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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 **TRADES' REPLY TO THE COMMISSIONER'S OPPOSITION TO PETITION FOR WRIT OF MANDATE**
CONSUMER WATCHDOG, Intervenor.	Date: May 2, 2014 Time: 11:00 a.m. Dept.: 24
PERSONAL INSURANCE FEDERATION OF CALIFORNIA, et al., Intervenors.	Action Filed: March 1, 2013

TABLE OF CONTENTS

TABLE OF AUTHORITIES

STATUTES

OTHER AUTHORITIES

I. INTRODUCTION

The Commissioner and intervenor Consumer Watchdog ("CW") take quite different positions in opposing the Trades'[1] petition for writ of mandate. For this reason, the Trades reply separately to each opposition. The Trades reply first to the Commissioner's opposition ("Opp."), as the Commissioner is the regulator.

In contrast to CW, the Commissioner makes an earnest attempt to reconcile the law enshrining the fair rate of return standard as the standard limiting a regulator's power to regulate price (protecting against prices that would be confiscatory), and the notion – derived from a superficial reading of *20th Century Ins. Co. v. Garamendi*, 8 Cal. 4th 216 (1994) – that an applicant must suffer some sort of physical financial distress as a result of a rate order in order to challenge a rate order as confiscatory. The Commissioner's theory is that a regulated entity *is* entitled to a rate allowing the opportunity to earn a fair rate of return, and the goal of the formula is to achieve that end result. Opp. at 3. So far so good. But, then, the only way the Commissioner finds to reconcile *20th Century*'s "deep financial hardship" label with the "fair rate of return" standard is to conclude that, while an applicant is entitled to the opportunity to earn a fair rate of return, the applicant must meet a far more rigorous standard in order to earn the right to put on its case establishing that the rate order deprives the applicant of a fair return. The price of admission, according to the Commissioner's attempt to reconcile apparently conflicting statements, is that the applicant must show that it has suffered (or will suffer) financial distress as a result of the rate order. Opp. at 4. Then, according to the Commissioner's theory, the applicant can get it all: not only can the applicant move up to a rate avoiding financial distress, the applicant can put on its evidence that the rate order deprives it of a fair return, and can achieve a rate order allowing a fair return.

The Trades recognize and appreciate the Commissioner's integrity in attempting to account for settled authority recognizing that due process checks the police power, in the context of price regulation, by the "fair return principle": that is, the State's power to regulate price is

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[1] The Trades employ the same abbreviations herein as in their Opening Memorandum in support of their writ petition.

recognized as legitimate so long as the State allows the owner of the property subject to the price control the opportunity to earn a fair rate of return. The Trades do not believe, however, that the Commissioner's "two step" solution is plausible.

If a postulated rate order would deprive an applicant of the right to charge a price allowing the opportunity to earn a fair return, the rate order would transgress the limits imposed by due process.[2] Settled law establishes that, to meet constitutional standards, price control schemes must allow for an adequate avenue for relief guarding against that outcome. To make that relief subject to proof of a loss far deeper than required to establish a deprivation of property would be to deny relief from the due process violation. To borrow from *Calfarm Ins. Co. v. Deukmejian*, a "safely solvent" applicant would be without recourse for a constitutional violation. 48 Cal. 3d 805, 818-819 (1989).

It should be noted that *20th Century* was decided in 1994, prior to the U.S. Supreme Court's clarification in 2005, in *Lingle v. Chevron U.S.A.*,[3] of the distinction between a takings and due process analysis (a clarification called for by Justice Kennard in her concurring opinion in *Santa Monica Beach*, in 1999)[4]. The discussion in *20th Century* focuses on a takings analysis addressed to the showing that would be necessary to establish *compensable damage for a taking of property,* entitling the owner to just compensation. Certainly, the "deep financial hardship" quotation comes from a footnote discussing what is necessary to prove up a compensable taking. *See 20th Century*, 8 Cal. 4th at 296, quoting *Jersey Central Power & Light Co. v. Federal Energy Regulatory Comm'n*, 810 F.2d 1168, 1181 n.3 (D.C. Cir. 1987) ("[A]bsent the sort of deep financial hardship described in *Hope*, ***there is no taking, and hence no obligation to compensate*** . . . .") (emphasis added). Nonetheless, the Court defined "deep financial hardship" by the fair return principle, explaining that a firm would experience "deep financial hardship" if it failed to

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[2] In their Opening Brief, the Trades explained the constitutional underpinnings of the limits on "confiscatory" price controls, including open issues as to the interplay of the takings and due process clauses. This reply assumes that discussion, and does not repeat it.

[3] *Lingle v. Chevron U.S.A., Inc.*, 544 U.S. 528, 540-43 (2005); *see discussion in* Trades' Opening Brief at pp. 8-9.

[4] *Santa Monica Beach, Ltd. v. Superior Court*, 19 Cal. 4th 952, 975-83 (1999) (opinion of Kennard, J., concurring).

"earn enough revenue for both 'operating expenses' and 'the capital costs of the business,' 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 having corresponding risks' and 'sufficient to ensure confidence in the financial integrity of the enterprise***, so as to maintain its credit and attract capital.'" *20th Century*, 8 Cal. 4th at 296 (emphasis added) (*see discussion in* Trades' Opening Brief pp. 20-21).

Be that as it may, the Trades' petition is not about establishing a "taking," or a right to "just compensation," or a right to damages. The Trades' petition does not argue that a specific rate level or return is constitutionally required. The Trades' petition is about *standards.* The Trades challenge the Commissioner's rate regulations – as interpreted by the Commissioner – as unconstitutional, because – as interpreted by the Commissioner – the regulatory scheme does not permit relief from a putative rate order that would be confiscatory in depriving the applicant of the opportunity to earn a fair rate of return. That is, the Trades seek to enforce constitutional limits on the power to regulate price, preventing a taking from occurring in the first place.

The Commissioner's formulaic approach to rate regulation seeks to allow an opportunity to earn a fair rate of return. But, the inclusion of insensitive components the Commissioner considered necessary to balance manageability against accuracy create the risk, in an individual case, that individualized circumstances will preclude a constitutionally-acceptable rate. All the Trades seek, for their members, is a fair chance to present a case, when those individualized circumstances are present.

As previously, the Trades will address the "institutional advertising issues" separately.

II. BACKGROUND: ANATOMY OF A RATE FILING

Thus far, this Court has been presented with briefing attempting to clarify and make specific the application of the most esoteric of constitutional principles. In this section, the Trades will describe the practicum of the rate regulations as applied to a rate application, to provide a concrete illustration for the Court of the problems for which the Trades seek review.

The California rate regulations – in common with ratemaking generally – seek to project the loss costs and expenses an insurer will experience in a future period – the "rating period" – by extrapolating from actual experience in a concluded period – the "recorded period". *See* 10 C.C.R §§ 2642.5, 2642.6. Actuaries use accepted techniques to project how future loss payouts will develop for a body of claims. This is called "loss development." *See* § 2644.6. Actuaries also study the manner in which external forces impact events covered by the policy, to determine whether the historical experience may be likely to change directionally and in degree. *See* § 2644.7. Generally, actuaries study insurance data to understand any ***trends*** that should be taken into account in projecting future experience. Actuaries also consider the expenses associated with running the business, and income from sources other than premium (typically investment income on invested capital). Actuaries consider all of these components, plus a component for a reasonable profit, in developing a calculation of projected rate need for the period of the rate.

As has been discussed in prior briefing, the California regulations attempt to balance rating accuracy with manageability, making gross assumptions in various areas to alleviate the burden on Department rate analysts and actuaries.[5] This discussion highlights just a few of those areas – focusing on troublesome elements where shortcuts for the sake of administrative efficiency may, in individual cases, raise substantial questions regarding rate adequacy.

Significantly in this respect, and of great significance in projecting rates, is ***trend***. As recited in the regulations, "trend" captures the impact external forces can be expected to have in affecting historical data for purposes of projecting future experience. *See* 10 C.C.R. § 2644.7(a). An actuary would consider trend separately for loss frequency (the rate at which covered losses occur), loss severity (the dollar amount associated on average with losses), premium trend (changes in premium due to widespread increases or decreases in coverage amounts, or rate increases or decreases), and, for homeowners insurance, loss trends by peril (e.g., weather-related losses, theft, homeowner liability under the liability section of the policy). Clearly, each of these phenomena will react to separate forces, and no assumption could be made that (for example) trends in theft will behave similarly to trends in weather-related losses.

For purposes of manageability, however, the regulations do not allow separate

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[5] Trades' Opening Brief pp. 11-12, 12-15, 26-27.

consideration of trend. Under 10 C.C.R. § 2644.7, an applicant must calculate "trend" for each of five time periods. The "trends" that must be calculated are "premium" trend, "loss severity" trend, and "loss frequency" trend. The applicant cannot further analyze the data to consider the various perils covered by a homeowner's policy. The applicant must then select, from the five time periods, the ***time period*** identified as the "most actuarially sound." *See* 10 C.C.R. § 2644.7(b) ("The insurer shall file its rate change application using the single data period that it determines to be the most actuarially sound. The Commissioner may require the use of an alternative data period if the Commissioner determines that the use of the alternative is the most actuarially sound.").

It should be noted that CW is incorrect in stating that the regulations call for the most actuarially sound "trend" (of course there are many trends). They do not. The regulation expressly calls for selection of the most actuarially sound ***data period***.

A conundrum results from the reality that there will necessarily be numerous trends and "data periods" impacting projection of future experience, contrasted with the regulations' simplification (for purposes of manageability) that a single data period can capture all of the differing forces impacting the projection. Selecting a single data period will almost inevitably be wrong. But, that may be acceptable, in the grand scheme. It is acceptable if it all works out in the give and take of the various components of ratemaking that the "end result" still allows the opportunity to earn a fair rate of return. But, adequate access to relief is necessary, in the event deficiencies do not wash out in the end result.

Another point of vulnerability within the regulations has to do with treatment of the cost of reinsurance. An applicant is not allowed to include that cost in the rate application, except for the earthquake line. *See* 10 C.C.R. § 2644.25(a). At the rulemaking hearings, CW opposed allowance of that cost because reinsurance premiums are not regulated. That may be so, but neither are the costs of stationary, building contractors, or permits, all of which must be covered by homeowner's insurance. These remain – all of them – costs the insurer must pay to deliver the product. Be that as it may, it could occur, for a homeowner's insurer where the line is prone to catastrophes, that exclusion of the costs of reinsurance has such a pronounced impact on rate versus cost that the insurer cannot earn a fair return.

The regulations also include a "short cut" in determining the investment income that will be imputed to the applicant within the formula. The statutory system mandates that the Commissioner consider "investment income" in considering whether rates are "inadequate" or "excessive". Ins. Code 1861.05(a). To fulfill this mandate, the regulations develop various calculations for projecting yields for various forms of securities (e.g., bonds and stocks) that may be held by an insurer. *See* 10 C.C.R. § 2644.20(c). The regulations (§ 2644.20(a)) prescribe that the distribution of assets (e.g, as between stocks and bonds) will be determined by the insurer's "actual portfolio" – but then goes on to state that the insurer's (the applicant's) actual portfolio will be determined by ***the group*** Annual Statement. In many cases, this would be a sensible determination, as in many situations a subsidiary operates as a whole with the group, and claims the group's capitalization. While that generalization may be supported as a generalization, it will not necessarily be true in an individual case. It could occur that a subsidiary operating in California is 100% invested in bonds, while the group holds (e.g.) 20% stocks. To attribute to the California subsidiary investment income it cannot possibly receive on stocks it does not hold could well push the rate order into the confiscatory level.

Perhaps the most obvious "short cut" within the regulations is the use of an artificial expense component, labeled the "efficiency standard". The "efficiency standard" is an industry average expense ratio to premium, calculated at the national level. *See* 10 C.C.R. § 2644.12.[6] This expense ratio is used as the "expense component" in the regulatory rate calculation, in place of the applicant's own expense data. *See* 2644.2(c)(2) (using the "efficiency standard" as the expense component); *compare former* 10 C.C.R. § 2644.9 (projected fixed expenses using applicant's expense data), § 2644.10 (excluded expenses), § 2644.2 (subtracting "fixed expenses" in the

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[6] In discussing the "institutional advertising" issue, the Commissioner argues that the "specific insurer" phrase is justifiably interpreted as requiring the identity of a specific insurance company to make sure that advertising expense is for California. This makes no sense, as the efficiency standard and the excluded expense penalty are both calculated on a nationwide basis. Thus, the expense of an advertising campaign by "Mercury of Omaha" with acceptably "pertinent" content would ***not*** be excluded.

numerator of the permitted earned premium calculation)[7]. The "efficiency standard" is just an average, and is not backed by any efficiency study. There exists a substantial chance that an individual applicant's actual expense ratio would be higher than the average, and there can be no presumption that the actual ratio is higher due to "inefficiency", rather than, for example, provision of superior service, which costs more. While there are variances to the efficiency standard, these variances, in practice, can be difficult to access. *See* 10 C.C.R. § 2644.27(f)(1), (2) and (4). As with the defects in each component, the defect inherent in using the "efficiency standard" as the expense component in the rate calculation may or may not carry through to the "end result."

These are just examples of situations that could arise where the Commissioner's regulations are insufficient to filter a confiscatory result. The Trades recognize that the Commissioner has added variances ostensibly to account for individualized circumstances, as one means to avoid a confiscatory result. The specific variances represent good faith, but they are not sufficient. They do not effectively address any of the situations described in this subpart.

The Trades' prayer here is for that to which its members are entitled. There is no need for disruption to the existing system. In most cases – assuming the regulatory formula is appropriately calibrated, as we do assume – the formula will produce a rate that allows for an opportunity to earn a fair rate of return. But, the Trades' members are entitled to make the case that, in an individual situation, (1) the rate produced by the formula did not meet constitutional standards, and (2) in that event, the insurer/applicant is entitled to relief, allowing the insurer a rate that permits the insurer the opportunity to earn a fair rate of return.

III. A THRESHOLD ISSUE: COURTS ARE THE FINAL ARBITERS OF WHAT THE LAW IS, AND THE COURTS DO NOT DEFER TO THE COMMISSIONER ON THE CORRECT CONSTRUCTION OF CONSTITUTIONAL LAW

The Commissioner recites as the legal standard that his interpretations of his own regulations are entitled to "great weight." Opp. at 9. In certain circumstances, with respect to certain types of regulations, that would be true. Courts defer to agencies on technical subject matters, and on policy judgments.

In this case, however, the Trades challenge the Commissioner's interpretations and

[7] The former regulations are set forth in Exhibit 3 to the Trades' 2/11/2014 RJN.

regulations as inconsistent with law – in particular, with constitutional law. The interpretation of the law – most particularly constitutional law – falls squarely within the judicial prerogative. In this case, courts do not defer to agency interpretations. *See Interinsurance Exch. of the Auto. Club v. Superior Court*, 148 Cal. App. 4th 1218, 1235-36 (2007) (court gave no deference to Commissioner's interpretation of Ins. Code § 381 where that construction was solely a legal interpretation); *Farmers Ins. Exch. v. Superior Court*, 137 Cal. App. 4th 842, 858-859 (2006) (no deference to Commissioner's constructions of law).

IV. A CONSTITUTIONALLY ADEQUATE HEARING ON A CONSTITUTIONALLY ADEQUATE "VARIANCE" MUST ALLOW FOR REVIEW OF THE RATE OF RETURN PERMITTED BY THE PROPOSED RATE ORDER

In order to evaluate whether the rate of return resulting from a proposed rate order meets "fairness" standards, it is necessary to know what that rate of return is. The rate of return can then be considered, as the "end result" of the rate calculation, to determine whether it is fair. That is the practice illustrated throughout confiscation jurisprudence. *See, e.g.*, *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 312 (1989); *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944); *20th Century*, 8 Cal. 4th at 327-28.

The "two step" approach advocated by the Commissioner is backwards. According to that approach, the applicant has to meet a blind standard, in attempting to establish that the rate of return yielded by a proposed rate order is not fair, without the chance to produce evidence of what the rate of return is. It is not rational to expect meaningful litigation regarding the fairness of a rate of return without knowing the rate of return that is the subject of contention. The "two steps" must proceed: (1) calculate rate of return, based on evidence; and (2) apply balancing test to determine if it is fair.

As explained in the Trades' Opening Brief, the regulatory rate formula can be simplified as:

(projected losses + projected expenses) – investment income + fair return = permitted earned premium

Trades' Opening Brief p. 13. Where a "permitted earned premium" has been proposed, the resulting return is solved for by the equation:

Permitted earned premium + investment income – (projected losses + projected expenses) = return[8]

Obviously, this equation represents the equivalent of the equation for calculating the permitted earned premium, but the unknown variable is the return, rather than the permitted earned premium. The accepted methodology for isolating the actual return that will be produced by the rate calculation is to perform this calculation using the applicant's evidence of its actual numbers. By this means, it can be determined whether the "end result" of the rate calculation has been infected by the claimed defect in a component.

For example, assume that the point of contention is that the regulations' restrictions regarding the calculation of trend have not allowed a reasonable projection of losses. The applicant would present its evidence of projected losses, using accepted actuarial procedures for calculating trend which, while accepted, are outside the regulatory approach (which balances accuracy with manageability). The Department and any intervenors might agree with the applicant's loss projection, or might present evidence of a different loss projection. The potential values are then run through the formula, also accounting for any point at which the regulations have favored the applicant. For example, if the applicant's actual expense ratio is lower than the efficiency standard, the calculation must use the lower expense value. By this means, it can be determined whether a claimed miscalibration at one component in the formula has been cancelled out by other components, or whether it has carried through to the "end result". As the standard is fair rate of return, the end result is tested by the resulting rate of return.

This is the exercise performed by the Court in *20th Century*, in assessing whether the "rolled back" premium 20th Century was allowed by the formula was confiscatory. Of course, in *20th Century*, the applicant's evidence of what the projected rate should be (all components) was represented by the rate actually charged in 1989. The Court used that as the comparator. The

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[8] As explained in the Trades' Opening Brief, the "return" is the same thing, expressed in dollars, as the "rate of return", which is expressed as a percentage of the capital devoted to the regulated business. Opening Brief p. 1 n.2. Where the dispute is a disagreement regarding the amount of capital devoted to the regulated business, that disagreement would have to be evaluated by also comparing the rate of return resulting from the ratio of the dollar return to dollars of capital, using the applicant's evidence of its actual capital devoted to the business.

Court considered that the rate order caused 20th Century to "lose" $78 million of revenue, compared to the amount actually charged. *20th Century*, 8 Cal. 4th at 327-28. But that was not the "end result." The "end result" included avoidance of $29 million in expenses, resulting in a return of $27 million and a rate of return of about 11%. *Id.*

The Opinion appears to concede that this would be an appropriate methodology. *See* Opinion pp. 116-17. The Opinion, however, would label the presentation of evidence regarding the applicant's actual values as "relitigation." *See* Opinion pp. 116, 118. Thus, the Opinion supports using the above equation, but substituting for the actual values the component values produced by the regulatory assumptions. *See* Opinion pp. 116-117, 119 (utilizing chart that assumes losses, DCCE, and ancillary income produced by the regulations). But the regulatory assumptions were already used – including a component for return – to derive the proposed permitted earned premium. Using those same component values does not solve for anything, it just shuffles the same components around. It is this exercise that the Trades and Mercury have described as "tautological".

The Commissioner argues that *20th Century* authorizes a tautological approach, because it approves a "recursive" formula. A "recursive" formula is not the same as a tautology. A "recursive" formula is one where "the value solved for figures in the solution itself." *20th Century*, 8 Cal. 4th at 288. For example, in the ratemaking formula, allowed expenses are determined by a ratio to the permitted earned premium, which is the "value solved for." The "vice" in the Opinion's proposal is not that it suggests a "recursive" formula, or even a "complex" formula. *Id.* The "vice" is that it proposes to test a result by the result itself.

Moreover, the "relitigation" objection is not well-taken. As the Trades explained in the Opening Brief, the regulations do not purport to pronounce upon the best expert methodology that must be used to, for example, project losses. They admittedly balance accuracy with manageability, to allow for efficient disposition of a large volume of rate applications with generally acceptable results. Neither the Commissioner nor CW dispute this design.

With respect to each component of the rate calculation, the regulations do not purport to fix what the value for that component must be. They merely prescribe a generally acceptable result. The regulations do not purport to dictate an accurate projection tailored to the specific applicant and specific application, and the presentation of evidence for this purpose does not "relitigate" the formula established by the regulations, which serve a different purpose (i.e., balancing accuracy and manageability to produce generally acceptable results).

Evidence presented to show the rate of return – the "end result" – that would be produced by a proposed rate order in an individualized case is not presented to challenge "the underlying premises" of the regulations as "[un]sound". *See 20th Century*, 8 Cal. 4th at 312. The regulations are the rules, they apply, and the point is not to argue that the rules are wrong. Rather, the point is to access the Variance 9 "safety valve" that is a part of the regulations, which – as the implied constitutional variance from *20th Century* – is "sufficient to accommodate . . . proof" that the formula is producing a confiscatory result in a particular case. *Id.* at 313.

Once there is evidence regarding the return and rate of return that would result from the proposed rate order, it is possible to evaluate whether that rate of return is fair. While other processes can be acceptable, in the general case there will have to be evidence regarding what the return will be, before its fairness can be considered.

An assessment of whether a rate of return for a future period is "fair" will likely require evidence of a "cost of capital". As the Court observed in *20th Century*, "cost of capital" is "'pertinent for prospective ratemaking' under the 'prior approval' system" (8 Cal. 4th at 321), because there must be some means of evaluating whether a rate to be charged ***in the future*** will produce "enough revenue for both 'operating expenses' and 'the capital costs of the business,' 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 credit and to attract capital.'" (8 Cal. 4th at 296, *quoting and paraphrasing Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944)). As the U.S. Supreme Court similarly observed in *Duquesne Light Company v. Barasch*, "[o]ne of the elements always relevant to setting the rate under *Hope* is the return investors expect given the risk of the enterprise." 488 U.S. 299, 312-314 (1989). "Cost of capital" is a measurement of a rate of return meeting those criteria.

To be sure, evidence that a rate of return meeting these criteria – i.e., the cost of capital – would be "exploitative" to consumers is also admissible, in evaluating a fair rate of return.[9]

A hearing applying a correct constitutional standard – the "fair return" principle – and admitting the evidence necessary to even consider the return allowed by the proposed rate would meet constitutional requirements.[10] The Trades believe that this is permitted by Variance 9 and not precluded by any of the other regulations. If it is not – and it is not permitted, under the Commissioner's interpretations – the regulatory scheme does not provide the necessary means of redress in the event of a potentially unconstitutional result, and the entire system is invalid.

V. "KICKING THE CAN DOWN THE ROAD" DOES NOT SATISFY CONSTITUTIONAL REQUIREMENTS

Citing *Kavanau v. Santa Monica Rent Control Bd.*, 16 Cal. 4th 761 (1997), the Commissioner argues, in essence, that there can never be a confiscation violation resulting from a rate order, because an insurer can always apply for a new rate order that would "fix" its predecessor. Opp. at 15-16. This is not an adequate response to the question of whether the Commissioner exceeded the constitutional bounds of his power to regulate price. What is more, the "fix" – which can only constitute a "fix" in the context of damage to the applicant, there is no "fix" with respect to the Commissioner's assumption of a power in excess of that permitted by the Constitution – cannot occur without a determination that the Commissioner has, indeed, issued a confiscatory rate order, requiring a "fix."

In *Kavanau*, the Court considered a follow-on case, in which a prior appellate decision had held that rents to which a landlord was constrained were confiscatory (violation of due process). In *Kavanau* – called "*Kavanau II*" because it is a sequel to the prior case – the landlord brought an inverse condemnation action seeking the "just compensation" due when the government has exacted a "taking". *Kavanau II* addressed what is necessary to adequately

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[9] The Trades will address the "balancing" of the investor interest against the consumer interest in avoiding exploitation in their Reply to CW's opposition, as CW has raised the issue.

[10] The Trades do not suggest that this would be the only acceptable means of establishing that a proposed rate would be confiscatory. It is, however, the most likely means available, when considering a rate to be charged in the future.

recompense for a taking, and whether a taking had occurred.

As discussed in the Trades' Opening Brief, there is a distinction between the governmental overreaching in the price control context addressed by the due process clause, and evaluated by the fair return principle, and a "taking". The "takings" inquiry is neutral to the inquiry regarding government authority, and focuses upon impact to the regulated entity to evaluate whether that impact warrants just compensation. On the other hand, "[n]o amount of compensation can authorize" action outside a regulator's legitimate authority. *Lingle*, 554 U.S. at 543. The case presented by the Trades' petition is about the limitation on government power, not recompense for a taking. This difference must be considered in examining to what extent *Kavanau* informs the issues here.

Specifically, the relief sought by the Trades here was achieved by Kavanau in *Kavanau I* – a writ of mandate preventing the Rent Board from continuing a due process violation. 16 Cal. 4th at 779. Insofar as *Kavanau II* discusses constraints on obtaining damages (the purpose of the *Kavanau II* action), it sheds little light on the relief requested here by the Trades.

In *Kavanau II*, the Court held that in the context before it the potential "taking" could be addressed by including an "adjustment" in future rents sufficient to make up for the lost revenues resulting from the previously-adjudicated confiscatory rents. The Court reasoned that the tenants – not the government – had been the beneficiaries of the rents that were confiscatory as to the landlords, such that it was fitting that the tenants make up the difference, by including a compensatory adjustment in the rents. This type of adjustment is referred to as a "*Kavanau* adjustment".

The Commissioner argues that, in Kavanau's proceedings before the Rent Board seeking just compensation, the Rent Board applied the "deep financial hardship" test. Opp. at 16. In fact, the Rent Board underscored the distinction between the due process and takings clauses, and stressed that ***a taking*** occurs only in cases of "'deep financial hardship'". 16 Cal. 4th at 782. That is, the Rent Board set up "deep financial hardship" as the standard that must be met ***to obtain damages***, over and above a conclusive holding that there had occurred a due process violation resulting from preclusion of a fair rate of return. That, indeed, is true to the origins of the "deep financial hardship" concept.

The Commissioner argues that the availability to insurers of seriatim rate filings allows for a "*Kavanau* adjustment," such that there can never be a constitutional violation. Opp. at 21. At the threshold, the Trades' petition does not claim a taking, seek inverse condemnation, or request 42 U.S.C. § 1983 damages. The Trades seek a writ directed to the Commissioner requiring him to remain within the limits of constitutional authority in exercising his rate regulatory powers. In its due process aspect, the constitutional protections against confiscation ***limit government authority*** at least as much as they provide remediation to regulated entities suffering a taking.

Further, even in a case in which an applicant has been subjected to a confiscatory rate order and has suffered damage, it would still be necessary to prove that the order was confiscatory in order to get an adjustment. The Commissioner's theory seems to be that the data in the interim rating period will show deterioration, justifying a higher rate. But all that does is establish rate need at a higher level. It does not support a "boost" compensating for a rate that did not provide for a fair return – it does not provide compensation for a taking.

The Commissioner also seems to cite *Calfarm* for the proposition that applicants can be deprived of a fair return in the short term, so long as the applicant receives a fair return in the long term. The Court was making the opposite point. In addressing the argument that emergency conditions justified depriving insurers of a fair return for the one year period of the rollback, the Court observed that proponents had not identified a temporary exigency that could justify a short term deprivation of a fair return. In the absence of such an exigency, the general rule applied: "Over the long term the state must permit insurers a fair return; we do not perceive any short term conditions that would require depriving them of a fair return." 48 Cal. 3d 805 at 821.

VI. THE CONTROLLING "FAIR RETURN PRINCIPLE" IS INCOMPATIBLE WITH THE NOTION THAT A REGULATOR CAN COMPEL RATES THAT DO NOT PERMIT A FAIR RETURN, AS LONG AS THE REGULATED BUSINESS CAN BE SUPPORTED BY A NATIONWIDE ENTERPRISE

Consistently, Supreme Court case law emphasizes that the State holds the power to regulate the price of insurance, and that price control is rationally related to a legitimate government purpose, so long as the price control scheme allows a price permitting the regulated entity the opportunity to earn a fair rate of return. It is utterly implausible to suggest that the "fair return" that must be permitted can be satisfied so long as the regulated entity can earn a fair return based on its Fijian business, or some other business not subject to the rate order. That is simply not a plausible reading of the standard articulated in the cases, which plainly mean that the rate order must allow a fair return on the business regulated by the rate order.

The single argument in opposition consists of recitation of language occurring in *20th Century*. But *20th Century* was addressing something different, something unique. At issue in *20th Century* was an "all lines" "rollback" refund, calculated by an "all-lines" formula and distributed to all policyholders as a percentage of premium regardless of the line or lines in which the policyholders held policies. No policyholder asserted a class action claiming that this was unfair, that auto policyholders (for example) should not receive rollback refunds generated by a hindsight computation of losses versus premiums in the earthquake line. Perhaps there would have been a different result in that case. Be that as it may, the enterprise-wide rollback at issue in *20th Century* was *sui generis*. The text in the *20th Century* opinion identifies its holding as *sui generis* by carefully circumscribing its comments with the words, "***in this context***". 8 Cal. 4th 308, 322 (emphasis added).

Prior approval rate regulation, in contrast, is not "enterprise-wide". Indeed, the California regulator has no authority to regulate business in other states, as he would do under the "enterprise" test. In *BMW of North America, Inc. v. Gore*, 517 U.S. 559 (1996), the U.S. Supreme Court stated the foundational principle that a state's power to regulate is confined by the state's borders:

> "[I]t would be impossible to permit the statutes of [one State] to operate beyond the jurisdiction of the State . . . without throwing down the constitutional barriers by which all the States are restricted within the orbits of their lawful authority and upon the preservation of which the Government under the Constitution depends. This is so obviously the necessary result of the Constitution that it has rarely been called in question and hence authorities dealing with it do not abound."

517 U.S. at 572 n.16 *quoting New York Life Ins. Co. v. Head*, 234 U.S. 149, 161 (1914). As one court concisely explained, in the course of applying this principle in the context of price regulation:

> Separation of [different jurisdictions'] operations has been required by the United States Supreme Court for two related reasons: (1) to avoid jurisdictional conflicts between [different jurisdictions'] regulatory agencies and (2) to avoid discriminatory rates which result in one class of ratepayers subsidizing another.

United States v. RCA Alaska Commc'ns., Inc., 597 P.2d 489, 499 (Alaska 1979) *citing Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133 (1930) and *Lindheimer v. Illinois Bell Tel. Co.*, 292 U.S. 151 (1934); *see also Elkhart Tel. Co. Inc. v. State Corp Comm'n*, 640 P.2d 335, 338-39 (Kan. App. 1982).

The California regulator cannot effectively usurp gains from other jurisdictions to support California rates. What is more, even treating all California lines of business as "the enterprise" creates discriminatory rates, as recognized in *RCA Alaska*, *supra*, because the lines called upon to make up the difference between an inadequate return and a "fair" return are subsidizing the rates for the line which has not been allowed a fair return. This discrimination is prohibited by California law. *See* Trades' Opening Brief p. 18 lines 16-24.

More practically, a rate order is directed to a line of insurance. The only reasonable reading of the constitutional limits on a regulator's authority to regulate price is that the regulator must permit the opportunity to earn a fair rate of return *as to the property being regulated.* No other interpretation is plausible.

VII. A CORRECT DECISION IN THIS ACTION DOES NOT SPELL AN END TO RATE REGULATION

The Commissioner expresses a concern that recognizing constitutional protections against confiscation in this case will end rate review by regulation and introduce an era of case-by-case, standardless, rate review. Speaking for the industry, the Trades represent that this is not the object of their writ petition. So long as the formula produces "good enough" results, the Trades' members have no motivation to overthrow the more streamlined process represented by the regulations and formula. The interest of the Trades' members is in access to redress, in the (hopefully) few instances in which the formula does not produce an acceptable result.

VIII. THE COMMISSIONER'S "INSTITUTIONAL ADVERTISING" REGULATION IMPOSES A FINANCIAL PENALTY ON SPEECH – COMMERCIAL AND NON-COMMERCIAL SPEECH – BASED ON THE WORDS AND MESSAGE IN THE SPEECH. THIS IS A CLEAR EXERCISE OF CENSORSHIP AND VIOLATES THE FIRST AMENDMENT.

The Commissioner accords only short shrift to the First Amendment concerns the Trades have identified with the "institutional advertising" regulation. Without analysis, the Commissioner asserts the conclusions that the speech at issue is only commercial speech, that his regulation is not content-based (although it defines affected speech based on the message), and that imposing an excluded expense factor is not, in any event, an unconstitutional burden on speech. These assertions do not survive the missing analysis.

A. Speech Cannot Be Designated "Commercial Speech" In The Abstract, Simply Because It Is Contained In Advertising.

The Commissioner makes the assumption that because the regulated speech is advertising, it must constitute "commercial speech". That assumption is contradicted by First Amendment jurisprudence. In *Bolger v. Youngs Drug Products Corp.*, 463 U.S. 60, 66 (1983), the U.S. Supreme Court rejected such a presumption. In determining whether advertising is commercial speech, courts consider whether its principal purpose is to influence a sale, whether the advertising references a specific product, and whether the speaker is economically motivated. If all of these characteristics are present, they provide "strong support" for the conclusion that the advertising in question constitutes commercial speech. *Id.* at 67.

Considered against the regulation in question, particularly as interpreted in the Opinion, the regulation primarily singles out advertising that would qualify as *non-commercial* speech for the excluded expense penalty. The regulation singles out advertising *not* directed to sale of a specific product, and *not* pertaining directly to the buying decision (in whatever way the Commissioner chooses to apply that censoring factor) as subject to the penalty. *See* 10 C.C.R. § 2644.10(f). That is, characteristics that make it *less* likely that speech is commercial speech make it *more* likely the speech will be penalized. This inverse relationship is underscored by the examples provided in the Opinion of advertising to which the excluded expense penalty attaches: event sponsorship of a "worthy cause," "promotion of a company's environmental efforts," and "campaigns against cell phone use while driving." Opinion at 94.

Whether specific advertising at issue would be considered commercial or non-commercial speech would have to be determined on a case-by-case basis. There is no general assumption that advertising constitutes commercial speech. In any event, that is not a critical question, because attaching a penalty to speech based on content violates the First Amendment whether or not the speech is commercial speech.

B. The Regulation Identifies Speech Subject to the Excluded Expense Penalty Based On The Words and Message Contained In The Advertising. That Is A Content Based Regulation of Speech.

The regulation distinguishes between advertising "aimed at obtaining business for a specific insurer" and "providing consumers with information pertinent to the decision whether to buy the insurer's product" on the one hand and all other advertising on the other hand. *See* 10 C.C.R. § 2644.10(f).[11] The first two categories are permitted without penalty; all other advertising is subject to the excluded expenses penalty. The Opinion identifies examples of advertising subject to the excluded expense penalty ***by their content***: advertising warning of the risks of texting while driving, sponsorship of sporting events, and promotion of environmental efforts. *See* Opinion at 94.

Regulation is "content-based" and not "content-neutral" when the regulation distinguishes between favored and disfavored speech based on the message, or idea, expressed in the speech. *Turner Broadcasting Sys., Inc. v. Fed. Commnc's. Comm'n*, 512 U.S. 622, 641, 643 (1994). Section 2644.10(f) distinguishes amongst speech contained in advertising based solely on the content of the advertising, as illustrated by the examples provided in the Opinion. If the advertising conveys the message that the consumer should buy the product due to price (for example), there is no penalty. If the advertising conveys the message that the insurer supports a local sports team

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[11] It may be observed that ***all*** advertising – at least of the type considered in the Opinion – "provid[es] consumers with information pertinent to the decision whether to buy the insurer's product". Advertising which appeals to sports team loyalty, or appreciation of corporate responsibility, or the desire to be entertained, provides the consumer with information pertinent to the consumer's choice of product. The regulation, however, must intend that some advertising be affected by the excluded expense penalty. Further, the Commissioner has already crossed that censorship bridge: he describes the regulation as permitting costs of advertising "including pertinent facts about the insurance product" (Opposition p. 28:6-9), rather than "***information pertinent to the decision whether to buy*** the insurer's product" (emphasis added).

(and, inferentially, that the consumer should purchase the product for that reason), the penalty applies. The penalty applies or does not based on the message in the advertising.

The Commissioner asserts that the regulation is justified as expressing a policy determination that a certain category of expense – certain speech – is disfavored. That is precisely the form of regulation banned by the First Amendment. As the U.S. Supreme Court explained, "[a]t the heart of the First Amendment lies the principle that each person should decide for himself or herself the ideas and beliefs deserving of expression, consideration, or adherence." *Turner Broadcasting*, 512 U.S. at 641. In this case, consumers may want to purchase insurance from a company that sponsors a favorite sports team, or student athletics, or that supports responsible behavior by warning against the dangers of texting while driving. They have that choice, and insurers have the choice to promote their products based upon these varying messages. The Commissioner does not get to decide, or to burden the choice by imposing a monetary penalty on disfavored advertising.

C. The Regulation Cannot Be Justified Based on The Public Utility Concept of Neutral Allocation of Costs Between Consumer And Shareholder Accounts.

Without addressing the distinctions set forth in the Trades' Opening Brief between the public utility model and insurance rate regulation as governed by Insurance Code § 1861.05(a), the Commissioner simply reasserts the fiction that § 2644.10(f) does not impose a penalty, it merely prevents a pass-through to consumers of expenses appropriately allocated to an insurer's shareholders. The Trades here summarize the reasons that theory cannot be sustained, as discussed in detail in the Trades' Opening Brief.

First, this concept of allocating between a shareholder "account" and a ratepayer "account" is inconsistent with the governing statute. Insurance Code section 1861.05(a) requires that investment income – the income earned on the owner's property devoted to the business – all be considered in reviewing rates. That would be the owner income out of which the owner of the business would pay expenses allocated to the owner. The governing statute thus requires an "all in" approach that does not leave a separate source of funds out of which the owner could pay expenses allocated to it. *See* Trades' Opening Brief Part V.B.

Second, the structure of the insurance industry is wholly different from the model for utility ratemaking. The insurance market features competitors which are not, in large part, publicly-traded corporations – and which do not have shareholders – with strong product competition. In this market, the purpose for advertising is to sell product, not to promote investment in the corporation. *See* Trades' Opening Brief Part V.B.

Third, as the regulations have evolved, the individual applicant's expenses are not included in the expense component of the regulatory formula, and the expense exclusion penalty does not serve to prevent a "pass-through" of expenses that are not there. *See* Trades' Opening Brief Part V.A. and Pat V.C. p. 38:9-18.

The excluded expense penalty imposed by § 2644.10(f) on advertising such as "event sponsorship," "promotion of a company's environmental efforts," or "campaigns against cell phone use while driving" (Opinion at 94) burdens speech based on the content of that speech. It violates the First Amendment.

IX. CONCLUSION

By their petition, the Trades pray that this Court issue its mandate to compel the Commissioner to comply with constitutional and statutory law in interpreting and administering California law governing insurance rate review. Such a mandate will not prevent the Commissioner from the proper exercise of his regulatory powers, contrary to the Commissioner's expressed fears. It will, however, check that regulatory power, by imposing judicial oversight over questions of law, and requiring that the Commissioner remain within constitutional bounds in wielding the power of the State. This petition should be granted.

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