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October 11, 2012

VIA ELECTRONIC MAIL AND FEDERAL EXPRESS

Bryant Henley
California Department of Insurance
300 Capital Mall, 17th Floor
Sacramento, California 95814

Re: Proposed Prior Approval Regulations
File No. OV-2011-00076

Dear Mr. Henley:

Enclosed please find the written comments of the Personal Insurance Federation of California regarding the Proposed Prior Approval Regulations, file no. OV-2011-00076.

Very truly yours,

KENT R. KELLER
For the Firm

KRK:ppr
Enclosure

cc: Rex D. Frazier, Esq,

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COMMENTS BY
PERSONAL INSURANCE FEDERATION OF CALIFORNIA
TO PROPOSED TEXT OF PRIOR APPROVAL REGULATIONS

DEPARTMENT OF INSURANCE WORKSHOP
FILE NO. OV-2011-00076
OCTOBER 15, 2012

1. INTRODUCTION

These comments are submitted on behalf of the Personal Insurance Federation of California ("PIFC"). PIFC is a non-profit trade association dedicated to representing its member companies' interests before governmental bodies, including the California Legislature, the executive branch, and California courts. PIFC's members are insurers specializing in personal lines of insurance, primarily private passenger automobile and homeowners insurance, in the State of California and elsewhere. PIFC's membership accounts for approximately 50% of all personal lines insurance premiums sold in California.

2. THE PROPOSED REGULATIONS LIMITING THE DEPARTMENT'S APPROVAL

A. Section 2632.11(a)-(g)

This proposal would replace current section 2632.11(b) with a new subsection (b) that would divide class plans into two parts. If adopted, Part I will contain those portions of the class plan that the Department will approve. If adopted, Part II will consist of portions of the class plan that will be reviewed but not approved. PIFC urges the Department of Insurance ("Department") to reconsider this proposed regulation. The division of approved and unapproved "materials," as stated in proposed section 2632.11(a)-(g), is contrary to the decision in *MacKay v. Superior Court*, 188 Cal. App. 4th 1427 (2010), and would not withstand judicial scrutiny, as we explain below.

B. The Conflict between *MacKay* and Section 2632.11(a)-(g)

MacKay involved a class action challenging 21st Century Insurance Company's accident verification and persistency rating practices. It was admitted that during the entire class period 21st Century had used rates approved by the Department. Despite that fact, plaintiffs argued the accident verification factor was: (1) in violation of Insurance Code section 1861.02(c); and (2) the accident verification factor, while included in 21st Century's class plan, was an unapproved

"underwriting guideline."[1]

In rejecting the plaintiffs' argument, the Court of Appeal explained that distinguishing a rating factor from an underwriting guideline[2] was "unnecessary" because "the relevant difference, in this case, depends on the language submitted to the DOI for approval." *MacKay, supra* at 1436. The Court further explained that "the issue is not whether a particular factor . . . is, standing alone, to be called a 'rating factor' or an 'underwriting guideline.' Instead, ***the issue is whether it is submitted to the DOI as a factor affecting the rates to be charged.***" *MacKay, supra* at 1437 (emphasis added).

PIFC urges the Department to reconsider the proposed regulatory change because its structure is inconsistent with current law as announced in *MacKay.* To be sure, the Department can and has for years prescribed the form that a rating plan must take. But what the Department cannot do is to take away from the insurer the right – by inclusion in the class plan – to designate materials for approval. Any factor, calculation or material that is inherent in the rates to be charged which is included by the insurer in its class plan is – pursuant to *MacKay* – necessarily submitted for approval.

Beyond the issue of the insurer's right to designate materials for approval, the structure of section 2632.11(a)-(g) is inconsistent with the fundamental concept of prior approval. Under section 1861.05(a), the Commissioner approves a "complete rate application," not parts of a "complete rate application." *Insurance Code* § 1861.05(b). Yet under proposed section 2632.11(b)(2), the sequential analysis data source information, the sequential analysis methodology, the factor weights calculation and other information – all essential to determination of whether the rate application should or should be approved – would be unapproved factors.

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[1] Since "persistency" has been an optional rating factor for many years, there was no similar unapproved underwriting guideline argument with respect to 21st Century's persistency factor.

[2] As we explain in Section 4 below, the Commissioner does not have the power to regulate underwriting guidelines.

Thus, even if *MacKay* did not exist, the structure of section 2632.11(a)-(g) would still be inconsistent with existing law. Whether a rate is compliant with Proposition 103 cannot be determined by simply looking at the end result. A rate by itself is neither inadequate or excessive or compliant or non-compliant with section 1861.02. How the rate was determined is essential to determining whether it is compliant with law. "Materials" such as the complete rating manual, the factor weights calculation – all matters essential to the determination of whether the class plan or rate application should be approved – are approved when the resulting rate is approved.

While PIFC assumes an unintended result of the adoption of the proposed regulation, it would assuredly result in civil litigation challenging approved rates on the theory that some "unapproved" material is not compliant with Proposition 103. Regardless of what regulatory changes are made, the holding of *MacKay* will remain and will bar claims seeking to challenge approved rates. Thus, the proposed change carries with it the prospect of inviting ultimately meritless litigation, but litigation costly to insurers and policyholders.

For the foregoing reasons, PIFC urges the Department to reconsider the adoption of section 2632.11(a)-(g).

C. Section 2648.4(a)-(d)

Section 2648.4(a)-(d) is largely the mirror image of section 2632.11(a)-(g) for lines other than private passenger automobile. As such, the structure of section 2648.4(a)-(d) is similarly inconsistent with existing law. Indeed, the "materials" that would be "unapproved" under the proposed change for the other lines include matters that are integral rating making components, necessarily approved when the rate is approved. Accordingly, PIFC urges the Department to reconsider the adoption of section 2648.4(a)-(d).

3. THE PROPOSED TRADE SECRET REGULATIONS

The Department proposes to add section 2632.11(k)-(q) (private passenger automobile) and section 2648.4(e)-(k) (lines other than private passenger automobile). In both instances, the

changes are substantively the same and therefore PIFC's comments below relate to both proposed changes.

A. Trade Secrets Are Constitutionally Protected From Disclosure

Trade secrets are protected from disclosure by the Takings Clause of the Constitution and by similar state law protections. *Philip Morris, Inc. v. Reilly,* 312 F.3d 24, 31 (1st Cir. 2002). Consequently, without a waiver by the holder of a trade secret, a law requiring public disclosure of that trade secret cannot trump the Takings Clause.

While the proposed sections purport to permit insurers to protect their trade secrets, there is no explanation of the standards that the Commissioner will use to decide what is and is not a trade secret. Further, it is not clear that if the Commissioner disallows an insurer's trade secret claim, the subject material will be protected from disclosure during the time that the insurer challenges the Commissioner's decision in a judicial proceeding. Subsections 2632.11(n) and 2648.4(h) provide that an insurer may request a hearing "in front of the Administrative Hearing Bureau" to contest a determination by the Commissioner that information is not a trade secret. Presumably, during that hearing process the information will be protected from disclosure, but again there is no apparent protection for a subsequent judicial challenge. In summary, there is neither an announced standard by which the Commissioner will decide trade secret designations nor apparent protection of the trade secret in the event of a judicial challenge.

B. The Evidentiary Standard is Inappropriate

Subsections 2632.11(l) and 2648.4(f) provide that the standard for determining whether information is a trade secret is "clear and convincing evidence." This is, of course, the evidentiary standard for awarding punitive damages in civil lawsuits under California law. *Civil Code* § 3294(a). The standard of proof in a rate hearing is the "preponderance of the evidence," a standard common to judicial and administrative hearings. *California Code of Regulations,* tit. 10, § 2646.5. No explanation for the punitive damage evidentiary standard is provided in the Notice,[3] and requiring an elevated standard of proof for the protection of constitutionally

[3] See **NOTICE OF WORKSHIOP REGARDING PROPOSED REGULATIONS: SCOPE OF PRIOR APPROVAL**, September 14, 2012, No. OV-2011-00076, p. 2.

protected trade secrets may itself be unconstitutional. PIFC urges the Department to remove the "clear and convincing" standard from the proposed regulations.

C. The Proposed Regulations Lack Clarity

In some respects the proposed regulations appear to be incomplete or at least unclear. Under 2632.11(n) and 2648.4(h), an insurer may withdraw information submitted under seal within 10 days after an adverse ruling by the Administrative Hearing Bureau. However, it is not explicitly stated that if the Commissioner rejects an insurer's initial request for the trade secret designation, and the insurer elects not to request a hearing from the Administrative Hearing Bureau, the insurer may withdraw the information. We assume this is the intent, but it is not explicitly stated.

Subsections 2632.11(p) and 2648.4(j) state that any "person at any time may initiate or intervene in a proceeding concerning an insurer's request to designate information as trade secret or the Commissioner's decision concerning such a request." Unanswered by the proposed changes is how "any person" would know the basis for a challenge since the trade secret designated information will be filed under seal. This merely underscores the problems of allowing "any person" to participate in the initial determination by the Commissioner. Such a procedure is unnecessary – the Commissioner can surely make the determination – and can only produce delay.

D. The Proposed Regulations Will Add to Delays

As noted above, to the extent that the proposed regulations are intended to permit "[a]ny person" to participate in the Commissioner's determination of whether information should receive trade secret protection, this can only result in delay and increased costs. Specifically, such a proposal creates the possibility of (1) a "trade secret" hearing before the Commissioner; (2) followed by review before the Administrative Hearing Bureau; (3) followed by the actual rate hearing.

Currently, the Department permits insurers to designate some matters as confidential without the difficulties presented by the proposed regulations. Accordingly, PIFC does not

believe that the proposed regulations are wise or needed and encourages the Department to reconsider these changes.

4. THE "FULLY DESCRIBES" REGULATIONS

Proposed sections 2632.20(a)-(c) (private passenger automobile) and 2648.5(a)-(c) (other lines) are identical and the comments below apply to both sections.

A. The Conflict with Approval Limiting Regulations

Sections 2632.11(a)-(g) and 2648.4(a)-(d) would limit the approval to those items included in Part I of a class plan and rating application. Sections 2632.20(a)-(c) and 2648.5(a)-(c) introduce a new term – "rating method" – and require that a class plan or a rate application must fully describe "the rating method." "Rating method" is defined as "any rating rule, rating factor, underwriting rule, eligibility guideline, coverage form with an impact on losses, or any other change that has an impact on rates or losses." Does a "rating method" include items that are Part II items under sections 2632.11(b)(2) and 2648.4(b)(2)? Stated differently, for example, does the "sequential analysis" for private passenger automobile insurance, or, for other lines, the "rate making data and template" constitute factors that have an impact on rates or losses? They surely appear to be, yet the adoption of the four proposed regulations would result in a situation where some factors are part of a "rating method" and therefore essential to rate review but excluded from the list of factors approved by the Commissioner. There is a clear conflict between the approval limiting regulations and the rating method regulations.

B. The Commissioner Does Not Have the Power to Regulate Underwriting Rules

As noted above, the "rating method" included "underwriting rules" and "eligibility guidelines." In *American Insurance Association v. Garamendi,* 127 Cal. App. 4th 228, 246 (2005), the court concluded that "the Insurance Code does not give the Commissioner authority to regulate underwriting rules for homeowners insurance." To be sure, this decision was ordered to be depublished; however, it nevertheless remains binding on the parties to that litigation,

including the Commissioner. Accordingly, sections 2632.20 and 2648.5 seek to exercise regulatory power not possessed by the Commissioner.

C. "Underwriting Guidelines" vs. "Underwriting Rules"

Sections 2632.11(b) and 2648.4(b) use the term "underwriting guidelines" while sections 2632.20(c) and 2648.5(c) use the term "underwriting rule." The question is whether this difference is intentional and, if so, in what way does an "underwriting guideline" differ from an "underwriting rule"? If there is a difference, this may indicate further conflict between the approval limiting regulations and these rating method regulations. If the two terms are being used interchangeably, this should be made clear.

5. SECTION 2632.2

In *MacKay,* the definition of "rating factor" was simply the first sentence of subsection 2632.2(a). *MacKay, supra* at 1436. The Department seeks no change in the first sentence but would add two sentences, the purpose of which is unclear. The second sentence of proposed subsection 2632.2(a) would provide that an insurer may not use a rating factor unless it has been "filed with [and approved] by the Commissioner" and "is in compliance with the requirements set forth in Insurance Code section 1861.02." The concluding sentence of proposed subsection 2632.2(a) provides that the use "of any rating factor not authorized by Insurance Code section 186.102(a) shall constitute the use of an illegal rate in violation of Insurance Code sections 1861.01 and 1861.05." There is no mention in the concluding sentence of approval by the Commissioner. To the extent that the proposed change is intended to declare rates approved by the Commissioner to be retrospectively illegal, it is inconsistent with *MacKay.*

A. Regulations, of Course, Must be in Harmony with Existing Law

In the Notice, the Department asks what is the effect of the approval of a rate filing which is subsequently found to "not comport with California law."[4] This is a strange question since it was definitively answered in *MacKay.* Specifically, *MacKay* declared that a rate approved by

[4] **NOTICE,** p. 1.

the Department is "compliant with the law" and a subsequent discovery to the contrary "cannot invalidate the DOI's prior approval." *MacKay*, *supra* at 1436 n.6. To the extent that the proposed change to subsection 2632.2(a) is intended to overrule *MacKay* by regulation, it cannot. Regulations must be "in harmony with, and not in conflict with or contradictory to, existing statutes, court decisions, or other provisions of law." *Gov't Code* § 11349(d)(3), *see also Association of California Ins. Cos. v. Poizner*, 180 Cal. App. 4th 1029, 1045 (2009).

B. The Possible Attempt to Overrule *MacKay* by Regulation

During part of the class period in *MacKay,* the Department began using an approval letter which stated that if any "portion of the application or related documentation conflicts with California law, that portion is specifically not approved." The addition of language "any use of a rating factor not authorized by Insurance Code section 1861.02(a) shall constitute the use of any illegal rate" even if approved by the Commissioner may be intended to move that concept from the approval letter to the regulations. If this is the Department's intent, the proposed change would be contrary to existing law.

In *MacKay*, the court stated: "We are not long detained by plaintiffs' suggestion that, by including this provision in its approval letters, the DOI can, as a general matter, prospectively disapprove any rating factor which may subsequently be determined to have been in conflict with California law." *MacKay, supra* at 1435 n.6. The court explained that an "approved rate has the imprimatur of the DOI; it has been approved as compliant with the law, to the best of the DOI's determination. If that rate is subsequently determined to have been illegal, the insurer may no longer charge the rate, but that cannot retroactively invalidate the DOI's prior approval." *Ibid.*

Thus, the Department's approval of a rate means it is compliant with the law. Should it later be determined that the Department made an error, the insurer must cease using the rate, but "the insurer's use of an approved rate is condemned or prohibited only prospectively from the time it is determined to be illegal." *Ibid.* To the extent that the proposed additional language is intended to retroactively invalidate prior approval, it is inconsistent with *MacKay.*

C. Possible Inconsistency With Section 1858.07(b)

Prior to *MacKay,* it was argued that Proposition 103 rates were subject to dual regulation. That is, first review and approval by the Commissioner but second, a challenge by private parties in a civil action. *MacKay* rejected the "dual regulation" theory on various grounds, one of which was based on section 1858.07.

Section 1858.07 was adopted after the passage of Proposition 103. Subsection (a) permits the Commissioner to seek a civil penalty against an insurer "who uses any rate, rating plan, or rating system in violation of this chapter. . . ." However, subsection (b) prohibits the Commissioner from seeking such civil penalties if the insurer "used any rate, rating plan, or rating system that has been approved for use by the commissioner. . . ." So an insurer using a rate in violation of Proposition 103 is subject to a civil penalty but an insurer using an approved rate, whether or not in violation of Proposition 103, is not subject to a civil penalty.

To the extent that the proposed additions to subsection 2632.2(a) are intended to create dual regulation, they would authorize the bizarre result in which the Commissioner could not seek civil penalties because the rate was approved but a private party could seek damages in a civil action by challenging an approved rate. The Legislature's action in adopting section 1858.07 shows the inappropriateness of an effort to authorize a system of dual regulation.

6. CONCLUSION

PIFC appreciates the Department's willingness to receive comments on its proposed regulations. PIFC will be happy to respond to any questions the Department may have with regard to the above comments.