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August 5, 1997

Memo to: Frank Haines, Vice President – Claims  
Tom L'Hote, Vice President - Auto Claims  
Bill Hardt, Assistant Vice President – Property Claims  
Wayne Sorenson, Vice President – Research

From: Gregg Mecherle, Assistant Council  
John Kent, Sr. Claim Consultant  
John Werner, Assistant Director – Research

Re: Aftermarket Sheet Metal

Due to the continuing and escalating costs, in both money and personnel resources, of defending class actions and other lawsuits involving our use of aftermarket sheet metal parts and the public relations problems we continue to have with our customers and their auto repair service providers by the exercise of our right to estimate aftermarket sheet metal. We believe it is time to consider no longer estimating aftermarket sheet metal parts regardless of whether they are CAPA certified. The direct cost savings realized when estimating an aftermarket sheet metal part versus the comparable OEM part is beginning to be dwarfed by the cost of defending the class action litigation (which to date we estimate at approximately \$8.5 million for outside counsel, not counting costs of settlement or internal legal personnel), the costs of claim personnel time and resources which must be devoted to aftermarket sheet metal issues, and the customer dissatisfaction with our practices caused by OEM and body shop advertising. We are also facing a new wave of state legislative activity designed to prohibit or restrict our use of aftermarket parts.

While we believe the use of aftermarket sheet metal parts has created significant competitive pressure on the OEMs to keep the price of equivalent parts competitive, we do not feel that aftermarket sheet metal parts usage and the competitive pressure they provide will be eliminated should State Farm no longer estimate those parts. The aftermarket part industry will continue to exist and provide competitive pressures on the OEM parts to our benefit in property damage loss costs. Regardless of those competitive pressures, it is apparent that the OEM can achieve significant markups on parts not subject to competition that can make up any cost savings we realize on parts subject to competition.

Our defense of the aftermarket part cases depends on our ability to cite CAPA as a guarantee of the quality of the non-OEM sheet metal parts. CAPA's role and success in ensuring that the quality of the aftermarket sheet metal parts is comparable to the OEM

parts has recently been questioned publicly by the ASA. While ASA has never been fully supportive of CAPA and its views could not be interpreted as a reversal of any prior position, it is disturbing to our possible defense of the aftermarket part cases to have such a large and well-recognized automotive body repair trade association questioning the quality of aftermarket parts and CAPA's ability to effectively monitor that quality. Until the aftermarket part manufacturers have enough competition within their own industry to begin to compete on quality rather than price, there will be part lots with quality problems that undermine our defense in our lawsuits.

We have been discussing internally whether we can enter into some type of manufacturer alliance by which we can achieve some concessions on OEM parts in exchange for estimating OEM parts utilizing whatever remaining leverage we have on this issue with the OEMs. We recommend that we try to negotiate some type of discount with the OEMs or body shops to last for an extended period, in exchange for our no longer estimating aftermarket sheet metal parts.

We had discussed options other than no longer writing aftermarket sheet metal parts and find that other options discussed are not feasible.

- We discussed using only CAPA certified aftermarket sheet metal parts, but begin a program within State Farm to restrict that list to parts for which we have had no complaints. That proposal essentially introduces us into the certification process and we do not have the resources to devote at this point to second guessing CAPA certification.
- We also discussed restricting the estimating of aftermarket sheet metal parts during the current model year plus two. However, we felt it hard to justify why the line should be drawn at two years.
- We discussed offering an endorsement for the customer to purchase that would require OEM parts, but we could not justify a significant additional premium for this option. In addition, not every car has a comparable aftermarket sheet metal part for the OEM part.
- Finally, we discussed an option to write the aftermarket sheet metal parts on our estimate but allow the customer to put on the OEM part if desired, without paying the difference. We felt that raised procedural concerns in obtaining the customer's consent after a full disclosure and did not recognize that there may be quality problems with particular parts that still cause customer dissatisfaction, potential lawsuits and public relations problems.

This proposal does not affect our use of salvage or recycled parts. It also would not affect our use of aftermarket plastic bumpers which account for nearly half our aftermarket crash parts.

We are also not recommending that we withdraw from CAPA. In fact, we recommend continuing our support. Pursuant to the Krinsk settlement agreement we are committed for a few more years of payments to CAPA. We currently are paying CAPA approximately \$500,000 in assessments. We do believe that CAPA still serves an important function in providing a check on the quality of aftermarket parts which we know will continue to be used by the body shop industry. Our support of CAPA is an integral part of ensuring a healthy aftermarket part industry that will provide competitive pressures on the OE manufacturers regardless of whether we are estimating non-OEM parts.

The net effect of a decision to no longer estimate aftermarket sheet metal parts would be to eliminate disputes we have been having with body shops who prefer to utilize OEM parts with their higher net profit. Naturally, this may result in increased claim costs that would drive premiums higher. However, we believe the direct savings not to be that significant. In addition, by affecting primarily the property damage portion of the premium, there would not be a substantial increase in premium that would render us uncompetitive. If we can achieve a manufacturers alliance with a discount we could contain those cost concerns even further, but only for a limited time.

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