.

Talk about strange bedfellows: insureds, public interest advocates, repair shops and auto companies. All lined up against the auto insurance industry. It wasn't hard to figure out who would win that battle. The political configuration was made even more interesting by the fact that the market structured by the insurers was in the interest of insurance consumers. First, it held the price of auto insurance down. Second, it gave consumers a second defendant—one with a really deep pocket—to attack in case a repair job was defective.

Be all that as it may, in 1991, the coalition put an end to part and service specification. Section 5.07-1(a) of the Texas Insurance Code forbade insurance companies from "specifying the brand, type, kind, age, vendor, supplier, or condition of parts or products that may be used to repair a damaged vehicle," and it prohibited insurers from "limiting the beneficiary of the [first-party insurance] policy from selecting a repair person or facility to repair damage to the motor vehicle covered under the policy." In other words, by statute insurers could not stringently apply the Principle of Indemnity either to parts or to labor.

Current events

As almost everyone knows, the insurance industry is under heavy fire from lawyers trying to make a buck. People work for the Texas Department of Insurance for a while, notice some glitch in the Code, leave the Department, join forces with some plaintiffs' firms, file a class action, and walk away with a substantial sum. This has happened more than once. The story is not very complicated. Still, we need a little more background.

There are three kinds of parts available to repair cars. First, there are parts manufactured by or on behalf of the company that manufactured the car. These are called "Original Equipment Manufactured" parts, or "OEM parts," for short. Second, there are used, reconditioned, recycled, and salvaged OEM parts, third, there are new parts which are not made by or on behalf of the original manufacturer. These are called "non-OEM" parts. (There are also used non-OEM parts, but they play no role in insurance repair pricing.)

First-party auto insurance contracts



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specify that insurers shall replace damaged or ruined parts with parts of "like kind or quality." The question becomes, therefore, whether insurance companies can use the price of non-OEM parts in computing the amount of their contractual obligations.

Enormous sums are at stake. Between 1984 and 1994, State Farm alone saved over \$1.25 billion by using non-OEM parts. This is over \$100 million a year. Can you just imagine what the amounts would be if Allstate, Nationwide and Progressive were included in the aggregate? Then, add on top of that all of the other personal auto insurers.

Finally add on commercial auto insurance.

At some point along the way, some lawyers realized that they if they could induce the courts to interpret §5.07-1(a) so as to forbid the utilization of the prices of non-OEM parts in computing their lost payments, they would have truly extraordinary class actions.

The lawsuit

In *Berry v. State Farm*, decided by the Austin Court of Appeals on Jan. 6, 2000, the precise issue was strikingly simple. Does §5.07-1(a) require that insurers compute

their losses using OEM parts. The Austin Court of Appeals said that it did not. The court based its decision on quite straightforward grounds.

First, the key to figuring out what a statute means is the language of the statute. This statutory section is fairly clear on its face. It says nothing about how loss payments are to be computed. It prohibits specifying parts with certain characteristics and forbids specifying certain service organizations. This mandate has nothing at all about how to figure the amount of the loss.

Second, to the extent that a statute is unclear, courts look to legislative intent. In 1991, some legislators tried to amend the proposed statute so as to forbid the use of non-OEM parts in pricing the loss. That proposed amendment failed. Had the legislature wanted to mandate the use of OEM parts, it could have done so expressly. Moreover, the deletion of a provision from a pending bill, or the defeat of a proposed amendment, discloses legislative intent to reject that proposal.

Third, for years, auto policies prescribed by TDI have included "like kind and quality" language. For years everyone has thought that this language permitted the use of non-OEM parts. The legislature surely understood that when it passed §5.07-1(a). Consequently, that statute should be construed so as not to invalidate existing, approved policies.

Fourth, and finally, TDI has never thought that §5.07-1 forbade the use of non-OEM parts in computing loss exposures. It has consistently taken the opposite position. When construing a statute, the practice of the agency charged with interpreting the statute is an important consideration in interpreting a statute, although it is not binding on a court.

Observations

One can only hope that the courts are right. Any other decision will substantially drive up the price of auto insurance. Nevertheless, just possibly the plaintiff's lawyers screwed this matter up by asking the court to decide the wrong question.

Instead of focusing on the statute, the plaintiffs should have focused on the contract. It requires that the price of parts be computed by using parts of "like kind and quality." There was apparently evidence before the legislature in 1991, when §5.07-1 was passed, that, as a class, non-OEM parts are not reliably of like kind and quality, when compared to OEM parts.

Here is some of that evidence. (1) Many non-OEM parts consistently fail to fit properly. (2) Frequently, non-OEM parts are made to slightly different specifications. (3) Often, non-OEM parts are more likely to rust or corrode due to inadequate priming



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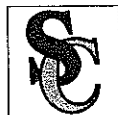
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and corrosion protection. (4) Non-OEM parts are often structurally inferior, providing less safety precaution and collision protection than the new OEM parts. (5) Non-OEM "crash parts" such as hoods, bumpers and fenders, are often "not tested in accordance with federal safety regulations, and their performance in collisions is potentially life-threatening. And, (6) repairs made with non-OEM parts often "void existing warranties and reduce the vehicle's resale value."

This evidence, assuming it really is evidence, should have been before the court. The insureds should have argued that non-OEM parts are constitutionally incapable—at least as a class—of being parts of like kind and quality when compared to OEM parts. Obviously, if part A does not affect the warranty on a car, whereas the use of part B voids the warranty, then part B is not "like" part A and so on for each of the other considerations.

Of course, individual non-OEM parts might be just as good as OEM parts, but because first-party auto insurance must proceed quickly and unreflectively in order to serve its social purpose, parts have to be considered and compared as classes. Of course, it would be possible for insurance companies to say that parts are alike and that they are of the same quality, even though one will affect the warranty and one will not. They could claim that such was never the intent of the word "like" or the phrase "same quality."

But this argument is a loser. In the absence of internal or extrinsic evidence, ambiguous terms are construed in favor of coverage and in favor of the insured. If an interpretation of a term will increase the amount of coverage available, or increase the value of an adjustment, then—at least arguably—that interpretation should be adopted. Thus, the focus of the plaintiff's case should have been, not upon the statute, which is clearly inapplicable, but upon the language of the contract.

Of course, much of the Berry case is pointless. From the point of view of overall social worth, the use of non-OEM parts makes perfect sense. Trying to invalidate this arrangement is probably nothing but the eternal search for large fees. Besides, if plaintiffs ever win this argument, either TDI or the legislature can be counted upon to invalidate the result almost immediately, and rightly so. ■

Quinn is an Austin shareholder in the law firm of Sheinfeld, Maley & Kay. He is mostly involved in litigation problems involving insurance coverage. Many of the problems upon which he works involve conduct of lawyers. He testifies from time to time on insurance related issues and on issues pertaining to the conduct of lawyers.

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