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SUPERIOR COURT OF THE STATE OF CALIFORNIA

FOR THE COUNTY OF SACRAMENTO

MERCURY CASUALTY COMPANY, Petitioner and Plaintiff, v. DAVE JONES, IN HIS OFFICIAL CAPACITY AS THE INSURANCE COMMISSIONER OF THE STATE OF CALIFORNIA, Respondent and Defendant.	Case No. 34-2013-80001426 Hon. Shellyanne W.L. Chang, Dept. 24 **RESPONSE TO INSURANCE COMMISSIONER'S MOTION FOR JUDGMENT ON THE PLEADINGS**
CONSUMER WATCHDOG, Intervenor.	Date: March 28, 2014 Time: 10:00 a.m. Dept.: 24
PERSONAL INSURANCE FEDERATION OF CALIFORNIA, et al., Intervenors.	Action Filed: March 1, 2013

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I. SUMMARY OF ARGUMENT

The case before this Court presents an issue of continuing importance which impacts every insurer subject to "Proposition 103" rate regulation in California. The Court's decision here will reach beyond Petitioner Mercury Casualty Company ("Mercury") and the precise facts of Mercury's specific rate application. It will determine the standards applied to every insurer in diverse circumstances, and inform the Commissioner's application of each of the rate regulations. For this reason, the Trades[1] submit this response to the Commissioner's Motion for Judgment on the Pleadings, to underscore that the importance of the issues presented – and their recurring nature – counsels that the Court entertain Mercury's Petition for Writ of Mandamus, even if the Court determines that the Mercury writ petition is moot.[2]

Mercury includes in its Verified Petition for Writ of Mandate And Complaint for Declaratory Relief and Injunctive Relief ("Petition") several issues of regulatory construction and application arising from the Insurance Commissioner's February 11, 2013 Order Adopting

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[1] The "Trades" include intervenors Personal Insurance Federation of California ("PIFC"), American Insurance Association ("AIA"), Property Casualty Insurers Association of America ("PCIAA") (doing business in California as Association of California Insurance Companies or "ACIC"), National Association of Mutual Insurance Companies ("NAMIC"), and Pacific Association of Domestic Insurance Companies ("PADIC").

[2] The Insurance Commissioner's Motion for Judgment on the Pleadings is addressed only to Mercury's writ petition. It is not addressed to the counts within the Trades' Complaint in Intervention sounding in mandate. The Trades' mandate counts are addressed to issues of law, clearly not resolved by a settlement, which is inherently a compromise not affecting the Commissioner's Opinion stating his legal interpretations and positions. As intervenors, the Trades have independent standing to pursue their own claims, which do not simply stand or fall with Mercury's claims. *See, e.g., Deutschmann v. Sears, Roebuck, & Co.*, 132 Cal. App. 3d 912, 916 (1982) ("An intervener becomes an actual party to the suit by virtue of the order authorizing him to intervene."); *see also W. Heritage Ins. Co. v. Superior Court*, 199 Cal. App. 4th 1196, 1207 (2011) ("A party permitted to intervene is permitted to do so in order to pursue its *own interests*. Once permitted to intervene, it is a party to the action not bound by other parties' procedural [issues].") (emphasis in original). And the Trades' Petition is more than able to stand on its own given the well-settled law that a regulated entity may seek a judicial declaration as to the correctness of an interpretation of law asserted by the regulating agency. *Walker v. County of Los Angeles*, 55 Cal. 2d 626, 636-37 (1961); *Redwood Coast Watersheds Alliance v. State Bd. of Forestry & Fire Protection*, 70 Cal. App. 4th 962, 970 (1999); *Hayward Area Planning Ass'n v. Alameda County Transp. Auth.*, 72 Cal. App. 4th 95, 103 (1999); *Alameda Cnty. Land Use Ass'n v. City of Hayward*, 38 Cal. App. 4th 1716, 1723-24 (1995); *Gilb v. Chiang*, 186 Cal. App. 4th 444, 458 (2010).

Proposed Decision in *In the Matter of the Rate Application of Mercury Casualty Company*, CDI File No. PA-2009-00009 (the "Opinion" or the "Commissioner's Opinion"). Central to each of those issues is the constitutional limit on the state's power to regulate price, described generally as protection from "confiscation."[3] The scope of this constitutional protection is presented directly by Mercury's request that this Court review and correct the Commissioner's misapplication of "the implied constitutional variance" created by the California Supreme Court in *20th Century Ins. Co. v. Garamendi*, 8 Cal. 4th 216 (1994) and codified in 10 C.C.R. § 2644.27(f)(9). Petition ¶¶ 75-88. More fundamentally, it is the foundation on which the regulatory formula is built, as the Commissioner stressed in adopting the current rate regulations.

At the time the regulations were adopted, the Commissioner accepted "the fair return principle"[4] – described by the Commissioner as "an opportunity to earn a fair and reasonable rate of return"[5] – as that foundation. In the Opinion, the Commissioner expressly renounces the fair return principle. In its place, the Commissioner sets up an illusory standard for constitutional protection, requiring that a rate order must produce financial distress for its impact to constitute confiscation. Moreover, that financial distress must be of such a nature that it is felt by "the

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[3] California Supreme Court opinions have generally viewed "confiscation" protections as derived from both the due process and takings provisions of the federal and state constitutions, describing the line between due process and takings analyses in this context as "blur[red]." *See Kavanau v. Santa Monica Rent Control Bd.*, 16 Cal. 4th 761, 771, 773-77 (1997). This was an apt reading of U.S. Supreme Court authority at the time of the California Supreme Court jurisprudence. Since that time, in 2005, the high court decided *Lingle v. Chevron U.S.A. Inc.*, 544 U.S. 528 (2005). While *Lingle v. Chevron* was not a confiscation case, the Court's analysis of the takings clause, and distinction between the takings and due process clauses, suggests that there should be a focus on whether the question in the case at bar is whether or not the state can exercise the police power to the extent that it has (due process), versus whether the state has in fact accomplished a "taking," such that it must pay for property "taken," albeit pursuant to a legitimate power. The Trades' brief in support of its petition for writ of mandate discusses this issue at Part II.A.2. *See also* U.S. Const. amend. V; U.S. Const. amend. XIV § 1 (making Fifth Amendment applicable to the states through the privileges and immunities clause); Cal. Const. art. I § 19.

[4] *Kavanau*, 16 Cal. 4th at 773; *see also id.* at 771-72 (describing "the fair return principle") (citing *20th Century* and *Calfarm Ins. Co. v. Deukmejian*, 48 Cal. 3d 805, 816 (1989)).

[5] *See* Ex. 1 to Request for Judicial Notice and Declaration of Vanessa Wells ("RJN"), (*Summary of and Response to Public Comment Received Prior To September 13, 2006 Public Comment Deadline* at 128).

insurer's enterprise as a whole" (Opinion at 113). While it is not clear what "the insurer's enterprise as a whole" means, the Opinion subsequently states that "Mercury Casualty as a whole" must experience financial distress as a result of the rate order (Opinion at 122). Finally, the Order requires that in attempting to meet this financial distress standard the insurer is bound to the default assumptions contained in the regulations and cannot present individualized evidence establishing that the default assumptions result in a confiscatory rate in the insurer's individual case. That is, the "end result" of the formula is tested against the formula's end result: in its application the standard is a pure tautology.

This illusory standard affords no protection against confiscation through price regulation for insurers writing insurance in California. What is more, it changes the interpretive framework for the entire regulatory scheme. An "opportunity to earn a fair and reasonable rate of return" drives a different notion of reasonableness than the financial distress standard. What is reasonable or "most actuarially sound" drives each regulatory selection in the rate formula, and each decision as to whether an applicant may be allowed a variance. Thus, the continued viability of the core "fair return principle" – expressly at issue here – impacts all insurers' rights under the current regulatory structure.

The Commissioner's Opinion includes an additional error of law with substantial impact, in its incorrect construction of the regulation describing expenses excluded from the rate calculation. One such excluded expense is the expense associated with "institutional advertising," 10 C.C.R. § 2644.10(f). The Opinion recites a common understanding of "institutional advertising" versus "product advertising," then abandons that common understanding in its construction of the regulation. The Opinion's tortured construction of an awkwardly worded regulation would label virtually all advertising as "institutional advertising," when it plainly is not. Because of the way the excluded expense factor operates within the formula, labeling typical product advertising expense as excluded "institutional advertising" expense can drive the ultimate rate indicated by the regulatory formula down by several percentage points. The Opinion's construction of the regulation is wrong on the face of the regulation, unsupported in the record, and, at bottom, an unconstitutional, content-based burden

on protected commercial speech.

The settlement of Mercury's subsequent rate application does not affect the Opinion's rulings on the interpretation and application of the Commissioner's rate regulations, and the critical questions of constitutional law outlined here. A settlement is a compromise. A compromise, inherently, reflects an intent to resolve the issue at hand without impact to the parties' positions. Thus, nothing about the settlement impacts the Commissioner's Opinion, which remains the current statement of the Commissioner's interpretation of constitutional law and the rate regulations applied in every case.

The Trades leave to Mercury the question of whether its petition for writ of mandate is or is not moot. The Trades submit this response to underscore that, whether or not the Commissioner is technically correct, this is indisputably the class of case presenting recurring issues of statewide importance appropriate for review.

II. THE COURT SHOULD CONSIDER THE CONTINUING QUESTIONS OF GREAT IMPORTANCE PRESENTED IN MERCURY'S PETITION

A. The Law Recognizes A Well-Settled Exception To The "Mootness" Doctrine For Recurring Questions of Great Importance

It is well-settled that there exists an exception to a "mootness" dismissal for important public interest issues that are likely to recur. *Gilb v. Chiang*, 186 Cal. App. 4th at 460 ("Even if the[] [issues] were moot, we would decide them under the mootness exception for public interest issues. Thus, 'if a pending case poses an issue of broad public interest that is likely to recur, the court may exercise an inherent discretion to resolve that issue even though an event occurring during its pendency would normally render the matter moot.'") (citing *Edelstein v. City and County of San Francisco*, 29 Cal. 4th 164, 172 (2002)); *MacKay v. Superior Court*, 188 Cal. App. 4th 1427, 1451 n.21 (2010) ("This court has been advised by written communications from the parties, each dated September 29, 2010, that a tentative 'settlement' of this class action has been negotiated. We have nonetheless determined to exercise our discretion to retain jurisdiction and file our decision in this matter . . . [because] . . . the issues presented by these consolidated writ petitions and addressed in this opinion are of major importance to both insurers and policy holders in California and are clearly of continuing public interest and are likely to recur.") (citing

People v. Eubanks, 14 Cal. 4th 580, 584 n.2 (1996)); *DuBarry Int'l, Inc. v. Sw. Forest Indust., Inc.*, 231 Cal. App. 3d 552, 556 n.2 (1991) ("[T]he parties informed us that they had reached a settlement in this matter and jointly sought this court's consent to an order dismissing the appeal. Although such a stipulation might ordinarily end the matter, we nevertheless, in this case, have determined that the appeal should go forward. Apart from its discretionary authority under California Rules of Court, rule 19(b), a reviewing court has inherent discretion to resolve issues of continuing public interest, even though those issues may have become moot in the particular case before it."). Given the recurring, important questions of law presented in Mercury's (and the Trades') Petition(s), this Court can and should resolve these significant issues, even if it determines that Mercury's Petition is moot.

B. The Confiscation Issues Presented Herein

1. The history of the formula and the "implied constitutional variance."

Some history is helpful in understanding the nature and overwhelming importance of the constitutional issues presented here by Mercury's (and the Trades') Petition(s).

The voters enacted "Proposition 103" in November, 1988. Proposition 103, primarily, regulates rates and premiums for most insurance in California. *See generally* Insurance Code Div. 1 Part 2 Chapter 9 Article 10 Section 1861.01 *et seq*. Proposition 103 included two phases. The first phase went into effect immediately and for one year, requiring insurers to "roll back" rates to 80% of 1987 rates. Ins. Code § 1861.01(a). This "roll back" phase applied, essentially, to 1989. The second phase went into effect one year after passage of Proposition 103 (i.e., in 1990), and required that insurers obtain the Commissioner's prior approval before implementing any new rate. Ins. Code § 1861.01(c).

Seven insurance companies and a trade group petitioned the California Supreme Court for relief from the "rollback" provision of Proposition 103 immediately upon adoption of the initiative. *See Calfarm Ins.*, 48 Cal. 3d at 812, 814. The petitioners contended, among other things, that the mandatory rollback rate for 1989 (80% of 1987 rates) presented a substantial risk of confiscation, and that the alleged provision for relief – allowing relief only if the insurer was "threatened with insolvency" as a result of the rollback rate (Ins. Code § 1861.01(b)) – did not

afford sufficient relief to render the rollback constitutional.

In large part, the California Supreme Court agreed. It held that "[t]he risk that the rate set by the statute is confiscatory as to some insurers from its inception is high enough to require an adequate method for obtaining individualized relief." *Calfarm*, 48 Cal. 3d at 820. Further, the Court held that the "threatened with insolvency" standard included within the initiative was constitutionally defective:

> The insolvency standard of subdivision (b) refers to the financial position of the company as a whole, not merely to the regulated lines of insurance. [footnote omitted] Many insurers do substantial business outside of California, or in lines of insurance within this state which are not regulated by Proposition 103. If an insurer had substantial net worth, or significant income from sources unregulated by Proposition 103, it might be able to sustain substantial and continuing losses on regulated insurance without the danger of insolvency. In such a case, the continued solvency of the insurer could not suffice to demonstrate that the regulated rate constitutes a fair return.

Id. at 818-19. Based on this analysis, the Court concluded that the "threatened with insolvency" standard was unconstitutional because it was not sufficient to protect "safely solvent" insurers from confiscation, i.e., the denial of the opportunity to earn a fair return. *Id.* at 819.

The Court then effectively re-drew the "rollback" phase of Proposition 103 rate regulation, turning it into a rebate rather than a prospective rate, based, however, on a post-period analysis of the minimum non-confiscatory rate for the "rollback" period. The Court announced that insurers were permitted to file for and charge the rate they believed appropriate for the one year rollback period, subject to a requirement that the insurer pay a "rollback refund" if it were later determined that the insurer had charged a rate higher than the minimum non-confiscatory rate during 1989. *Calfarm*, 48 Cal. 3d at 825.

Ultimately, the Commissioner developed a regulatory formula intended to determine the minimum non-confiscatory rate. The regulatory formula made gross assumptions and included "plug in" numbers based on industry averages. The regulations, however, allowed "variances" from the rate set by the regulatory formula. The regulations included a further formula to determine whether or not the insurer owed a rollback refund based on a comparison of the rates actually charged during the rollback period and the minimum non-confiscatory rates, which was to be calculated and paid out on a gross, all-lines basis. *See* 10 C.C.R. § 2645.9.

In *20th Century v. Garamendi*, the California Supreme Court considered a challenge to the regulatory formula brought by 20th Century and industry supporters, five years after the rollback was supposed to have been accomplished. The California Supreme Court upheld the regulatory system as constitutionally adequate, because the regulatory system allowed "variances" from the result produced by the formula to allow sufficient flexibility to take into account situations in which the regulatory formula might produce a confiscatory result. *20th Century*, 8 Cal. 4th at 298, 309, 311-13 (repeatedly holding that any tendency of the regulations to produce a confiscatory rate could be avoided by application of the variances, including the "separate and independent constitutionally mandated 'variance'").

The key "variance" by which the California Supreme Court achieved this result was not actually in the regulations. Rather, the Court recognized an implied "constitutional variance" that would allow insurers the opportunity to present evidence that the formula would create a confiscatory result as it operated in a particular case. *Id.* at 313. As interpreted by the Court, if the formula would produce a confiscatory result for whatever reason, that result could be adjusted under the implied "constitutional variance." That is to say, an unconstitutional result could be avoided, because the result of the methodology would always be reviewable under the implied constitutional variance.

In *20th Century*, the California Supreme Court expressly applied U.S. constitutional law in defining and applying the confiscation standard. *See, e.g.*, 8 Cal. 4th at 291-92 (identifying the Fifth and Fourteenth Amendments to the U.S. Constitution as the source for the protection against confiscation). The Supreme Court of the United States has consistently upheld and applied the "fair return principle" as the applicable standard in price control cases. *See, e.g.*, *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 310 (1989) ("[W]hether a particular rate is 'unjust' or 'unreasonable' will depend to some extent on what is a fair rate of return given the risks under a particular rate-setting system, and on the amount of capital upon which the investors are entitled to earn that return.").[6]

[6] As the Opinion attempts to isolate insurance rate cases from other contexts in which the California Supreme Court indisputably applied the "fair return principle," it is worth noting that

2. The current regulations are grounded in "the fair return principle."

The regulations considered in the *20th Century* case were intended to be applicable to both rollbacks and "prior approval" rate regulation, with different temporal-specific components adopted by the Commissioner. The Commissioner, however, never adopted the necessary components for the prior approval phase.

Thus, the Commissioner – recognizing the need for clarity – adopted a new set of regulations effective in April, 2007. The regulations utilized the model approved in *20th Century* consisting of default assumptions subject to variances. The Commissioner took his obligations and the role of the variances seriously, announcing:

> The *20th Century* Court emphasized the importance of variances and stated time and time again that the variances expressly provided for in the regulations are the final mechanism for rate adjustments necessary to avoid confiscation before the final rate determination is made. The Commissioner recognizes the importance of variances and is fully cognizant that the Court in *20th Century* relied on variances as an extremely important protection against confiscation. Both the *Calfarm* and *20th Century* Courts made it clear that the Commissioner has the legal authority to take those steps reasonably necessary to make the job of rate regulation manageable. (*20th Century*, (quoting *Calfarm*), 8 Cal. 4th 216, 245; 32 Cal. Rptr. 807, 824.) ***The Commissioner is also 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. However, a variance cannot be created for every possible contingency. The Commissioner has determined that variances must be carefully considered, otherwise the exceptions will swallow the rule making meaningful rate regulation impossible. ***And the opposite is also true. The regulations must contain enough of these safety valves to ensure insurers may avoid confiscation.***

See RJN Ex. 1 (*Summary of and Response to Public Comment Received Prior To September 13, 2006 Public Comment Deadline* at 128) (emphasis added). That is, the current regulatory model incorporates the "fair return principle" as its cornerstone.

3. The Commissioner's Opinion in Mercury's rate case articulates rulings regarding confiscation principles that affect ongoing and future rate applications.

The Commissioner issued his Opinion in Mercury's rate application on February 11, 2013, approximately 18 months after issuing the notice of hearing on the rate application. The

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Texas has also applied the fair rate of return standard in the insurance rate regulation context. *See Geeslin v. State Farm Lloyds*, 255 S.W.3d 786, 795 (Tex. App. 2008) ("A rate that does not allow for a reasonable rate of return is confiscatory and unconstitutional;" holding Texas scheme unconstitutional).

Order requires Mercury to reduce its overall homeowner's insurance rate by approximately 5%, in response to Mercury's application for a 3.9% increase. Petition ¶¶ 2, 15.

The Commissioner's Opinion holds that an insurer does not have a right to the opportunity to earn a fair rate of return on its investment in a regulated line of insurance in California. Opinion at 123-26. The Commissioner's Opinion holds that an insurer gains constitutional protection only if it can prove that a rate order (which, by definition, is directed to a single line of insurance within California) will cause financial distress to the entire company nationwide. Opinion at 118.

The Opinion, in this regard, is inconsistent with a century of constitutional jurisprudence, and is wrong as a matter of law. Certainly, the courts allow regulatory agencies their proper quasi-legislative scope to assess and resolve technical questions pertinent to pricing in a particular context. But it is and always has been the judicial prerogative to decide questions of law, and to enforce constitutional requirements. *See Yamaha Corp. of Am. v. State Bd. of Equalization*, 19 Cal. 4th 1, 7, 11 (1998); *see also id.* at 16-17 (Mosk, J, concurring); *Bodinson Mfg. Co. v. California Emp't Comm'n*, 17 Cal. 2d 321, 325-26 (1941); *Farmers Ins. Exch. v. Superior Court*, 137 Cal. App. 4th 842, 858-59 (2006).

At bottom here is a fundamental disagreement concerning a regulated entity's rights in the price regulation context. It is the Trades' position (and, we believe, Mercury's) that each regulated entity, whether large or small, whether conservatively capitalized or operating at the margin, is entitled to the same *opportunity to earn a fair rate of return*. The state unquestionably has the power to regulate price, as an aspect of the police power. But that power is limited by the constitutional protection against confiscation. The Commissioner's Opinion stakes out the position that the constitutional protection against confiscation protects only against the threatened financial destruction of a countrywide entity which has invested capital in (in this case) the homeowner's line of insurance in California. The Trades (and, we believe, Mercury), in contrast, believe that an insurer-applicant writing homeowner's insurance in California is entitled to the opportunity to earn a fair return on the capital devoted to that investment.

This issue recurs with, potentially, every rate application submitted. The intent underlying

the regulations is that in most cases any inadequacies in one component of the rating formula will wash out against more generous allowances in other parts of the formula, producing a fair rate of return. That, of course, is desirable. The constitutional concern is that there is always a risk, in any formulaic approach, that the data in a specific case do not fit the formula, and the result does not allow a fair rate of return. Consequently, courts look to whether the controlling statutes (or regulations) provide sufficient accommodation for the uncommon case. *Calfarm*, 48 Cal. 3d at 817-19.

That is the crux of the problem here. The regulations are what they are, and they produce a result. From the Trades' perspective (and, we believe, Mercury's), the system must provide relief from that result if, in the specific case, it does not allow the insurer-applicant the opportunity to earn a fair rate of return on the investment devoted to that line of insurance. *Id.* As described, the Commissioner does not believe the insurer-applicant is entitled to relief unless the entire company of which it is a part is placed in financial distress by the rate order. This is predictably a recurring issue.

Further, the Opinion contains additional errors of law, which not only present other important questions that should be addressed, but also explain why opportunities to correct these errors prove elusive. This is a further reason justifying maintenance of Mercury's petition.

During the course of the Mercury proceeding, the Administrative Law Judge ("ALJ") struck or sustained objections to virtually all of Mercury's evidence submitted in an attempt to prove up the "implied constitutional variance" of 10 C.C.R. § 2644.27(f)(9). This variance is intended to allow an applicant to show that, in a particular case, the formula has not operated to allow the applicant a constitutionally valid rate – i.e., a rate that is not confiscatory. The ALJ's rulings applied the "relitigation bar" of § 2646.4(c), interpreting that bar to preclude *both* Mercury's legal argument regarding the proper constitutional standard (Opinion at 113, 118, 123), *and* Mercury's evidence that would be relevant and admissible to establish that the rate order would be confiscatory *if* Mercury were correct in its legal argument (Opinion at 121-22).

This application of the "relitigation bar" is not only incorrect, it renders the process incapable of allowing for relief from a confiscatory rate. As applied, this process is

unconstitutional in its own right. *See, e.g.*, *Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129, 169 (1976) ("The mechanism [for protecting regulated entities from a confiscatory price control] is sufficient for the required purpose only if it is capable of providing adjustments in maximum rents without a substantially greater incidence and degree of delay than is practically necessary.") (citing *Smith v. Illinois Bell Tel. Co.*, 270 U.S. 587, 591 (1926)); *20th Century*, 8 Cal. 4th at 313 (finding that the existence of "a separate and independent constitutionally mandated 'variance' . . . available to the individual insurer on proof of confiscation . . ." saved the rollback regulations from constitutional invalidity by providing "a variance or variances sufficient to accommodate" proof of confiscation, which was not barred by the "relitigation bar").

Very few insurer-applicants can afford the heavy price tag of a rate hearing. That group narrows further when each applicant can see that it must face not only the rate hearing, but review, reversal, and *another* rate hearing just to get to the point of presenting its evidence that the rate order denies the applicant a fair rate of return. If the Commissioner can block Mercury's petition on the grounds of "mootness" after Mercury has undergone at least 18 months of heavy litigation just to get to the point where it has earned the right to ask the Court to be allowed to put on a case, the Commissioner can perpetually forestall review, and can maintain an unconstitutional scheme by that tactic.

This is exactly why recurring questions of great importance justify judicial review, even if technically "moot."

C. The Institutional Advertising "Expense Exclusion" Presents Recurring Questions of Statewide Importance

One of the substantial contributors to the Mercury rate order was the imposition of an exceptionally large excluded expense factor. This derived significantly from the Commissioner's interpretation and imposition of the regulation calling for exclusion of "institutional advertising" expense, defined in 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 C.C.R § 2644.10(f). After correctly describing the general concept of "institutional advertising" as "'image' advertising which strives to enhance a company's

reputation or improve corporate name recognition" (Opinion at 93), the Opinion incorrectly construes section 2644.10(f) to sweep in virtually all advertising.

At the threshold, the Opinion completely misreads the regulation. Without detailed discussion (already set forth in the Trades' brief in support of the petition for writ of mandate), the impact of the Opinion's interpretation is to effectively designate all advertising as "institutional advertising." The Opinion largely reaches this result by applying an inapt public utility model – a context in which the regulated entities are primarily natural monopolies which do not compete for business. Within that model (as discussed in the Trades' brief in support of their petition for writ of mandate), expenses are sorted into a "shareholder" account and a "ratepayer" account. Advertising expense which is geared to enhancing the image of the utility rather than selling product (an unnecessary act, where the utility is the only game in town) is assigned to the "shareholder" account.

But insurance companies – operating in a competitive environment – are competing for business in a voluntary market. That is the purpose for their advertising. Advertising expense is a reasonable and accepted cost of doing business, and is ***the insurer's*** expense. Plainly, advertising expenses are an element of price. But the price charged is not a mere conduit through which expenses are funneled to "ratepayers" (Order at 97, 101) – if through some exercise unauthorized by Proposition 103 they are deemed "chargeable" to "ratepayers" – any more than a manufacturer's expenses are funneled to "ratepayers" in the price charged for a bottle of aspirin or a box of cornflakes. These expenses are part of the manufacturer's reasonably incurred expenses, and expense affects price, but that does not make any expense considered in pricing the "ratepayers'" expense (versus the shareholders' expense).

Further, the regulation on its face is a content-based regulation that seeks to chill and burden constitutionally protected speech. U.S. Supreme Court law recognizes that imposing a financial burden on speech – based on content – restricts speech as effectively as an outright ban. "A statute is presumptively inconsistent with the First Amendment if it imposes a financial burden on speakers because of the content of their speech." *Simon & Schuster, Inc. v. Members of New York State Crime Victims Bd.*, 502 U.S. 105, 115 (1991). *See also Pitt News v. Pappert*,

379 F.3d 96, 111-12 (3d Cir. 2004) ("The threat to the First Amendment arises from the imposition of financial burdens that may have the effect of influencing or suppressing speech, and whether those burdens take the form of taxes or some other form is unimportant.").

The Mercury petition does not raise the First Amendment issue. The Trades have presented their case that the constitutionality of the institutional advertising expense exclusion is the most critical of the "institutional advertising" questions presented. Nonetheless, it remains important that the regulation is properly interpreted, before its constitutionality is considered.

This question then, likewise, presents a question of recurring statewide importance, which should be considered whatever the resolution of the "mootness" question presented by the Commissioner's motion.

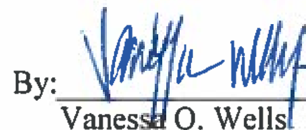
III. CONCLUSION

The case before this Court presents significant constitutional questions of vital concern to all insurers subject to the Proposition 103 rate regulatory system. These questions inherently will recur. Whether or not the Commissioner is correct that the 2013 settlement renders the 2009 rate application underlying the Opinion "moot," the legal questions addressed by the Opinion remain vital. They should be heard, by this Court. The Commissioner's motion should be denied.

Dated: March 17, 2014

Respectfully submitted,

HOGAN LOVELLS US LLP

By: 
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