HARVEY ROSENFIELD (SBN: 123082)
harvey@consumerwatchdog.org
PAMELA PRESSLEY (SBN: 180362)
pam@consumerwatchdog.org
LAURA ANTONINI (SBN: 271658)
laura@consumerwatchdog.org
CONSUMER WATCHDOG
2701 Ocean Park Blvd., Suite 112
Santa Monica, CA 90405
Telephone: (310) 392-0522
Facsimile: (310) 392-8874

DANIEL Y. ZOHAR (SBN: 177866)
dzohar@zoharlawfirm.com
ZOHAR LAW FIRM, P.C.
601 S. Figueroa Street, Suite 2675
Los Angeles, CA 90017
Telephone: (213) 689-1300
Facsimile: (213) 689-1305

Attorneys for Intervenor Consumer Watchdog

IN THE SUPERIOR COURT OF CALIFORNIA

COUNTY OF SACRAMENTO

MERCURY CASUALTY COMPANY,

Petitioner and Plaintiff,

v.

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

Respondent and Defendant.

CONSUMER WATCHDOG,

Intervenor.

Case No. 34-2013-80001426
Assigned to: Hon. Eugene L. Balonon, Dept. 14

CONSUMER WATCHDOG'S RESPONSE TO THE TRADES' MOTION FOR LEAVE TO INTERVENE

Date Action Filed: March 1, 2013

Date: June 7, 2013
Time: 9:30 a.m.
Dept.: 14

I. INTRODUCTION

Intervenor Consumer Watchdog does not oppose the intervention of Personal Insurance Federation of California, American Insurance Association, Property Casualty Insurers Association of America dba Association of California Insurance Companies, National Association of Mutual Insurance Companies, and Pacific Association of Domestic Insurance Companies (collectively the "Trades") in this matter pursuant to Insurance Code section 1861.10. Consumer Watchdog submits this response to the Trades' Motion for Leave to Intervene and supporting Memorandum of Points and Authorities ("Memorandum") to make clear, however, that while Consumer Watchdog does not oppose the Trades' intervention, it strongly disagrees with the substantive positions and crucial inaccuracies set forth in the Trades' Memorandum and proposed Complaint in Intervention on the issues raised in Petitioner Mercury's Verified Petition for a Peremptory Writ of Mandate ("Petition").[1]

The Trades join Mercury in asking this Court to overturn the long-accepted meaning and application of key provisions of the prior approval regulatory formula that governs all property casualty insurance rate applications under Proposition 103, which was adopted by California voters in 1988.[2] Specifically, the Trades challenge two aspects of the Insurance Commissioner's February 11, 2013, Order adopting the Administrative Law Judge's Proposed Decision[3] in the underlying administrative proceeding: (1) the Commissioner's application of the "deep financial hardship" test articulated by the California Supreme Court in *20th Century v. Garamendi* (1994) 8 Cal.4th 216 ("*20th Century*") in

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[1] This response is not intended as an exhaustive discussion of Consumer Watchdog's disagreement with the Trades' positions, which Consumer Watchdog expects to set forth more fully in briefing on the merits of Mercury's Petition.

[2] A detailed set of regulations was promulgated after the passage of Proposition 103 to provide the ratemaking formulae and the definitions of its component factors that are used to determine whether an insurer's proposed rates are excessive pursuant to section 1861.05 (the "Prior Approval Regulations"). (See Cal. Code Regs., tit. 10 ("10 CCR"), §§ 2641.1-2644.27.) The Prior Approval Regulations, which have governed the insurance industry for more than two decades, specify the calculation of the "maximum permitted earned premium" and the "minimum permitted earned premium" (see, e.g., 10 CCR §§ 2644.2, 2644.3). These are the Commissioner's determination of the statutory boundaries of "excessive" and "inadequate." (*20th Century Insurance Co. v. Garamendi* (1994) 8 Cal.4th 216, 254.) The Prior Approval Regulations include nine separate provisions that grant additional regulatory flexibility by permitting insurers to seek "variances" from certain components or the output of the maximum permitted earned premium calculation. (See 10 CCR § 2644.27(f)(1)-(9).)

[3] Certified Administrative Record filed Mar. 12, 2013 ("CR"), Vol. I, pp. 2037-2178 (Order Adopting Proposed Decision ["Order"] dated February 11, 2013; Proposed Decision ["Decision"]).

determining whether an insurer (here, Mercury) qualifies for a "confiscation variance" under 10 CCR § 2644.27(f)(9); and (2) the Commissioner's interpretation of "institutional advertising expenses" under 10 CCR § 2644.10(f).

The Trades' framing of the issues in their intervention papers reveal their attempt to use this proceeding as a vehicle to revise the well-established meaning and application of the Commissioner's Prior Approval Regulations as interpreted and upheld by the California Supreme Court in order to allow the property casualty insurance industry to charge consumers excessive rates and collect more profit.

II. THE COMMISSIONER APPLIED THE PROPER TEST IN ANALYZING THE REQUESTED CONFISCATION VARIANCE.

A. *20th Century v. Garamendi* Does Not Apply a "Fair Return Principle" for Determining Whether Insurance Rates Produced Under the Regulatory Ratemaking Formula are Confiscatory.

The Trades echo the fiction being thrust upon this Court by Mercury that *20th Century*, *supra*, 8 Cal.4th 216, is grounded on a "fair return principle" (Mem. at 7:13) for determining whether the regulatory ratemaking formula would produce a confiscatory result. The Trades incorrectly state that the *20th Century* Court "recognized an 'implied constitutional variance'" to allow insurers to "adjust[]" and "avoid[]" confiscatory rates (Mem. at 7:6-8), which the Trades claim is based on a "fair return principle" (Mem. at 7:9-17). Notably, neither of the phrases the Trades place in quotes throughout their Memorandum – "implied constitutional variance" or "fair return principle" – appear anywhere in the *20th Century* opinion.

The Trades' repeated use of invented phrases and selected quotes cannot supplant the confiscation test applicable to insurance rates under the Commissioner's regulatory ratemaking formula as actually articulated by the *20th Century* Court. As the Court in *20th Century* explains, "[w]hen a regulation is challenged as violative of the takings clause as applied, ***the question is whether***, in the particular case, ***its terms set a rate that is unjust and unreasonable and hence confiscatory***." (*20th Century*, *supra*, 8 Cal.4th 216 at 318, emphasis added.) The Court went on to state, "[j]udicial inquiry as to whether or not a rate is just and reasonable is also limited." (*Ibid*.) Indeed, such an inquiry by the court is "at an end" "[i]f the total effect of the rate order cannot be said to be unjust and unreasonable." (*Ibid*., quoting *Power Comm'n v. Hope Gas Co.* (1944) 320 U.S. 591, 602; see also *id*. at 292-293.) Following *Hope*, *supra*, 320 U.S. 591, the *20th Century* Court held that "confiscation" requires a

showing by the insurer that "the rate in question does not allow it to operate successfully" and that it will cause the company to suffer "deep financial hardship." (*20th Century*, *supra*, 8 Cal.4th at 296, citing Tribe, American Constitutional Law (2d ed. 1988) p. 593, fn. 3 [characterizing *Hope* as a "standard that only the most egregiously confiscatory rate structure would have difficulty meeting"].) "In a word, the inability to operate successfully is a necessary-but not a sufficient-condition of confiscation." (*Ibid*.) Whether a rate "is unjust and unreasonable in its consequences and therefore confiscatory depends on a ***balancing*** of the interests of [the insurer] and its insureds." (*Id*. at 325, emphasis added; see also *id*. at 293-295 [discussing the "balancing of the interests of the producers of the goods or services under regulation and the interests of the consumers of such goods or services" under the standards set forth by the U.S. Supreme Court in *Hope*, *supra*, 320 U.S. 591].) While the Court noted that the insurer has an ***interest*** in "a 'return to the equity owner' that is 'commensurate with returns on investments in other enterprises having corresponding risks' and 'sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital' [citations omitted]," it went on to state that the insurer's "interest, however, is just that: ***it is an interest, not a right***" and is "'***only one of the variables in the constitutional calculus of reasonableness***.'" (*Id*. at 325-326, citations omitted, emphasis added.) Indeed, the insurer "has no constitutional right to a profit ...." [citation omitted] and "it has no constitutional right even against a loss." (*Id*. at 326.)

Contrary to the Trades' contentions, the Court, relying on and quoting U.S. Supreme Court precedent, determined that confiscation with respect to property-casualty insurance rates is ***not***: (1) "whenever a rate simply does not 'produce[] a profit which an investor could reasonably expect to earn in other businesses with comparable investment risks and which is sufficient to attract capital'" (*id.* at 297); (2) limiting allowed costs by, among other things, using an efficiency standard (*id.* at 289-90); (3) requiring the use of a uniform leverage factor (*id.* at 309-11); or (4) a line-by-line test; rather it is a test of "the condition of the insurer as a whole" (*id*. at 308-09).

The Commissioner's Decision correctly noted that *20th Century* never uses the invented phrase, "fair rate of return"; nor does *20th Century* rely on such a test (or articulate a "fair return principle"), contrary to the Trades' assertions. (See CR at 2169.) Under the actual confiscation test set forth in *20th Century*, and as correctly applied by the ALJ and the Commissioner in this case, a determination of

"confiscation" involves a case-by-case complex factual determination of the actual effects of implementing a particular rate on the totality of an insurer's business and a balancing of the insurer's and the insured's interests, not an abstract analysis of why, in an insurer's view, the Commissioner's chosen rate of return is insufficient, or whether an insurer simply disagrees with the amount of its projected losses, which is the case with Mercury here. Instead, an insurer must offer evidence to show that its entire enterprise will have an inability to operate successfully when the proposed rate is enacted. (See *20th Century*, *supra*, 8 Cal.4th at 295 ["In attempting to balance producer and consumer interests, one may of course arrive at a rate that disappoints one or even both parties. But a striking of the balance to the producer's detriment does not necessarily work confiscation. Indeed, it can *threaten* confiscation only when it prevents the producer from 'operating successfully,'" emphasis in original].) In essence, were the Trades' and Mercury's argument that a "fair return principle" is the proper confiscation standard to be accepted, then whenever an insurer claimed that the resulting rate would not allow it to achieve enough profit in the eyes of Wall Street analysts, then the matter would suddenly become a debate over constitutional takings. The result would be that the regulatory formula would be rendered meaningless, since whenever an insurer felt that it was entitled to a higher profit, the application of the entire formula could be called into question. But this was not the intent of the regulations and finds no support in the regulatory history or established California and U.S. Supreme Court precedent discussing regulatory takings.

B. The Current Regulations Are Not Grounded in the "Fair Return Principle."

The Trades' claim that the Commissioner "accepted 'the fair return principle'" (Mem. at 2:5-6) as a foundation "in adopting the current rate regulations" (*id.* at 2:4) is likewise without support. In support of this claim, the Trades cite to an excerpt from a "Summary of and Response to Public Comment Received" by the Department on a proposed regulation on variances generally. (Mem. at 8:3-13.) In that Summary, the Commissioner stated: "The Commissioner is also aware that insurers must be allowed an opportunity to earn a fair and reasonable rate of return." (Wells Decl., Exh. 1, p. 128.) Contrary to the Trades' contentions, the Commissioner ***did not*** state that this "opportunity" was the "foundation on which the regulatory formula is built" (Mem. at 2:3-4), nor did he state that "the fair return principle" is the test for confiscation articulated in *20th Century* (Mem. at 8:14).

The language in 10 CCR § 2644.27(f)(9) speaks for itself. 10 CCR § 2644.27(f)(9) provides for a confiscation variance based on a showing "[t]hat the maximum permitted earned premium would be confiscatory as applied." As further stated in the regulation, "[t]his is the constitutionally mandated variance articulated in *20th Century v. Garamendi* (1994) 8 Cal.4th 216 which is ***an end result test applied to the enterprise as a whole***." (10 CCR § 2644.27(f)(9), emphasis added.) The regulation thus expressly requires adherence to the standard "articulated in 2*0th Century*". As discussed above, the confiscation standard articulated in *20th Century* is not grounded on a "fair return principle" as urged by the Trades.

C. The Commissioner's Decision Correctly Applies the *20th Century* Confiscation Test.

Contrary to the Trades' claims, the Commissioner's Decision in this matter ***did not*** renounce the prior statements articulated at the time the regulations were adopted about the importance of the variances by "requiring that a rate order must produce financial distress for its impact to constitute confiscation" (Mem. at 2:7-10; see also Mem. at 8:15-17). Indeed, the Commissioner's Decision discussed the proper legal standards for confiscation as articulated in U.S. Supreme Court decisions and *20th Century* (CR at 2154-2158), as discussed above. Then, applying those standards, the Commissioner found that Mercury did not meet its burden of proving that the maximum indicated rate would result in confiscation because, based on the evidence presented, "the maximum indicated rate permits Mercury to earn a profit and maintain its financial integrity." (CR at 2164-2165 [finding that the maximum permitted rate would result in "at least a 7.32% after-tax rate of return and at least $1.8 million profit to Mercury"].)

Also, the Trades' assertion that the Commissioner incorrectly applied the relitigation ban[4] to prevent Mercury from presenting its legal arguments and evidence on the "fair rate of return" test is

[4] The Commissioner's review of rates must use a single, consistent methodology. (10 CCR § 2643.1.) To assure that uniformity, and prevent each rate proceeding from becoming a protracted battle, an insurance company is barred from challenging particular components of the Prior Approval Regulations during a rate application proceeding. This is known as the "Relitigation Ban." (See 10 CCR § 2646.4(c) ["Relitigation in a hearing on an individual insurer's rates of ***a matter already determined either by these regulations or by a generic determination*** is out of order and shall not be permitted." (Emphasis added)].) As the Supreme Court in *20th Century* explained in discussing the Relitigation Ban: "[i]n adjudication, the judge applies declared law; he does not entertain the question whether its underlying premises are sound. That is as it should be. Otherwise, standardless, *ad hoc* decisionmaking would result." (*Id*. at 312.)

without merit. (See Mem. at 9:25-10:3.) The Decision discusses at length Mercury's testimony and evidence that was admitted on the confiscation issue, and weighs it against that presented by the Department and Consumer Watchdog. (CR at 2158-2166.) The Commissioner's Decision is thus supported by the weight of the evidence and follows the controlling decision of the California Supreme Court in *20th Century*.

III. THE COMMISSIONER'S INTERPRETATION OF "INSTITUTIONAL ADVERTISING" IS CORRECT.

The Trades present a breadbasket of reasons for why, in their view, the Decision "incorrectly construes § 2644.10(f) to sweep in virtually all advertising" (Mem. at 11:2-3) as "institutional advertising", none of which have merit.

The regulations, at 10 CCR § 2644.10(f), require that expenses for institutional advertising be excluded from the rate calculation.[5] Subsection (f) defines institutional advertising as "advertising not aimed at obtaining business for a specific insurer and not providing consumers with information pertinent to the decision whether to buy the insurer's product." In other words, institutional advertising includes advertising that is not aimed at obtaining business for a specific insurer and advertising that does not provide consumers with information pertinent to an insurer's product.

The underlying intent of this regulation is that if a specific insurer expends money to promote their insurance products and provides useful information to policyholders about those products, that expense should be factored into the rate calculation. However, since "institutional" ads, such as the display of the company's logo at sporting events or other sponsorship activities, are not aimed at specific insurers and do not provide information relevant to consumers' decisions to purchase the insurer's

[5] Expenses are accounted for in the regulatory formula by way of an "efficiency standard," which is expressed as a "ratio of historic underwriting expenses, including adjusting and other expenses to historic earned premiums" and "represents the fixed and variable cost for a reasonably efficient insurer to provide insurance and to render good service to its customers." (10 CCR § 2644.12(a).) The Commissioner sets an efficiency standard for each insurance line and type of distribution system. (*Ibid.*) The regulations mandate that certain expenses be "excluded" – i.e., "not [] allowed for ratemaking purposes." Expense items that must be excluded include "[i]nstitutional advertising expenses." (10 CCR § 2644.10(f).) These excluded expenses are calculated for each company on an all lines (subject to Proposition 103), group-wide basis, and then the efficiency standard is reduced by a ratio of those excluded expenses to direct earned premium. (See, e.g., 10 CCR § 2644.10 ["The disallowance shall be effected by reducing the efficiency standard by the ratio of the insurer's national excluded expenses to its national direct earned premium."])

products, the regulations preclude insurers from passing through the expenses related to such ads to its policyholders.

First, the Trades contend that the Commissioner interprets the word "and" in 10 CCR § 2644.10(f) incorrectly. (See Mem. at 11:4-11.) Contrary to this contention, the Decision parsed the words of the regulation and its underlying intent to properly conclude institutional advertising, as defined in 10 CCR § 2644.10(f), is both advertising that is not aimed at obtaining business for a specific insurer and advertising that does not provide consumers with information pertinent to an insurer's product. (CR at 2138-2139, 2147-2148.) Here, the Commissioner found that the advertisements in question did not mention a specific insurer *and* did not provide consumers with pertinent product information. (See CR at 2142-2148.)

The Trades next contend that "the Order appears to require that advertising specifically name a specific insurer, by its formal name, to be advertising 'aimed at obtaining business for a specific insurer'" (Mem. at 11:12-13), which the Trades argue "is not a stated requirement." (*Id*. at 11:13-14.) Contrary to the Trades contention, however, the Commissioner's Decision did not state that naming a specific insurer by its formal name is a requirement of the regulation. Instead, considering the intent of the regulation, the Commissioner explained that "[c]onsumers are obligated to pay only expenses necessary in the offering of an insurance product or that in some way provide them a benefit. Mercury may not charge consumers for advertising that promotes corporate identity, enhances public opinion, or increases name and brand awareness." (CR at 2144.) Since "Mercury chose to directs its advertising budget towards its entire group of affiliates," the Commissioner concluded that Mercury's advertisements were not aimed at obtaining business for a "specific insurer" under 10 CCR § 2644.10(f). (CR at 2143.) The analysis set forth in the Decision applies to the situation where Mercury chose to use the fictitious name "Mercury Insurance Group" rather than to promote any specific insurer or insurer's products, and in this instance, the Commissioner found that these ads were "institutional" in nature.

Finally, the Trades' argument that the regulation is an unconstitutional burden on protected commercial speech (Mem. at 12:2-10) is nonsensical, as insurers remain free to advertise as a group of companies or specific insurers with or without providing pertinent information about an insurer's

products as they wish. The regulation simply requires that if they choose to engage in advertising that is "institutional" in nature, they must exclude those costs from the calculation of policyholders' premiums.

In sum, the Commissioner's interpretation and application of 10 CCR § 2644.10(f) is fully supported by the law and the evidence, as set forth in the Decision's discussion of the plain meaning and intent of the regulation, relevant case law, and Mercury's ads, which do not seek business for a specific insurer and do not provide consumers with pertinent information about a Mercury insurance product. (See CR at 2142-2148.)

IV. CONCLUSION

Although Consumer Watchdog does not oppose the Trades' intervention, Consumer Watchdog strongly disagrees with and opposes the arguments and misstatements set forth by the Trades in their intervention papers regarding the Commissioner's interpretation and application of the law governing confiscation variances and institutional advertising. Consumer Watchdog expects to more fully brief these issues in conjunction with the Court's consideration of the merits of Mercury's Petition.

Dated: May 24, 2013

Respectfully Submitted,

CONSUMER WATCHDOG
Harvey Rosenfield
Pamela Pressley
Laura Antonini

BY: Pamela Pressley
Pamela Pressley
Attorneys for Intervenor CONSUMER WATCHDOG

PROOF OF SERVICE

[BY OVERNIGHT OR U.S. MAIL, FAX TRANSMISSION, EMAIL TRANSMISSION AND/OR PERSONAL SERVICE]
State of California, City of Santa Monica, County of Los Angeles

I am employed in the City of Santa Monica and County of Los Angeles, State of California. I am over the age of 18 years and not a party to the within action. My business address is 2701 Ocean Park Blvd., Suite #112, Santa Monica, California 90405, and I am employed in the city and county where this service is occurring.

On May 24, 2013, I caused service of true and correct copies of the documents entitled

CONSUMER WATCHDOG'S RESPONSE TO THE TRADES' MOTION FOR LEAVE TO INTERVENE

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1. If marked FAX SERVICE, by facsimile transmission this date to the FAX number stated to the person(s) named.

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3. If marked U.S. MAIL or OVERNIGHT or HAND DELIVERED, by placing this date for collection for regular or overnight mailing true copies of the within document in sealed envelopes, addressed to each of the persons so listed. I am readily familiar with the regular practice of collection and processing of correspondence for mailing of U.S. Mail and for sending of Overnight mail. If mailed by U.S. Mail, these envelopes would be deposited this day in the ordinary course of business with the U.S. Postal Service. If mailed Overnight, these envelopes would be deposited this day in a box or other facility regularly maintained by the express service carrier, or delivered this day to an authorized courier or driver authorized by the express service carrier to receive documents, in the ordinary course of business, fully prepaid.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on May 24, 2013, at Santa Monica, California.

Jason Roberts

1. **SERVICE LIST**

Person Served	**Method of Service**
Kamala D. Harris Attorney General of California Steven Green Deputy Attorney General 1300 I Street Sacramento, CA 94244-2550 Tel: (916) 445-5367 Fax: (916) 327-2247 Steven.green@doj.ca.gov	_____ FAX _____ U.S. MAIL _____ OVERNIGHT MAIL _____ HAND DELIVERED ____X__EMAIL
W. Dean Freeman Felix E. Leatherwood Supervising Deputy Attorneys General Stephen Lew Deputy Attorney General 300 South Spring Street, Suite 1702 Los Angeles, CA 90013 Tel: (213) 897-8526 Fax: (213) 897-5775 Stephen.Lew@doj.ca.gov	_____ FAX _____ U.S. MAIL _____ OVERNIGHT MAIL _____ HAND DELIVERED ____X__EMAIL
Steven H. Weinstein Marina M. Karvelas Spencer Y. Kook Peter Sindhuphak Barger and Wolen LLP 633 West Fifth street, 47th Floor Los Angeles, CA 90071 Tel. No.: (213) 680-2800 Fax No.: (213) 614-7399 sweinstein@bargerwolen.com mkarvelas@bargerwolen.com skook@bargerwolen.com psindhuphak@bargerwolen.com	_____ FAX ___X_ U.S. MAIL _____ OVERNIGHT MAIL _____ HAND DELIVERED ___X__EMAIL

Vanessa O. Wells
Hogan Lovells US LLP
525 University Ave., 4th Floor
Palo Alto, California 94301
Tel No.: (650) 463-4000
Fax No.: (650) 463-4199
Vanessa.wells@hoganlovells.com

_____ FAX
_____ U.S. MAIL
_____ OVERNIGHT MAIL
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___X__EMAIL