SUPERIOR COURT OF CALIFORNIA

COUNTY OF SACRAMENTO

DATE/TIME: **JUDGE:**	**May 2, 2014 11:00 a.m.** **HON. SHELLEYANNE W. L. CHANG**	**DEPT. NO.:** **CLERK:**	**24** **E. HIGGINBOTHAM**
MERCURY CASUALTY COMPANY, **Petitioner and Plaintiff,** **vs.** **DAVE JONES, IN HIS OFFICIAL CAPACITY AS THE INSURANCE COMMISSIONER OF THE STATE OF CALIFORNIA,** **Respondent and Defendant.** **CONSUMER WATCHDOG,** **Intervenor.** **PERSONAL INSURANCE FEDERATION OF CALIFORNIA, et al.** **Intervenors.**		**Case No.: 34-2013-80001426**	
Nature of Proceedings:	**Petition for Writ of Mandate and Complaint for Declaratory Relief and Injunctive Relief**		

TENTATIVE RULING

The following is the Court's tentative ruling to Petitioners' Petition for Writ of Mandate, and pertinent claims in Intervenors' Petition for Writ of Mandate, set for hearing in Department 24 on Friday, May 2, 2014, at 11:00 a.m. The tentative ruling shall become the final ruling of the Court, unless a party wishing to be heard so advises the clerk of this Department no later than 4:00 p.m. on the court day preceding the hearing, and further advises the clerk that such party has notified the other side of its intention to appear.

Oral argument, if requested, shall not exceed 20 minutes per party or 40 minutes per side.

Petitioner, Mercury Casualty Company (Petitioner or Mercury) seeks a writ of mandate either setting aside the February 2013 order of Respondent State Insurance Commissioner (Commissioner or Respondent) or granting Mercury its requested rate increase and related declaratory and injunctive relief. Interventor trade associations[1] (the Trades) join Mercury in challenging the Commissioner's decision.

[1] Intervenors are: Personal Insurance Federation of California, American Insurance Association, Property Casualty Insurers Association of America, doing business as Association of California Insurance Companies, National Association of Mutual Insurance Companies, and Pacific Association of Domestic Insurance Companies.

Mercury and the Trades[2] challenge the decision on two bases: (1) the Commissioner's order requiring Mercury to decrease its rates is invalid because it is confiscatory and does not allow Mercury a fair rate of return, and (2) the Commissioner improperly excluded all of Mercury's advertising expenses from the Commissioner's ratemaking calculation.

I. FACTUAL AND PROCEDURAL BACKGROUND

The pertinent facts are largely undisputed.

Pursuant to Proposition 103, the Commissioner must approve property and casualty insurance rates set by an insurer. The parties refer to this rate-setting as the "prior approval" process. (Ins. Code, § 1861.01(c).) On May 15, 2009, Mercury filed an application with the Department of Insurance (DOI) to increase rates for its Homeowners' Multi-Peril line of insurance, RFB App. No. 09-3851 (Rate Application). (AR, 20.) Specifically, Mercury sought to increase rates in three separate lines: HO-3 (residential homeowners' insurance), HO-4 (tenants' insurance), and HO-6 (condominium owners' insurance). (AR, 2048.) Mercury sought an overall rate increase of 6.9%, and alternatively, an increase of 8.8% if its request for a variance were granted. (AR, 2048.)

The administrative proceedings following Mercury's Rate Application lasted nearly four years. After extensive evidentiary hearings, the administrative law judge (ALJ) issued a proposed decision on September 27, 2012. (AR, 1880.) The Commissioner rejected the ALJ's proposed decision and ordered the ALJ to take additional evidence on Mercury's investment income and rate of return. (AR, 1880-84.) After an inquiry from the ALJ, the Commissioner rescinded this request and stated that its previous order could be "disregarded." (AR, 1939.) The ALJ issued another proposed decision on January 28, 2013, which was adopted by the Commissioner on February 11, 2013 (Order). (AR, 1973, 2037-2178.)

The Commissioner's Order concluded that Mercury's proposed overall rate increase of 8.8% was excessive. (AR, 2174.) It ordered Mercury to *decrease* its HO-3 rates by 8.18%, and allowed increases of 4.32% and 29.44% in its HO-4 and HO-6 lines, respectively.[3] (AR, 2174.) It is the 8.18% decrease that is the subject of the Petition.

As stated in the Order, the ALJ made particular findings that affected how the ordered rates were calculated. In particular, the ALJ found that all of Mercury's advertising expenses were "institutional advertising," such that these expenses could not be considered in setting the rate (AR, 2173.) The ALJ also found that Mercury was not entitled to certain "variances," from the ratemaking formula, including the "confiscation variance." (10 Cal. Code Regs., § 2644.27, subdivision (f)(9).) (AR, 2174.)

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[2]As Mercury and the Trades advance similar arguments contesting the Commissioner's decision, this ruling shall refer to Mercury and the Trades as "Petitioners," when applicable.

[3] Because the premiums in HO-3 lines outnumber those in the HO-4 and HO-6 lines, Mercury contends that the effect of the Order requires it to decrease its overall rates by approximately 5%. (Petition, ¶¶ 2-3.)

The Petition was filed on March 1, 2013. Later that month, the Court granted Intervenor Consumer Watchdog's (CW) unopposed motion for leave to intervene. On May 7, 2013, this Court denied Mercury's ex parte application for a stay of the Order. On June 18, 2013, the Court granted the unopposed motion to intervene of the Trades.

On March 28, 2014, Respondents, joined by CW, moved for judgment on the pleadings against Mercury, on the basis that the Petition was moot. The basis for this motion was that the rates set by the Commissioner's Order were no longer effective. This is because Mercury and the Commissioner settled another prior rate approval action and entered into a November 2013 stipulation approving an 8.26% rate increase for Mercury's 2013 Homeowner's Multi-Peril rate application. Respondents also moved to strike the Trade's complaint in intervention or portions thereof.

The Court denied both motions. The Court found that the Petition was not moot, because Petitioner increased its rates under February 2013 Order for a period of about 6 months, until the stipulated rate increase took effect in November 2013. Thus, a court decision setting aside the February 2013 order on the basis that the rates were "confiscatory" could provide the basis for a future administrative adjustment of Mercury's rates. Additionally, the Court found that the matters raised by the Petition were not moot in that they involved issues of broad public interest that are likely to recur.

Mercury and the Trades have filed two separate petitions for writs of administrative mandamus or mandate, and complaints for declaratory relief (Petitions). Mercury and the Trades have purported to set for hearing the mandate/mandamus claims *only* for May 2, 2014, and no party has objected. Accordingly, in this proceeding, the Court will consider the mandamus claims filed by Mercury, and where relevant, the mandate claims of Trades. The Court does *not* consider claims for declaratory relief filed by the Trades. As discussed later, the declaratory relief claims filed by Mercury are denied.

II. LEGAL BACKGROUND

a. Proposition 103 and Regulation of Insurance

In 1988, California voters enacted Proposition 103, which dramatically changed regulation of property-casualty insurance rates. Prior to Proposition 103 insurers could set rates in a competitive market.

Among other things, Proposition 103 required insurers to "rollback" insurance rates 20% below 1987 levels for one year, starting November 1988. (*20th Century Ins. Co. v. Garamendi* (*20th Century*) (1994) 8 Cal.4th 216, 239-240.) Insurers could only obtain relief from the 20% rollback if they could show that they were "substantially threatened with insolvency." (Ins. Code, § 1861.01, sub. (b).) This is known as the "insolvency standard."

Proposition 103 also implemented the "prior approval" system, which required the Commissioner to approve any insurance rate adjustment in a rate-making process. (*See*

Ins. Code, § 1861.05.) The Commissioner may neither require insurers to charge "excessive" rates nor subject insurers to "inadequate" rates.[4] (*20th Century*, *supra*, 8 Cal.4th at p. 243; Ins. Code, § 1861.05, subd. (a).) Under the prior approval ratemaking process, the Commissioner determines the bounds of such "excessive" and "inadequate" rates: the maximum and minimum permitted earned premium. (*20th Century*, *supra*, 8 Cal.4th at p. 254.) Insurers can charge any rate between this range of "excessive" and "inadequate" rates. (*Ibid.*)

The parties cite heavily to two cases interpreting Proposition 103 and, in the case of *20th Century*, its implementing regulations: *Calfarm Insurance Company v. Deukmejian* (*Calfarm*) (1989) 48 Cal.3d 805, and *20th Century*, *supra*, 8 Cal.4th at 263.

In *Calfarm*, the insurance industry challenged the constitutionality of Proposition 103 immediately after its passage. The California Supreme Court largely upheld Proposition 103 and the 20% rollback requirement. (*Id.* at p. 815.) However, it held that Proposition 103's "insolvency standard"—wherein an insurer could only receive a relief from the 20% rollback if "threatened with insolvency"—was unconstitutional. This is because the "insolvency standard" could not "conform to the constitutional standard of a fair and reasonable return." (8 Cal.4th at p. 818.) For example, companies that were not threatened with insolvency could nonetheless be subject to "confiscatory" rates in violation of the Constitution. (*Ibid.*)

Although the Court invalidated the "insolvency standard," it left untouched the "general standard for rate adjustment" set out in Insurance Code section 1861.05[5] and affirmed that this statute "provide[d] a constitutionally valid standard for rate adjustment." (*Id.* at p. 822-823.) Because an "inadequate" rate under Section 1861.05 was necessarily a "confiscatory" rate, the statute required rates to be "fair and reasonable" and prohibited confiscatory rates. (*Ibid.*)

After *Calfarm*, the Commissioner adopted "Prior Approval Regulations" to implement Proposition 103.

These regulations established procedures to calculate whether rates were "excessive" or "inadequate" under Section 1861.05. (*See* 10 Cal. Code Regs., §§ 2641.1-2644.67.) The regulations also included comprehensive formulas for the upper and lower boundaries of the "excessive-inadequate" range: the "maximum permitted earned income premium" and "minimum permitted earned income premium" (maximum PEP and minimum PEP). (10 Cal. Code Regs., § 2644.2, 2644.3.) The regulations also allowed insurers to seek "variances" from the maximum or minimum PEP derived from the rate-setting formula. (10 Cal. Code Regs., § 2644.27(f)(1)-(9).)

In his first "rollback exemption order" made after a hearing, the Commissioner ordered 20th Century Insurance to refund each insured 12% of the "rollback year" premium rather

[4] Insurance Code section 1861.05, subdivision (a) provides in pertinent part: "No rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter…."
[5] Unless otherwise indicated, all future statutory references shall be to the Insurance Code.

than 20%. (*20th Century*, *supra*, 8 Cal.4th at p. 263.) 20th Century Insurance petitioned for a writ of mandate, joined by the majority of the property-casualty insurance industry. The trial court ruled largely 20th Century's favor. The California Supreme Court did not, and held that the application of the rollbacks to 20th Century were not invalid. Among other things, the Court found that:

- The regulations implementing the ratemaking formula were valid. The Commissioner could set rates by a formula rather than on a case-by-case basis, and the insurer was not entitled to an "individualized" hearing outside the regulations to determine its rollback liability. (*20th Century*, *supra*, 8 Cal.4th at p. 324.)

- The trial court erroneously found that "confiscation," *does not* require "deep financial hardship." (*Id*. at pp. 320, 324.)

- "Confiscation is judged with an eye toward the regulated firm as an enterprise. In this context, it depends upon the condition of the insurer as a whole, and not on the fortunes of any one or more of its [insurance] lines." (*Id*. at p. 322.)

- The regulations' "relitigation bar"[6] does not allow a regulated entity to introduce evidence to challenge the premises of the regulatory formula. The trial court erroneously determined that the relitigation bar operated to bar the insurer from presenting proof of confiscation. (*Id*. at pp. 257, 311-312, 324.)

- Whether the insurer's rollback order is unjust and unreasonable and therefore "confiscatory," depends upon balancing the interests of the insurer and insured consumers. (*Id*. at p. 325.)

- Although a regulated industry has an "interest" in its cost of capital, it has no right to it, and it has no constitutional right to a profit or right against a loss. (*Id*. at pp. 320-321, 326.)

b. Price Control Regulation

A brief discussion of background law governing price control measures is warranted. These principles apply to regulated entities such as Mercury that challenge the price control laws or a specific rate order. (*20th Century*, *supra*, 8 Cal.4th 319.)

"When a regulation is challenged as violative of the takings clause as applied, the question is whether, in the particular case, its terms set a rate that is unjust and unreasonable and hence confiscatory." (*20th Century*, *supra*, 8 Cal.4th at 318 (emphasis added).) When a rate order itself is challenged as violative of the takings clause, 'the question is whether that order 'viewed in its entirety' meets the [relevant] requirements …. Under the … standard of 'just and reasonable' it is the result reached not the method

[6] The "relitigation bar" appears at 10 Cal. Code Regs., § 2646.4, subdivision (e).

employed which is controlling. [Citations.]" (*Ibid.* (citing *Federal Power Comm'n v. Hope Natural Gas Co.,* (*Hope*) (1944) 320 U.S. 591, 602).)

"Judicial inquiry as to whether or not a rate is just and reasonable is necessarily difficult." (*20th Century, supra*, 8 Cal.4th a p. 318.) "[N]either law nor economics has yet devised generally accepted standards for the evaluation of rate-making orders …." (*Id.* (citing *Permian Basin Area Rate Cases* (1968) 380 U.S. 747, 790).)

Accordingly, "[j]udicial inquiry as to whether or not a rate is just and reasonable is also limited. Indeed, it '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….[H]e who would upset the rate order … carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences." (*20th Century, supra* 8 Cal.4th at p. 318-319 (citing *Hope* 320 U.S. at p. 602).)

"The *Hope* court identified one situation in which 'he who would upset the rate order' could not bear that 'heavy burden.' Rates 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 …." (*20th Century, supra* 8 Cal.4th at p. 319 (citing *Hope* 320 U.S. at p. 605).) "More simply, 'a company [cannot] complain if the return which was allowed made it possible for the company to operate successfully.'" (*20th Century, supra* 8 Cal.4th at p. 318-319 [citation omitted].)

In setting rates for regulated entities, the regulator is *not* bound to use any single formula or combination of formulas. The regulator's rate-making function involves making "pragmatic adjustments." (*Hope*, *supra*, 320 U.S. at p. 602; *20th Century, supra,* 8 Cal.4th at 216.) Additionally, the regulator's fixing of "just and reasonable rates" involves a balancing of investor and consumer interests. (*Hope, supra*, 320 U.S. at p. 602.)

III. ANALYSIS

a. Requests for Judicial Notice

The Court makes the following rulings on the requests for judicial notice filed in support of (1) Mercury's Opening Brief, (2) the Trades' Opening Brief, (3) CW's Opposition Brief, and (4) the Commissioner's Opposition Brief:

As to CW's Request for Judicial Notice, Exhibits 1, 2, and 3, are **DENIED** and Exhibits 4 and 5 are **GRANTED**. As to the Trades' Request for Judicial Notice, Exhibits 1, 2, and 3 are **GRANTED**. The Commissioner's Request for Judicial Notice, Exhibit 1, is **GRANTED**.

As to Mercury's Request for Judicial Notice, Exhibits 1, 5 and 6 are **GRANTED**. The parties dispute whether the Court may take notice of Exhibits 2, 3, and 4, prior non-precedential decisions of the Insurance Commissioner. The Commissioner objects on the

basis that the Exhibits are irrelevant and inconsistent with a position adopted by the Trades. However, Mercury attaches these exhibits not to show that the Commissioner's application of the law is binding, but to show how the Commissioner has applied regulations in previous instances. The Court of Appeal has held that this information is relevant in an administrative proceeding on an insurer's rollback liability. (*RLI Insurance Group v. Superior Court* (1996) 51 Cal.App.4th 415, 435.) Accordingly, the Court **GRANTS** the request as to Exhibits 2, 3, and 4.

b. Standard of Review

Mercury seeks review of the Commissioner's Order pursuant to Code of Civil Procedure section 1094.5, which requires Mercury to show that the Commissioner abused his discretion. "Abuse 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." (Code Civ. Proc, § 1094.5(b).) Section 1858.6. also requires the Court to apply its independent judgment in reviewing the Order. This statute provides in part:

> "Any finding, determination, rule, ruling or order made by the commissioner…shall be subject to review by the courts of the State and proceedings on review shall be in accordance with the provisions of the Code of Civil Procedure….[T]he court is authorized and directed to exercise its independent judgment on the evidence and unless the weight of the evidence supports the findings, determination, rule, ruling or order of the commissioner, the same shall be annulled." (Ins. Code, § 1858.6.)

"The independent judgment standard requires the trial court to accord a strong presumption of correctness to the Commissioner's findings, and the burden of proof rests on the party challenging those findings, but ultimately the trial court is free to reweigh the evidence and substitute its own findings." (*State Farm Mut. Auto. Ins. Co. v. Quackenbush* (1999) 77 Cal.App.4th 65, 71.)

The parties dispute the degree of judicial deference owed to the Commissioner's interpretation of his regulations implementing Proposition 103. "The Commissioner's interpretations are to be respected, though they are not binding… An administrative agency's interpretation of its own regulation deserves substantial weight, even if it amounts to a 'litigating position.' On the other hand, it is well settled that the interpretation of a regulation, like the interpretation of a statute, is a question of law ultimately decided by the courts. [Citation.] The level of deference due to an agency's regulatory interpretation turns on a legally informed, commonsense assessment of its merit in the context presented." (*State Farm Mutual Auto. Ins. Co. v. Quackenbush* (1999) 77 Cal.App.4th 65, 75 (citing *Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 14).)

The Trades do not seek review of the Commissioner's Order under Code of Civil Procedure section 1094.5, but rather seek a writ of mandate pursuant to Civil Procedure

section 1085 to compel the Commissioner to interpret the regulations in a lawful and constitutional manner. Accordingly, the standards of review for the Trades' Petition and Mercury's petition are materially different. Without addressing the standard of review, the Trades merely advance arguments as to why the Commissioner's Order was invalid. Because the Court denies Mercury's Petition and concludes that the Order was valid, it also concludes that the Trades' arguments fail under the more deferential standard of review applicable to "traditional" mandate petitions.

Additionally, the Trades advance certain arguments attacking the Commissioner's decision[7] in Mercury's rate application that were not raised by Mercury or in the administrative proceedings below. Because the Commissioner could not and did not consider these arguments in issuing its decision, the Court declines to address those arguments here.

c. Whether the Rate Order is Confiscatory

In issuing the Order, which required Mercury to decrease rates in its HO-3 line by approximately 8%, the Commissioner determined that Mercury did not qualify for a "confiscation variance." Petitioners argue that (1) Mercury did qualify for the confiscation variance, but (2) the Commissioner applied the wrong standard in determining whether Mercury qualified and (3) the Commissioner prevented Mercury from showing that it could qualify. Thus, Petitioners argue, the Order is invalid.

i. Background—How the Commissioner Sets Rates

As discussed earlier, the Commissioner uses a formula to determine the maximum and minimum permitted earned premium, which define the bounds of "excessive" and "inadequate" (or confiscatory) rates. (10 Cal. Code Regs., §§ 2644.2, 2644.3.)

The rate regulations are purposefully formulaic, to allow the Commissioner to manageably determine insurance rates:

> [The ratemaking method] may implicate formulaic ratemaking (see *Permian Basin Area Rate Cases* (1968) 390 U.S. 747, 768-770) using data reflecting the condition and performance of a group of regulated firms…It is not subject to piecemeal examination: "The economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result. The Constitution is not designed to arbitrate these economic niceties." [Citation.] And, of course, courts are not equipped to carry out such a task. [Citation.] "[S]o long as rates as a whole afford [the regulated firm] just compensation for [its] over-all services to the public," they are not confiscatory. [Citation.] That a

[7] For example, the Trades argue that the hearing requirement to obtain a variance violates due process. The Trades also challenge the Commissioner's Order regarding "institutional advertising" expenses, because he compared advertising for insurance expenses to advertising for public utility cases, and because he interpreted the regulations in a manner that violated the First Amendment.

> particular rate may not cover the cost of a particular good or service does not work confiscation in and of itself. [Citation.] (*20th Century*, *supra*, 8 Cal.4th at p. 293.)

The ratemaking formula takes into consideration projected losses, projected expenses, projected income, and uses broad assumptions and "plug-in" data to represent variables in the formula. For example, the regulations define how variables, such as "losses," are calculated. (10 Cal. Code Regs., §§ 2644.4; 2644.7.) The regulations also use for the "expenses" variable the average of industry-wide experience throughout the country for an average line of insurance, rather than the insurer's actual expenses.[8] (10 Cal. Code Regs., § 2644.12.)

The regulations also allow "variances" from the rate set by the ratemaking formula: that the maximum or minimum permitted earned premium set by the formula be adjusted. (10 Cal. Code Regs., § 2644.27.) One such variance is the "confiscation variance."[9] The basis for a confiscation variance occurs when:

> [] the maximum permitted earned premium would be confiscatory as applied. This is the constitutionally mandated variance articulated in *20th Century v. Garamendi* (1994) 8 Cal.4th 216 which is an end result test applied to the enterprise as a whole. Use of this variance requires a hearing pursuant to [Regulation] 2646.4. (10 Cal. Code Regs., § 2644.27(f)(9).)

The applicant requesting the variance must identify the amount of the variance and the "applicable component" of the ratemaking formula, set forth the expected result that the variance would have if granted compared to the result if the variance were denied, and "identify the facts and their source justifying the variance request and provide the documentation supporting the amount of the change to the component of the ratemaking formula." (10 Cal. Code Regs., § 2644.27, subd. (b).)

ii. The Commissioner Properly Determined that Mercury Must First Demonstrate Evidence of Confiscation Before Entertaining Whether to Allow it the Confiscation Variance

The ALJ found that Mercury did not qualify for a confiscation variance from the rate set by the formula, because Mercury did not make a *prima facie* showing that the applying formula to yield the rate decrease would cause Mercury to suffer "deep financial hardship" to its "enterprise as a whole." (AR, 2164.) Rather, the Commissioner found that the rate set by the formula would permit Mercury to earn a profit and maintain its financial integrity. (Id.) Thus, the rate set by the formula was not "confiscatory" and Mercury was not entitled to the "confiscation variance." (AR, 2163.)

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[8] This "expense variable" is also called the "efficiency standard."
[9] The "confiscation variance" is also referred to as "Variance 9."

The parties first take issue with the Commissioner's requirement that the applicant make a prima facie showing of confiscation before it entertains the question of whether a variance is necessary.

Mercury and the Trades make similar arguments against this requirement. The Trades respond that this threshold *prima facie* confiscation showing is unreasonable because sometimes applying the standard formula may not show that a rate order is confiscatory; in some cases an insurer can only show confiscation if it uses its own data. Mercury does not argue that it cannot show confiscation under the standard formula, but argues that the Commissioner prevented it from using data which Mercury claims would have shown confiscation.

However, *20th Century* supports the Commissioner's approach: a variance is "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 p. 312 (emphasis added); *see also* 10 Cal. Code Regs., § 2644.27, subd. (b) [requiring the applicant to submit evidence in support of its request].) Because the ratemaking formula derives from the regulations, it was reasonable for the Commissioner to require Mercury to make a *prima facie* showing that applying the ratemaking formula would result in confiscation.

Further, given the complex and time-consuming nature of the ratemaking process, the applicant must do more than simply allege that it needs a variance to trigger the Commissioner's duty to entertain whether one is warranted.

Thus, the Commissioner properly determined that Mercury was required to make a *prima facie* showing of confiscation before the Commissioner considered whether Mercury was eligible for a confiscation variance.

iii. The Commissioner Applied the Correct Standard for Confiscation

Petitioners claim that the Commissioner applied the wrong standard to assess whether Mercury could show confiscation to entitle Mercury to a variance. Petitioners assert that the Commissioner should have assessed whether Mercury could earn a "fair rate of return" under the rate order, and not whether the company would suffer "deep financial hardship to its enterprise as a whole."

Mercury and the Trades argue that the "fair rate of return" test is applicable to show confiscation, not "deep financial hardship." Mercury describes the "fair rate of return test" as whether the applicant's ability to earn a return is commensurate with the returns on investments in other similar risky enterprises. (Mercury Opening Brief pp. 18-19 (citing *Hope*, supra, 329 U.S. at p. 603; *Permian Basin, supra*, 390 U.S. at 790-91.)

The parties devote a substantial amount of briefing as to which of these tests applies. The Commissioner and CW argue that *20th Century* establishes that confiscation requires a

showing of “deep financial hardship.” The Court agrees that *20th Century* sets forth the test for confiscation as “deep financial hardship.”

20th Century held that an insurer can threaten confiscation only when it demonstrates that the maximum permitted rate prevents it from “operating successfully” during the period of the rate and subject to the then-existing market conditions; in such circumstances, the insurer experiences “deep financial hardship” from the total effect of the rate. (*20th Century*, *supra*, 8 Cal.4th at pp. 295-299.)

The California Supreme Court considered federal case law in defining the standard by which an insurer could show confiscation: "[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 …." (*20th Century*, *supra*, 8 Cal.4th at p. 295 (citing *Hope*, supra, 320 U.S. at p. 605).) “‘[A] company [cannot] complain if the return which was allowed made it possible for the company to operate successfully.’” (*Ibid.* (citing *Market Street R. Co. v. Railroad Comm’n of California* (1945) 324 U.S. 548, 566).)

20th Century cited *Hope* and observed that the regulated entity may experience “deep financial hardship” “when it does not earn enough revenue for both ‘<u>operating expenses</u>’ <u>and ‘the capital costs of the business</u>,’ including ‘service on the debt and dividends on the stock,’ of a magnitude that would allow 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.’” (*20th Century*, *supra*, 8 Cal.4th at p. 296 (citing *Hope*, *supra*, 320 U.S. at p. 603) (emphasis added).) Accordingly, absent this “deep financial hardship,” an entity cannot complain that a rate is confiscatory. (*Ibid.*)

20th Century made clear that confiscation “does *not* arise…whenever a rate simply does not ‘produce [] a profit which an investor could reasonably expect to earn in other businesses with comparable investment risks and which is sufficient to attract capital.’” (*20th Century*, *supra*, 8 Cal.4th at pp. 298-299.) An insurer has an interest in profit, but it is not a right that it can demand. “It is only one variable in the “constitutional calculus of reasonableness.” (*Ibid.* (citing *Permian Basin Area Rate Cases*, *supra*, 390 U.S. at p. 769).)

Thus, confiscation arises when a regulated entity cannot earn enough revenue for its operating expenses and business costs, not when a rate does not produce profit that the entity could reasonably expect to earn in similar business.

Mercury and the Trades cite *Calfarm*’s rejection of the “insolvency standard,” and other federal cases to argue that the standard for confiscation is not “deep financial hardship” but “fair rate of return.” However, *20th Century* represents the California Supreme Court’s most recent, comprehensive articulation of the standard for confiscation in

insurance rollback cases. The other cases cited by Petitioners do not persuade the Court that the Commissioner applied the wrong standard in this proceeding.

Petitioners seek to distinguish *20th Century* by arguing that confiscation standard set therein applies only to insurance "rollback" proceedings, and not rate-setting proceedings.

Petitioners note that variables in the "rollback" formula are derived from past, actual events. In contrast, because the ratemaking formula is forward-looking, some variables therein are represented by generic, industry-wide data.

Although *20th Century* considered "rollback" proceedings, it addressed Proposition 103 and its implementing regulations in a lengthy decision spanning over 100 pages. *20th Century* considered in detail how the Proposition 103 regulations work and how they apply to prior approval and rollback proceedings. Additionally, federal case law, considered and cited by *20th Century,* approves the regulator's use of "generic" industry-wide data in setting price control regulations.

The Court concludes that the California Supreme Court did not intend to set forth two different standards to show confiscation depending upon the specific nature of the proceedings before the Commissioner. (*20th Century*, *supra*, 8 Cal.4th at p. 293 (citing *Permian Basin Area Rate Cases, supra*, 390 U.S. at p.768-770).)

Mercury also cites prior non-precedential decisions of the Commissioner to argue that the Commissioner did not always apply the "deep financial hardship test" when considering confiscation. However, the fact that the Commissioner may have acted differently in other non-precedential decisions (many of which did not involve rate-setting) does not meet Mercury's "heavy burden" of showing that the Commissioner's rate order was unconstitutionally confiscatory.

Finally, the regulation defining the confiscation variance defines the variance as "the constitutionally mandated variance articulated in *20th Century*…which is an end result test applied to the enterprise as a whole." (10 Cal. Code Regs., § 2644.27(f)(9).) The test for confiscation set forth in *20th Century* is "deep financial hardship." The regulation does not reference any other test for confiscation.

Here, the Commissioner denied use of a confiscation variance because it 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.

The Commissioner found that the regulatory "formula results in at least $1.8 million profit from Mercury's California homeowner's line [of insurance]" and that "Mercury fail[ed] to demonstrate that the total effect of such a profit is unjust." (AR, 2164.) The Order noted that while "perhaps not generating the profit margin Mercury desires, Mercury failed to demonstrate the rate decrease will impair the company's financial integrity." (AR, 2164-2165.) The Commissioner noted that Mercury maintained an A+

financial strength rating with AM Best from 2006 through 2010, California operations showed a "robust policyholder surplus in 2010, and that Mercury issued dividends over the last 5 years totaling nearly $5 billion. While acknowledging that confiscation is determined prospectively, the Commissioner noted that Mercury had not exhibited any signs of financial distress, or indicated that past rates weakened the company's financial integrity. (AR, 2165.)

Having reviewed the Order, the Court agrees that (1) the Commissioner properly concluded that the test for confiscation is "deep financial hardship" required by *20th Century*, and (2) Mercury did not demonstrate "deep financial hardship" to support its request for a confiscation variance.

Rather, Mercury argues that the Commissioner should have applied a different standard. Mercury appears to fault the Commissioner because the rate ordered would not allow it to 'produce [] a profit which an investor could reasonably expect to earn in other businesses with comparable investment risks and which is sufficient to attract capital.'" (*20th Century*, *supra*, 8 Cal.4th at pp. 298-299.) However, this is not evidence of confiscation. Accordingly, Mercury has not shown that the Commissioner applied the incorrect standard, and thus erroneously denied its request for a variance.

iv. The Commissioner Correctly Ruled that Mercury's Attempt to Use its Own Expense Data to Show Confiscation, Amounted to "Relitigation"

Mercury attempted to introduce evidence of its own expenses to show that, if its expenses were substituted as a variable in the ratemaking formula, Mercury would suffer confiscation from the rate order. The Commissioner barred Mercury from presenting this evidence, under the "relitigation bar." Petitioners argue that the Commissioner improperly denied Mercury the ability to present evidence of confiscation.

The "relitigation bar" appears at 10 Cal. Code Regs., § 2646.4, which pertains to hearings on individual insurer's rates. It states:

> 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. However, the [ALJ] shall admit evidence he or she finds relevant to the determination of whether the rate is excessive or inadequate (or, in the case of a proceeding under Article 5, relevant to the determination of the minimum nonconfiscatory rate), whether or not such evidence is expressly contemplated by these regulations, provided the evidence is not offered for the purpose of relitigating a matter already determined by these regulations or by a generic determination. (10 Cal. Code Regs., § 2646.4, subd. (c).)

The California Supreme Court interpreted the "relitigation bar" in *20th Century* to mean that it is improper relitigation for an insurer to request that the ALJ "entertain the

question of whether the underlying [regulations] are sound…Otherwise standardless, ad hoc decisionmaking would result." (*20th Century, supra*, 8 Cal.4th at p. 312.)

Petitioners respond that they are not inviting the ALJ to question whether the pertinent regulations are sound, rather, they argue that Mercury should be allowed to present its evidence that is relevant to confiscation—e.g., whether the rate is excessive or inadequate. However, the "relitigation bar" requires the ALJ to admit evidence that he or she—not the insurer—finds to be relevant to confiscation. (10 Cal. Code Regs., § 2646.4, subd. (c)); *20th Century*, *supra*, 8 Cal.4th at p. 257 (noting that the ALJ "effectively lifted the 'relitigation bar' to allow [the insurer] to introduce evidence to challenge the premises of the rate regulations, 'accord[ing] it the opportunity to present evidence … on every issue that it contended was material.'").)

Moreover, the ratemaking formula, and the variables used therein (such as expenses) are established by the regulations. Thus, Mercury's request to substitute its own expenses in the formula would effectively relitigate "a matter already determined either by [the] regulations or by a generic determination." (10 Cal. Code Regs., § 2646.4, subd. (c).)

Here, the Court finds that the ALJ properly determined that the evidence Mercury proposed to submit was not relevant to confiscation, because Mercury did not make a prima facie showing of confiscation. The ALJ rejected Mercury's argument that "any analysis of confiscation must permit an insurer to apply cost and expense amounts different from those provided by the regulatory formula." (AR, 2166.) Accordingly, Mercury's attempt to admit that evidence amounted to challenging or "relitigating" the regulations used to set the ratemaking formula. Therefore, Mercury has not shown that the ALJ improperly applied the relitigation bar in these proceedings.

d. It is Irrelevant Whether the Ratemaking Formula is "Tautological"

Mercury challenges the Commissioner's refusal to consider in the ratemaking formula Mercury's actual expected losses, expenses and returns by attacking the formula itself. Petitioners argue that the Commissioner adopted a "tautological" test for confiscation, because the test is nothing more than a restatement of the formula and its components, and the components do not vary. In *20th Century*, the petitioners made a similar argument that the regulations for the ratemaking formula for rollbacks were "recursive." The California Supreme Court responded as follows:

> To be sure, the ratemaking formula is indeed "recursive." But contrary to the superior court's evident belief and the insurers' vigorously urged position, that is no vice. The adjective is not pejorative. It is merely descriptive. Simply put, it means in this context that the value solved for figures in the solution itself. For example, an insurer desires to determine the rate it must charge its insureds to net $100 after paying a 20 percent commission to its agents. It uses the following "recursive" formula, in which "*r*" REFERS TO THE RATE TO BE CHARGED: $r = \$ 100 + 0.2$

> r; r 0.2 r = $ 100; 0.8 r = $ 100; r = $ 125. In and of itself, "recursiveness" is not objectionable. (*20th Century, supra*, 8 Cal.4th at p. 288.)

Mercury argues that the test is infirm because it can "never show" confiscation if it cannot use its own loss and return estimates in the formula. However, the relevant inquiry is whether the insurer can make a *prima facie* showing of "deep financial hardship" to its enterprise as a whole under the ratemaking formula. If it can, then the insurer can obtain a variance and use its actual data.

The ratemaking formula is not unconstitutionally tautological because Mercury cannot use its own data in the formula to show confiscation.

To conclude, Petitioners have not shown that the Commissioner abused his discretion in setting Mercury's rates under the Order or that the Order should be annulled under Section 1858.6. The Commissioner appropriately applied the "deep financial hardship" test for confiscation and determined that Mercury had not made a *prima facie* showing of confiscation under the proposed rate decrease. Accordingly, Mercury was not entitled to a variance to present its own data in the ratemaking formula. Moreover, the Commissioner did not abuse his discretion in applying an unconstitutionally "tautological" ratemaking formula, and appropriately disallowed Mercury from presenting data under the "relitigation bar."

e. Insurance Commissioner Properly Excluded Mercury's Advertising Expenses from the Ratemaking Calculation

The "prior approval" regulations disallow the Commissioner from considering certain "excluded expenses" in the ratemaking calculation. (10 Cal. Code Regs., § 2644.10.) "Excluded expenses" include excessive executive compensation, "institutional advertising expenses, political contributions and lobbying, bad faith judgments, costs of unsuccessful defense of discrimination claims, fines and penalties, and payments to affiliates in excess of fair market value. (*Ibid*.)

Accordingly, regulated insurers have an interest in insuring that their advertising expenses are *not* excluded from the ratemaking calculation. Here, the Commissioner determined that Mercury's entire advertising budget was excluded from its rate application. (AR, 2148.)

Petitioners contend that the decision is erroneous because the Commissioner misinterpreted the regulation defining "institutional advertising," and because Mercury's advertising met the definition under the regulation. The Court rejects these arguments.

i. The Commissioner Properly Interpreted the Regulation Governing Institutional Advertising

The regulations define "institutional advertising," as it pertains to "excluded expenses" as follows:

> "Institutional advertising" means advertising not aimed at obtaining business for a specific insurer and not providing consumers with information pertinent to the decision whether to buy the insurer's product. (10 Cal. Code Regs., § 2644.10, subd. (f).)

Petitioners contend that the Commissioner can consider advertising "institutional advertising," only if *both* criteria are met: (1) it is not aimed at obtaining business for a specific insurer, *and* (2) does not provide consumers with information pertinent to the decision to buy the insurance product. Thus, advertising that meets only "one prong" of this test, is not "institutional advertising," and the Commissioner must consider these advertising expenses in setting a rate. This argument is not well-taken.

First, the Commissioner's interpretation of the regulation is supported by the clear language thereof: "institutional advertising" is advertising meeting the criteria set forth in the regulation. The regulations do not require that only advertising meeting *both* criteria be considered "institutional advertising" and thus excluded from the ratemaking calculation.

Second, the Commissioner's interpretation is reasonable and consistent with Proposition 103's goals of consumer protection. Proposition 103 seeks to set insurance rates based on "risks or operations in [California]" (*See* Cal. Code Regs., § 2641.2), so that California consumers do not inadvertently fund nationwide "operations" or advertising campaigns by the insurers.

The Commissioner's order defined institutional advertising as "image advertising." This type of advertising enhances a company's reputation or improves name recognition and may benefit the company's shareholders. However, it does not assist insurance consumers. Companies may use institutional advertising to promote a series of products or to promote a product on a nationwide basis. (See AR, 2138.)

The intent behind regulation 2644.10, subdivision (f) is to limit the types of advertising expenses that could be factored into the calculation of rates paid by consumers. Petitioners' interpretation would greatly expand the scope of advertising that must be factored into the ratemaking formula. It would include all advertising directed at garnering business for "specific insurer," whether or not it benefitted the consumer—e.g., by providing consumers helpful information about the product. In contrast, the Commissioner's interpretation of the regulation limits insurers from including all manner of advertising. The Court finds that the Commissioner's interpretation of "institutional advertising" was reasonable and supported by Proposition 103 and its regulations.

Thus, if Mercury wished to include its advertising expenses in the ratemaking calculation, it was required to show that (1) its advertising was aimed at obtaining business for a specific insurer *and* (2) provided consumers with information pertinent to the decision whether to buy the insurer's product.

ii. The Commissioner Properly Concluded that the Mercury's Advertising did not Issue from a "Specific Insurer"

The Commissioner first concluded that Mercury's advertising expenses were excluded from the calculation, because Mercury did not show that the advertising was aimed at obtaining business for a "specific insurer." (10 Cal. Code Regs., § 2641.2.) Rather, the expenses Mercury submitted reflected advertising on behalf of the organization as a whole, and not for a specific affiliate or company within Mercury. (AR, 2142145.)

The dispute is whether the term "specific insurer" means only the rate applicant (in this case, Mercury Casualty Company) or whether it encompasses advertising on behalf of a group of affiliated entities, which are not rate applicants.

First, this regulation distinguishes between a "specific insurer" and an "insurance group." (*See* 10 Cal. Code Regs., § 2644.10, subd. (b) [excluding executive compensation in "insurer's five highest-paid policymaking positions in each 'insurance group'"], subd. (f) [referring to "specific insurer" in institutional advertising definition].) When different words are used in adjoining subdivisions of a statute that was enacted at the same time, this fact raises a compelling inference that a different meaning was intended. (*See People v. Childs* (2013) 220 Cal. App.4th 1079, 1102.) Accordingly, by using the terms "specific insurer" and "insurance group" within the same regulation, the Court infers that the Commissioner intended to give these terms different meanings. Had the Commissioner intended to include affiliate or group advertising in the ratemaking calculations (e.g., require consumers to bear these costs) he could have eliminated the reference to "specific insurer" and used the term "insurance group."

The Commissioner properly concluded that Mercury's advertising was not directed at a "specific insurer."

The advertising did not refer to Mercury Casualty Company, the rate applicant, but rather "Mercury Insurance Group," a name under which Mercury Casualty Company and its affiliates advertise. (AR, 2139, 2142-2143.) "Mercury Insurance Group" includes all 22 affiliates that make up "Mercury General Corporation." (AR, 2145.)

The Commissioner found that: Mercury Insurance Group is not a legal entity in any state and not a licensed insurer in California; Mercury General Corporation's advertising department supports all Mercury affiliates; Mercury guides all prospective customers to one telephone number; Mercury does not allocate advertising expenditures to specific insurance affiliates; Mercury's advertising department does not distinguish between insurance entities when generating advertising campaigns; and all Mercury companies shared a common website that identifies the company as "Mercury Insurance Group." (AR, 2139-2140.) The total advertising for Mercury General Corporation was $26, $27, and $30 million a year for 2008, 2009, and 2010, respectively. (AR, 2140.)

Mercury does not dispute these findings. Rather, it argues that the entire advertising expenses attributable to “Mercury Insurance Group” are advertising expenses of a “specific insurer” under the regulations.

Mercury has not demonstrated that the Commissioner’s order was invalid on this basis.

The Commissioner’s interpretation of the regulation’s term “specific insurer” was reasonable. The advertising did not relate specifically to Mercury Casualty Company, the rate applicant. Rather it related a large group of affiliates, that were not applying for a rate reduction, and that may or may not do business in the state. Accordingly, the Commissioner’s interpretation protects consumers from underwriting advertising expenses of other entities that may not operate in California, and were not applying for the rate adjustment.

Mercury argues that these concerns are not present, because it “only accounted for its fairly allocated share of advertising expenses that were spent on group advertising in California.” (Reply Brief, p. 15:14-15.) Mercury argues that the Commissioner’s interpretation penalizes insurers advertising under a group name, which it claims is a more efficient means of advertising that will lower rates for consumers. Mercury also points to Proposition 103’s goals of protecting insurers from inadequate or confiscatory rates.

Mercury argues that a *more reasonable* interpretation of “specific insurer” includes companies that, *unlike Mercury*, engage in business unrelated to insurance. For example, advertising that only mentions the name of such company.

In sum, 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.

Mercury also argues that the Commissioner incorrectly excluded all of its advertising expenses, because at least some of Mercury’s advertising provided consumers with information pertinent to the decision whether to buy the insurer's product. (10 Cal. Code Regs., § 2644.10, subd. (f).) However, even if this were the case, the Commissioner found that all of Mercury’s advertising was not aimed at obtaining business for a “specific insurer.” Accordingly, the advertising was excluded from the rate calculation. (*Id.*)

IV. DISPOSITION

Mercury has not briefed several of its mandamus claims in the Petition. The Court considers Mercury to have abandoned those claims and they are denied.

Additionally, Mercury raises declaratory relief claims that essentially duplicate the mandamus claims. The resolution of the writ claims necessarily disposes of the

mandamus claims. Further, the declaratory relief claims challenge the Commissioner's "interpretation" and "application" of the regulations in the rate proceeding. Declaratory relief is not appropriate to review an administrative decision. (*Walter Leimert Co. v. Calif. Coastal Commn.* (1983) 149 Cal.App.3d 222, 225, 230-231 (citing *State of California v. Superior Court (Veta)* (1974) 12 Cal.3d 237, 249).) Accordingly, Mercury's claims are for declaratory relief are denied, and Mercury's claims for injunctive relief are denied.

Mercury's Petition for Writ of Mandate is **DENIED**, and all claims in its Complaint for Declaratory Relief are **DISMISSED**. The Trades' claims in its Petition for Writ of Mandate are **DENIED**.

In the event this tentative ruling becomes the final ruling of the Court, Counsel for the Commissioner is directed to prepare a formal order, incorporating the Court's ruling as an exhibit thereto, and a separate judgment, submit them to the parties for approval as to form, and thereafter submit it to the Court for signature, in accordance with California Rules of Court, Rule 3.1312.