Nos. C077116, C078667

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA
THIRD APPELLATE DISTRICT

MERCURY CASUALTY COMPANY,

***Plaintiff and Appellant*,**

v.

DAVE JONES, IN HIS OFFICIAL CAPACITY AS THE INSURANCE COMMISSIONER OF THE STATE OF CALIFORNIA,

***Defendant and Respondent*;**

CONSUMER WATCHDOG,

***Intervenor and Respondent*.**

PERSONAL INSURANCE FEDERATION OF CALIFORNIA, et al.,

***Intervenors and Appellants*.**

Appeal From Sacramento County Superior Court
Shelleyanne W.L. Chang, Judge
Case No. 34201380001426CUWMGDS

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I. INTRODUCTION

Before this Court, the Trades seek to maintain their members' rights, as regulated insurers, to rates that allow the opportunity to earn a fair rate of return. That is the boundary to the State's legitimate governmental interest in regulating price.[1] The State's obligation to meet this standard does not end with a regulatory rate equation *designed* to provide a fair return in the general case, as the Commissioner appears to argue. Inevitably there will be individual cases where the assumptions in the regulatory equation – which include industry averages and administrative simplifications – will so lack fit with a specific insurer's facts that the end result does not match the design.[2] Due Process requires that a rate scheme include a mechanism for relief when the regulatory equation does not meet the fair return standard. That is why the California Supreme Court threw out the "threatened with insolvency" standard for relief in *Calfarm*.

Here, "Variance 9", as the ultimate "safety valve" in the California rate regulations, is supposed to play this role. But the Commissioner contends that no insurer may obtain Variance 9 without first showing that the entire organization of which it is a part will suffer financial distress under the proposed rate order. Requiring this threshold showing displaces the fair return standard, because "safely solvent" insurers would not be able to avoid confiscatory rates.[3]

The Commissioner's position seems to flow from the confusion between due process and "takings" analyses, which plagued the

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[1] *California Building Industry Association v. City of San Jose*, 61 Cal. 4th 435, 464 (2015).

[2] *Calfarm Ins. Co. v. Deukmejian*, 48 Cal. 3d 805, 816-817 (1989).

[3] *Calfarm*, 819.

jurisprudence for some time. The U.S. Supreme Court has now "correct[ed] course" in that regard.[4] In this case, the question is the due process standard. Neither Mercury nor the Trades argue for an award of compensation from the State.

20th Century Ins. Co. v. Garamendi[5] addressed a unique situation, and did not consider application of a due process standard to the prior approval of insurance rates – i.e., the price for the transfer of risk existing in a future period. *20th Century* considered whether an ordered refund based on an accounting of past experience would create a taking. That is a different question, not presented in this prior approval context.

The Commissioner's position simply cannot be sustained against the great weight of constitutional jurisprudence.

The Trades also challenge the Commissioner's election to regulate the "reasonableness" of expenses by deciding whether he considers advertising messages to be reasonable, i.e., beneficial to consumers. The First Amendment precludes the Commissioner from deciding what messages are appropriate for consumers to hear and insurers to air. Consumers are allowed to pick their insurance because an insurer sponsors a home team, or contributes to the community, or just because they find the insurer's advertisements entertaining – and insurers have a corresponding right to deliver these messages. It is not up to the Commissioner to find certain messages not worthy.

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[4] *Lingle v. Chevron USA, Inc.*, 544 U.S. 528, 548 (2005).

[5] 8 Cal. 4th 216 (1994).

While Respondents argue that the Commissioner has not *banned* speech, that is of no moment. The Commissioner controls the purse strings, and by that means burdens and controls speech.

The Trades' positions on both issues are soundly supported by constitutional authority. The trial court's judgment should be reversed.

II. CONFISCATION ISSUES

A. No Party Defends The Incorrect Standard Applied By The Trial Court.

The Trades' threshold question presented to this Court was:

> Did the Trial Court apply the wrong standard of review when it deferred to the Commissioner's legal interpretations and conclusions regarding the constitutional standard limiting the state's power to regulate price?

Trades' Opening Brief ("AOB") 15. As the Trades explained, the determination and application of constitutional issues and standards are within the province of the judiciary, and courts do not defer to agency interpretation of constitutional standards, which is what is at issue in this case. *See* AOB 33-35.

Neither the Commissioner nor Consumer Watchdog ("CW") disputes this threshold principle and assignment of error. By itself, this error by the trial court is sufficient for reversal.

B. The Respondents' "Financial Distress" Standard Is A Takings Standard, Inconsistent With Due Process Authorities.

Respondents argue that the standard measuring "confiscation" is that the rate must cause "deep financial hardship" – which Respondents interpret to mean structural financial distress – to the entire global system of which the applicant is a part.[6] This proposed standard requires

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[6] *See* RJN Exs D and E, showing that both Respondents claim the "enterprise" is the national group of affiliates.

examination of (1) the financial distress measure (versus the Trades' advocated fair return measure), and (2) the level at which confiscation is judged (i.e., the insurance holding company system level, versus the line of insurance business in which the subject capital is invested). The Trades address the first issue in this Part B, and address the second issue in Part C, *post*.

1. As confirmed by the California Supreme Court in 2015, the due process standard applied to pricing regulation requires a fair rate of return.

In *California Building Industry Association v. City of San Jose*, 61 Cal. 4th 435 (2015) (hereinafter "*CBIA*"), the California Supreme Court reaffirmed that "[pricing] controls would be unconstitutional if they are found to be confiscatory, that is, ***if they deny a property owner a fair and reasonable return on its property***. (*See Birkenfeld [v. City of Berkeley,* 17 Cal. 3d 129, 165 (1976)]; *Calfarm, supra, 48 Cal. 3d at 816-17.*)" *CBIA*, 61 Cal. 4th at 464 (emphasis added). The Court thus firmly endorsed, in 2015, the "fair return" standard it upheld previously in *Calfarm*, *Birkenfeld*, and *Kavanau v. Santa Monica Rent Control Board*, 16 Cal. 4th 761 (1997).

But what of the "deep financial hardship" standard discussed in *20th Century*? This may be best explained by Justice Mosk, the author of the *20th Century* opinion, in his concurrence in *Kavanau*.

Recall that *Kavanau* was preceded by "*Kavanau I*", which held that the controlled rent rate at issue was confiscatory due to a 12% ceiling on increases. The Court recognized that the *Kavanau I* due process violation was remedied by the writ issued in *Kavanau I*. *Kavanau*, 779 ("[W]e must accept as true for purposes of this proceeding that application of the Rent Board's 12 percent limit on rent increases violated Kavanau's right to due

process of law. Of course, Kavanau obtained a remedy in the form of a writ of mandate[.]").

In "*Kavanau II*", the question presented was whether the due process violation was also a taking. *Kavanau,*781 ("Kavanau asks us to consider whether a rent regulation that violates a particular property owner's right to due process by depriving him of a fair rate of return also necessarily constitutes a taking."). Because the taking in *Kavanau* – if any there was – would result from the due process violation, the Court was called upon to examine both due process and takings standards. *Kavanau*, 770; *Compare Kavanau*, 771-73 *with* 773-77.

In his concurring opinion, Justice Mosk sought to emphasize a distinction between a substantive due process violation and a taking. He described *Calfarm* as a substantive due process case because the law "failed to pursue a legitimate state purpose" in allowing rates that might provide "less than a fair rate of return", with inadequate recourse if in fact that occurred. *Kavanau*, 789. In contrast, Justice Mosk described the "deep financial hardship" standard as applicable "when [a regulation's] effect has been actually confiscatory, not when it violates substantive due process. *Kavanau*, 790. As has been stated, '[A]bsent . . . deep financial hardship [of a regulated public utility], there is no taking, and . . . no obligation to compensate . . . .' (*Jersey Cent. Power & Light Co. v. F.E.R.C.* (1987) 810 F.2d 1168, 1181, fn.3; accord, *20th Century Ins. Co.*, *supra*, 8 Cal. 4th at p. 297.)"

That is to say, Justice Mosk saw exactly the distinction identified by the Trades in their AOB. *See* AOB 43-44. This distinction assumes a

heightened significance in light of the bright line subsequently drawn by *Lingle* between "due process" and "takings" analyses. AOB 37-38.[7]

The question for this Court is what standard must apply for California insurance rate regulation to meet constitutional due process requirements? The trial court held – in accordance with the Commissioner's opinion – that the Commissioner does not have to consider whether the rate produced by the regulations allows the opportunity to earn a fair return unless and until the insurer first establishes that the broad organization of which it is a part has suffered financial distress as a result of the rate order. (App. 12, 3312; 3316-3317) But that is a takings analysis. The threshold question, in contrast, must be whether the permitted rate has been determined under a constitutionally permissible standard. Mercury is not seeking a monetary award compensating for a taking – which is notionally[8] and temporally[9] a follow-on inquiry. The question is whether the regulatory system, *ab initio*, allows an insurer to obtain a constitutionally adequate rate in the hopefully rare but inevitable circumstance that the regulations fail to produce a rate allowing the opportunity to earn a fair rate of return.[10]

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[7] Respondents misunderstand the Trades to suggest that *Lingle* overrules *20th Century*. The Trades actually argue that *20th Century* ***must be read in light of*** *Lingle*'s distinction between the takings and due process provisions. AOB 43-44.

[8] *See Lingle v. Chevron*, 543 (due process inquiry is "logically prior to and distinct from the question of whether a regulation effects a taking.").

[9] *See Kavanau*, discussed *supra*, addressing whether due process violation for past period created a compensable taking.

[10] Plunging ever deeper into the depths of a takings analysis, the Commissioner asserts that insurers must meet a "*Penn Central*" test – an *ad hoc*, multi-factor takings test developed to consider regulatory takings accomplished by a means other than price regulations. *See Kavanau*, 775,

2. The laudable goal underlying the rate regulations to produce a rate allowing a fair rate of return does not dispose of the constitutional necessity to meet this standard when the rate that would be produced by the formula falls short of the mark.

The Trades acknowledged, in their AOB, that the Commissioner has recognized "that insurers must be allowed an opportunity to earn a fair and reasonable return" and intended that the "regulations . . . contain enough . . . safety valves to ensure insurers may avoid confiscation." AOB 23-24, quoting App. 6, 1443. Variance 9 operates within this system as the ultimate "safety valve", allowing evidence to make a case where the regulations lack fit. *See generally* AOB pp. 23-29; *20th Century*, 313 (identifying "independent and constitutionally mandated 'variance'" allowing consideration of evidence as necessary to avoid confiscatory rate).

The Commissioner now argues that the regulations themselves produce rates permitting a fair rate of return, and that allowing an insurer to present evidence that the rate produced by the regulations does not meet constitutional requirements equates to "simply an attempt to calculate the rate in a different way." Comm'r Br. at 35, see also CW Br. at 14, 24. This is nowhere near the result pressed by Mercury and the Trades in this case.

Assuming that the regulations are *designed* to produce a fair rate of return in most cases, in order to "reduce the job to a manageable size" (*Calfarm*, 824) the regulations rely upon industry averages and allocation methodologies. *See* AOB 23-29. For that reason, in an individual case "flexibility in one part of a regulatory scheme may [not] offset

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discussing *Penn Central Transp. Co. v. City of N.Y.*, 438 U.S. 104 (1978). This is a takings test, having nothing to do with the due process questions raised here. Moreover, the California Supreme Court expressed doubt that it would apply in the context of price controls. *See Kavanau*, 776-77 (*discussing Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307-10 (1989)).

restrictiveness in another" (*Kavanau*, 778), and the result may be confiscatory. This is an inherent feature of rate regulation, accounting for the constitutional necessity for a mechanism adjusting a potentially confiscatory rate produced by the regulatory scheme. *See Calfarm*, 816-17 ("Recognizing that virtually any law which sets prices may prove confiscatory in practice, courts have carefully scrutinized such provisions to ensure that the sellers will have an adequate remedy for relief from confiscatory rates.").

Indeed, *20*th *Century*'s approval of the regulations "as to rollbacks" depended upon the implied constitutional variance as a safety valve in the event the regulations produced results not meeting constitutional standards. AOB 22-23, 32, 46-47.

In the AOB, the Trades described examples of the ways in which the regulations might be unable to accommodate the real-world circumstances of an individual insurer, confining that individual insurer to a confiscatory rate. AOB 27-29. None of these examples involves dueling regulatory methodologies. In addition, actual experience shows that Variance 9 applications do not challenge the Commissioner's choice of actuarial methodology, but – as anticipated by the implied constitutional variance now adopted as Variance 9 – address the (hopefully) unusual circumstance where the regulatory assumptions do not fit, and produce a putative confiscatory rate.

In the pending State Farm General Insurance Company ("SFG") rate case (PA-2015-00004), SFG applied for Variance 9 based on the lack of fit of the regulation assigning investment income, as construed by the California Department of Insurance ("CDI"). As explained in the AOB, investment income is an offset to the allowed rate (AOB 25-26), *i.e.*, the

allowed rate is reduced by the amount of investment income. 10 C.C.R. § 2644.20(a), as construed by CDI, would assign to SFG an assumed investment portfolio consisting of about 40% stocks, whereas SFG's actual portfolio consists of 100% bonds. SFG challenged the amount of investment income assumed by the regulation, on the grounds that SFG cannot earn the 9% + stock returns assigned by the regulations to phantom stock assets it does not own. SFG further contended that the attribution of fictional investment income produced an "end result" that does not allow SFG a fair return. *See* Trades' RJN ¶ 3 and Exs. F and G.

This is a pending, undecided case – the point here is that real life experience does not show "simply an attempt to calculate the appropriate rate in a different way." It shows resort to Variance 9 when the regulatory assumptions are wrong, and the "end result" does not balance out to a fair rate of return.

3. The "fair rate of return principle" *does* balance the consumer interest in non-exploitative rates, absent special circumstances not present here.

Respondents fundamentally misunderstand the role that balancing consumer and business owner interests plays in a confiscation analysis in relation to the fair return principle. CW contends that an insurer can show confiscation only if "after balancing of consumer and the insurer's interest," there is a "finding that the ordered rate would prevent the insurer from operating successfully." CW Br. 21. CW's argument that "balancing" must be adjudicated on a case-by-case basis, rather than *descriptive* of a "fair return", misreads case law, and is specifically inconsistent with our high court's most recent statement that rates are unconstitutionally confiscatory if the rate "den[ies] a property owner a fair and reasonable return on its property." *CBIA*, 61 Cal. 4th at 464.

Descriptively, a "fair return" balances "investor"[11] and consumer interests. *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). Descriptively, "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks." *Id.* Practically, regulators use models to estimate a "fair rate of return", typically by estimating the "cost" of equity capital, because under economic theory "cost of capital" measures the collective impact of the narrative factors describing this fair return standard. *See*, *e.g.*, *Ill. Bell Tel. Co. v. F.C.C.*, 988 F.2d 1254, 1259-60 (D.C. Cir. 1993) (explaining models used to determine allowed rate of return, and relating to *Hope* narrative). *See also 20th Century*, 302-06 (describing methodologies considered by Commissioner to set a fair rate of return for the rollback year) and 321 (explaining that "cost of capital" is relevant to the prior approval phase of rate regulation).

Case law identifies two circumstances where the "consumer interest" in "freedom from exploitation"[12] affects the fair return described in *Hope*. The first is addressed in *Hope* itself. Prior to *Hope*, the jurisprudence accepted a constitutional mandate to use the "fair value" valuation as the capital base to which the fair rate of return must be applied. *See Duquesne*,

[11] The "investor" refers to the capital owner, investing the capital into the regulated investment. *See Hope*, 320 U.S. at 603: "[T]he investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. . . . By that standard, the return to the equity owner . . . should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and attract capital."

[12] *20th Century*, 293-94.

308-10, providing an extensive discussion of the jurisprudence concerning the capital base necessary to the ultimate "fair return" determination.[13] As explained in that discussion, the *Hope* Court held that the "fair value" – or market valuation – of the business enterprise is not constitutionally mandated as the capital base. While *Duquesne* describes abandonment of that standard as primarily practical (*ibid.*), it is also significant that the "fair value" standard tends to perpetuate market distortions contributing to excessive prices. *See Fisher v. City of Berkeley*, 37 Cal. 3d 644, 680 n.33 (1984). In that sense, it could "exploit" consumers.

The "failing business" presents the second circumstance. *Market Street Railway Company v. Railroad Commission of California*, 324 U.S. 548 (1945) concerned a regulated cable car company, unable to survive in the market, without the aid of supra-competitive rates supported by rate regulation. The Court held that price regulation is not intended to be price support, and that it would exploit consumers to set a rate fixing a profit at a level not achievable without regulatory intervention. *Id*. 566-67.

Here, neither the *Hope* "fair value/market valuation" not the *Market Street Railway* "price support" issues is implicated. There is no suggestion of consumer exploitation that could occur by application of the fair return principle. There is simply nothing to balance against the general rule that regulated rates must afford a fair return.

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[13] Other regulatory schemes have used "prudent investment" (investment prudent when made, regardless of future developments), or "used and useful" (considers whether, taking into account future developments, investment turned out to be productive) measures. *Duquesne, ibid*.

C. The "Enterprise" In Rate Regulation Is The Business Enterprise, Defined By The Invested Capital.

1. The constitutional question of the minimum non-confiscatory rate turns on a fair rate of return applied to the capital invested in the business enterprise.

The Commissioner himself provided the best articulation of the "enterprise" that is the focus of rate regulation, when first adopting California's rate regulations:

> As set forth in *Calfarm*, each insurer must be given an opportunity to earn a fair profit. ***The investment, or equity, must be measured***, because what is or is not deemed to be a "fair profit" (i.e., what level of profit the insurer is entitled to earn), ***will be gauged by the amount of the insurer's equity or investment in the business enterprise.***

App. 8, 2531 (emphasis added). That is, the Commissioner himself announced that the "enterprise" that is relevant to California's total return model is "the business enterprise", in which the "insurer's equity" is invested. *See Hope*, discussed *ante*.

In the same passage, the Commissioner stated that the "end result" in the California rate formula is "the ultimate profitability of rates to the insurer [established by] the return on the investment." *Id. See also Ill. Bell Tel.*, 988 F.2d at 1258 (allowed rate of return must be "'viewed in tandem'" with allowed capital base to determine if net result is unconstitutional).

The Commissioner incorporated these principles into the rate regulations. 10 C.C.R. § 2644.17 specifically defines the scope of the business enterprise upon which the fair return must be earned ***by line of insurance*** – this regulation separately calculates a by-line "measure[]" in order to "gauge[] the amount of the insurer's equity or investment in the business enterprise." *See* App. 8, *ante*. 10 C.C.R. § 2644.17(b).[14] As the

[14] Section 2644.17 creates "leverage factors" assigning "surplus" to each line of insurance. *20th Century*, 309-311. "Surplus" is an accounting

regulation explains: "The Commissioner finds that investors' perceived investment risk may vary from line to line. Thus while the rate of return does not vary by line, insurance perceived to have a greater risk will yield higher returns per premium dollar." 10 C.C.R. § 2644.17(c). That is, both the Commissioner's articulated philosophy and the regulations describe the capital devoted to the business – further parsed as the line of insurance – as the "enterprise" on which an insurer must be permitted to earn a fair rate of return.

2. *20th Century* described a unique and expressly circumscribed rule, inapplicable to prior approval.

Respondents rely on the *20th Century* Court's application of the "enterprise" concept in the rollback context, which the Court expressly limited to "***this context***". *20th Century*, 308-09 (emphasis added). The Court's equation of "the insurer as a whole" to the "enterprise" in "this context" (*id.*) does not fit prior approval.

In *20th Century*, the Court held that the impact of the rollback regulations *on the earthquake line of insurance* did not render the rollback order confiscatory – to reach this ruling, the Court had to consider what constituted the "enterprise" for purposes of its *retrospective* examination of *results for a past period*. *Id.* The rollback regulations did not price risk – i.e., did not price what was sold. AOB 46-48. The rollback examined ***past*** results. What actually happened during a specified time period is not the same thing as the ***risk*** that existed for that time period. As the Trades

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term denoting assets minus liabilities, and equates to an insurer's equity. *State Farm Mut. Auto. Ins. Co. v. Superior Court*, 114 Cal. App. 4th 434, 441 (2003). That is why "leverage factors" are used to determine the amount of equity capital, on a by-line basis, on which an applicant can earn a return.

explained in the AOB, the price for insurance is the price for ***the transfer of the risk*** during the specified time period, it is not a *post hoc* accounting. *Id*.

The absence of earthquakes in the *actual* experience for Southern California during 1989 – contrasted with the *risk* of a Southern California earthquake – is largely responsible for the 20th Century rollback. *See* AOB 46-48. The Court judged the rollback by a retrospective consideration of the impact of the rollback order. Never did the Court consider whether *the rate for the earthquake risk* – or the rate for any other risk for a different line – was constitutionally adequate. *See* discussion, AOB *id*. That is, *20th Century* was decided as a pure "takings" case, not as a rate case, and not as a due process case. *Id*.

Calfarm, on the other hand, applied due process principles to price regulation. *See Calfarm*, 816. *Calfarm* unequivocally held that a standard masking unconstitutionally low rates of return with earnings from other lines and other states allows confiscatory rates, and is unconstitutional. *Calfarm*, 818-19. The standard urged by the Commissioner here fails this test. That standard – by requiring consideration of the national system of affiliates of which the insurer-applicant is a part – inherently covers up a confiscatory rate imposed for the line of California business at issue.

3. For insurance, the "business enterprise" defining the capital base upon which the fair rate of return is earned is delineated by line of insurance.

CW cites *Baltimore & O.R. Co. v. United States*, 345 U.S. 146 (1953) ("*Baltimore*") as claimed support for its position that "noncompensatory rates" – rates that do not fully compensate the regulated entity for the costs of providing the service – are constitutionally permissible so long as the entity receives a fair return on an overall basis. CW Br. 39. CW misreads the opinion.

First, *Baltimore* involved *federal* regulation applicable nationwide through a complex network of rates. *Baltimore*, 148. A federal regulator does not face the jurisdictional restrictions that limit a state regulator to the state's borders. *See* AOB 49-51.

Second, *Baltimore* is properly understood as holding that confiscation does not occur at a level that is more segmented than the "business enterprise" to which the investor has invested its capital. The Court simply held that carrots with tops, and string beans, lettuce, and parsnips, do not describe a separate "business enterprise". A railway does not invest capital in a separate business of transporting specific vegetables: the finest plausible investment must be the vegetable transportation business. Here, "carrots with tops" would equate to insurance for mansions, or for wood cabins, or for houses built before a certain date. No doubt there would be separate risk/cost considerations involved with each grouping of housing stock, but none describe the "business enterprise" to which the capital has been devoted.

The regulations recognize separate investment risk – separate business enterprises – by line of insurance. *See* 10 C.C.R. § 2644.17(b) and (c). This is appropriately the "enterprise" for confiscation analysis, under *Baltimore.*

D. The "Relitigation Bar" Establishes A Line Between Agency Legislative Function And Agency Adjudicatory Function. It Does Not Bar Evidence Of An Insurer's Actual Circumstances Deviating From Regulatory Assumptions, and Does Not Mandate A Tautological Approach To Variance 9.

The Commissioner holds both "quasi-legislative" authority – to the extent delegated by the legislative body – and "quasi-adjudicatory" authority to adjudicate, in the first instance, matters within his special

jurisdiction. In *20th Century*, the Court explained that the "relitigation bar" – referring to what is now 10 C.C.R. § 2646.4(c) – equates to the separation of powers principle that "[i]n adjudication, the judge applies declared law; he does not entertain the question of whether its underlying premises are sound." *Id*. at 312. The relitigation bar applies this constitutional principle to an administrative agency with both quasi-legislative and quasi-adjudicatory powers: it does not, and cannot under the constitution,[15] limit the judicial function. Far from precluding relevant evidence typically considered by courts, "[b]y its very terms, . . . [§ 2646.4(c)] *requires* admission of evidence found 'relevant to the determination of [whether the rate is excessive or inadequate]. . . .'" *Id*.

The "relitigation bar" does not, either on its face or permissibly, operate as a bar to an affected insurer's presentation of its case that the regulations ***as applied*** do not produce a fair return. As explained in Part B.2., the Commissioner is mistaken in his assumption that the industry intends by this challenge to open the door to "simply an attempt to calculate the appropriate rate in a different way." Commr's Br. at 35; CW Br. at 14,

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[15] *See, e.g., McClung v. Emp't Dev. Dep't*, 34 Cal. 4th 467, 469-70 (2004) ("'It is, emphatically, the province and duty of the judicial department, to say what the law is. Those who apply the rule to particular cases, must of necessity expound and interpret that rule.'" . . . Under fundamental principles of separation of powers, the legislative branch of government enacts laws. Subject to constitutional constraints, it may *change* the law. But *interpreting* the law is a judicial function.") (emphasis in original) (*quoting Marbury v. Madison*, 5 U.S. 137, 177 (1803)); *Woods v. Superior Court*, 28 Cal. 3d 668, 678 (1981) ("'[The judicial task] is to inquire into *the legality* of the regulations, *not their wisdom* . . . . Administrative regulations that violate acts of the Legislature are void and no protestations that they are merely an exercise of administrative discretion can sanctify them.'") (emphasis added) quoting *Morris v. Williams*, 67 Cal. 2d 733, 737 (1967).

24. The Trades would hold the Commissioner to the promise of the regulations: that the variances – specifically Variance 9 – will operate to permit relief where the regulatory assumptions adopted for convenience do not fit.

Under Respondents' notion of the "relitigation bar", each and every component of the ratemaking formula retains the value assigned by the regulations – the components are just shuffled according to algebraic truisms. That is not the "relitigation bar" contemplated by *20th Century*. And there is no precedent authorizing a bar to evidence showing that a rate formula as applied in a specific case produces a confiscatory result – i.e., a rate not permitting the opportunity to earn a fair rate of return.

E. A Correct Decision In This Action Will Not Overthrow The Regulatory Process.

The Commissioner's "doomsday argument" is without merit—applying the correct constitutional standard to insurance rate regulations will not overthrow the regulatory process. The Commissioner asserts that application of the correct constitutional standard would require "a hearing [for] every insurer that *claimed* confiscation to determine a unique rate of return under whatever formula the insurer wishes to use," and that "[s]uch a result would threaten to create an unmanageable and ad hoc regulation process." Comm'r Br. 17. This is an unrealistic argument. Similarly, the Commissioner's assertion that the Trades' goal is to "eliminate meaningful formulaic insurance-rate regulation in California" is fabricated. *See id.*

There is no evidence that insurers have clamored for the delay and expense attendant upon an administrative hearing as a means of adjusting rates. The record is to the contrary. Although the trial court deemed the Trades' challenge to the Variance 9 hearing requirement outside the scope

of the Trades' complaint (App. 12, 003255-63, 003269-70, 003282-87, 003289-90), it is apparent from that challenge that the Trades do not want more expensive hearings. (App. 6, 001389.) If anything, the Trades' members' aversion to expensive and time-consuming hearings is greater than the Commissioner's ever could be – it is *the insurers'* rates that are delayed, and *the insurers* have to pay for intervenor participation. CIC § 1861.10(b). There is nothing about the hearing process that is enticing. It is only unavoidable, when necessary to challenge an unconstitutional rate.

F. The Commissioner's Arguments Attempting To Shield The Ratemaking Process From Constitutional Protections Are Meritless.

1. California insurance rate regulation does not permit a compensatory component for a past confiscatory rate.

Springboarding off *Kavanau*, the Commissioner argues that an insurer's ability to submit a follow-on rate application precludes the possibility that there can ever be a confiscatory rate. Whatever its viability in the rent control context, this argument has none in the context of insurance rate regulation.

We have discussed *Kavanau's* context in part A.1., *ante*. Of specific import, the object in *Kavanau* was to decide whether due process confiscation also necessarily resulted in a taking. The Court held that the rent control scheme at issue was sufficiently flexible to permit the regulator to include a component in future rates to make up for the past confiscatory rate, thereby ensuring that the due process violation did not result in a taking. *Id*. 782-85.

The "*Kavanau* adjustment", however, is not a workable solution to the concerns presented in this case.

First, at issue here is the standard the Commissioner must meet as a matter of *due process*. This is the *Kavanau I* issue, which was remedied by the writ issued in *Kavanau*. *Kavanau II* addressed the separate question of whether the due process violation had also occasioned a taking, for which government must provide just compensation.

The Commissioner's argument disregards that a determination of whether the rate order at issue violated the due process requirement of a fair return is an inherent precondition to application of a *Kavanau* adjustment. It is impossible to evaluate whether a *Kavanau* adjustment is warranted without a finding that a due process violation occurred.

Second, the ability to apply a *Kavanau* adjustment depends upon a regulatory scheme that is "sufficiently flexible" (*Kavanau* 784) to allow a rate component compensating for past confiscatory rates. The system here is not. The components of the rate calculation are rigidly limited to projected losses and expenses, for the period of the rate. There is no room anywhere in the formula allowing insertion of a "make-up" component for prior constitutionally inadequate rates. *See* 10 C.C.R. §§ 2644.2-2644.27.

Regulation of insurance rates differs from the rent control regulation considered in *Kavanau*. The premise of the "*Kavanau* adjustment" was that the same tenants who had enjoyed the constitutionally inadequate rents would pay the "make-up" rents. 16 Cal. 4th at 784. The adjustments were to apply on a tenant-by-tenant basis. *Id*. In the homeowner's insurance business, an insurer may have over a million policyholders. There is no way to make individualized adjustments matching the "make-up" rates with the policyholders who enjoyed unconstitutionally low rates.

2. The Commissioner's argument that short term confiscation can be covered by a long term adequate rate misinterprets *Calfarm*.

The Commissioner argues that an applicant can be denied a fair return in the short term, so long as the applicant receives a fair return over the long run. Comm'r Br. 23, 40. The Commissioner bases this argument on a passage in *Calfarm* that, effectively, holds exactly the opposite of the Commissioner's announced interpretation.

The Commissioner references *Calfarm*'s consideration of the "emergency" exception to the requirement that regulated prices must provide a fair rate of return. *See Calfarm*, 820-21. Under the "emergency" exception, it would be possible to compel short term prices not meeting the fair rate of return standard. *Id*. As the Court explained, however, "[t]o justify a measure which deprives persons of a fair rate of return . . . 'an emergency would have to be a temporary situation of such enormity that all individuals might be required to make sacrifices for the common weal.'" *Id*. The Court found that no such emergency appeared, leading it to hold that "[o]ver the long term the state must permit insurers a fair return; we do not perceive any short term conditions that would require depriving them of a fair return. We therefore conclude that subdivision (b) cannot be sustained as an emergency measure fashioned to meet a temporary exigency." *Id*. at 821.

The "threatened with insolvency" standard at issue in *Calfarm* inherently applied solely to the rollback – i.e., for one year. The Court took the extreme step of holding that provision unconstitutional because it was insufficient to allow "safely solvent" insurers to achieve the constitutionally mandated fair rate of return, ***for the one year*** of its operation. The Commissioner's argument is soundly refuted by the authority he cites.

III. SECTION 2644.10(F)'S CONTROL OF THE MESSAGE THROUGH CONTROL OF THE PURSE TRANSGRESSES THE FIRST AMENDMENT.

A. Regulation 2644.10(f) Squarely Implicates The First Amendment.

Respondents contend that Regulation 2644.10(f) does not implicate the First Amendment because it allows insurers to engage in any advertising they want; they just cannot include the expenses of certain advertising messages in their rates. Comm'r Br. at 59; CW's Br. at 51. That is the point. Excluding expenses reduces the permitted rate. Unlike public utility rating, California rate regulation is an "all-in" approach: all revenues and all costs are considered in the rate. If advertising expense is excluded from the dollars permitted in the rate, there is no revenue source from which it can be paid. The insurer can either pay for such advertising out of profit, or stop the advertising. Thus, the regulation burdens and chills speech.

1. The First Amendment Prohibits Government From Burdening Speech As Surely As It Prohibits Government From Banning Speech.

It is established beyond cavil that "the 'distinction between laws burdening and laws banning speech is but a matter of degree' and that the 'Government's content-based burdens must satisfy the same rigorous scrutiny as its content-based bans.' . . . Lawmakers may no more silence unwanted speech by burdening its utterance than by censoring its content." *Sorrell v. IMS Health, Inc.*, 564 U.S. 552, 565-66 (2011) citing *Simon & Schuster, Inc. v. Members of N.Y. State Crime Victims Bd.*, 502 U.S. 105,

115 (1991) (content-based financial burden).[16] Regulation of the purse is perhaps the most powerful governmental tool available to shape behavior.

Accordingly, in *Pitt News v. Pappert*, 379 F.3d 96, 105-06 (3d Cir. 2004), the court held that a statute that permitted a newspaper to print alcoholic beverage ads but prevented it from receiving payment violated the newspaper's commercial speech rights under *Central Hudson Gas & Electric Corporation v. Public Services Commission of New York*, 447 U.S. 557, 561-62 (1980). In so holding, the court rejected the government's argument that there was no burden on speech because the law did not ban the newspaper from advertising about alcoholic beverages. The court explained:

> Although the Commonwealth makes much of the fact that Section 4-498 does not prohibit *The Pitt News* from printing alcoholic beverage ads but simply prevents the paper from receiving payments for running such ads, Section 4-498 clearly restricts speech. The very purpose of Section 4-498 is to discourage a form of speech (alcoholic beverage ads) that the Commonwealth regards as harmful. ***If government were free to suppress disfavored speech by preventing potential speakers from being paid, there would not be much left of the First Amendment.*** Imposing a financial burden on a speaker based on the content of the speaker's expression is a content-based restriction of expression and must be analyzed as such**.**

Id. at 105-106, emphasis added.

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[16] *See also Minneapolis Star & Tribune Co. v. Minnesota Comm'r of Revenue*, 460 U.S. 575 (1983) (speaker-based financial burden); *Forsyth County, Ga. v. Nationalist Movement*, 505 U.S. 123, 134-35 (1992) ("Speech cannot be financially burdened, any more than it can be punished or banned, simply because it might offend a hostile mob."). *See also Doe v. Harris*, 772 F.3d 563, 572 (9th Cir. 2014) ("Appellants are correct that, on its face, the CASE Act does not prohibit speech. But a law may burden speech—and thereby regulate it—even if it stops short of prohibiting it.").

Similarly, in *Thompson v. Western States Medical Center*, 535 U.S. 357 (2002), the United States Supreme Court considered whether statutory provisions that exempted compounded drugs from the FDA's standard approval requirements so long as providers refrained from advertising or promoting particular compounded drugs failed the *Central Hudson* test for acceptable government regulation of commercial speech. The Court held that this statutory disincentive to advertise and promote the compounded drug products "amount[ed] to unconstitutional restrictions on commercial speech . . . ." *Id.* at 360. *See also Keenan v. Superior Court of L.A. Cty.*, 27 Cal. 4th 413, 424-29 (2002) (statute placing direct financial disincentive on speech or expression about a particular subject held facially invalid under the First Amendment and California constitution); *Italian Colors Restaurant v. Harris,* 99 F. Supp. 3d 1199 (E.D. Cal. 2015) (First Amendment applied to and barred law restricting surcharges for payment by credit card but allowing discounts to induce paying by check); *U.S. Satellite Broadcasting Co., Inc. v. Lynch*, 41 F. Supp. 2d 1113, 1116-23 (E.D. Cal. 1999) (Boxing Act tax on some telecasts and not others based on content, thus creating a financial disincentive to broadcast telecasts with a particular content, was subject to First Amendment scrutiny and was not narrowly tailored to advance compelling state interests).

2. Respondents' public utilities cases are inapposite.

In contending that Regulation 2644.10(f) does not implicate the First Amendment, Respondents rely on public utilities cases upholding regulatory exclusions of expenses in that rate-setting context. *See* Commissioner's brief at 60 (citing *El Paso Electric Co. v. New Mexico Public Service Comm'n.*, 706 P.2d 511, 304 (N.M. 1985); *Pacific Tel. & Tel. Co. v. Public Utilities Comm'n.*, 62 Cal. 2d 634, 669 (1965); and

Public Service Comm'n v. Federal Energy Regulatory Comm'n, 813 F.2d 448, 456 (D.C. Cir. 1987)) and CW's brief at 52 (citing *El Paso*; *Appeal of Concord Natural Gas Corp.*, 121 N.H. 685, 693 (1981); and *Rochester Gas and Elec. Corp. v. Public Service Com. Of the State of N.Y.*, 51 N.Y.2d 823, 825 (1980)). But insurance companies are not public utilities and those cases are inapposite.

At the threshold, public utilities are the classic example of a natural monopoly. Barry Posner, Natural Monopoly, Introduction to Energy and Earth Sciences Economics, https://www.e-education.psu.edu/ebf200up/node/139 (last visited Feb. 6, 2014). *See Cantor v. Detroit Edison Co.*, 428 U.S. 579, 595-96 (1976) ("[P]ublic utility regulation typically assumes that the private firm is a natural monopoly."). *See also El Paso*, 103 N.M. at 302 (discussing "monopolistic nature of utility service"). As (in general) the only source for the product they offer, public utilities' customers are "captive" – public utilities are not vying with competitors in an open marketplace, and their advertising is not directed to obtaining business from consumers. *See id.* at 304 (utility rate regulation "reasonably require[d] that the cost of certain advertising not be passed on to a utility's 'captive' customers, the ratepayers.").

In contrast, insurance companies are competitors in a voluntary market. They advertise to attract consumers and encourage them to buy the company's product. And unlike utility ratepayers, insurance "ratepayers" are not captive. They can choose from the marketplace, based on advertised messaging and other factors. Whether the advertising attracts consumers by highlighting lower price or better service, or providing entertainment, or sponsoring a favorite sport or a home team, or presenting an appeal to a particular target audience (such as the technologically

savvy), the point is to sell insurance. That is, advertising serves the same purpose as in any competitive market, whether it is the market for OTC analgesics, breakfast cereal, or insurance.

In fact, most of the relevant market here consists of companies that are not organized as publicly-traded stock companies. *See 20th Century*, 260 n.5 (recognizing that, "[a]s a stock insurance company, 20th Century is apparently an exception among insurers.") RJN ¶ 4 and Exs. H and I (CDI Market Share Report For Homeowners' Insurance, disclosing that most of market consists of companies that are part of mutual systems or reciprocal/interinsurance exchange systems, not publicly traded companies and publicly traded companies in SIC Code 6331 (Fire, Marine and Casualty Sector)). When there are no shareholders, there is no shareholders' account. When there is no market for a company's stock, there is no advertising to maintain stock price.

The system of price regulation applicable to utilities versus insurers reflects this distinction in the markets. In regulating public utilities, the regulator considers the utility's income and costs as falling into two different conceptual accounts: either the "shareholders'" account or the "ratepayers'" account. If an expense is determined to primarily benefit shareholders, it is charged to the "shareholders'" account, and paid out of the "shareholders'" income – i.e., the investment income on the shareholders' property used in the utility's business. If an expense is determined to primarily benefit ratepayers, it is "charged against the ratepayers" by including it in the rates. *See*, *e.g.*, *Ponderosa Tel. Co. v. Public Util. Comm'n*, 197 Cal. App. 4th 48 (2011) (analyzing proper allocation of revenues to either the ratepayers or shareholders); *Koponen v. Pacific Gas & Elec. Co.*, 165 Cal. App. 4th 345, 351-352, 352 n.5 (2008)

(observing Commission's use of the "two account" methodology). In this context, expenses for advertising held to benefit the shareholders' interest in maintaining the value of their stock in the company (considered "institutional advertising") is charged to the shareholders and paid out of shareholders' income.

This is not how California insurance rating works. CIC § 1861.05(a) sets the standard for insurance rate review, and precludes the two-account concept. Under § 1861.05(a), an insurer's rates must fall within a range between that which is "inadequate" and that which is "excessive". The statute mandates that the Commissioner take into account investment income – classically, the owner's or "shareholders'" income – in reviewing proposed rates against that standard. All income is considered. *See* AOB 24-26. There is no separate account out of which separate "shareholders'" expenses can be paid.

This difference in the rate regulatory structure for public utilities versus insurers distinguishes Respondents' public utilities cases on a crucial point: in the public utilities context, the regulator is simply deciding whether specific advertising expense should be paid out of shareholders' income – i.e., the income earned on the business – or out of the rates paid by ratepayers. In either case, there are revenues from which the expense may be paid. In California insurance regulation, all revenues are included in the ratemaking formula. There are no unassigned revenues from which expenses may be paid. This creates a financial penalty and chill on the speech for which expenses are excluded – a far cry from simply assigning expenses to one account or another.[17]

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[17] To the extent Respondents' cases also conclude that excluding expenses based on content cannot violate the First Amendment, they are out

3. *20th Century* did not consider the issue.

CW further contends that excluding institutional advertising expenses from the rate calculation is lawful because *20*th *Century* upheld the Commissioner's authority to limit rates to reasonable expenses. CW's brief at 51-52. Plainly, 20th Century discussed "reasonableness" of expenses in the sense of their amount. *20th Century* at 289. The Court did not consider nor place its imprimatur on regulation of advertising expense on the basis of the "reasonableness" of the message.

B. Respondents Fail To Satisfy Their Burden Of Proving That Regulation 2644.10(f) Survives First Amendment Scrutiny Under Any Standard.

As the parties seeking to uphold a restriction on speech—whether non-commercial or commercial—Respondents have the burden of justifying it. *See Thompson*, 535 U.S. at 373 ("[i]t is well established that 'the party seeking to uphold a restriction on commercial speech carries the burden of justifying it.'"); *Steiner v. Superior Court*, 220 Cal. App. 4th 1479, 1489 (2013) ("The party seeking to uphold a restriction on commercial speech carries the burden of justifying it.").

1. The broad Regulation burdens non-commercial speech based on content, warranting strict scrutiny.

Respondents contend that the Regulation impacts only commercial speech. They fail to recognize that the test for distinguishing commercial speech inherently must be applied on a case-by-case basis. AOB at 64-67, and that the broadly-worded Regulation sweeps within its ambit non-commercial speech. *See Pacific Gas Elec. Co. v. Public Util. Comm'n*, 475 U.S. 1, 9 (1986) (utility's newsletter distributed to ratepayers with monthly

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of step with First Amendment jurisprudence. See Part A. 1., *ante*. Notably, *Rochester* specifically held that the reason that the content-based regulation did not violate the First Amendment was that the expenses could be paid out of the shareholders' account. *Rochester*, 825.

billing envelopes on topics ranging from political editorials to energy saving tips and billing information "extend[ed] well beyond speech that proposes a business transaction …[citations], and include[d] the kind of discussion of 'matters of public concern' that the First Amendment both fully protects and implicitly encourages"); *Bernardo v. Planned Parenthood Fed'n of Am.*, 115 Cal. App. 4th 322, 346 (2004) (Planned Parenthood website containing noncommercial and commercial speech entitled to full First Amendment protection). Because the Regulation at the least burdens hybrid non-commercial and commercial speech, it warrants strict scrutiny. *See Dex Media West, Inc. v. Seattle*, 696 F.3d 952, 960-61 (9th Cir. 2012)— a case cited in the AOB that Respondents ignore.

2. Even pure commercial speech is afforded substantial First Amendment protection and, where regulation of commercial speech is content-based, it demands heightened scrutiny.

Indisputably, lawful commercial speech is protected by the First Amendment. *See* AOB pp. 67-69. *Bolger v. Youngs Drug Prods. Corp.*, 463 U.S. 60, 68 (1983) (First Amendment protection of commercial speech is "qualified but nonetheless substantial.").

What is more, under more recent United States Supreme Court law, non-misleading content-based commercial speech is presumptively subject to the more exacting standard of "heightened scrutiny". As the Court held in *Sorrell,* 564 U.S. at 566:

> The First Amendment requires heightened scrutiny whenever the government creates 'a regulation of speech because of disagreement with the message it conveys.' [Citations omitted.] . . . Commercial speech is no exception.

Accord Retail Digital Network, LLC v. Appelsmith, 810 F.3d 638, 648-649 (9th Cir. 2016) ("In *Sorrell,* ... the Supreme Court held that content or-

speaker-based restrictions on non-misleading commercial speech regarding lawful goods or services must survive 'heightened judicial scrutiny.'…Consistent with *Sorrell's* plain language, we rule that *Sorrell* modified the *Central Hudson* test for laws burdening commercial speech. Under *Sorrell*, courts must first determine whether a challenged law burdening non-misleading commercial speech about legal goods or services is content- or speaker-based. If so, heightened judicial scrutiny is required….Heightened judicial scrutiny may be applied using the familiar framework of the four-factor *Central Hudson* test.").

3. Respondents fail to meet their burden of proof as to prongs 3 and 4 of the *Central Hudson* test.

The Commissioner incorrectly asserts that there is no dispute regarding the third prong of the *Central Hudson* test. The third and fourth prongs are related and frequently treated together. *See Rubin v. Coors Brewing Co.*, 514 U.S. 476, 486 (1995) ("We have said that '[t]he last two steps of the *Central Hudson* analysis basically involve a consideration of the 'fit' between the legislature's ends and the means chosen to accomplish those ends.'"). Further, to satisfy these prongs, the regulatory method of satisfying the government's asserted interest that burdens speech must be rational. *See Rubin*, 514 U.S. at 488 ("We conclude that § 205(e)(2) cannot directly and materially advance its asserted interest because of the overall irrationality of the Government's regulatory scheme.") As in *Central Hudson* itself, a regulation that regulates based on the content of speech is inherently too remote from the legitimate governmental interest in reasonable rates to justify the burden on speech. *See* AOB at 68-69.

Dated: June 13, 2016 HOGAN LOVELLS US LLP

By: s/ Vanessa O. Wells

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CERTIFICATE OF COMPLIANCE

The undersigned counsel certifies that pursuant to rule 8.204(c)(1) of the California Rules of Court, the text of this Respondent's Brief was produced using 13 point Times New Roman type and contains 8,308 words, excluding the Caption, Tables, and this Certification. Counsel relies on the word count of the computer program (Microsoft Word: Windows 7 Enterprise) used to prepare this brief.

June 13, 2016 s/Vanessa O. Wells
Vanessa O. Wells

PROOF OF SERVICE

I, Ramona Altamirano, declare:

I am employed in the County of San Mateo, State of California. I am over the age of 18 and not a party to the within action. My business address is: Hogan Lovells US LLP, 4085 Campbell Avenue, Suite 100, Menlo Park, California 94025.

On June 13, 2016, I served the foregoing document(s):

APPELLANTS' REPLY BRIEF

on the interested parties in this action by placing a true and correct copy thereof, in a sealed envelope addressed as follows and also via electronic transmission, as noted below:

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[ ] **BY MAIL**: I am "readily familiar" with the firm's practice of collection and processing correspondence for mailing. Under that practice it would be deposited with the U.S. Postal service on that same day with postage thereon fully prepaid at Menlo Park, California in the ordinary course of business. I am aware that on motion of the party served, service is presumed invalid if postage cancellation date or postage meter date is more than one day after date of deposit for mailing in affidavit.

[ ] **BY OVERNIGHT DELIVERY**: I am "readily familiar" with the firm's practice of collection and processing correspondence for overnight delivery. Under that practice it would be deposited in a box or other facility regularly maintained by the express service carrier, or delivered to an authorized courier or driver authorized by the express service carrier to receive documents, in an envelope or package designated by the express service carrier with delivery fees paid or provided for, addressed to the person on whom it is to be served, at the office address as last given by that person on any document filed in the cause and served on the party making service; otherwise at that party's place of residence..

[ ] **BY FACSIMILE**: By transmitting an accurate copy via facsimile to the person and telephone number as follows:

[XX] **BY E-SERVICE**: By transmitting an accurate copy(ies) via E-service to the person(s) and E-service address(es) as follows: SEE ABOVE

I declare under penalty of perjury under the laws of the State of California that the above is true and correct. Executed at Menlo Park, California on June 13, 2016.

By:
Ramona Altamirano