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SUPERIOR COURT OF THE STATE OF CALIFORNIA

FOR THE 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.

PERSONAL INSURANCE FEDERATION OF CALIFORNIA, et al.,

Intervenors.

Case No. 34-2013-80001426-CU-WM-GDS

Assigned to Judge Shelleyanne W.L. Chang, Dept. 24

RESPONDENT'S MEMORANDUM OF POINTS AND AUTHORITIES IN OPPOSITION TO PETITIONS FOR WRIT OF MANDATE

Writ Hearing Date: May 2, 2014
Action Filed: March 1, 2013

TABLE OF CONTENTS

TABLE OF CONTENTS
(continued)

Page

TABLE OF AUTHORITIES

Page

CASES

///

///

///

///

///

///

TABLE OF AUTHORITIES
(continued)

Page

REGULATIONS

INTRODUCTION

In 2009, Petitioner and Plaintiff Mercury Casualty Company ("Mercury") filed a 180 page application seeking a rate increase for its homeowners' line of business (the "Application"). The Department of Insurance (the "Department") reviewed the Application and ascertained that Mercury's rates were already too high and that California law required a rate decrease.

During negotiations with the Department and Consumer Watchdog, Mercury waived its right to a hearing while it continued to charge excessive rates. Mercury submitted updated data – the equivalent of a new rate application – at least three times. According to the Department's calculations, the data always showed that a rate decrease was required. In February 2013, after the administrative hearing, respondent Insurance Commissioner (the "Commissioner") issued a final decision ordering Mercury to reduce its homeowners' rates by 5.4% (the "February 2013 Rate Order"). Mercury implemented the rate decrease in May 2013.

Meanwhile, in January 2013 – after the hearing but before the Commissioner issued a final decision – Mercury submitted a new application with updated data that did justify a rate increase. In November 2013, the Commissioner approved an 8.7% rate increase (the "November 2013 Rate Order"). The new rates are in effect. Therefore, this case does not involve Mercury's current rates. Mercury overcharged its policyholders for more than three years, but the 5.4% rate decrease was in effect for less than one year before Mercury stipulated to, and the Commissioner ordered, an 8.7% rate increase. Accordingly, if one of Mercury's goals in this case was to obtain a rate increase, that goal is no longer at issue.

Instead, Mercury's and the intevenor Trade Groups' (the "Trades'") goal is to eliminate formula-based rate making under the guise of a "fair return principle." Mercury and the Trades advocate for *ad hoc* case-by-case determinations of each insurer's "rate of return" – and any other factor the insurer wishes to present evidence on.

But the California Supreme Court has made clear that formulaic ratemaking is the *preferred* mechanism for determining insurance company rates. "One of the purposes of Proposition 103 is 'to protect consumers from arbitrary insurance rates.' Formulaic ratemaking furthers that goal. Case-by-case ratemaking does the opposite." (*20th Century Ins. Co. v.*

Garamendi (1994) 8 Cal.4th 216, 285-286 (*20th Century*) [citations omitted].) And the Court has also made clear that ratemaking may use data "reflecting the condition and performance of a group of regulated firms" and "average costs rather than the costs of individual regulated firms." (*Id.* at p. 293 [citation omitted].)

Thus, the Commissioner was not required to abandon his regulations and offer Mercury a custom-tailored "fair rate of return" analysis. But the Commissioner did hold a hearing, at which Mercury requested "Variance 9" to determine whether the formula-generated rate was confiscatory. After a lengthy proceeding, the administrative law judge and later the Commissioner found that the rate reduction was not confiscatory. The Commissioner applied the governing standard for confiscation: Does the rate result in "deep financial hardship" to the enterprise as a whole (alternatively phrased, does the rate prevent the company from "operating successfully")? (*20th Century, supra*, 8 Cal.4th at p. 296; Reg. 2644.27, subd. (f)(9).)[1] In essence arguing that this standard does not apply, Mercury did not put on evidence of deep financial hardship. The Commissioner found that Mercury did not establish confiscation.

Calfarm Insurance Co. v. Deukmejian (1989) 48 Cal.3d 805 ("*Calfarm*") and *Kavanau v. Santa Monica Rent Control Bd.* (1997) 16 Cal.4th 761 ("*Kavanau II*") do not support Mercury's and the Trades' contention that the test for confiscation is "opportunity to earn a fair return" rather than "deep financial hardship. Although cases refer to "opportunity to earn a fair rate of return," that concept is not an alternative to deep financial hardship. Neither *Calfarm* nor *Kavanau II* so state. Rather, in the context of formulaic ratemaking, an insurer asserting confiscation first must show deep financial hardship and, if it is successful, then may attempt to demonstrate that some other rate not contemplated by the regulations is required to afford an opportunity to earn a fair rate of return.

In any event, to the extent there is any inconsistency between *20th Century*, *Calfarm* and *Kavanau II*, *20th Century* controls. It is the California Supreme Court's most comprehensive and specific exposition of the law of confiscation in the Proposition 103 context. Contrary to the

[1] References to Regulations are to title 10 of the California Code of Regulations.

Trades' assertion, the holding is not limited to rate rollbacks and is not "*sui generis*." (Trades Mem. at p. 17.) The discussion of confiscation in *20th Century* that starts at page 292 and goes to page 297 quotes six United States Supreme Court cases spanning a hundred years addressing confiscation in a panoply of ratemaking contexts unrelated to rollbacks. The Court described this exposition of the law of confiscation as the "background" against which it then considered the specific issue of rollbacks. (*20th Century, supra*, 8 Cal. 4th at p. 297.) Further, *Kavanau II* supports the Commissioner because the Court recognized that future rate increases, which Mercury got, could cure a previously inadequate rate, if any had existed.

THE ISSUES IN THIS CASE

The Constitutional Issue. The Commissioner does not dispute that a regulated entity is entitled to a rate that, over time, allows it the opportunity to earn a fair return. As the California Supreme Court has stated, that opportunity is built into the Commissioner's formulaic ratemaking regulations. (*20th Century, supra*, 8 Cal.4th at pp. 250-251. The issue in this case is what are Mercury's options if it wants to contest the maximum rate under the formula as unconstitutional as applied to Mercury.

The answer is what the United States and California Supreme Courts have ruled in over 50 years of constitutional jurisprudence. To obtain relief from a formula-generated rate, an insurer must pursue a two-step process. First, the insurer must demonstrate that the end result of the regulations causes or will cause deep financial hardship to the insurer as a whole. This means the insurer must show that the rate would make it unable to operate successfully during the period of the rate. An insurer can show this only by demonstrating the financial condition of the enterprise (not the specific line of insurance) within the meaning of *20th Century* and *Jersey Central Power & Light Co. v. Federal Energy Regulatory Commission* (D.C. Cir. 1987) 810 F.2d 1168 ("*Jersey Central*"). The second step would be to make a determination of the minimally non-confiscatory rate that would not be limited by the strictures of the regulations.

One who would overturn a rate order on constitutional grounds has a "heavy burden." (*Federal Power Commission v. Hope Natural Gas Co.*(1944) 320 U.S. 591, 602 ("[H]e who would upset the rate order . . . carries the heavy burden of making a convincing showing that it is

invalid because it is unjust and unreasonable in its consequences.") This burden cannot be met by substituting one or more components of the regulatory formula with an insurer-specific component, nor by substituting a completely different formula, nor by demonstrating that a special rate of return is allegedly necessary for the particular insurer. Rather, it must be shown by indicators of financial condition or financial hardship such as inability to pay dividends, maintain its financial integrity, attract capital, and compensate its investors for the risks assumed. Here, Mercury has not even attempted to make such a showing.

All of the other confiscation issues that Mercury and the Trades raise require the Court to reject the need to show deep financial hardship to obtain a variance from the regulatory formula.

The Institutional Advertising Issue. Mercury and the Trades wrongly argue that the Commissioner should not have excluded Mercury's "institutional advertising" expenses because Regulation 2644.10 supposedly requires that an insurer meet only one of the two prongs set forth in order for its advertising *not* to be considered institutional advertising. Regulation 2644.10, subdivision (f) states:

> (f) Institutional advertising expenses. "Institutional advertising" means 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.

The regulation is unambiguous. "Advertising not aimed at obtaining business for a specific insurer" is institutional advertising. And, advertising "not providing consumers with information pertinent to the decision whether to buy the insurer's product" is also institutional advertising. (See Proposed Decision p. 93.) So, a company's advertising must meet both prongs set forth in Regulation 2644.10(f) in order *not* to be considered institutional advertising.

Further, the industry's argument here is also a red herring. The ALJ found that Mercury's advertising was both "not aimed at obtaining business for a specific insurer" *and* did not provide consumers with information pertinent to the decision whether to buy the insurer's product. (Proposed Decision pp. 97-100.) In other words, even if the court were to accept the industry's interpretation of Regulation 2644.10, subdivision (f) as correct – which the Commissioner does not concede – Mercury's advertising still falls within the Regulation's definition of institutional

advertising. Accordingly, Mercury's advertising in fact was institutional advertising under the Regulation.[2]

Finally, the industry argues that Regulation 2644.10 implicates free speech concerns. Again, this argument is groundless. The Regulation is content-neutral and neither controls nor compels specific content. Moreover, the Regulation does not even prohibit an insurer from engaging in institutional advertising. Rather, Regulation 2644.10 simply dictates what kind of advertising may be included in an insurer's ratemaking application for purposes of allocating costs to California consumers. This does not implicate free speech protections, and any argument to the contrary is without foundation.

PROPOSITION 103 BACKGROUND

On November 8, 1988, California voters enacted Proposition 103, fundamentally changing the way property-casualty rates are regulated in California. Before Proposition 103, insurers were free to set their rates in a competitive market. Among other things, Proposition 103 instituted a one-year rate "rollback" and a permanent "prior approval" system of rate regulation. (See *20th Century*, *supra*, 8 Cal.4th at pp. 239-240.)

Rollbacks. Proposition 103 required insurers to immediately roll back their rates 20% below their 1987 levels for one year starting November 8, 1988 (the "Rollback Year") (§ 1861.01, subd. (d)).[3] Insurers could only obtain relief from the 20% rollback if they could show that they were "substantially threatened with insolvency." (§ 1861.01, subd. (b).) This provision became known as the "insolvency standard."

Prior Approval. Proposition 103 also implemented a prior approval rate review system for any rate adjustment -- up or down. (§ 1861.05). For prior approval, Proposition 103 recognized a range of permissible rates bounded between "excessive" and "inadequate" (the "prior approval" or "excessive-inadequate" standard):

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[2] Mercury also argues that the Commissioner's interpretation of the regulation was "new," and that the regulation is illogical. Even if either of these arguments is true, they are irrelevant. As set out above and more extensively in the Proposed Decision, the Commissioner simply applied the plain language of this regulation in a straightforward and correct manner.

[3] Statutory references are to the Insurance Code unless otherwise indicated.

> No rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter. ...

(§ 1861.05, subd. (a).) Under the prior approval standard, an insurer is free to charge whatever rate it wants as long as it is within the range of excessive and inadequate. (*20th Century*, *supra*, 8 Cal.4th at p. 254.)

Calfarm. The insurance industry immediately challenged Proposition 103 facially on various constitutional grounds. (*Calfarm*, *supra,* 48 Cal.3d at p, 812.) The California Supreme Court assumed original jurisdiction and issued an alternative writ. On November 10, 1988, the Supreme Court granted the industry's request to stay the entire initiative. (*Id.* at p. 812.) Ultimately, the Court held that the insolvency standard could not "conform to the constitutional standard of a fair and reasonable return." (*Id.* at p. 818.) Accordingly, the Court struck the insolvency standard on constitutional grounds. But except for the insolvency standard, *Calfarm* rebuffed the industry's attack on Proposition 103 and largely upheld the initiative.

> W]e conclude that except for the insolvency standard the provisions of Proposition 103 relating to the setting of insurance rates, and procedures for the adjustment of rates, do not on their face deprive insurers of due process under the state or federal Constitutions.

(*Id.* at p. 815.)

Although it struck the insolvency standard for rollbacks, *Calfarm* left the 20% rollback requirement in place. In lieu of the insolvency standard, *Calfarm* acknowledged that the prior approval excessive-inadequate standard would prevent the rollbacks from resulting in inadequate rates. Specifically if a 20% rollback would result in an "inadequate" rate, a lesser rollback would be required. Since any rate that is confiscatory is also necessarily inadequate, the prior approval standard protected insurers from confiscatory rates.

> Since a confiscatory rate is necessarily an 'inadequate' rate under the statutory language, section 1861.05 requires rates within that range which can be described as fair and reasonable and prohibits approval or maintenance of confiscatory rates.
>
> As stated above, we have concluded that the [prior approval] standards set by 1861.05, subdivision (a), govern rate regulation during the first year of the initiative's operation.

(*Calfarm*, *supra*, 48 Cal.3d at pp. 822-823.) Later, *20th Century* referred to the "inadequate" end of the excessive-inadequate range as the "minim[um] nonconfiscatory" rate for determining the "constitutional percentage" for rollbacks.

> For the rollback year, the Commissioner determines only the minimum permitted earned premium, and does so only to define what is minimally above "inadequate" or minimally nonconfiscatory.

(*20th Century*, *supra*, 8 Cal.4th at p. 254.)

The Rate Regulations. After *Calfarm* upheld Proposition 103, the Commissioner adopted regulations to implement the initiative (the "rate regulations" or simply the "regulations"). The regulations established procedures for determining "reasonable rates" including comprehensive formulas for the upper and lower boundaries of the excessive-inadequate range as well rules and procedures for hearings on individual rate applications. The regulations are codified as title 10, chapter 5, subchapter 4.8, articles 1 through 7, sections 2641.1 through 2647.1 of the California Code of Regulations. The regulations will be discussed in greater detail below. (See also *20th Century*, *supra*, 8 Cal.4th at pp. 248-255.)

20th Century. In his first rollback order after a hearing under the regulations, then Commissioner Garamendi ordered 20th Century Insurance Company to refund not 20% but just 12.2% (the "Rollback Order"). This was the "constitutional percentage" – the bottom or "inadequate" end of the prior approval range of reasonable rates specifically for 20th Century Insurance Company's rollback year. 20th Century Insurance Company then filed a writ of mandate. The vast majority of the California property and casualty insurance industry joined, **raising the same or similar issues as the issues raised in this case**. The trial court ruled almost across the board for 20th Century Insurance Company and the industry. The California Supreme Court did not. Rather, it held that, among other things:

- The trial court erred in overturning the administrative law judge's holding that confiscation requires deep financial hardship. "It is rather the superior court that erred. • • • Confiscation does indeed so require, at least in the general case, such as this." (*20th Century*, *supra*, 8 Cal.4th at p. 324; see also *id.* at pp. 288 & 325.)

- The trial court erred in failing to balance investor and consumer interests and "in mistaking what is an interest that [the insurer] may pursue for a right that it can demand." (*Id.*at p. 326.)

- An "individualized" hearing outside of the regulations was not required to determine the firm's rollback liability. (*Id.*at p. 324.)
- That the rate of return allowed for in the regulations was valid. (*Id.* at p. 320.)
- The trial court erred in determining that the so-called relitigation bar regulation prevented proof of confiscation. (*Id.* at p. 311.)
- Although a firm has an interest in its cost of capital, it has no right." (*Id.* at p. 320; compare Mercury's Petition at p. 20 [alleging that confiscation analysis must include the insurer's actual cost of capital].)

What is At Stake In This Case: Meaningful Rate Regulation Under Proposition 103

Mercury's and the Trades' goals are the same as they were in *20th Century*: to eliminate meaningful formulaic insurance rate regulation in California. In this case, the industry argues for opening up the regulatory process to give every insurer an individualized hearing on its rate of return on request – in addition to the hearing that is currently available to insurers under the regulations. If the industry were to succeed, the Commissioner would be required to provide a hearing to every insurer on request to determine a unique rate of return under whatever formula the insurer wishes to use. The result would be an unmanageable and *ad hoc* regulation process. Though the industry argues otherwise, such a process is precisely what *20th Century* discouraged. (*20th Century*, *supra*, 8 Cal.4th at p. 286.)

ARGUMENT

Mercury and the Trades have advanced two grounds in support of their respective petitions for writ of mandate[4]: (1) that the Commissioner applied the wrong standard for confiscation in his February 2013 Rate Order; and (2) that he misconstrued and misapplied the institutional advertising exclusion regulation. Neither ground is meritorious.

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[4] Mercury has abandoned three other grounds it asserted for seeking a writ of mandate: that the February 2013 Rate Order was not based on the "most updated data" (Pet. at pp. 12-14); that Commissioner wrongfully excluded what Mercury claimed were political contributions and lobbying expenses as expense items in computing Mercury's rates (Pet. at p. 18); and that Commissioner wrongfully determined that Mercury did not qualify for the "leverage variance" under Regulation 2644.27, subdivision (f)(3) (Pet. at pp. 23-24).

I. MERCURY HAS THE BURDEN OF PROOF.

In a rate proceeding, the applicant (here, Mercury) has the burden of demonstrating by a preponderance of the evidence that the rate applied for is not excessive, inadequate, or unfairly discriminatory, or otherwise in violation of Chapter 9 of Part 2 of Division 1 of the Insurance Code (dealing with rates and rating organizations). (Reg. 2646.5.) The burden of proof remains with the insurer and never shifts to the Department or any other party. (§ 1861.05, subd. (b); Reg. 2646.5.)

II. THE COMMISSIONER'S INTERPRETATION OF HIS OWN REGULATION IS ENTITLED TO GREAT WEIGHT AND DEFERENCE.

The Commissioner's interpretation of his own regulation is entitled to great weight and deference. (*Calderon v. Anderson* (1996) 45 Cal.App.4th 607, 613, citing *Ralphs Grocery Co. v. Reimel* (1968) 69 Cal.2d 172, 176, 179-180.) "[A] court may not substitute its independent judgment for that of the administrative agency on the facts or on the policy considerations involved." (*Credit Ins. Gen. Agents Assn. v. Payne* (1976) 16 Cal.3d 651, 657.)

III. THE COMMISSIONER APPLIED THE CORRECT STANDARD FOR CONFISCATION IN THE FEBRUARY 2013 RATE ORDER.

In the rate proceeding, Mercury sought a variance from the ratemaking formula based on "confiscation" under Regulation 2644.27, subdivision (f)(9) ("Variance 9"). The ALJ and Commissioner carefully considered Mercury's request for the confiscation variance and concluded that Mercury did not qualify for it. (Proposed Decision at pp. 109-126.)

Mercury and the Trades argue that the test for confiscation is "fair rate of return" and that the ALJ improperly excluded testimony relevant to whether the rates would produce a "fair rate of return." The crux of the constitutional issue in this case, however, is not whether an insurer has a constitutional right to the opportunity to earn a fair rate of return, but rather how that right is protected and what the insurer can do to assert that right in the context of Proposition 103 rate regulations.

20th Century determined that the Commissioner's regulations are constitutionally sound and are designed to produce a fair return to insurers. (*20th Century*, *supra*, 8 Cal.4th at p. 291).

Further, rate orders are presumed valid and to upset a rate order requires a convincing showing that it is unjust and unreasonable in its consequences.

> A presumption of validity therefore attaches to each exercise of the Commission's expertise, and those who would overturn the Commission's judgment undertake "the **heavy burden** of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences."

(*In re Permian Basin Area Rate Cases* (1968) 390 U.S. 747, 767 [bold added].)

Permian Basin supports the Commissioner's contention that an insurer must follow a two-step process for demonstrating confiscation. The insurer must first make a threshold showing of deep financial hardship. If it is successful, then an alternative minimally non-confiscatory rate would have to be determined. But if the total effect of the order is not unjust and unreasonable, the judicial inquiry is at an end. The court does not go to the second step to determine a minimally non-confiscatory rate. (*Ibid.* ["if the 'total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end.'"].)

A. Before An Insurer Can Obtain An Adjustment to the Rate Under Variance 9 (Confiscation) It Must Demonstrate Deep Financial Hardship, Including An Inability to Operate Successfully.

Variance 9, also known as the "confiscation" or "constitutional" variance is based on *20th Century*. Variance 9 provides:

> That the maximum permitted earned premium would be confiscatory as applied. This 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. Use of this variance requires a hearing pursuant to 2646.4.

(Reg. 2644.27, subd. (f)(9).)

Mercury confuses the issues in this case by arguing matters that are not in dispute. For example, it is not in dispute that the constitutional variance is the final "safety valve" and that to show confiscation an insurer is entitled to "go outside of the formula." (Mercury Mem. at pp. 26, 31.) But Mercury cannot, just by invoking the constitutional variance, simply substitute other economic models, evidence about the required rate of return, or otherwise recalculate a different rate. Mercury must first demonstrate deep financial hardship, including an inability to operate

successfully as described by *20th Century*.

> This point is crucial. It deserves special emphasis. The superior court committed fundamental error. At least in the general case, such as this, confiscation does indeed require "deep financial hardship" within the meaning of *Jersey Central*, i.e., the inability of the regulated firm to operate successfully--meaning, again, the inability of the regulated firm to operate successfully during the period of the rate and subject to then-existing market conditions. Hence, it does not arise, as the superior court erroneously believed, 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."

(*20th Century*, *supra*, 8 Cal.4th at p. 297 [citation omitted].)

Deep Financial Hardship Is a Measure of Financial Condition - Not an Alternative Rate Calculation:

20th Century interpreted the requirement for confiscation to require "deep financial hardship" on an "enterprise-wide" basis, and not parsed on a line by line basis.

> Confiscation requires at least "deep financial hardship"-albeit "deep financial hardship" *short of bankruptcy*-within the meaning of *Jersey Central*. (*Jersey Cent. Power & Light Co. v. F.E.R.C.*, *supra*, 810 F.2d at p. 1181, fn. 3.) Moreover, it "is an enterprise-wide issue, not one to be parsed on a line-by-line basis."

(*20th Century*, *supra*, 8 Cal.4th at p. 258 [italics by the Court].)

20th Century's reference to deep financial hardship "short of bankruptcy" is an indication of how an insurer may show confiscation under the rate regulations. The reference was an acknowledgement of *Calfarm*'s holding that Proposition 103's "insolvency" standard was unconstitutional. But it also indicates that "deep financial hardship" is a measure of the entity's financial condition.

In short, to show deep financial hardship, an insurer could produce evidence showing deterioration of financial condition. This could include an inability to pay dividends to shareholders, a decline in its AM Best ratings, an inability to attract capital or other indicators of financial condition. Of course, a company like Mercury that is thriving under the profits it earns under the regulations, will probably not be able to show that the "total effect" of the February 2013 Rate Order is "unjust and unreasonable." Instead, Mercury is clearly operating

successfully.[5]

Mercury Did Not Present A Deep Financial Hardship Case

As stated, Mercury has failed to even attempt to demonstrate deep financial hardship. To the contrary, the evidence shows that its financial condition appears to be very healthy. For example:

- Mercury failed to demonstrate past rate applications have weakened its financial integrity. (Proposed Decision at p. 120.)
- Mercury has realized millions of dollars of profits every year. (*Ibid.*)
- Over the last five years Mercury has issued dividends totaling nearly $1 billion. (*Ibid.*)
- Mercury made no effort to show that it had any plans or need to raise capital during the period in which the rates would be in effect
- Mercury made no effort to show that the February 2013 Rate Order would prevent the company from operating successfully. (*Market Street Railway Co. v. Railroad Comm'n* (1945) 324 U.S. 548, 566,)
- Mercury made no effort to show why Mercury's rate of return needs were significantly different from the rate of return needs of other California insurers.[6]
- Mercury has eschewed any end result test of confiscation other than that confiscation can be established merely by proposing alternative models to calculate its preferred rate of return.

B. The Commissioner Correctly Applied the *20th Century* Standard for Confiscation In Part Because *20th Century* Elaborated on the Standards of *Calfarm*

The Trades criticize the Proposed Decision for disregarding *Calfarm* (as well as the rent control cases the Trades cite) in favor of *20th Century* on the confiscation standard. (Trades Mem. at p. 16.) The Trades also claim that the ALJ was wrong when she said that *20th Century*

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[5] Mercury's counsel has represented to the court in this case that "I submit, your Honor, that this [Mercury] is a highly solvent company that's monitored by the Department of Insurance." (Transcript of May 3, 2013 hearing on Mercury's motion for a stay, at p. 9.)

[6] Mercury offered testimony to show a purported 9% rate of return on investment in "comparable" industries. Mercury had effectively disavowed making a showing of deep financial hardship and, instead, focused exclusively on evidence regarding its rate of return. The proposed testimony does not go to showing Mercury's own financial condition and thus the testimony was property excluded by the ALJ as improper relitigation. (See, e.g., *20th Century*, *supra*, 8 Cal.4th at p. 294 (stating that a rate of return that is comparable to returns in other industries with comparable risk is an interest an entity "may pursue and not a right it can demand.")

"modified" *Calfarm*. (*Ibid.*) But as *20th Century* states, its decision "rehearse[d]" and "elaborate[d]" on *Calfarm* in the very context at issue here -- due process standards and state price control regulation. (*20th Century*, *supra*, 8 Cal.4th at p. 291.)

Accordingly, *20th Century* was based on the principles set out in *Calfarm*. But the question in *Calfarm* was fundamentally different from the questions in *20th Century* and in this case. The question before *Calfarm* was whether Proposition 103 was unconstitutional **on its face**. The Trades argue for the *Calfarm* standard because, in the context of the facial challenge in that case, *Calfarm* observed the need for Proposition 103 to provide for a "fair return" to the industry, albeit over the "long-term." *Calfarm's* comments on "fair return" were also in the context of its decision to strike the insolvency standard. *Calfarm* found that standard incompatible with "fair and reasonable rates": "Over the long-term the state must permit insurers a fair return." (*Calfarm*, *supra*, 48 Cal.3d at p. 821.) "[Insolvency] precludes adjustments necessary to achieve the constitutional standard of fair and reasonable rates." (*Ibid.*)

Calfarm did not address the rate regulations, which were written later. But *Calfarm* did specifically uphold the excessive-inadequate standard for rate regulation in section 1861.05, stating that the excessive-inadequate standard established "fair and reasonable" rates.

> Since a confiscatory rate is necessarily an "inadequate" rate under the statutory language, section 1861.05 requires rates within that range which can be described as fair and reasonable and prohibits approval or maintenance of confiscatory rates.

(*Calfarm*, *supra*, 48 Cal.3d at pp. 822-823.)

This case involves many of the same issues as in *20th Century*. And, as in *20th Century*, this case involves an "as-applied" challenge to the rate regulations. *20th Century* upheld the Commissioner's formulaic rate regulations and explicitly stated that they provide the constitutional protection required. Further, *20th Century* stated that "[i]n view of the foregoing, the variances must be deemed sufficient for rate adjustments necessary to avoid confiscation." (*20th Century*, *supra*, 8 Cal.4th at p. 313.)

The hearing on Mercury's rates was conducted under the regulations. *20th Century* discussed the regulations in great depth. (See, e.g., *20th Century*, *supra*, 8 Cal.4th at pp. 251

[describing what premium the ratemaking formula is designed to yield], 253 [stating the rate regulations' definition of a "fair return"].) *20th Century* also addressed the confiscation issue in the context of the regulations.

> [The Superior Court's determination that the 20th Century rate rollback order is void] is based on the belief that confiscation does not require 'deep financial hardship' within the meaning of *Jersey Central.* It does, at least in the general case, such as this. This erroneous belief fatally taint the conclusion in question . . . .

(*20th Century*, *supra*, 8 Cal.4th at p. 320.) Accordingly, the ALJ in this matter properly relied on the confiscation standards in *20th Century*.

***20th Century* Applies to Prior Approval Matters**

The Trades further argue that "*20th Century* expressly limited its holdings, analysis, and observations to the regulations 'as to rollbacks.'" (Trades Mem. at pp. 16-17.) But the conceptual analysis in *20th Century* applies generally and is not restricted to rollbacks. The 90-page opinion addresses rate regulation under Proposition 103, both as to prior approval cases and rollbacks. Naturally, the Court frequently references the specific context of its analysis, the rollback order at issue in that case. But *20th Century* never states that its holdings, analysis or observations do not also apply to prior approval rate orders. The opposite is the case.

For example, *20th Century* explains in detail how the rate regulations work, how they apply to both rollbacks and prior approval and how they apply differently in each situation. (*20th Century*, *supra*, 8 Cal.4th at pp. 248-256.) The Court stated:

> To cover both the rate rollback and "**prior approval**" system, the ratemaking formula may be used to yield both a *maximum* permitted earned premium (when the profit factor variable takes as its value a maximum profit factor based on the maximum permitted after-tax rate of return [citing Regs. 2644.2 & 2644.15]) and *minimum* permitted earned premium (when the profit factor variable takes as its value a *minimum* profit factor based on a minimum permitted after-tax rate of return [citing Regs. 2644.3, & 2644.15]).

(*Id.* at pp. 253-254 [italics by the Court; bold added].) The Court further stated that:

> **Central to this proceeding is not only the ratemaking formula itself, but also the nature and scope of the hearing at which the individual insurer's rates are reviewed.**

(*Id.* at p. 255 [bold added].)

Even when *20th Century* uses the phrase "as to rollbacks," often that language applies with equal, and sometimes greater, force in the prior approval context. For example, in the following passage, limiting expenses to "reasonable" expenses applies equally in the rollback and the prior approval context.

> We do not think it improper -- constitutionally or otherwise -- for the rate regulations as to rollbacks to recognize as the insurer's cost of service only the *reasonable* cost of providing insurance. It is not objectionable that the ratemaking formula's efficiency standards operate to define the reasonable cost of providing insurance after subjecting the insurer's "expenses ... to downward normative pressure." [citation omitted] ... '[I]t surely cannot be reasonable for an investor to assume that each and every expenditure ... will be allowed by regulatory authorities." [citation omitted]

(*20th Century*, *supra*, 8 Cal.4th at pp. 289-290 [italics by the Court],)

The Trades also argue that the Supreme Court was operating under extreme pressure in *20th Century* and that this somehow marginalizes the decision's precedential value. (Trades Mem. at p. 19.) None of this is supported by any language from the Court itself. In spite of the array of attacks and arguments the Trades throw at it, *20th Century* is the preeminent authority with regard to confiscation in the context of Proposition 103 rate regulation.[7]

C. The Rent Control Cases Do Not Support the Argument That the Commissioner Applied the Wrong Confiscation Standard.

Mercury and the Trades cite to rent control cases in support of their "fair return" argument. Those cases do not support their position. An analysis of one of the cases cited, *Kavanau II*, illustrates the fallacies in Mercury's and the Trades' argument. To begin with, *Kavanau II* did not find any unconstitutional taking and seriously questioned whether there was a due process violation as the Court of Appeal had found. (*Id.* at p. 777-779.)

In *Kavanau II*, the California Supreme Court held that Santa Monica's 12 percent rent increase limit as applied to the landlord in that case did not constitute a taking. (*Id.* at p. 782.)

[7] The Trades also argue that the end result of the rollback in *20th Century* was skewed by the "extreme inadequacy of the earthquake [insurance] piece." (Trades Mem. at p. 18.) In fact, this shows that the Court in *20th Century* allowed the rollback lines to cross-subsidize each other for purposes of the rollback and that this was constitutionally permissible. *20th Century* nowhere states that it is any less permissible for prior approval lines to cross subsidize than it is for rollback lines to cross subsidize each other in a constitutional confiscation analysis.

The Court stated that the landlord's "continuing right to an adjustment of future rents can provide an adequate remedy" for any alleged due process violation in Santa Monica's rent control process. (*Id.* at p. 783.) "Put another way, the *ongoing process* of setting rent ceilings *dispels* the due process violation (*id.* at p. 786 [italics added], and "obviates a finding of a taking" (*id.* at p. 782). Here, the prior approval rate-making process under the Insurance Code and the rate regulations is an ongoing rate setting process that affords – and did afford -- Mercury the "continuing right to an adjustment of future" premiums. The November 2013 Rate Order was the result of the rate regulation process that allows an insurer such as Mercury to continuously seek approval of adjustments to its rates.

Further, while Mercury and the Trades essentially argue that *Kavanau II* repudiated a "deep financial hardship" test and overruled *20th Century*, that is incorrect. The rent control board in *Kavanau II* invoked the "deep financial hardship" test. Although offered an opportunity to reject it, the Court did not do so. (*Kavanau II, supra*, 16 Cal.4th at p. 782.) The Court left the test intact, resolving the case in the regulator's favor based on the availability of later rate increases to cure any alleged confiscation.

While *Kavanau II* did say that a price control regulation is proper so long as the law does not deprive investors of a "fair return" and thereby become "confiscatory" (*Kavanau II, supra*, 16 Cal.4th at p. 771), the Court went on to elaborate on these concepts, which Mercury and the Trades failed to cite to the court.

> Determining prices that will provide a fair return "involves a balancing of the investor and the consumer interests." ([*Power Comm'n v. Hope Gas Co.* (1944) 320 U.S. 591, 603].) "It is the product of expert judgment which carries a presumption of validity." (*Id.* at p. 602 [].)

(*Ibid.*) The Court also noted that the United States Supreme Court "has struggled to articulate a standard for when a regulation 'goes too far' and effects a taking," and that the U.S. Supreme Court has thus "concluded that the inquiry in any particular case is 'essentially ad hoc.'" (*Id.* at pp. 773-774.) The Court went on to list the circumstances of the various cases in which the U.S. Supreme Court has found a taking. (*Id.* at p. 775.) The California Supreme Court concluded, however:

> This list is not a comprehensive enumeration of all the factors that might be relevant to a takings claim, and we do not propose a single analytical method for these claims. Rather, we simply note factors the high court has found relevant in particular cases. Thus, instead of applying these factors mechanically, checking them off as it proceeds, a court should apply them as appropriate to the facts of the case it is considering.

(*Id.* at p. 776.)

Turning specifically to the rent control scheme at issue in that case, the *Kavanau II* Court's discussion in this regard also applies to the rate regulations at issue here. The Court first stated:

> Though we have used the phrase "just and reasonable return", we have never held that either the state or federal Constitution requires application of the fair return on investment formula or any other specific formula.

(*Kavanau II*, *supra*, 16 Cal.4th at p. 777 [citations omitted].) The Court then rejected the Court of Appeal's analysis, emphasizing that the rent increase cap was but one aspect of a comprehensive regulatory scheme, as is rate of return in the insurance rate regulations, and intimated that such scheme as whole may provide the landlord with a "fair return." "We see no reason why a reasonable annual limit on rent increases cannot be consistent with a fair return." (*Id.* at p. 778.) The Court further found that "[t]he Court of Appeal did not expressly find that the 12 percent limit prevented Kavanau from 'operating successfully.' (*Id.* at pp. 778-779.) The Court continued:

> Regulated prices must fall within a "broad zone of reasonableness" to be constitutional and due process requires fundamentally a balancing of interests (*Hope Gas*, *supra*, 320 U.S. at p. 603 []). The 12 percent limit achieved this balance. It balanced landlords' interests in recouping their increased costs against tenants' interests in avoiding sudden, large rent increases.

(*Id.* at pp. 778-779 [other citations omitted].)[8]

[8] The Trade Groups also cite a subsequent California Supreme Court decision regarding the Santa Monica rent control provisions. (*Santa Monica Beach, Ltd. v. Superior Court* (1999) 19 Cal.4th 952.) In that case, in which the Court frequently cited to its prior *Kavanau II* decision, the Court held that the rent control scheme as a whole did not constitute a taking. (*Id.* at pp. 956-957.) It did not decide whether the scheme as applied to the landlord in that case was a taking. (*Id.* at p. 963.)

Here, Mercury did not even attempt to show that it did not operate successfully as a result of the February 2013 Rate Order. And, as with the rent control scheme in *Kavanau II*, one of the aims of the rate regulations is to achieve the appropriate balance between the insurer and its insureds.[9]

D. The Rate Regulations Are Permissibly Formulaic in Order to Make the Task of Managing Prior Approval Rate Applications Manageable.

Proposition 103 requires the Commissioner to review every rate application filed by every insurer that conducts property and casualty insurance business in California. Determining an appropriate rate for each line of insurance for a particular period of time is a complex matter. For this reason, the courts have acknowledged that formulaic ratemaking is necessary even though it may not achieve a perfect individually tailored result in every case.

> [The method of rate setting] may implicate formulaic ratemaking [citation omitted] using data reflecting the condition and performance of a group of regulated firms [citations omitted]. It is not subject to piecemeal examination: "The economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result. The Constitution is not designed to arbitrate these economic niceties." [citation omitted] And, of course, courts are not equipped to carry out such a task. [citation omitted] "[S]o long as rates as a whole afford [the regulated firm] just compensation for [its] over-all services to the public," they are not confiscatory. [citation omitted] That a particular rate may not cover the cost of a particular good or service does not work confiscation in and of itself. [citation omitted] . . .

(*20th Century*, *supra*, 8 Cal.4th at p. 293)

In fact, *20th Century* makes it clear that formulaic ratemaking is the *preferred* mechanism for determining insurance company rates. "One of the purposes of Proposition 103 is 'to protect consumers from arbitrary insurance rates.' Formulaic ratemaking furthers that goal. Case-by-case ratemaking does the opposite." (*20th Century*, *supra*, 8 Cal.4th at pp. 285-286 [citations

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[9] Also, it should be noted that *Kavanau II* cited *20th Century* only twice and then largely in passing. (*Kavanau II*, *supra*, 16 Cal.4th at pp. 771, 777.) By contrast, the Court cited three rent control cases and examined them in depth. (*Id.* at pp. 772-773.) The Court's minimal attention to *20th Century* strongly suggests the Court viewed rent control confiscation analysis as distinct.

omitted].)

> Proposition 103 authorizes the Insurance Commissioner to adopt rate regulations to implement the rate rollback provisions with a view toward factors including the individual insurer's profits and not -- as 20th Century claims he must -- through the imposition of general "price caps" on the rates of insurers generally.

(*Id.* at pp. 257-258)

> In her own words, the administrative law judge considered "hundreds of pages of prefiled testimony and detailed exhibits as well as several weeks of live testimony, posthearing briefs and oral argument ...."

(*Id.* at p. 256.)

E. The Regulations Provide Constitutional Protections for Insurers, Including A Fair Rate Of Return

20th Century recognized that the regulations inherently provide constitutional protections to insurers including a fair rate of return

> "The ratemaking formula is designed to yield a premium that the insurer should receive from its insureds in order to earn a sum amounting to (1) the reasonable cost of providing insurance and (2) the capital used and useful for providing insurance multiplied by a **fair rate of return.**"

(*20th Century*, *supra*, 8 Cal.4th at p. 251 [citations omitted; bold added].)

Thus, *20th Century* found that the regulations themselves give insurers the opportunity to earn a fair rate of return. Specifically, the regulations build in a rate of return equal to the "risk-free rate" plus 6%. At the time of the administrative hearing in this case, the risk free rate was determined to be 1.33% and the regulations thus provided Mercury with a 7.33% (6% + 1.33%) return on surplus. (Regs. 2644.16, subd. (a) and 2644.20, subd. (d).)

The regulations also define "fair return" favorably for the industry -- as the "profit that an investor can reasonably expect to earn from an investment in a business other than insurance subject to regulation [thereunder] presenting investment risks comparable to the risks presented by insurance subject' thereto." (*20th Century*, *supra*, 8 Cal.4th at p. 253, citing Reg. 2642.2.) As the Court also noted, the regulations also define the terms "excessive" and "inadequate" so as to incorporate the concept of "fair return." Specifically, an "excessive" rate "is 'expected to yield the reasonably efficient insurer **a profit that exceeds a fair return** on the investment used to

provide the insurance'." (*Id.* at p. 253, citing Reg. 2642.1 [bold added].) Similarly, the regulations define an "inadequate" rate as a rate "under which a reasonably efficient insurer is not expected to have the **opportunity to earn a fair return on the investment** that is used to provide the insurance.'" (*Ibid.*, citing Reg. 2642.3 [bold added].) Moreover, within the parameters of "excessive" and "inadequate" rates, the regulations provide an insurer considerable freedom. (*Id.* at p. 251 (noting that "[u]nder the 'prior approval' system, the insurer is effectively free to set for itself whatever rate it chooses, provided that (as relevant here) its rate is neither 'excessive' nor 'inadequate.'") And the regulations include a "Profit Factor" (Reg. 2644.15) and a "Rate of Return" (Reg. 2644.16) for the insurer.

Further, the regulations provide nine variances to accommodate unique circumstances in prior approval cases such as this one. For rollbacks, only three of the variances applied but they were determined to be sufficient to protect against confiscation.

> [T]he three applicable variances should not be considered, as it were, each in isolation, but rather together within their full context. ... Because [the ratemaking formula] has "safety" built-in, it does not appear to need "safety valves" different from those provided by the variances. . . .
>
> In view of the foregoing, the variances must be deemed sufficient for rate adjustments necessary to avoid confiscation. [Page 313]

(*20th Century*, *supra*, 8 Cal.4th at p. 313.)

The regulations also provide protection for consumers. Both the definitions of "excessive" and "inadequate" rates contemplate a balancing of the interests of insurers and consumers. (See Regs. 2642.1, 2642.3; *20th Century*, *supra*, 8 Cal.4th at p. 253.) For example, the efficiency standard tests the reasonableness of the insurer's expenses: certain expenses are subject to the efficiency standard which is a test of reasonableness of the expenses, some of which are excluded by the regulations. (*20th Century*, *supra*, 8 Cal.4th at p. 250.) Excluded expenses include items such as "bad faith judgments" and "institutional advertising." (Reg. 2644.12.) In addition, the regulations require insurers to use conservative accounting principles (SAP as opposed to GAAP) so only certain types of assets can be used in valuing the insurers financial condition. (*20th Century*, *supra*, 8 Cal.4th at p. 249.)

In summary, the regulations provide the following constitutional protections to insurers:

> a. The regulations are designed to provide insurers with a fair rate of return.
>
> b. The regulations allow insurers to charge rates at the top of the range of reasonable rates. Recall that for the rollbacks, the "minimum non-confiscatory rate" was defined as the bottom of the range of reasonable rates and the 20% rollback was not determined to be confiscatory unless it was below the bottom of the range. Mercury is arguing that the top of the range of reasonable rates is confiscatory as to it.
>
> c. The regulations allow insurers to file rate applications as frequently as they want. No rate is necessarily in effect for any particular period. In this case Mercury's rate was in effect less than 6 months when the Commissioner ordered a rate increase for Mercury.
>
> d. The regulations provide nine variances in prior approval cases. *20th Century* found that only three variances were sufficient to protect against confiscation for the rollbacks. (*20th Century*, *supra*, 8 Cal.4th at p. 313.)

Thus, "the ratemaking formula cannot be deemed arbitrary, discriminatory, or demonstrably irrelevant to legitimate policy. It is demonstrably relevant to the policy of protection of consumer welfare." (*20th Century*, *supra*, 8 Cal.4th at p. 297.) But at the same time, "[**n]either can the ratemaking formula be deemed confiscatory**. Its terms do not themselves preclude the setting of a rate that is just and reasonable." (*Ibid.* [bold added].)

F. Whether The Department or the Commissioner Applies The Regulations in a "Tautological" Manner Is Irrelevant

Mercury and the Trades vigorously argue that the Commissioner adopted a "tautological" test for confiscation that is "nothing more than a restatement of the formula and its components." (Mercury Mem. at p. 29.) In *20th Century*, the industry made a similar argument -- that the regulations were "recursive." The Supreme Court disposed of that argument as follows:

> To be sure, the ratemaking formula is indeed "recursive." But contrary to the superior court's evident belief and the insurers' vigorously urged position, that is no vice. The adjective is not pejorative. It is merely descriptive. Simply put, it means in this context that the value solved for figures in the solution itself. ... In and of itself, "recursiveness" is not objectionable.

(*20th Century*, *supra*, 8 Cal.4th at p. 288.)

A similar response is appropriate here. The industry appears to be arguing that the Department's own witnesses did what Mercury should have done – stay within the regulations for the rate calculation, or present evidence of deep financial hardship.

G. The Commissioner Properly Invoked the Relitigation Bar.

Mercury and the Trades argue that the ALJ wrongfully prohibited Mercury from introducing evidence of its own individualized rate of return, absent a showing of deep financial hardship. Part of the basis for these rulings was the relitigation bar regulation.

> Relitigation in hearing on individual insurer's rates of the matter already determined either by these regulations or by a generic determination is out of order and shall not be permitted. However, the administrative law judge shall admit evidence he or she finds relevant to the determination of whether the rate is excessive or inadequate, ... whether or not such evidence is expressly contemplated by these regulations, provided the evidence is not offered for the purpose of relitigating a matter already determined by these regulations or by a generic determinations.

(Reg. 2646.4, subd. (c).)

The ALJ applied the relitigation bar correctly. But even if she had not, Mercury would still have had the burden of demonstrating deep financial hardship as described by *20th Century* and *Jersey Central* to be entitled to Variance 9. Both Mercury and the Trades quote or paraphrase the following language from *20th Century*:

> The effect of the "relitigation bar" is simply to assure that, in determining an individual insurer's rate rollback liability, the administrative law judge does not entertain the question whether the premises underlying the rate regulations as to rollbacks are sound.

(*20th Century*, *supra*, 8 Cal.4th at p. 312.)

The quoted passage itself does not elaborate on the meaning of the phrase **"question whether the premises underlying the rate regulations are sound."** But, in a passage that neither Mercury nor the Trades cite, *20th Century* states that lifting the relitigation bar means to allow the insurer to present evidence on "every issue" that it contends is material:

> [The administrative law judge] effectively **lifted the "relitigation bar" to allow 20th Century to introduce evidence to challenge the premises of the rate regulations, "accord[ing] it the opportunity to present evidence ... on every issue that it contended was material."**

(*20th Century, supra*, 8 Cal.4th at p. 257 [bold added].)

Having stated that the relitigation bar prevents an insurer from presenting evidence on "every issue it contended was material," the Court goes on to approvingly cite the ALJ's comments that further elucidate the purpose of the relitigation bar.

> "The regulations," explained the administrative law judge, "avoid the administrative gridlock that would result from readjudicating over and over hundreds of issues that affect multiple insurers in lengthy hearings that would yield inconsistent results -- *if* they ever yielded any result at all." (Italics added in place of underscoring in original.) "The regulations employ generic determinations and a detailed formula designed to ensure manageability and consistent treatment of insurers and insureds." "At the same time, the regulations incorporate multiple company-specific factors into the rollback formula, and then are applied in individual adjudicatory hearings. The company-specific hearings allow further tailoring to a company's situation ...."

(*Ibid.* [italics by the Court].)

The comments by the ALJ in this matter on the relitigation bar are consistent with those set out above in *20th Century*.

> Mercury argues any analysis of confiscation must permit an insurer to apply cost and expense amounts different from those provided by the regulatory formula. . . . This argument amounts to little more than impermissible relitigation of the regulatory formula and must again be rejected.

(Proposed Decision at p. 121 [footnote omitted].)

H. The Commissioner Has Not "Abandoned The Fair Return Standard."

Mercury erroneously alleges the Commissioner has "abandoned" the fair rate of return standard based on the discussion in the Proposed Decision with the section heading that reads: "Confiscation Is Not Judged Under a 'Fair Rate of Return' Standard." (Proposed Decision at pp. 123-125.) As is made abundantly clear in the Proposed Decision and in the arguments made above in this Memorandum, "fair rate of return" is not the correct standard for demonstrating that confiscation exists in the context of rate regulations' formulaic ratemaking. To avoid the results of the rate regulations' formulaic ratemaking, an insurer must demonstrate deep financial hardship to the enterprise as a whole and the inability of the enterprise to operate successfully during the period of the rate. As the Commissioner noted in this case:

> But, the ALJ also indicated confiscation testimony might become relevant upon a showing by Mercury that the maximum permitted earned premium resulted in deep financial hardship to Mercury's enterprise as a whole.

(Proposed Decision at p. 5.)

Thus, the ALJ was prepared to allow the testimony if it were to show deep financial hardship.

> That is not to say that Dr. Hamada's methodology will always remain irrelevant or improper. Dr. Hamada's testimony regarding a more appropriate rate of return would be relevant if Mercury met the threshold requirement of demonstrating deep financial hardship by application of the Commissioner's formula. But, Mercury must first show evidence that it could not operate successfully under the maximum permitted earned premium. Absent that prima facie showing, there is no confiscation. Because Mercury has not produced any evidence on the impact of the maximum permitted earned premium, Dr. Hamada's testimony and methodology are irrelevant and an improper relitigation of the variance.

(ALJ's Ruling on Motion to Strike at AR00912.)

Accordingly, the discussion in the Proposed Decision on the standard for confiscation under the rate regulations is correct.

IV. THE COMMISSIONER CORRECTLY CONSTRUED AND APPLIED THE INSTITUTIONAL ADVERTISING REGULATION.

A. The Commissioner Correctly Interpreted Regulation 2644.10 Pertaining To Excluded Expenses as It Relates to "Institutional Advertising."

Regulation 2644.10, subdivision (f) provides:

> (f) Institutional Advertising Expenses. "Institutional Advertising" means advertising not aimed at obtaining business for a specific insurer *and* not providing consumers with information pertinent to the decision to buy the insurer's product.

(Emphasis added.)

The impact of this disallowance "reduces the efficiency standard by the ratio of the insurer's national excluded expenses to its national direct earned premium. (Reg. 2644, subd. (g).) The Commissioner in this matter concluded that Regulation 2644.10, subdivision (f) only allows Mercury to expense advertising costs pursuant to the ratemaking formula if the advertising is directed: (1) at obtaining business for a specific insurer *and* (2) provides

consumers with pertinent information. (Proposed Decision at AR4117, ¶ e.) The ALJ agreed, finding that "the Regulation permits only advertising that seeks to obtain business for a specific insurer **and** also provides consumers with pertinent information." (*Id.* at AR02142 [bold added].) In other words, *both* prongs of Regulation 2644.10, subdivision (f) must be met in order for an insurer's advertising expenses not to be excluded.

Mercury's argument – that its advertising need only meet *one* prong in order to be included – is wrong. The requirement that **both** of these criteria be present is well supported by the Proposition 103 ratemaking goals. In today's insurance environment, many insurers with far-flung subsidiaries engage in marketing and operations with national reach. The entire ratemaking regulatory scheme rests on the foundation that insurance rates charged in California are based on "risks or on operations in this state" – and that California consumers do not inadvertently fund nationwide advertising campaigns by their insurers. (Reg. 2641.2.) Regulation 2644.10, subdivision (f) simply codifies the reality of attempting to ensure that California consumers pay premiums that reflect costs or expenses related to an applicant's advertising in this state and for this line of insurance.

Regardless, Mercury's advertising did not meet either of these prongs. Under the first prong, the regulation's reference to "specific insurer" implicitly means the insurer making the rate application, in this case Mercury Casualty Company. Every insurer in California is required to transact the business of insurance in its own name. (§ 880.) Advertising is a form of solicitation. (See § 35.) Further, the Insurance Code's statutory scheme expressly contemplates that insurers advertising on the internet include the legal name under which they are admitted to transact insurance business.[10] Virtually none of Mercury's advertisements admitted into evidence in the Rate Proceeding (Exs. 68-70 [AR7043-7629]) contain the name Mercury Casualty Company. Much of the advertising submitted in the hearing below referred to various Mercury websites yet did not carry the information required by section 702. This was

[10] See § 702, which provides that an insurer admitted in California that wishes to advertise on the internet must include on the advertisement its official name, state of domicile and certificate of authority number.

presumably because the entity called Mercury Insurance Group is not an admitted insurer in the State of California. (See AR4139:3-7, 4436:20-24.) In fact, Mercury witness Erik Thompson admitted that all advertising is aimed at supporting Mercury Insurance Group as a whole -- not any specific insurer within the Mercury affiliated companies. (AR 4126:7-10) Simply put, Mercury's advertising did not refer to a specific insurer, and thus Mercury failed to meet the first prong of Regulation 2644.10, subdivision (f).

Likewise, Mercury's advertising failed the second prong of the Regulation. That prong provides that the advertising itself must provide consumers with information pertinent to the decision on whether to purchase or not purchase the applicant's product. Again, Mercury's advertising was directed at obtaining business for the entirety of the Mercury Insurance Group -- which consists of 22 separate legal entities comprising Mercury General Corporation (AR4436:20-24). Its advertising did not providing specific information regarding a particular product line of Mercury Casualty Company. (See, e.g., AR7564, 7310.) Moreover, Mercury never broke down its advertising costs in such a way that the Commissioner would have been able to discern which advertising costs would accrue to the ratemaking process and which were attributable to other operations of other entities under the Mercury Insurance Group umbrella. Thus, by failing to reference a specific insurer, Mercury's advertising was inherently unable to refer to a specific insurer's *product*.

Finally, Mercury's and the Trades' arguments concerning the alleged unwieldiness of the regulation – because it is framed in the negative – are unavailing. The regulatory language amounts to no more than saying advertising expenses can be applied towards an applicant's efficiency standard calculation *only if* such advertising (1) relates to obtaining insurance business for this applicant *and* (2) provides pertinent information for a consumer to buy the type of insurance subject to the ratemaking. Both prongs of this regulatory test must be met and Mercury failed to meet either.

B. The First Amendment is Not Implicated by Regulation 2644.10(f).

The Trades' argument that Regulation 2644.10, subdivision (f) violates the First Amendment speech of insurers, and Mercury's related argument that the Regulation

impermissibly imposes a financial penalty on Mercury's advertising, are groundless. Historically, courts have recognized several types of speech, some more deserving of a higher level of judicial protection than others. Advertising has long been recognized as a type of commercial speech. "Commercial speech," at its core, is speech that does "no more than propose a commercial transaction" and, more broadly, is speech that goes beyond proposing such a transaction but yet "relate[s] solely to the economic interests of the speaker and its audience." (*Cincinnati v. Discovery Network, Inc.* (1993) 507 U.S. 410, 420-423 [citations omitted].) But the Trades incorrectly assumes that constitutional free speech protections would bar Regulation 2644.10, subdivision (f) from applying a "penalty" to Mercury's advertising.

The Trades misapprehend the intent of the Regulation. This regulation is content neutral on its face[11]. Specifically, its purpose is a part of the process "to establish the process and policies the Commissioner shall employ to determine whether proposed rates are excessive or inadequate." (Reg. 2641.3.)[12] There is no prohibition or restriction on speech expressed in the language of the Regulation. An insurer is free to spend its advertising dollars in any manner it pleases. There is nothing in the Regulation coercing or compelling an insurer to advertise or not to advertise. An insurer has the unfettered choice of which type of advertising (speech) it wishes to pursue, if any. The Regulation does not prohibit Mercury -- or any other insurer -- from advertising based on *message*. Nor does it prohibit any particular advertising content at all. Rather, the Regulation merely provides that institutional advertising may not be included in an insurer's expenses for purposes of the ratemaking formula. It does not prohibit an insurer from engaging in institutional advertising.

To the extent that Regulation 2644.10 arguably implicates speech at all, it is only to distinguish certain types of disfavored expenses that for public policy purposes are not

[11] Regulation 644.10 resides in Subchapter 4.8 of Title 10 of the California Code of Regulations. It is entitled "Review of Rates" and sets out the regulatory formula implementing Proposition 103 governing approval of insurance rates. Subchapter 4.8 applies to all rates charged for insurance on risks or on operations in this state.

[12] The complete regulatory formula with definitions and ratios for technical calculations pertaining to rate making is contained in Regulations 2642.1 through 2644.28. These Regulations are authorized by sections 1861.01 and 1861.05.

appropriately included in the ratemaking process to inappropriately influence the rate in favor of an insurer and against the consumer. These include political contributions and lobbying (Reg. 2644.10, subd. (a)), unreasonable executive compensation (*id.*, subd.(b)), bad faith judgments and associated costs (*id.*, subd. (c)), costs related to the defense of unsuccessful discrimination claims (*id.*, subd. (d)), fines and penalties (*id.*, subd. (e)), and payments to affiliates exceeding fair market value of goods and services (*id.*, subd. (g)). In fact, Regulation 2644.10 implicitly recognizes that costs related to advertising specific to the applicant and including pertinent facts about the insurance product would naturally be a reasonable cost associated with providing insurance to the consumer.

CONCLUSION

For the foregoing reasons, the petitions for a writ of mandate should be denied in all respects.

Dated: April 7, 2014

Respectfully Submitted,

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DECLARATION OF SERVICE BY U.S. MAIL

Case Name: **Mercury Casualty Company v. Dave Jones, et al.**
No.: **34-2013-80001426**

I declare:

I am employed in the Office of the Attorney General, which is the office of a member of the California State Bar, at which member's direction this service is made. I am 18 years of age or older and not a party to this matter. I am familiar with the business practice at the Office of the Attorney General for collection and processing of correspondence for mailing with the United States Postal Service. In accordance with that practice, correspondence placed in the internal mail collection system at the Office of the Attorney General is deposited with the United States Postal Service with postage thereon fully prepaid that same day in the ordinary course of business.

On April 7, 2014, I served the attached ***RESPONDENT INSURANCE COMMISSIONER'S MEMORANDUM OF POINTS AND AUTHORITIES IN OPPOSITION TO PETITIONS FOR WRIT OF MANDATE*** by placing a true copy thereof enclosed in a sealed envelope in the internal mail collection system at the Office of the Attorney General at 1300 I Street, Suite 125, P.O. Box 944255, Sacramento, CA 94244-2550, addressed as follows:

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I declare under penalty of perjury under the laws of the State of California the foregoing is true and correct and that this declaration was executed on April 7, 2014, at Sacramento, California.

Maria Conde
Declarant

Signature

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