Nos. C077116, C078667

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

MERCURY CASUALTY COMPANY
Petitioner/Plaintiff and Appellant,

v.

DAVE JONES, IN HIS OFFICIAL CAPACITY AS THE COMMISSIONER OF INSURANCE OF THE STATE OF CALIFORNIA,
Respondent/Defendant and Respondent,

CONSUMER WATCHDOG,
Intervenor and Respondent

PERSONAL INSURANCE FEDERATION OF CALIFORNIA, ET AL.,
Intervernors and Appellants

Appeal from the Sacramento County Superior Court
Honorable Shelleyanne Chang
Case No. 34-2013-80001426-CU-WM-GDS

RESPONDENT'S BRIEF OF INTERVENOR CONSUMER WATCHDOG

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CERTIFICATE OF INTERESTED ENTITIES OR PERSONS

(Cal. Rules of Court, rule 8.208)

The following entities or persons have either (1) an ownership interest of 10 percent or more in the party filing this certificate (Cal. Rules of Court, Rule 8.208(e)(1)), or

(2) a financial or other interest in the outcome of the proceeding that the justices should consider in determining whether to disqualify themselves (Cal. Rules of Court, Rule 8.208(e)(2)):

None.

Dated: March 31, 2016 By: Pamela Pressley

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INTRODUCTION AND SUMMARY OF ARGUMENT

By this appeal, Appellant Mercury Casualty Company ("Mercury") and the three insurance industry trade association Intervenors ("the Trades") persist in their same arguments that were properly rejected below seeking to overturn the California Insurance Commissioner's February 2013 Order requiring Mercury to lower its overall homeowners rates by 5.4%.[1] Beyond merely challenging the rate order, Mercury and the Trades attempt to use this case as a vehicle to overturn the unanimous California Supreme Court decision in *20th Century Insurance Company v. Garamendi* (*20th Century*) (1994) 8 Cal.4th 216 and gut the Proposition 103 prior approval ratemaking formula ("Regulatory Formula"), notwithstanding that Mercury and the entire California property casualty industry has profited under it for over 20 years.[2] The Commissioner and the Superior Court properly rejected this attempt.

Of the issues raised by Mercury's and the Trades' writ petitions, they present just two on appeal, each of which is without merit.

First, they claim the Commissioner and the Superior Court applied the wrong legal standard in rejecting Mercury's request for a "confiscation variance" under the Commissioner's regulation that allows for an upward adjustment to the maximum permitted rate calculated under the Regulatory Formula. They argue, contrary to the applicable U.S. and California Supreme Court precedent, that insurers must be provided a "fair return" as

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[1] ***The ordered rate decrease was only in effect for about seven months***, having been implemented on May 11, 2013 (Joint Appendix ("JA") 8:2473, fn. 5), after which Mercury had an 8.26% rate ***increase*** approved, effective December 5, 2013. (JA 5:1290-91.)

[2] According to the National Association of Insurance Commissioners' Report on Profitability by Line by State in 2012 (2013), California insurers had an average return on net worth of 18.1% for the homeowners line, and 10.7% for all lines combined, over the ten-year period from 2003-2012. (JA 8:2519-21.)

measured by their own economists and that anything less is confiscatory. Instead, as the Commissioner and the Superior Court held, the well-settled constitutional jurisprudence requires a ***balancing*** of insurers' and consumers' interests in determining confiscation and places the "heavy burden" squarely on the insurer to make "a convincing showing" that it would be unable to operate successfully under the ordered rate. While insurers may have an ***interest*** in earning a "fair return," that interest is "not a right"; it is "'***only one of the variables in the constitutional calculus of reasonableness***.'" (*20th Century*, *supra*, 8 Cal.4th at 294, emphasis added, quoting *In Re Permian Basin Area Rate Cases* (*Permian Basin*) (1968) 390 U.S. 747, 769.) (See Argument, § I.A, *infra*.)

Applying these constitutional standards, the Commissioner correctly found that Mercury failed to meet its heavy burden of proving that it would suffer confiscation because "the [Commissioner's ordered] rate permits Mercury to earn a profit and maintain its financial integrity" by resulting in "at least a 7.32% after-tax rate of return and at least $1.8 million profit to Mercury."[3] (See Argument, § I.B, *infra*.)

Second, Mercury and the Trades claim the Commissioner misinterpreted the regulation that requires insurers to exclude from the rate calculation their expenditures for "institutional advertising" (i.e., advertising aimed at promoting "brand awareness" rather than providing consumers with pertinent information about the products of a specific insurer). As explained in the Commissioner's challenged decision, "this type of corporate advertising is consistently excluded from ratemaking formulas since it benefits mainly the shareholders and not the ratepayers." (AR 2139.) Mercury and the Trades ask this Court to rewrite the Commissioner's regulation, which has been applied to tens of thousands of

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[3] Administrative Record ("AR") 2164-65.

auto, home, and business insurance rate applications for over 20 years. Contrary to Mercury's and the Trades' contentions, the Commissioner applied the regulation consistently with its plain text and underlying intent to prevent policyholders from having to pay for Mercury's expenditures on advertising promoting the logo of the fictitious "Mercury Insurance Group," including at hockey rinks, baseball stadiums, and tennis tournaments. (See Argument, § II.A-C, *infra*.)

Moreover, the Trades erroneously claim that the regulation excluding institutional advertising expenses facially violates insurers' First Amendment rights. The California Supreme Court has upheld the Regulatory Formula's use of a standard expense provision and exclusions for certain expense items, such as institutional advertising expenses and political contributions and lobbying expenses. Indeed, other state high courts have upheld similar regulations against First Amendment challenges because they do not infringe on free speech; rather, they only reasonably require that the cost of certain advertising not be passed on to ratepayers. Accordingly, the Superior Court properly upheld the Commissioner's regulation against this facial attack. (See Argument, § II.D, *infra*.)

This Court should affirm the Superior Court's final order and judgment upholding the Commissioner's February 2013 Order and reject the insurance industry's attempt to overturn established California and U.S. Supreme Court precedent and the Proposition 103 prior approval regulatory regime, which has been upheld as constitutional and has successfully saved consumers billions of dollars in premiums.[4]

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[4] According to a 2013 Consumer Federation of America report, Proposition 103 has saved California consumers over $102 billion in automobile premiums alone over the last 25 years. (See http://www.consumerfed.org/news/720.)

BACKGROUND AND SUMMARY OF PROCEEDINGS BELOW

A. Proposition 103 and the Prior Approval Regulations.

The voters passed Proposition 103 in November 1988 to "protect consumers from arbitrary insurance rates and practices," "provide for an accountable Insurance Commissioner," and "ensure that insurance is fair, available, and affordable for all Californians." (*Donabedian v. Mercury Ins. Co.* (2004) 116 Cal.App.4th 968, 977, quoting Prop. 103, § 2 [uncodified preamble "Purpose"].) Proposition 103 "replace[d] the former system for regulating insurance rates (which relied primarily upon competition between insurance companies) with a system in which the commissioner must approve such rates prior to their use." (*Amwest Surety Ins. Co. v. Wilson* (1989) 11 Cal.4th 1243, 1259; see Ins. Code §§ 1861.01(c), 1861.05.)

1. The Prior Approval Statute Prohibits Excessive Rates.

Insurance Code section 1861.05(a) requires, in relevant part, that "[n]o rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter." The California Supreme Court unanimously upheld Proposition 103 against constitutional attack by the insurance industry, holding that section 1861.05 "provides a constitutionally valid standard for rate adjustment...." (*Calfarm Ins. Co. v. Deukmejian* (*Calfarm*) (1989) 48 Cal.3d 805, 823.)

Under the prior approval statute, insurers "***have the burden of proving that the requested rate change is justified and meets the requirements of this article***." (Ins. Code § 1861.05(b), emphasis added; see also Cal. Code Regs., tit. 10 ("10 CCR"), § 2646.5 ["The insurer has the burden of proving, ***by a preponderance of the evidence, every fact necessary to show that its rate is not excessive***, inadequate, unfairly discriminatory, or otherwise in violation of chapter 9," emphasis added].)

2. The Prior Approval Regulatory Formula is Designed to Yield a Reasonable, Nonconfiscatory Rate.

In 1991, the Commissioner promulgated regulations to implement the prior approval standards under section 1861.05. (See 10 CCR §§ 2641.1-2644.27 ("Prior Approval Regulations").) The Prior Approval Regulations include the Regulatory Formula for the calculation of the "maximum permitted earned premium" (10 CCR § 2644.2), which was used to calculate the ordered rate Mercury challenges here. There is a separate formula for calculating the "minimum permitted earned premium." (10 CCR § 2644.3.)[5] The output of the maximum and minimum permitted premium rate calculations reflect the Commissioner's determination of the statutory boundaries of "excessive" and "inadequate" rates, such that any rate falling above the maximum permitted earned premium level would be considered excessive and any rate below the minimum permitted premium would be considered inadequate. (See *20th Century*, *supra*, 8 Cal.4th at 254.) In other words, any rate falling between the maximum and minimum earned premium rate levels demarcating the "excessive" and "inadequate" is a reasonable, non-confiscatory rate. (See *Calfarm*, *supra*, 48 Cal.3d 805, 822-823 ["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"].)

In this case, it is important to note that Mercury challenges as confiscatory the ordered rate decrease calculated under the ***maximum permitted*** premium Regulatory Formula, not the ***minimum permitted*** amount. Mercury claims it should instead have been permitted to charge a

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[5] The maximum and minimum permitted premium formulas differ only in the rate of return allowed under each. (*20th Century*, *supra*, 8 Cal.4th at 254.)

rate ***higher*** than the uppermost "excessive" rate boundary, even though the regulations as upheld by *20th Century* are designed to ensure a range of reasonable, nonconfiscatory rates.

The Regulatory Formula includes a profit factor, which incorporates a return on equity defined as "the risk free rate of return plus 6%." (10 CCR §§ 2644.15(a) [defining profit factor], 2644.16(a) [defining rate of return].) As the *20th Century* Court held, and as acknowledged by Mercury (Opening Brief ("OB") 18-19) and the Trades (OB 25-26), ***the Regulatory Formula itself thus affords each insurer the opportunity to earn a fair return***. (*20th Century*, *supra*, 8 Cal.4th at 251 ["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"].)

The Regulatory Formula also includes a provision for allowable expenses known as the "efficiency standard," which "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.) The California Supreme Court has expressly upheld the use of the efficiency standard to limit the expenses insurers are permitted to pass through to their policyholders. (*20th Century*, *supra*, 8 Cal.4th at 289.)

Moreover, the Regulatory Formula requires that expenses that do not benefit the policyholder be excluded from the rate calculation, such as political contributions and lobbying expenses (see 10 CCR § 2644.10(a)). At issue here is the exclusion of expenditures for "institutional advertising," which is defined 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." (10 CCR § 2644.10(f).) Displaying a company logo at sporting events is a prime example of institutional advertising that does not provide information about a specific product. (AR 2138-39.) The exclusion is effectuated by a reduction to the efficiency standard. (10 CCR § 2644.10.)

3. The Prior Approval Regulations Provide "Safety Valves" Known as Variances.

The Prior Approval Regulations provide further constitutional "safety valves," which permit insurers to seek "variances" from certain components or the output of the maximum permitted earned premium Regulatory Formula on 22 separate grounds. (See 10 CCR § 2644.27(f)(1)-(9); *20th Century*, *supra*, 8 Cal.4th at 313.) The variance at issue here is referred to as the "confiscation variance," which codifies "the constitutionally mandated variance articulated in *20th Century Insurance Co. 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).)

4. The Prior Approval Regulations Bar Relitigation of the Regulatory Formula.

Finally, the Commissioner's regulations provide that, "[r]elitigation in a hearing on an individual insurer's rates of ***a matter already determined either by the[] regulations or by a generic determination*** is out of order and shall not be permitted." (See 10 CCR § 2646.4(c), emphasis added.) This is known as the "relitigation bar."

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The California Supreme Court has upheld each of these provisions of the Commissioner's Prior Approval Regulations, including the relitigation bar, against constitutional challenges by the insurance industry, both facially and as applied. (*20th Century*, *supra*, 8 Cal.4th at 243, 291, 297, 312, 328, cert. den. *State Farm Mutual Automobile Ins. Co. v. Quackenbush* (1995) 513 U.S. 1153.)

B. After a Full Evidentiary Hearing Before an ALJ, the Commissioner Ordered Mercury to Decrease its Homeowners Rates by 5.4%.

On May 1, 2009, Mercury filed a rate application with the Department of Insurance (the "Department") seeking to increase its overall homeowners insurance rates by approximately 3.9%. (AR 2049.) Consumer Watchdog petitioned for a hearing and was granted intervention in the rate proceeding. (AR 2049, fn. 14.) The Commissioner noticed a hearing on May 13, 2011. (AR 2049.) Both the Department and Consumer Watchdog took the position that Mercury's requested rate was excessive and that instead a rate decrease was warranted under the Regulatory Formula.

During the course of the hearing held before an administrative law judge ("ALJ"), Mercury was allowed to update its financial data. It then claimed that it was entitled to an overall rate increase of 8.8% – 4.4% higher than its original request – and that anything less would be confiscatory, entitling it to a confiscation variance under 10 CCR § 2644.27(f)(9). (AR 2048-50.) Mercury also claimed it did not spend any money on "institutional advertising" subject to exclusion under 10 CCR § 2644.10(f). (AR 2141.)

The ALJ conducted an evidentiary hearing over twelve days. (AR 2049-55, 2171.) Mercury filed numerous rounds of written testimony prior to the hearing, presented additional testimony orally, and cross-examined the Consumer Watchdog and Department witnesses. Mercury also filed written rebuttal testimony, presented additional oral rebuttal testimony, and filed a 110-page post-hearing opening brief, and a 48-page post-hearing reply brief. (See AR 2053.) Subsequently, the ALJ issued a 130-page proposed decision, which thoroughly discussed and weighed the evidence on each disputed issue. (AR 2039-2175.)

On the issue of confiscation, the ALJ applied "the clear holding of *20th Century*" to determine that the "maximum indicated rate is not confiscatory" and would instead result "in at least a $1.8 million profit from Mercury's California homeowner's line." (AR 2164.)

The ALJ also found that none of Mercury's ads mentioned a "specific insurer," as "Mercury chose to advertise as the fictitious Mercury Insurance Group. As a consequence [section 2644.10(f)] requires Mercury remove such advertising expenses from its rate application." (AR 2146.) The ALJ also held: "Even assuming Mercury Insurance Group constituted a 'specific insurer,' Mercury fails to demonstrate significant portions of its advertising provided consumers with pertinent insurance information." (AR 2147.)

The ALJ "conclude[d] that Mercury's proposed rate increase of 8.8% [wa]s excessive" and ordered Mercury to *decrease* its overall homeowners insurance rates by approximately 5.4%. (AR 2048.) The Commissioner adopted the ALJ's Proposed Decision (hereafter "Commissioner's Decision") in full by his February 11, 2013 Order ("February 2013 Order"). (AR 2037-38.)

C. The Superior Court Denied Mercury's and the Trades' Writ and Declaratory Relief Claims.

On March 1, 2013, Mercury filed a Petition for Writ of Administrative Mandamus ("Petition"), seeking to vacate the February 2013 Order on the grounds that the Commissioner did not properly interpret and apply the Prior Approval Regulations. (JA 1:44, 64.) Of the issues it raised in its Petition, Mercury's trial court briefing (and its Opening Brief to this Court) ***solely*** addressed the issues of the interpretation and application of the (1) the confiscation variance,[6] (2) excluded institutional advertising expenses, and (3) the relitigation bar. (Mercury OB 30-69.)

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[6] Mercury's Petition did ***not*** seek a finding of confiscation by the court; instead, Mercury requests remand for review of its rate application under what it claims are the "correct" legal standards (OB 69).

The Trades were granted intervention three months later, on June 18, 2013. The Trades' complaint in intervention greatly broadened the case to include a facial challenge to the institutional advertising regulation on First Amendment grounds. (JA 5:981-5:1005.)

After extensive briefing and oral argument, the Superior Court dismissed all of Mercury's causes of action in its June 11, 2014 Ruling. (JA 11:2843-44.) The Superior Court also dismissed all of the Trades' related writ and declaratory relief causes of action.[7] (JA 11:2843-2844.)

Relying on the constitutional standards articulated by the California and U.S. Supreme Courts in *20th Century* and *Federal Power Com. v. Hope Natural Gas Co.* (*Hope*) (1944) 320 U.S. 591, the Superior Court held that the Commissioner applied the correct legal standard in determining the ordered rate was not confiscatory. (JA 11:2835-38.) The court noted that the Commissioner "found, after applying the ratemaking formula, that Mercury would not suffer financial hardship; it would profit even with a proposed 8.18% decrease to its HO-3 rates." (JA 11:2837.)

The Superior Court further determined that Mercury's attempt to substitute its own expense data for the values established by the Regulatory Formula was properly rejected under the relitigation bar in 10 CCR § 2646.4(c). (JA 11:2838-39.) Consequently, the Superior Court properly found that Mercury failed to carry its evidentiary burden to demonstrate confiscation. (JA 11:2834-35, 2838-39.)

The Superior Court also upheld the Commissioner's interpretation of 10 CCR § 2644.10(f) as consistent with the clear language and intent of the regulation (JA 11:2840-2842) and therefore concluded that Mercury's advertising was "institutional advertising," and was properly excluded from the rate calculation. (JA 11:2841-43.)

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[7] The Superior Court deferred ruling on the Trades' claims challenging 10 CCR § 2644.10(f) on First Amendment grounds.

After further oral argument, the Superior Court dismissed the Trades' remaining claims in its January 16, 2015 Ruling, holding that the excluded institutional advertising expense regulation did not facially violate the First Amendment. (JA 12:3227-29.)

On February 5, 2015, the Superior Court entered a final order denying Mercury's and the Trades' writ claims, dismissing their declaratory relief claims, and entering judgment in favor of the Commissioner and Intervenor Consumer Watchdog and against Mercury and the Trades. (JA 12:3336, 3337-3420.)

Mercury and the Trades appealed, and the two appellate cases were consolidated on May 19, 2015.

STANDARD OF REVIEW

To prevail on its claims for administrative mandamus under Code of Civil Procedure section 1094.5(b), Mercury must show that the February 2013 Order was an abuse of the Commissioner's discretion.[8] Section 1094.5(b) provides that "[a]buse of discretion is established if the respondent has not proceeded in the manner required by law, the order or decision is not supported by the findings, or the findings are not supported by the evidence."[9]

Moreover, upon judicial review of a rate order, the Court may "exercise its independent judgment on the evidence." (See Ins. Code §

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[8] Section 1094.5(b) states, in relevant part: "The inquiry in such a case shall extend to the questions whether the respondent has proceeded without, or in excess of jurisdiction; whether there was a fair trial; and whether there was any prejudicial abuse of discretion." Mercury makes no claim that the Commissioner acted without or in excess of his jurisdiction or that Mercury was not afforded a fair trial, so the inquiry here is limited to whether there was any prejudicial abuse of discretion. (See JA 1:50-54.)

[9] As to the Trades' claims seeking review under Code of Civil Procedure section 1085, "the inquiry is limited to whether the decision was arbitrary, capricious, or entirely lacking in evidentiary support[.]" (*Bunnett v. Regents of Univ. of Cal.* (1995) 35 Cal.App.4th 843, 849.)

1861.09 [incorporating Ins. Code § 1858.6]; *20th Century*, *supra*, 8 Cal.4th at 272.) "The independent judgment standard requires the trial court to accord a strong presumption of correctness to the Commissioner's findings." (*State Farm Mutual Automobile Ins. Co. v. Quackenbush* (1999) 77 Cal.App.4th 65, 71, citing *Fukuda v. City of Angels* (1999) 20 Cal.4th 805, 816-819.)

In reviewing the application of the challenged ratemaking regulations, the Court must give the Commissioner's interpretations substantial weight:

> The Commissioner's interpretations are to be respected, though they are not binding on [a court]. An administrative agency's interpretation of its own regulation deserves substantial weight, even if it amounts to a "litigating position."

(*Ibid.*; see also *Ohio Casualty Ins. Co. v. Garamendi* (2006) 137 Cal.App.4th 64, 79 [court deferred to Commissioner's interpretation because he "thoroughly considered the issue and reached a reasonable conclusion in harmony with the [statute], long-standing administrative construction, and public policy considerations"].)

Finally, as to questions of law, this Court exercises *de novo* review of the Superior Court decision. (*20th Century*, *supra*, 8 Cal.4th at 271.)

ARGUMENT

I. THE TRIAL COURT PROPERLY UPHELD THE COMMISSIONER'S INTERPRETATION AND APPLICATION OF THE CONFISCATION VARIANCE.

Mercury and the Trades claim that the Commissioner and the Superior Court applied the wrong legal standard to find that Mercury was not entitled to a confiscation variance under 10 CCR § 2644.27(f)(9) ("section 2644.27(f)(9)"). (Mercury OB 40-51; Trades OB 39-48.) Contrary to their assertions, the Commissioner properly applied the controlling California and U.S. Supreme Court precedent, which requires a balancing of consumer and the insurer's interests and a finding that the ordered rate would prevent the insurer from operating successfully.[10] The Superior Court correctly upheld the Commissioner's Decision, also following the controlling California and U.S. Supreme Court constitutional jurisprudence.[11] (See § I.A.1-2, *infra*.)

Both Mercury and the Trades recognize and quote the *Hope* "inability to operate successfully" standard. (See Mercury OB 46-47; Trades OB 36 [quoting *Hope*, *supra*, 320 U.S at 605].) Where they go astray, however, is that they equate "operate successfully" with the regulated entity's interest in a "fair return." (Mercury OB 46-47; Trades OB 36.) Under Mercury and the Trades newly invented "fair return" test, a finding of confiscation would be required anytime the maximum permitted rate as calculated by the Regulatory Formula is lower than the rate that an insurance company's economists determine is necessary to earn a "fair" return. (Mercury OB 64-69; Trades OB 53-56.) This manifestly self-serving proposal would overturn well-established jurisprudence and obliterate the

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[10] See AR 2154-58; AR 2157 (citing *20th Century*, *supra*, 8 Cal.4th at 296, relying on *Hope*, stating that "the inability to operate successfully is a necessary, but not sufficient, condition of confiscation").

[11] JA 11:2835-36 (citing and discussing *20th Century*, *supra*, 8 Cal. 4th at 295-296, 298-299 and *Hope*, *supra*, 320 U.S. at 603, 605).

Regulatory Formula, which the *20th Century* Court upheld as constitutional. The Commissioner and the Superior Court properly rejected Mercury's and the Trades' proffered economist-projected "fair return" test as contrary to the constitutional standards articulated by the California and U.S. Supreme Courts. (See § I.A.3, *infra*.)

Applying controlling constitutional jurisprudence, the Commissioner also correctly found that Mercury failed to meet its heavy evidentiary burden of proving confiscation when it instead chose to substitute its economist's preferred rate of return and actual costs into the Regulatory Formula and claimed anything less would result in a confiscatory rate. (AR 2164-66.) The Superior Court properly upheld the Commissioner's determination based on the evidentiary record that Mercury would not suffer any confiscation because Mercury would continue to maintain its financial integrity and earn a profit.[12] (See § I.B.1-2, *infra*.)

Finally, the Commissioner's application of the confiscation test to Mercury's enterprise as a whole, rather than its California homeowner's line, is also consistent with *20th Century* and U.S. Supreme Court precedent. Mercury and the Trades fail to cite to a single case that requires a different result, particularly in the insurance context. (See § I.B.3, *infra*.)

A. The Commissioner and the Superior Court Applied the Proper Legal Standard For Determining Whether a Rate is Confiscatory.

<u>1. The Prior Approval Regulations Expressly Incorporate the Confiscation Test Articulated in *20th Century*.</u>

Mercury and the Trades ask this Court to rewrite the standard for obtaining a confiscation variance under the Regulatory Formula. That invitation should be rejected.

As discussed in the Background, section A.3, *supra*, the Prior Approval Regulations contain multiple safeguards (referred to as variances)

[12] JA 11:2837-38; AR 2164-65.

to protect insurance companies against confiscation. The variance invoked by Mercury expressly permits an insurer to request an adjustment to the rate calculated under the Regulatory Formula on the ground "[t]hat the maximum permitted earned premium would be confiscatory as applied." (10 CCR § 2644.27(f)(9).) The regulation explains that, "[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." (*Ibid.*)

As articulated in *20th Century*,

> [the Regulatory Formula itself] is designed to yield a nonconfiscatory rate for the individual insurer even before any variance might come into play. Because it has "safety" built in, it does not appear to need "safety valves" different from those provided by the variances. Be that as it may, there is also a separate and independent constitutionally mandated "variance," which … would be available to the individual insurer on proof of confiscation, that is to say, on proof that the regulations in question would otherwise be confiscatory as applied.

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

In adopting amendments to the Prior Approval Regulations, as noted by Mercury (OB 18) and the Trades (OB 24), the Commissioner stated that he was "aware that insurers must be allowed an opportunity to earn a fair and reasonable rate of return. Variances are important as the constitutional safety valves." (JA 6:1443.) The Commissioner ***did not*** state, however, as Mercury and the Trades insist, that insurers have a "right" to a "fair rate of return" (Trades OB 29) as judged by an insurer's economist or that a "fair rate of return" is the primary factor in determining confiscation (Trades OB 29-30; Mercury OB 49). Instead, he was explaining generally how the *20th Century* Court recognized that "the variances expressly provided for in the regulations" act as "safety valves" and provide an "important protection against confiscation." (JA 6:1443.)

As acknowledged by the Trades (OB 25-26) and Mercury (OB 18-19), ***the Regulatory Formula itself provides for the opportunity to earn a "fair return"*** *before* application of the variances. (See *20th Century*, *supra*, 8 Cal.4th at 251.) The variances act as further safety valves to avoid confiscation (*id.* at 313; JA 6:1443). The burden remains squarely on the insurer, however, to prove it meets the standard for a variance (see Ins. Code § 1861.05(b)). The standard for a confiscation variance under section 2644.27(f)(9) expressly requires a showing that the maximum permitted rate under the Regulatory Formula "would be confiscatory as applied" under the "end result test applied to the enterprise as a whole" as "articulated in *20th Century*[.]" If Mercury and the Trades believe the regulation should provide otherwise, their remedy is to petition for a rulemaking to amend the regulation, not to this Court.[13]

2. <u>Under the Controlling *20th Century* and U.S. Supreme Court Standards, an Insurer Must Show that the Ordered Rate Prevents it From Operating Successfully.</u>

Mercury and the Trades claim that in finding Mercury would not suffer confiscation, the Commissioner and Superior Court applied an improper "financial distress" test without considering Mercury's "opportunity to earn a fair rate of return." (Trades OB 39-46; Mercury OB 40-51.) These assertions are false. As clearly set forth in their decisions, the Commissioner and the Superior Court each discussed and applied the proper constitutional balancing test set forth by the California and U.S.

[13] Mercury and the Trades claim that *20th Century* is limited to the rate rollback context (see Mercury OB 45, 55; Trades OB 46-48). They are incorrect. *20th Century* explicitly discussed and upheld the Prior Approval Regulations. (See, e.g., *20th Century*, *supra*, 8 Cal.4th at 249-254 [discussing the Prior Approval Regulatory Formula generally and its components, including the efficiency standard [section 2644.12], excluded expenses [section 2644.10], and rate of return [section 2644.16].) Moreover, the regulation expressly incorporates the confiscation standard articulated in *20th Century*.

Supreme Court in *20th Century* and *Hope*. (See AR 2154-58; JA 11:2835-36.)

In *20th Century*, the California Supreme Court applied the constitutional protections embodied in the due process and takings clauses of the U.S. Constitution to uphold the Commissioner's Prior Approval Regulations both facially and as applied. (*20th Century*, *supra*, 8 Cal.4th at 291, 297, 328.) As articulated by the Court, when a regulation is challenged as being confiscatory as applied, "***the question is whether***, in the particular case, ***its terms set a rate that is unjust and unreasonable and hence confiscatory***." (*Id.* at 318, emphasis added.)[14] 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… The fact that the method employed to reach that result may contain infirmities is not then important." (*Ibid.*, quoting *Hope*, *supra*, 320 U.S. at 602; see also *id.* at 292-293.)

[14] Despite Mercury's and the Trades' attempts to disavow it, *20th Century* is the only California Supreme Court opinion to discuss the standards of confiscation as applied to the insurance ratemaking context under Proposition 103, and it has not been overruled by any subsequent California or U.S. Supreme Court opinion. The U.S. Supreme Court's holdings in *Hope* and *Duquesne Light*, upon which the *20th Century* confiscation test is grounded, also remain bedrock constitutional law for determining confiscatory rates. (See, e.g., *Verizon Communications, Inc. v. F.C.C.* (2002) 535 U.S. 467, 482-487 and 523-527 [relying on *Hope* and *Duquesne Light Co. v. Barasch* (*Duquesne Light*) (1989) 488 U.S. 299 in discussion of standards to determine confiscatory rates].) Nothing in *Lingle v. Chevron U.S.A. Inc.* (2005) 544 U.S. 528, cited by the Trades, suggests otherwise. In that case, the U.S. Supreme Court repudiated a "substantially advances" standard for determining a regulatory taking, which is not the standard for determining confiscatory rates at issue here. In fact, the *Lingle* Court explicitly stated that its holding in that case "does not require [the Court] to disturb any of [its] prior holdings." (*Id.* at 545.)

As the established U.S. and California Supreme Court precedent further elucidate***, whether a rate "is unjust and unreasonable in its consequences and therefore confiscatory depends on a <u>balancing</u> of the interests of [the insurer] and its insureds***." (*Id*. at 325, emphasis added; see also *id*. at 293-295; *Hope*, *supra*, 320 U.S. at 603 ["[T]he fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests"].)[15]

In applying the *Hope* balancing test, the *20th Century* Court noted that insureds have an interest in "freedom from exploitation." (*Id*. at 325.) On the other hand, 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.'" (*Id.* at 325-326, emphasis added, citing and quoting *Hope*, *supra*, 320 U.S. at 603 [discussing the "investor interest" in "the financial integrity of the company whose rates are being regulated"].) The Court emphasized that this insurer "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 326, emphasis in original, citing *Permian Basin*, *supra*, 390 U.S. 747, 769.) The Court held that an insurer "has no

[15] The rent control cases upon which Mercury and the Trades so heavily rely are in accord. (See *Kavanau v. Santa Monica Rent Control Bd.* (1997) 16 Cal.4th 761, 771-772, 778 [citing and quoting *Hope*, *supra*, 320 U.S. at 603]; *Galland v. City of Clovis* (2001) 24 Cal.4th 1003, 1021-1022 ["[R]egulators are permitted to adjust prices 'within a broad zone of reasonableness,' balancing the interests of landlords and tenants"]; *TG Oceanside, L.P. v. City of Oceanside* (*TG Oceanside*) (2007) 156 Cal.App.4th 1355, 1371-1372 ["In other words, rent regulation must not prevent an efficient enterprise from 'operating successfully,' but rent regulators are permitted to adjust prices 'within a broad zone of reasonableness,' balancing the interests of landlords and tenants"].)

constitutional right to a profit" and "[i]ndeed, it has no constitutional right even against a loss." (*Id*. at 294, 326.)

"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.'" (*20th Century*, *supra*, 8 Cal.4th at 295, emphasis in original.)[16]

The *20th Century* Court further explained:

> The *Hope* court itself expressly held that "[r]ates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, ***even though they might produce only a meager return***...." (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 605, 64 S.Ct. at p. 289.) A year later, the court restated this holding in even simpler terms in a unanimous opinion by Justice Jackson: "a company [cannot] complain if the return which was allowed made it possible for the company to operate successfully." (*Market Street R. Co. v. Comm'n, supra,* 324 U.S. at p. 566, 65 S.Ct. at p. 779.)

(*Id*. at 295, emphasis added.)

Accordingly, confiscation requires a showing by the insurer that "***the rate in question does not allow it to operate successfully***." (*Ibid.*, emphasis added; *Hope*, *supra*, 320 U.S. at 605.) "In a word, the inability to operate successfully is a necessary-***but not a sufficient***-condition of confiscation." (*20th Century*, *supra*, 8 Cal.4th at 296, emphasis added.)

The *20th Century* Court further explained that:

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16 Accord *Galland*, *supra*, 24 Cal.4th at 1026 ("[W]ithin this broad zone, the rate regulator is balancing the interests of investors, [], with the interests of consumers, [] in order to achieve a rent level that will on the one hand maintain the affordability of the mobilehome park and on the other hand allow the landlord to continue to operate successfully," citing *Kavanau*, *supra*, 16 Cal.4th at 778-779.)

> "absent the sort of deep financial hardship described in *Hope*," [] "there is no taking...." (*Jersey Cent. Power & Light Co. v. F.E.R.C., supra,* 810 F.2d at p. 1181, fn. 3.) This follows from the fact that, under *Hope,* a regulated firm may claim that a rate is confiscatory only if the rate does not allow it to operate successfully. In such circumstances, the firm is not inaptly characterized as experiencing "deep financial hardship" as a result of the rate.

(*Ibid.*)[17]

In sum, contrary to Mercury's and the Trades' assertions, there is no absolute right to the return that an insurer's economists consider to be more "fair" than the return allowed under the Regulatory Formula. Rather, a confiscation determination involves a case-by-case complex factual analysis. (See, e.g., *Kavanau*, *supra*, 16 Cal.4th at 776; *Santa Monica Beach, Ltd. v. Superior Court* (1999) 19 Cal.4th 952, 964.) That case-by-case analysis, as discussed above, requires the balancing of the insurer's and the insured's interests. (*20th Century*, *supra*, 8 Cal.4th at 293-295.) Moreover, as the California Supreme Court has made clear, specifically with respect to insurance rates, confiscation "does *not* arise": (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); or (2) when expenses are limited by an efficiency standard (*id.* at 289).

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[17] Contrary to Mercury and the Trades' contentions (Mercury OB 49-51; Trades OB 42, 52), the *20th Century* Court's reference to "deep financial hardship" as quoted by the Commissioner and the Superior Court is not the same as the "substantially threatened with insolvency" standard that was rejected for the calculation of rollbacks under section 1861.01 in *Calfarm*, *supra*, 48 Cal.3d 805. As the passage quoted above makes clear, the *20th Century* Court was equating "deep financial hardship" with the "inability to operate successfully" confiscation standard articulated in *Hope*. (See *Hope*, *supra*, 320 U.S. at 605.) That is the standard applied by the Commissioner and the Superior Court. (AR 2164-66; JA 11:2836.)

3. The Commissioner and the Superior Court Properly Rejected Mercury's and the Trades' Subjective "Fair Return" Test.

Mercury and the Trades cite and quote from the controlling U.S. and California Supreme Court cases, which state that the "***opportunity***" to earn a "fair rate of return" is but one factor in the confiscation analysis.[18] Their discussion of the controlling authority, however, misstates the relevant test by elevating a "fair return" to be the exclusive factor that must be met to avoid a finding of confiscation. (See, e.g., Mercury OB 43-49; Trades OB 39-42.) In rejecting precisely the same argument by the insurance industry, the California Supreme Court stated:

> One assumption seems to be that a regulated firm is entitled to its cost of capital. Although such a firm has an interest in this matter, it has no right. [citations omitted] The United States and California Constitutions make the point plain. As stated, a regulated firm has no constitutional right even against a loss. Manifestly, Proposition 103 is not to the contrary.

(*20th Century*, *supra*, 8 Cal.4th at 320-321.)

In focusing narrowly on their theoretical interest in earning a "fair return" as measured by their own economists, Mercury and the Trades entirely fail to discuss the fuller analysis in the rent control cases on which they rely (see, e.g., Mercury OB 47-48; Trades OB 36-38). Those cases confirm rather than disavow the application of the *Hope* balancing principles and consider whether the "end result" of the ordered rates prevent the business from "operating successfully."

[18] See, e.g., Mercury OB 44, 46-47 (citing and quoting from *Hope* regarding "the investor interest"); Trades OB 36 (citing *Hope* "inability to operate successfully" standard), 39-40 (citing *Duquesne Light* and *Hope*), 45 ("*20th Century* underscores that the constitution does not *guarantee* a fair return").

For example, in *Kavanau*, the Court, quoting the same principles from *Hope* and *Permian Basin* on which the *20th Century* Court relied, stated:

> [T]he essential inquiry in due process cases involving price controls is whether the regulatory scheme's *result* is just and reasonable. (*Hope Gas*, *supra*, 320 U.S. at p. 602 [].) The Court of Appeal did not expressly find that the 12 percent limit prevented Kavanau from " 'operating successfully.' " (*20th Century*, *supra*, 8 Cal.4th at p. 295.) Rather, the 12 percent limit merely delayed Kavanau's rent increase. Regulated prices must fall within a "broad zone of reasonableness" to be constitutional (*Permian Basin*, *supra*, 390 U.S. at p. 770 []; see also *Pipeline Co.*, *supra*, 315 U.S. at p. 585 []), 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.

(*Kavanau*, *supra*, 16 Cal.4th at 778-779, italics in original; accord *Galland*, *supra*, 24 Cal.4th at 1021-1022.)

Moreover, Justice Mosk, writing the majority opinion in *Galland*, explained that within this balancing test, the investor's interest in a "fair rate of return" is not to be measured by an insurer's economist, as Mercury attempted in the rate proceeding, but based on constitutional jurisprudence:

> Although the term "fair rate of return" borrows from the terminology of economics and finance, it is as used in this context a legal, constitutional term. It refers to a constitutional *minimum* within a broad zone of reasonableness. As explained above, within this broad zone, the rate regulator is balancing the interests of investors, i.e., landlords, with the interests of consumers, i.e., mobilehome owners, in order to achieve a rent level that will on the one hand maintain the affordability of the mobilehome park and on the other hand allow the landlord to continue to operate successfully. (*Kavanau*, *supra,* 16 Cal.4th at pp. 778-779.) For those price-regulated investments that fall above the constitutional minimum, but are nonetheless disappointing to investor expectations, the solution is not constitutional litigation but,

> as with nonregulated investments, the liquidation of the investments and the transfer of capital to more lucrative enterprises.

(*Galland*, *supra*, 24 Cal.4th at 1026.)[19]

In summary, the cases relied on by Mecury and the Trades actually confirm that the Commissioner applied the appropriate standard for confiscation by relying on the *Hope* balancing test as discussed and applied in the Proposition 103 ratemaking context in *20th Century*.

B. The Superior Court Correctly Upheld the Commissioner's Finding that Mercury Did Not Meet its Heavy Evidentiary Burden to Show Confiscation.

The Commissioner's finding that Mercury failed to meet its evidentiary burden to prove confiscation is amply supported by the record. Indeed, the evidence shows that Mercury has not only operated (and continues to operate) successfully, but has substantially profited under the Prior Approval Regulations.[20] (See § I.B.1, *infra*.)

The Commissioner also properly applied the relitigation bar, as upheld by the California Supreme Court, to prevent Mercury from substituting its preferred rate of return and costs for those established by the Regulatory Formula. (See § I.B.2, *infra*.)

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[19] The Commissioner's finding that the ordered rate decrease would not result in confiscation is also consistent with Justice Mosk's statements in his concurring opinions in *20th Century* and *Kavanau*. (See *Kavanau*, *supra*, 16 Cal.4th at 792 (conc. opn. of Mosk, J.) ["where a service provider voluntarily participates in a price-regulated program or activity, there is no legal compulsion to provide service and thus there can be no taking"].)

[20] Mercury makes no attempt to quantify for this Court the "harm" it allegedly suffered during the approximately 7-month period that the rate decrease was in effect. Consumer Watchdog submits that this is because it is unable to do so, as its financial statements indicate that it earned an after-tax income of $226 million (an after-tax return of 21%), had a surplus of $1.065 billion, and paid dividends to its shareholders of $120 million in 2013. (JA 8:2525.)

The Commissioner also properly rejected Mercury's argument that the test for confiscation should be applied solely to its homeowners line of insurance. (AR 2167-68.) In *20th Century*, the California Supreme Court rejected a line-by-line test as advocated by the industry; rather it held that confiscation is judged based on the condition of the insurer as a whole. (*20th Century*, *supra*, 8 Cal.4th at 293, 308-09, 322.) In any case, the admitted evidence also showed that Mercury would not suffer any confiscation, but would actually earn a profit with respect to its California homeowners line. (See § I.B.3, *infra*.)

1. Mercury Failed to Meet its Evidentiary Burden to Demonstrate Confiscation.

During the rate hearing, Mercury was required to prove by a preponderance of the evidence that it was entitled to the confiscation variance. (Ins. Code § 1861.05(b); 10 CCR § 2646.5.) Case law confirms that "he 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." (*20th Century, supra*, 8 Cal.4th at 318-319, quoting *Hope, supra,* 320 U.S. at 602.) Mercury woefully failed to meet that heavy burden.

Instead of addressing the impact of the "end result" of the maximum permitted rate under the Regulatory Formula on its business operations, Mercury turned the confiscation test on its head by attempting to present its economist witnesses' testimony about an alternative higher rate of return that they considered to be fairer than the return allowed under the Regulatory Formula.[21] In other words, in the view of Mercury's

[21] See Mercury's OB 65 (describing stricken testimony opining that Mercury was entitled to a return of between 8.15% and 9.23% [AR 2982] and that the difference between this "market rate of return" [yielding $30.7 to $34.8 million] and the return of 7.51% allowed under the Regulatory Formula [yielding $17.6 million] would be how he would quantify

economists, if the rate calculated under the Regulatory Formula would yield a return that is less than the market return calculated under their alternative theory, then the result would be confiscatory rates.

This is, manifestly, not the applicable standard. Indeed, it is no standard at all. To meet its heavy burden of proof, an insurer cannot simply present, as Mercury attempted to do, an abstract analysis of why, in the insurer's view, the rate of return allowed by the Ratemaking Formula is insufficient in the eyes of its economist or why another rate of return calculated under an alternative formula is more "fair,"[22] or whether an insurer simply disagrees with the allowable expense provision.[23] Instead, an insurer must offer concrete *evidence* of the impact of the rate calculated under the Regulatory Formula on its ability to operate successfully.[24]

Throughout the rate proceeding, Mercury repeatedly failed to offer admissible evidence to make this showing. On the first two occasions, the ALJ properly struck much of Mercury's confiscation testimony, mainly because it was either irrelevant, or violated the prohibition on relitigation because it substituted Mercury's actual expenses and its preferred rate of return for the rate calculation required by the Regulatory Formula and claimed that any lower rate would result in confiscation. (AR 2049-52.) Mercury was afforded a third opportunity to make its case, which resulted in the ALJ admitting testimony of Mercury's economist witness, but

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confiscation [AR 2982-84]; see also, e.g., 4/3/12 RT at 1758:8-15 [filed under seal] ("it's my belief that a regulated entity is entitled to opportunity to earn a fair and reasonable return on the investment in the enterprise, … And if the return is below that fair and reasonable return, that's improper in my view and not an appropriate end result of the regulatory process").

[22] See *20th Century*, *supra*, 8 Cal.4th at 298; *TG Oceanside*, *supra*, 156 Cal.App.4th at 1380-1381.

[23] See *20th Century*, *supra*, 8 Cal.4th at 289-290.

[24] See, e.g., *Hope*, *supra*, 320 U.S. at 603-604; *Duquesne Light*, *supra*, 488 U.S. at 311-312.

striking his calculations that were based on his alternative economic theory. (AR 2052.)

Mercury subsequently proffered further oral testimony by its economist that was admitted by the ALJ, but still did not come close to demonstrating confiscation. Instead, Mercury's witness conceded that his only basis for showing confiscation relied on using alternative methodologies for calculating components of the Regulatory Formula. (AR 4361:5-17.) Specifically, under his methodology, he used calculations for investment income, projected losses, and projected expenses that were all different than those required by the Regulatory Formula. (AR 4358:16 – 4359:3; Mercury OB 66-67.) He then explained that, for example, Mercury's calculation of its projected losses would result in a higher rate indication than if one used the losses projected under the Regulatory Formula. (AR 4348:23 – 4349:7.) Finally, he opined that if Mercury did not get its requested rate increase, any lower rate would be confiscatory. (4/3/12 RT at 1792:17 – 1794:24, 1808:16-25 (filed under seal); AR 2955:9-10 ["The only way to test whether a rate 'would be confiscatory as applied' is to base that test on projections…."]; see also AR 2982-84.)

Contrary to Mercury's assertions that the Commissioner failed to consider its evidence, the Commissioner's Decision contains a full discussion of each of the parties' testimony and evidence on confiscation (AR 2158-62) and summarizes Mercury's *admitted* testimony. (AR 2161.) The Commissioner's Decision stated:

> In essence, Mercury argues that unless it is permitted to earn a fair rate of return the formula results in confiscation. Alternatively, Mercury also argues that in order to demonstrate deep financial hardship, it must be permitted to substitute its own cost and expense calculations. Under this "out of pocket" test, any rate that does not allow an insurer to covers [sic] its own costs is confiscatory regardless of

> whether the insurer's costs match those provided for in the regulatory formula.

(AR 2163, footnotes omitted.)

The Court in *20th Century* rejected a similar industry argument:

> It appears to have assumed that the insurer must be permitted to recover its entire cost of service – at least insofar as it is reasonable – by operation of one or both of these guaranties. That is not so. A regulated firm may be disallowed an element of its cost of service – even one that is reasonable – without suffering a taking or a denial of due process. The United States Supreme Court has so concluded under the federal charter. (*B. & O.R. Co. v. United States*, *supra*, 345 U.S. at pp. 147–150.)

(*20th Century*, *supra*, 8 Cal.4th at 308; see also *id.* at 289-90.)

Moreover, the case relied upon by Mercury, *TG Oceanside*, *supra*, 156 Cal.App.4th 135, supports the Commissioner's rejection of Mercury's evidence of an alternative rate of return. In that case, the Court concluded that a property owner did not meet its evidentiary burden when it attempted to use an alternative formula rather than the standard specified by the city ordinance:

> Rather than presenting evidence tending to show the Ordinance as applied to it would result in a confiscatory rate of return, Owner presented an alternative formula different from the [Ordinance] standards;
>
> …
>
> In view of the presumption established by the Ordinance,[25] *it is not sufficient for Owner to attack City's showing or argue that a different formula will provide a fair return. As stated, it must first make its own threshold evidentiary showing that the formulas provided for by City's Ordinance are unjust and unreasonable in their consequences.*

(*Id.* at 1380-1381, emphasis added.)

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[25] Similar to the Proposition 103 Regulatory Formula, the formula used in the rent control ordinance was designed to allow an owner "a just and reasonable return" before any adjustment.

After discussing and weighing all the testimony, evidence, and arguments (AR 2158-66), the Commissioner made a number of findings, including that:

- **The Maximum Permitted Rate Results in a Profit to Mercury**. Applying a rate decrease of 8.18% to Mercury's HO-3 policy form and rate increases to policy forms HO-4 and HO-6, results in at least 7.37% after-tax rate of return and at least $1.8 million profit to Mercury. [¶] Mercury makes a number of assumptions regarding the impact of $1.8 million profit, but provides no definitive facts supporting these assumptions. Without such facts, Mercury's arguments amount to little more than conjecture and certainly do not carry the burden of showing the rate to be unjust. (AR 2164; see also AR 2875-77.)

- **The Maximum Permitted Rate Maintains Mercury's Financial Integrity**. While perhaps not generating the profit margin Mercury desires, Mercury failed to demonstrate the rate decrease will impair the company's financial integrity. In fact, examinations of Mercury's credit rating and past rate applications show quite the opposite. [¶] From 2006 through 2010, Mercury maintained an A+ financial strength rating from AM Best.[26] …at no time did Mercury's financial strength rating drop below the zenith mark of A…Mercury did not present evidence that its stock prices or credit ratings have slipped nor did Mercury demonstrate contraction in its homeowners business. Indeed, Mercury's California homeowners earned premiums have increased every year since 2004.[] (AR 2164-65, citing AR 7891.)

  In addition, over the last 5 years, Mercury has issued dividends totaling nearly $1 billion. (AR 2165; see also AR 2873, 8366.)

Mercury does not contest these findings, but instead claims that the Commissioner erred by relying in part on historical evidence of Mercury's financial strength. (See Mercury OB 52-53.) Contrary to Mercury's assertion, however, this is precisely the type of evidence that the U.S. Supreme Court has considered in a confiscation analysis. (See, e.g., *Hope*,

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[26] AR 2889, 8231-33. Mercury continued to maintain its A+ financial strength rating from AM Best from 2011 through 2013. (See JA 8:2527.)

supra, 320 U.S. at 603-604 [discussing historical financial data under the regulatory regime]; *Duquesne Light*, *supra,* 488 U.S. at 311-312 [same].)

Mercury has offered *no countervailing evidence* regarding any harm to its profits or financial strength for the period the challenged rate decrease was in effect.[27] Thus Mercury failed to meet its burden of proof, and the Commissioner's Decision is supported by the weight of the evidence.

2. The Superior Court Properly Upheld the Commissioner's Application of the Relitigation Bar.

Under the Prior Approval Regulations, the Commissioner is required to review rates using a single, consistent methodology. (10 CCR § 2643.1.) To ensure that uniformity, and prevent each rate proceeding from becoming a protracted litigation battle, an insurance company is barred from challenging components of the Regulatory Formula during a rate hearing. This is known as the "relitigation bar." (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"].)

Mercury and the Trades assert that the ALJ and the Commissioner improperly rejected Mercury's "evidence" of its "actual expected costs and revenues" and its projections of a "fair return." (See Mercury OB 58-64; Trades OB 53-56.) These arguments are without merit. In essence, Mercury and the Trades seek to avoid application of the Regulatory Formula any time they choose to assert the confiscation variance.

The California Supreme Court in *20th Century* rejected a similar industry attack on the relitigation bar: "the effect of the 'relitigation bar' is

[27] In fact, all indicators are that Mercury's financial integrity remained intact during the period the rate decrease was in effect in 2013, having maintained an A+ credit rating, had a surplus of $1.065 billion, and paid dividends to its shareholders of $120 million in 2013 (see footnotes 20 and 26, *supra*).

unobjectionable. In 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. Similarly, in quasi-adjudicatory proceedings, the administrative law judge applies adopted regulations; he does not entertain the question whether their underlying premises are sound. That is also as it should be, and for the same reason." (*20th Century*, *supra*, 8 Cal.4th at 312.)

Accordingly, the Superior Court properly upheld the Commissioner's application of the relitigation bar to prevent Mercury from presenting a theoretical analysis of why, in its economist's view, the maximum permitted rate of return allowed in the ratemaking formula is insufficient or claiming that its actual expenses should be substituted for the efficiency standard. (AR 2166-67.)

3. The Commissioner Properly Considered the Impact of the Rate Order on Mercury's Enterprise as a Whole.

The Commissioner properly rejected Mercury's (and the Trades') argument that confiscation should be measured by the impact of the Rate Order on Mercury's homeowners line of business instead of Mercury Casualty Company as a whole:

> [T]he California Supreme Court stated no less than three times that confiscation depends on the condition of the insurer as whole and not on the fortunes of any one or more of its lines.[] In so holding the Supreme Court stated the earned premium of 20th Century's earthquake line must not be viewed in isolation as an end result but instead as an intermediate step in evaluating the corporation's overall financial fitness.[]

(AR 2168, footnotes omitted.)

The Commissioner relied on the *20th Century*, which held:

> "[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. (*B. & O.R. Co. v. United States* (1953)

> 345 U.S. 146, 150 [].) That a particular rate may not cover the cost of a particular good or service does not work confiscation in and of itself. (See *id.* at pp. 147–150 [].) In other words, ***confiscation is judged with an eye toward the regulated firm as an enterprise***.

(*20th Century*, *supra*, 8 Cal.4th at 293, emphasis added; see also *id*. at 308-309 and 322 [same].) The *20th Century* Court noted that its opinion was consistent in this respect with its opinion in *Calfarm*:

> In *Calfarm*, we recognized that a court might subsequently be presented with a claim that Proposition 103's maximum rate for the rollback year "is confiscatory as to a particular insurer *and line of insurance.*" [citation omitted] Our recognition was factual: it concerns the nature of the complaint that an insurer might make. It was not normative: ***it does not mean that confiscation is judged other than with an eye toward the insurer as a whole***.

(*Id.* at 309, fn. 23, emphasis added.)

Mercury and the Trades claim the "regulated firm as an enterprise" standard is limited to the specific rollback context discussed in *20th Century*. This is incorrect. The *20th Century* Court cited U.S. Supreme Court precedent for this principle. (*20th Century*, *supra*, 8 Cal.4th at 293.) In the cited case, the U.S. Supreme Court held that "so long as rates as a whole afford railroads just compensation for their over-all services to the public the Due Process Clause should not be construed as a bar to the fixing of noncompensatory rates for carrying some commodities when the public interest is thereby served." (*B. & O.R. Co. v. U.S.* (1953) 345 U.S. 146, 150.) Here, the Commissioner determined the ordered rate was not confiscatory either to Mercury's homeowners line or to its enterprise as a whole.

Mercury claims that its asserted "line-by-line" confiscation analysis is consistent with the U.S. Supreme Court's opinion in *Permian Basin*, *supra*, 390 U.S. 747 (Mercury OB 56-57). Far from holding that such an analysis is *required*, however, the U.S. Supreme Court merely stated in that case that the Federal Power Commission's own procedures allowing "appropriate relief" from rates calculated under the Natural Gas Act by looking at whether " 'out-of-pocket expenses in connection with the operation of a particular well' exceed its revenue from the well under the applicable area price" were not "inadequate or excessively imprecise." (*Permian Basin*, *supra*, 390 U.S. at 770-772.) Mercury fails to cite any case holding that such a "line-by-line" analysis is required, or even applicable, to the business of insurance, especially since insurance companies are not required to sell insurance, or any particular line of insurance, in California.[28]

Moreover, from a regulatory perspective, an analysis of the enterprise as a whole, as opposed to just the line of insurance, is necessary to determine whether confiscation has occurred. (AR 5125:7-14.) As stated by the Department's expert witness, Mercury's homeowners line does not have its own published balance sheets, investors, credit rating, AM Best rating or any other common types of indicators for determining its separate and distinct financial condition. (AR 2887.) Thus, attempting to assess the financial condition of just the homeowners line would be neither practical nor fruitful.

But even assuming, *arguendo*, that only Mercury's homeowners line should be tested for confiscation, the evidence was still overwhelmingly against any finding of confiscation. For example, Mercury's profit for its California homeowners line alone was $57.5 million in 2010. (AR 2870:8-9, AR 5544:11.) Moreover, the evidence showed that Mercury would still earn $1.8 million after-tax profit on its California homeowners line under

[28] The two cases cited by the Trades in support of a line-by line test for confiscation (OB 49-50) are also inapposite. Neither case involved a determination of whether insurance rates set under a regulatory ratemaking scheme were confiscatory as applied.

the ordered rate. (AR 2162.) Mercury offered no credible evidence to establish its homeowners line would not continue to be profitable.

II. THE SUPERIOR COURT PROPERLY UPHELD THE COMMISSIONER'S INTERPRETATION OF THE REGULATION EXCLUDING "INSTITUTIONAL ADVERTISING" EXPENSES.

Interpreting and applying 10 CCR § 2644.10(f) ("section 2644.10(f)") in accordance with its plain meaning and underlying intent, the Commissioner properly excluded Mercury's expenditures on "institutional advertising" plastering the fictitious "Mercury Insurance Group" logo on hockey rinks and baseball stadiums.[29] (AR 2139-49.) In common advertising parlance, "institutional advertising is 'image' advertising which strives to enhance a company's reputation" and "does not promote a specific product or service but instead attempts to obtain favorable attention to the company as a whole." (AR 2138.) Sports sponsorships are classic institutional advertising. (AR 2139, 2148.) Regulatory ratemaking formulas commonly exclude these type of expenses, which are unrelated to the cost of providing insurance, because they provide no benefit to the consumer. (See AR 2139 [citing cases in utility ratemaking context].)

Mercury and the Trades argue for a construction of section 2644.10(f) that is contrary to the regulation's plain language and underlying intent. (Mercury OB 31-40; Trades OB 57-70.) Under their construction, consumers would be forced to pay for *all* insurer advertising, even if it did not mention a specific insurer or provide any product information. Once again, their arguments attempting to rewrite the regulation belong in a petition to amend the regulation, not in a writ proceeding. The Commissioner's construction is entitled to substantial weight. (*State Farm*

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[29] The impact of this reduction was to reduce the efficiency standard by about 1.04%, which resulted in about a 1.56% reduction to the overall rate. (AR 8647-8650.)

Mutual Automobile Ins. Co. v. Quackenbush, *supra*, 77 Cal.App.4th 65, 71.) (See § II.A.1-2, *infra*.)

Moreover, the Commissioner's finding that all of Mercury's advertising referring to the fictitious "Mercury Insurance Group" failed to refer to a "specific insurer" is consistent with the plain meaning of that term and the regulation's intent. By contrast Mercury and the Trades' construction arguing for "specific insurer" to mean a "group of insurers" is not. (See § II.B.1-2, *infra*.) Mercury also failed to carry its burden of proving the dollar amount it spent on advertising that it claimed provided pertinent product information to consumers; the Commissioner therefore properly excluded all of Mercury's advertising expenses. (See § II.C, *infra*.)

Finally, the Superior Court properly rejected the Trades' claim (which was never raised by Mercury either before the Commissioner or the Superior Court) that section 2644.10(f) facially violates the First Amendment. Section 2644.10(f) does not regulate or impose any burden on speech; it merely prohibits insurers from including certain advertising costs in the rate calculation. Insurers have no constitutional right to make policyholders pay for their speech. Even assuming the First Amendment was implicated, the Superior Court correctly determined that the restriction on Mercury's pass-through of institutional advertising expenses would pass the intermediate scrutiny standard applicable to commercial speech. (See § II.D, *infra*.)

A. The Commissioner Interpreted the Definition of "Institutional Advertising" Consistent with the Plain Meaning and Intent of the Regulation.

When interpreting a statute or regulation, a court's "fundamental task … is to determine the Legislature's intent so as to effectuate the law's purpose. [The court] begin[s] by examining the statutory language because the words of a statute are generally the most reliable indicator of legislative intent.… If the statute's text evinces an unmistakable plain meaning, [the court] need go no further." (*In re C.H.* (2011) 53 Cal.4th 94, 100.)[30] "[W]hatever may be thought of the wisdom, expediency, or policy of the act, [courts] have no power to rewrite the statute to make it conform to a presumed intention that is not expressed." (*Morillion v. Royal Packing Co.* (2000) 22 Cal.4th 575, 585.) "A statute must be given a reasonable and common sense interpretation consistent with the apparent purpose and intention of the lawmakers[.]" (*People v. Zambia* (2011) 51 Cal.4th 965, 969.) Courts consider an agency's summary of and response to public comments in a rulemaking file as "part of the official statement of regulatory intent." (*Friends of Sierra Madre v. City of Sierra Madre* (2001) 25 Cal.4th 165, 186, fn. 15.)

1. The Commissioner's Interpretation of the Definition of "Institutional Advertising" is Consistent with the Plain Meaning of the Regulation.

"Institutional advertising" is expressly defined under the regulation 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." (10 CCR § 2644.10(f), emphasis added.) In accordance with the plain language, the Commissioner has consistently interpreted this definition to include advertising that is not aimed at obtaining business for a specific insurer ***and*** (meaning also or plus) advertising that does not provide consumers with pertinent information. (AR 2147-48.) In other words, if an ad is not aimed at obtaining business for a specific insurer, it is institutional advertising; ***and***, if an ad does not provide consumers with pertinent information about the insurer's product, it is also institutional advertising.

[30] See also *Hoitt v. Dept. of Rehabilitation* (2012) 207 Cal.App.4th 513, 523 [applying same rules of statutory construction to courts' interpretation of regulations].)

In contrast, Mercury and the Trades claim that "institutional advertising" only includes advertising that falls within both of the two categories specified in the regulation. (Mercury OB 32; Trades OB 61.) In other words, under Mercury's and the Trades' construction, for advertising to be considered as non-institutional advertising, it is sufficient if it is either (1) "aimed at obtaining business for a specific insurer" ***or*** (2) provides "consumers with information pertinent to the decision whether to buy the insurers product."

The Commissioner rejected this argument, explaining:

> Contrary to Mercury's assertion, the ordinary and usual usage of 'and' is as a conjunctive, meaning "also" or "plus." It is the function of the word "or" to mark an alternative such as "either this or that." Thus, advertising which fails to provide consumers with information pertinent to an insurer's product is also properly considered institutional advertising regardless of whether it is aimed at a specific insurer.

(AR 2148; see also JA 11:2841.)

Under Mercury's and the Trades' flawed construction, if the advertising mentioned a specific insurer but did not provide any pertinent information about the insurer's product (such as plastering a "Mercury Casualty Company" logo on tennis stadium) it would *not* be considered "institutional advertising." The Commissioner found that this interpretation of the regulation "is both narrow and impracticable, and would render all advertising expenditures chargeable to the ratepayer; a fact Mercury concedes [citing AR 4117:21-25]." (AR 2142.)

<u>2. The Commissioner's Interpretation of "Institutional Advertising" is Consistent with the Purpose and Intent of Section 1861.05 and the Regulations.</u>

The Commissioner's interpretation carries out the purpose of section 1861.05, which is to prohibit excessive rates, and the intent of the efficiency standard and excluded expense provisions of the Regulatory

Formula, which is to prevent insurers from passing on expenses to consumers that are not incurred for the benefit of consumers or related to the reasonable costs of providing insurance and good service.

The efficiency standard limits the expenses insurers may include in the rate calculation to those "cost[s] for a reasonably efficient insurer to provide insurance and to render good service to its customers." (10 CCR § 2644.12.) In response to insurance industry comments in two rulemaking proceedings adopting and amending the Prior Approval Regulations, the Commissioner explained the purpose of this cost limitation:

> ***[I]nsurers may only pass on reasonable expenses to insurance consumers***. The efficiency standard complies with this requirement. [¶] Because insurance tends to be a cost-plus business, insurers have little incentive to avoid expenses that they can pass through to consumers. It is impossible for a regulatory agency to regulate price if one allows management complete freedom to spend money arbitrarily and excessively. ***Proposition 103 requires effective regulation of price***. There is no constitutional right to protection of inefficiency.

(JA 8:2530, 8:2539, emphasis added.)

Explaining the purpose underlying the excluded expense regulation, the Commissioner stated, "[t]he experience of the Department has shown that some costs []are inherently unreasonable, do not benefit the consumers, and therefore should not be borne by them"; "were incurred in the process of seeking to advance the insurer's interests, often at the expense of the ratepayer [and] should be borne by the intended beneficiaries, the shareholders"; or "are not related to 'transfer of risk' and thus to exclude those items is in accordance with [general actuarial principles]." (JA 8:2533.)

The Commissioner further explained:

> The Commissioner has relied on the principles familiar to utility ratemakers, who permit the company to pass through

> to customers only those costs that are reasonably incurred for the benefit of customers. Costs incurred for the benefit of insurer's shareholders and costs imprudently incurred are excluded for ratemaking purpose. Cases such as the California Supreme Court case, *Pacific Telephone and Telegraph Company v. Public Utilities Commission* (1965) 62 Cal. 2d 634 support this position.

(*Ibid.*)

In sum: "There is no requirement anywhere in the law that all costs associated with the insurance enterprise be recognized in the ratemaking formula. Only the *reasonable* cost of providing insurance need be taken into account." (JA 8:2539.)

The Commissioner's interpretation of section 2644.10(f) carries out this purpose – as discussed in the rulemaking record – by ensuring that only those advertising expenses are reasonably incurred for the benefit of consumers – i.e., that are aimed at providing business for the "specific insurer" *and* that provide consumers pertinent information about the insurer's product – are included in the rate calculation.

B. The Commissioner's Interpretation of "Specific Insurer" is Consistent with the Regulation's Plain Meaning and Intent.

The Commissioner found that Mercury's advertisements were "not aimed at obtaining business for a specific insurer" because, as acknowledged by Mercury's own witness, "all of Mercury's advertising is designed for [Mercury Insurance Group] and not for a specific affiliate or company within Mercury." (AR 2142.) The Superior Court correctly upheld the Commissioner's determination as consistent with the regulation's meaning and intent. (JA 11:2841-43.)

1. The Commissioner's Interpretation of "Specific Insurer" Is Correct Based on the Plain Meaning of that Term.

The Commissioner interpreted "specific insurer" to mean an individual insurance company, here Mercury Casualty Company, and not the fictitious "Mercury Insurance Group." (AR 2142-43.) "Mercury Insurance Group is not a legal entity" nor a licensed insurer in California and "includes all 22 legal entities that make up the consolidated Mercury General Corporation." (AR 2143.) Appellant Mercury Casualty Company is but one of the 22 legal entities under the umbrella of Mercury General Corporation.

Contrary to the plain text of the regulation, Mercury and the Trades urge the Court to interpret "specific insurer" to mean a group of affiliated insurers. (Mercury OB 35-39; Trades OB 59-60.) As the Commissioner's Decision states, however, "[h]ad the Commissioner intended to charge consumers for affiliate or group advertising, he could have eliminated the reference to 'a specific' insurer." (AR 2144.)

Mercury and the Trades second-guess the logic behind the plain language of the regulation. The Trades claim there is some sort of "mismatch" between the efficiency standard, which is calculated on a groupwide basis, and the exclusion of institutional advertising expenses for a "specific insurer." (Trades OB 60.) Mercury cites to Insurance Code section 1861.16, which uses the language "one or more insurers." (Mercury OB 38.) These examples only serve to underscore that had the Commissioner intended "specific insurer" to mean "insurance group," he would have written the regulation that way. For example, subdivision (b) of section 2644.10 requires insurers to exclude excessive compensation paid to "the insurer's five highest-paid policymaking positions in each ***insurance group***." (Emphasis added.) The use of "specific insurer" and "insurance group" in different subdivisions of section 2644.10 raises a compelling inference that the terms were intended to have different meanings, and thus supports the Commissioner's construction here. (See *People v. Childs* (2013) 220 Cal.App.4th 1079, 1102 ["When different words are used in adjoining subdivisions of a statute that were enacted at the same time, that fact raises a compelling inference that a different meaning was intended"].)

<u>2. The Commissioner's Interpretation of "Specific Insurer" Is Consistent With the Underlying Purposes of Proposition 103 and the Regulation.</u>

Because "specific insurer" "evinces an unmistakable plain meaning," the Court "need not go further." (*In re C.H.*, *supra*, 53 Cal.4th at 100.) Nevertheless, if there were any ambiguity, the underlying purpose of Proposition 103 and intent of section 2644.10 evidenced in the rulemaking record fully support the Commissioner's interpretation.

Mercury claims that the Commissioner's interpretation of "specific insurer" will lead to excessive rates. (Mercury OB 38.) The opposite is true. If "specific insurer" was interpreted as Mercury suggests, expenses for group advertising would be included in the rate calculation, meaning rates would increase and consumers would have to pay more for insurance. The Commissioner's interpretation results in lower rates for consumers, and thus is consistent with Proposition 103's purposes "to protect insurances from arbitrary insurance rates" and "to ensure that insurance is fair, available, and affordable for all Californians." (See *Donabedian v. Mercury Ins. Co.*, *supra*, 116 Cal.App.4th 968, 977.)

Mercury and the Trades claim that the regulation "penalizes" an insurer for engaging in group advertising (Mercury OB 38; Trades OB 63), but this "argument again disregards the intent of the [r]egulation." (AR 2146.) As the Commissioner explained, "[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" and "Mercury cannot require its [MCC] policyholders to fund its advertising for other Mercury companies…that does not benefit them in any fairly discernable and direct way." (AR 2144-45; see also AR 2146-47.) Moreover, the Commissioner noted that other large insurers have managed to remain competitive despite removing substantial group advertising expenditures from their rates under the regulation. (AR 2147.)

Mercury's reliance on *Golden v. City of Oakland* (1975) 49 Cal.App.3d 284 is misplaced. (See OB 37.) There, the appellate court's finding that the literal interpretation of an ordinance would lead to "absurd consequences" meant it was proper for the trial court to turn to extrinsic aids to ascertain the intent of the ordinance. (*Golden*, *supra*, 49 Cal.App.3d at 291.) Here, ***Mercury and the Trades fail to cite any extrinsic evidence*** in support of their interpretation of "specific insurer" to mean "group of affiliated insurers," which is directly at odds with the plain language, rulemaking record, and regulatory scheme of section 2644.10(f). There is simply no support for Mercury's and the Trades' interpretation.

As the Superior Court aptly noted in upholding the Commissioner's interpretation: "Mercury's arguments reduce to a dispute that its interpretation of the regulation is more reasonable than that of the Commissioner. However, the fact that another interpretation of the regulation may exist is not enough to show that the Commissioner's interpretation is incorrect or unreasonable." (JA 11:2843.)

C. The Commissioner's Finding that Mercury's Advertising Was Devoid of Pertinent Product Information is Supported by the Weight of the Evidence.

While Mercury claimed all of its advertising provides consumers with pertinent information, the Commissioner correctly found that "Mercury's sports sponsorship advertising demonstrates quite the opposite." (AR 2148.) As the Commissioner noted:

> Mercury's advertising includes the display of Mercury Insurance Group's logo on the sides of hockey rinks and baseball stadiums. The display of Mercury's logo does not provide consumers with pertinent information. Likewise sponsorship of a professional tennis tournament does not

> provide consumers product information. Indeed, Mercury acknowledges that such advertising creates "brand awareness." While Mercury may provide informational materials to some sports patrons, the advertising campaign is primarily designed to enhance Mercury's corporate image, and thus must be excluded.

(AR 2148.)

Moreover, the "600 hundred pages of print and television advertisements" Mercury references (Mercury OB 39) did not provide pertinent information about any Mercury Casualty Company product. (AR 7043-7629.)

Even if some ads could have been interpreted as providing consumers with pertinent information about a Mercury product, the burden was on Mercury to provide evidence of the amount it expended on such ads. (See 10 CCR § 2646.5.) The ALJ specifically requested such a breakdown. (AR 1135.) In responding to the ALJ's request, Mercury did not provide the ALJ with an amount it expended on those ads it claimed provided pertinent information. (Exh. 67 [filed under seal]; see AR 2832:22-26.) Mercury stated only that it had not engaged in any institutional advertising at all. (AR 2833:8-9.) Accordingly, on this record, because Mercury failed to provide any evidence of the cost of the ads it claimed provided pertinent information, it was entirely proper for the Commissioner to reflect all of Mercury's advertising expenses for the relevant years in the excluded expense calculation. (AR 2148.)

D. The Superior Court Properly Dismissed the Trades' Facial Challenge Under the First Amendment.

The Trades alone challenge the Superior Court's holding that section 2644.10(f) does not violate the First Amendment under the intermediate scrutiny standard for commercial speech (JA 12:3227-29). First, they claim without explanation that section 2644.10(f) "attaches a financial penalty to speech based on content" (Trades OB 64). They next claim that at least some advertising that falls within the scope of section 2644.10(f) must be *non*commercial speech subject to strict scutiny under the First Amendment. Finally, they claim that even if section 2644.10(f) regulated only commerical speech, it fails to meet the standard for intermediate scrutiny. Each of these arguments is without merit.

1. Section 2644.10(f) Does Not Implicate the First Amendment.

The Trades assert, without citing to any legal authority, that section 2644.10(f) "chills speech" because it "attaches a financial penalty to speech based on content." (Trades OB 63-64.)[31] Far from placing any financial burden on speech, however, the regulation allows insurers to freely engage in any type of advertising they wish; it merely precludes insurers from including all their advertising expenditures in the calculation of the reasonable rates they are allowed to charge their policyholders.[32] Thus, the Superior Court properly found "the Trades furnish no evidence of any financial or economic burden…or that the regulation has chilled insurers' speech." (JA 12:3231.)

This regulatory power to limit costs that can be included in policyholders' rates and disallow certain categories of expenditures unrelated to the cost of providing insurance, such as political contributions

[31] In their briefing below (JA 6:1397-98), the Trades cited inapposite cases striking down laws that "*confiscat[e] income* from speech based on content." (*Keenan v. Superior Court of Los Angeles County* (2002) 27 Cal.4th 413, 427-428, emphasis added.) Section 2644.10(f), however, does not confiscate any income from speech. Rather, the regulation merely requires that when insurers choose to *spend money* on advertising that is devoid of a specific insurer's product information, they cannot reasonably pass those expenses on to policyholders.

[32] The total excluded expense factor (reduction to the efficiency standard) applied to Mercury for both political contributions and lobbying costs and institutional advertising combined was 1.30%. (AR 2149) Of this, excluded advertising expenses accounted for 1.04%. (AR 2175.4, 8647 [Appendix 4].) The difference in the overall rate from reducing the expense ratio by 1.04% is minimal and can hardly be considered a "financial penalty."

and lobbying and institutional advertising, is beyond dispute. Our Supreme Court expressly upheld the Commissioner's broad authority to do so. (*20th Century*, *supra*, 8 Cal.4th at 289 ["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"].) Indeed, high courts in other states have upheld similar regulations excluding institutional advertising expenses because they "do[] not ban any speech; [they] only reasonably require[] that the cost of certain advertising not be passed on to . . . the ratepayers." (*El Paso Elec. Co. v. New Mexico Public Service Com.* (1985) 103 N.M. 300, 304; see also *Appeal of Concord Natural Gas Corp.* (1981) 121 N.H. 685, 693; *Rochester Gas and Elec. Corp. v. Public Service Com. of the State of N.Y.* (1980) 51 N.Y.2d 823, 825.)

Certainly, if the Trades are correct and consumers might want to buy insurers' products because of their advertising "campaign against cell phone use while driving" (Trades OB 69), then those insurers can freely engage in such advertising to attract more policyholders and generate more premium income. Section 2644.10(f) does not disturb their constitutional right to do so.

<u>2. Even Assuming Section 2644.10(f) Implicates the First Amendment, Which it Does Not, the Trial Court Correctly Held that it Survives Intermediate Scrutiny.</u>

Skipping over any analysis of their bald assertion that the regulation penalizes speech, the Trades claim a) that some institutional ads might be noncommercial speech requiring a strict scrutiny analysis; and b) the regulation does not meet the intermediate scrutiny standard for commercial speech. (Trades OB 64-69.) Both of these arguments fail.

"Commercial speech" is "expression related solely to the economic interests of the speaker and its audience." (*Central Hudson Gas & Elec.*

Corp. v. Public Service Com. of New York (*Central Hudson*) (1980) 447 U.S. 557, 561.)

Speech in the format of advertising[33] is easily classified as commercial speech when it is done with an "economic motivation" and it contains "product references." (*Kasky v. Nike, Inc.* (2002) 27 Cal.4th 939, 957-958, citing *Bolger v. Youngs Drug Products Corp.* (1983) 463 U.S. 60, 66-67.) "Product references" include not just statements related to "individual items offered for sale," but also statements related to "***the identity or qualifications of persons who*** manufacture, distribute, ***sell***, service, or endorse ***the product***." (*Id.* at 961, emphasis added.) The California Supreme Court explained that "[t]his broad definition of 'product references' is necessary, we think, to adequately categorize statements made in the context of a modern, sophisticated public relations campaign intended to increase sales and profits by enhancing the image of a product or of its manufacturer or seller." (*Id.* at 961-962.)

"Institutional advertising," such as Mercury's promotion of its logo at tennis tournaments and other sporting events, is easily classified as commercial speech under these standards. (See *Friedman v. Rogers* (1979) 440 U.S. 1, 11 [classifying business trade names as commercial speech]; see also *Jordan v. Jewel Food Stores, Inc.* (7th Cir. 2014) 743 F.3d 509, 517-520 [finding institutional advertisement "no less 'commercial' because it promotes brand awareness…rather than explicitly proposing a transaction in a specific product or service"].) As discussed above and explained at length in the Commissioner's Decision, Mercury engages in institutional advertising campaigns to enhance its image, and it does so to "cause consumers to purchase insurance from Mercury." (Mercury OB 31.) That some institutional advertising might also include messages about a "worthy

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[33] Under the regulation, "institutional advertising" is defined as "advertising" in the first instance. (10 CCR § 2644.10(f).)

cause" does not, as the Trades contend, make it "less likely" that it is commercial speech. (Trades OB 66.)[34] To the contrary, both the U.S. and California Supreme Court have held that expressions related to public issues may "constitute commercial speech notwithstanding the fact that they contain discussions of important public issues[.]" (*Bolger*, *supra*, 463 U.S. at 67-68; *Kasky*, *supra*, 27 Cal.4th at 965.) Thus, institutional advertising as defined by section 2644.10(f) is properly categorized as commercial speech, which is subject to an intermediate scrutiny standard. (See *Kasky*, *supra*, 27 Cal.4th at 952.)

Under intermediate scrutiny, a regulation must "directly advance[]" a "substantial state interest" in a way that is a "reasonable fit" with that interest. (*Board of Trustees of State Univ. of New York v. Fox* (1989) 492 U.S. 469, 475, 478, 480.) Here, as the Trades concede, the Commissioner clearly has an interest in prohibiting excessive rates under section 1861.05 by making sure "that only the 'reasonable cost of providing insurance' is included in the rates" (Trades OB 68). This interest is substantial given that the voters' very purpose in enacting Proposition 103 was to ensure that insurance rates are affordable and not arbitrary (see *Mercury Ins. Co. v. Donabedian*, *supra*, 116 Cal.App.4th at 977).

In claiming that the regulation does not directly advance this substantial interest, the Trades rely on an inapposite case that held an *outright ban* on advertising was not justified by the regulator's interest in rate regulation because "the link between the advertising prohibition and appellant's rate structure [wa]s, at most, tenuous." (*Central Hudson*, *supra*,

[34] Moreover, the Trades' contention that determining whether a specific institutional ad is commercial or non-commercial speech requires "a case-by-case" analysis further undercuts their argument that section 2644.10(f) *facially* violates the First Amendment.

447 U.S. at 569.)[35] Here, however, the link between the regulation's exclusion of institutional advertising costs and the Commissioner's interest in preventing excessive rates could not be more direct: the expense exclusion directly lowers policyholders' rates by reducing the efficiency standard used in the ratemaking calculation. (See 10 CCR § 2644.10(g).) Likewise, section 2644.10(f) is a "reasonable fit" for the Commissioner's interest as it reasonably ensures that consumers do not pay for advertising unrelated to the cost of providing insurance that does not provide them any benefit. Under the regulation, insurers remain free to fund "a campaign against cell phone use while driving" (Trades OB 69), but policyholders are not forced to pay higher premiums to cover the cost of such an ad campaign.

Accordingly, the Superior Court properly dismissed the Trades' First Amendment challenge.

CONCLUSION

For all the foregoing reasons, Consumer Watchdog respectfully requests that this Court affirm the Superior Court's judgment dismissing Mercury and the Trades' claims and upholding the Commissioner's February 2013 Order and Decision in accordance with all regulatory and constitutional standards.

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[35] Unlike the regulation in *Central Hudson*, section 2644.10(f) does not *ban* any type of advertising.

Dated: March 31, 2016

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CERTIFICATE OF WORD COUNT

(Cal. Rules of Court, rule 8.204(c)(1))

The text of this brief, including footnotes, consists of 13,969 words as counted by the word-processing program used to generate the document.

Dated: March 31, 2016

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PROOF OF SERVICE

I, Maritza Arizaga, declare:

I am employed in the County of Los Angeles, State of California. I am over the age of 18 and not a party to the within action. My business address is: Consumer Watchdog, 2701 Ocean Park Blvd., Suite 112, Santa Monica, California 90405.

On March 31, 2016, I served the foregoing document:
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I declare under penalty of perjury under the laws of the State of California that the above is true and correct. Executed at Santa Monica, California on March 31, 2016.

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