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STATE FARM GENERAL INSURANCE COMPANY

SUPERIOR COURT OF THE STATE OF CALIFORNIA

FOR THE COUNTY OF SAN DIEGO

STATE FARM GENERAL INSURANCE COMPANY,

Petitioner and Plaintiff,

v.

DAVE JONES, in his official capacity as the Insurance Commissioner of the State of California,

Respondent and Defendant.

CONSUMER WATCHDOG and CONSUMER FEDERATION OF CALIFORNIA,

Intervenors.

Case No. 37-2016-00041469-CU-MC-CTL (Lead Case)

STATE FARM GENERAL INSURANCE COMPANY'S PHASE 1 OPENING BRIEF

Hearing Date: Feb. 9, 2018
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I. INTRODUCTION

State Farm General Insurance Company ("SFG") asks this Court to set aside the November 7, 2016, decision of the California Insurance Commissioner (the "Commissioner"), which orders SFG to *decrease* its homeowner's rates overall by 7% in response to SFG's request for a 6.9% rate *increase* (the "Decision"). This action does not involve technical questions drawing upon the Commissioner's ratemaking expertise. On the contrary, SFG raises pure legal questions falling squarely within this Court's prerogative—most important, may the Commissioner disregard SGF's separate corporate form and treat it as nothing more than an indivisible part of one big "State Farm" company? The answer is no, and this fundamental legal error permeates and infects every aspect of the Decision.

The Insurance Code forbids the Commissioner from ordering a rate that is "excessive, inadequate, [or] unfairly discriminatory," and the Commissioner, in assessing a proposed rate, "shall consider whether the rate mathematically reflects *the insurance company's investment income*." (Insurance Code § 1861.05(a), italics added.) Section 1861.05(a) recognizes that insurers earn both investment income and premium income; to the extent investment income is available to pay claims and expenses, then the Commissioner may reduce permitted premium by the amount of that available investment income.

Here, the Commissioner's rate decrease resulted from ignoring the statutory phrase "the insurance company's investment income." The Decision substitutes for SFG's actual investment income—and SFG is indisputably "the insurance company" making the rate application—phantom income from a fictional asset portfolio derived from blending the assets of SFG *and its affiliates*. SFG is a separate company with its own corporate identity, responsible to cover its own losses and expenses with its own investment income and its own premiums. And SFG maintains a conservative, low-risk investment portfolio rounding to 100% bonds. Yet according to the Commissioner, he can ignore the statutory directive to consider "the insurance company's investment income," and put in its place a concocted investment income value generated from a composite of investment assets held by SFG, its corporate parent, and seven other State Farm affiliates, which the Decision refers to collectively as the "State Farm Group." This fictional portfolio includes about 40% stocks.

Specifically, two of SFG's affiliates—State Farm Mutual Automobile Insurance Company ("SF Mutual"), the parent company, and State Farm Fire and Casualty Company ("SF Fire"), which writes homeowner's and other property insurance in 47 states (but not California)—have risk profiles distinct from SFG's and hold portfolios with a substantial percentage of stocks. The Decision attributes to SFG stock assets from the portfolios of SF Mutual and SF Fire, even though SFG cannot

earn income on stock assets that it does not own or have any ability—either legally or practically—to access. Calculating "the insurance company's investment income" in this manner resulted in approximately $100 million of extra investment income annually that the Commissioner attributed to SFG, offsetting and drastically reducing SFG's allowable rates. Plainly, because this methodology did not "mathematically reflect" *SFG's* investment income, it is irreconcilable with the plain text and intent of Insurance Code section 1861.05(a). (See *20th Century Ins. Co. v. Garamendi* (1994) 8 Cal.4th 216, 243 [reference in section 1861.05(a) to "the insurance company's investment income" is to the income of the "*individual insurer*"], italics added.)

The Decision also cannot be squared with settled rules of rate regulation and core constitutional principles. The Commissioner disregarded SFG's separate corporate existence and a risk-management structure in which SFG, SF Mutual, and SF Fire exist as separate entities, and they as well as the State Farm Holding Company System are regulated by Illinois, not California. The Commissioner opined that State Farm should adopt a different corporate structure, enter into an intra-corporate pooling agreement, and/or transfer assets to provide SFG with access to its affiliates' assets or investment income. (Decision 43, 50.) But the Commissioner's assumption that the ratemaking process may be used to coerce SFG and its out-of-state affiliates into altering their financial structure encroaches upon fundamental notions of comity and state sovereignty embodied in the federal McCarran-Ferguson Act, the "internal affairs" rule, and multiple provisions of U.S. constitutional and statutory law—all of which prohibit states from employing their laws and regulations to reach beyond their own borders and influence and/or regulate conduct in other states. (See, e.g., *BMW of N. America, Inc. v. Gore* (1996) 517 U.S. 559, 570–572; *Hill v. State Farm Mut. Auto. Ins. Co.* (2003) 114 Cal.App.4th 434, 442–451 (*Hill I*).)

The Commissioner's erroneous reasoning also allowed him to avoid the reality that SFG's new rate is "confiscatory." The regulatory rate equation calls for a profit component at a 7.39% rate of return to SFG. The Decision achieves that return by assuming SFG has investment income from the fictional, blended portfolio of the "State Farm Group." But when SFG's *actual* portfolio is used, the profit/rate of return to SFG resulting from the ordered maximum premium is a mere 2.65%. Critically, this return is only 0.25% above what SFG could earn if it did not engage in the business of insurance at all—and did nothing more than collect investment income from its bond portfolio. Obviously, writing insurance in a catastrophe-exposed line is significantly riskier than simply investing in bonds. "Variance 9"[1] provides for relief from a rate that would be confiscatory. (10

[1] As explained by actuary Karen Terry during the proceedings below, "variances are included to

CCR § 2644.27(f)(9).) SFG is entitled to Variance 9 because under any conceivable standard, a rate that allows virtually no value in return for investment in a regulated business is confiscatory.

The Commissioner also denied SFG's request for "Variance 3" (10 CCR § 2644.27(f)(3)) based on a similar fundamental error. Variance 3 recognizes a slightly higher capital base for "an insurer" writing (as pertinent here) at least 90% of its business in California, if its mix of investments presents risks different from those presented by the line as a whole. Application of Variance 3 would allow a slightly enhanced rate to account for that added risk. But the Decision erroneously denied this variance on the basis that "the insurer" means "the group," not SFG itself.

Lastly, the Decision suffers from another serious flaw that, even apart from the investment income issue, renders the Decision contrary to established law. Under California's prior approval regime, an insurer is required to charge the current approved rate; the insurer cannot change its rate unless and until the Commissioner approves a new rate. And while the Commissioner can order a rate change, he can order such a change only prospectively. But here, for the first time in the twenty-eight year history of prior approval rate regulation in California, the Commissioner made his rate order retroactive, backdating it to July 15, 2015, seventeen months before the December 2016 effective date of the rate order, to be effectuated through $100 million in refunds. The Commissioner did so even though he had approved SFG's prior rate and it was still in effect, making it the *only* rate that SFG was legally allowed to charge during that period. Never before has the Commissioner imposed the extraordinary and burdensome remedy of a retroactive rate refund under the guise of his prospective rate authority, and his decision to do so here violates settled law and due process.

In sum, the Court should issue a writ commanding the Commissioner to set aside the Decision and directing him to enter a new decision that is consistent with this Court's ruling.

II. BACKGROUND

A. SFG And Its Relationship With Affiliates

SFG is wholly owned by SF Mutual, and is part of an insurance holding company system[2] that includes various other State Farm affiliates writing in various states and in different lines of

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allow an insurer to adjust mandatory components of the California rate application when the mandatory components are not appropriate for the insurer's circumstances or experience." (Administrative Record ("AR") 6305 ¶32.)

[2] An "insurance holding company system" is two or more affiliated companies, one or more of which is an insurance company. (215 ILCS 5/131.1(c); Ins. Code § 1215(e); Nat'l Ass'n of Ins. Commissioners ("NAIC") Model Act MDL 440 Section 1 E. (RJN Ex. B).) References to "State Farm" without identifying a specific affiliate are to the State Farm holding company system.

insurance. (AR 5245–5246 ¶¶ 7, 8, 10.) SFG and SF Mutual are incorporated in Illinois, and all of the other affiliates implicated in the Decision are incorporated or organized in states other than California. As a mutual insurer, SF Mutual is owned for the benefit of its policyholders, and has no investors. (AR 5245 ¶ 7; *Hill I*, 114 Cal.App.4th at 440.)

Historically, the State Farm system had included one company—SF Fire—that wrote homeowner's insurance in all 50 states and the District of Columbia. (AR 5245–5246 ¶ 8.) State Farm redesigned this structure after two major catastrophes within three years decimated SF Fire's companywide, countrywide surplus: Hurricane Andrew in Florida (1992) and the Northridge Earthquake in California (1994). (AR 6283 ¶ 8.)

The current State Farm structure is designed to provide homeowner's insurance through specific insurers: (1) one company, SF Fire, writing in 47 states and the District of Columbia and (2) three single-state companies in the most populous states, which also have unique catastrophe exposure: SFG in California, State Farm Florida in Florida, and State Farm Lloyds in Texas. (AR 5245–5246 ¶¶ 8, 10; RJN Ex. F.) The single-state company structure ensures that (1) policyholders in other states are insulated from those unique risks, and (2) risk mitigation strategies (such as separate surplus) can be tailored specifically to the needs of policyholders in these states. (AR 5246 ¶ 10.) This means that, in today's risk environment (see RJN Ex. E), SFG's surplus is not exposed to Florida claims from Hurricane Irma or Texas claims from Hurricane Harvey—or, for that matter, claims from events like Hurricane Sandy in other states—and it *is* situated to withstand the massive *California* claims that would follow devastating wildfires or fire following earthquakes.

Toward that end, SFG exists and operates as a separate company, responsible for the results of its own operations. It retains its own premiums, pays its own losses, and holds its own assets without comingling with its affiliates. (AR 5249 ¶ 19; AR 6226–6227 ¶ 45.) SFG is a party to certain shared services agreements, whereby State Farm affiliates achieve efficiencies through shared function centers providing technology, actuarial, legal, accounting, and other services; it pays for these services through contracts filed with and approved by the Illinois Department of Insurance, with further, additional filing and approval by other state regulators in some cases. (AR 5247–5248 ¶¶ 14, 15, 17; AR 7071–7074.) SFG also obtains part of its reinsurance through contracts with SF Mutual, also subject to Illinois regulatory approval. (AR 5248–5249 ¶¶ 16, 17.) But none of these contracts gives SFG access to its affiliates' assets or the investment income produced by those assets, just as its affiliates have no access to its assets or income.[3]

[3] For example, during the 2008 recession, SF Mutual and SF Fire lost billions in surplus through

Each State Farm affiliate maintains a carefully calibrated investment plan selecting assets tailored to that company's risk. (AR 5250 ¶¶ 22, 23.) For its part, SFG has "a liquid portfolio essentially 100% in bonds due to [its] earning volatility, risk profile, and level of capitalization." (AR 5250–5251 ¶ 24.) By contrast, SF Fire and SF Mutual maintain a significant position in equities in their investment portfolios. (*Id.* ¶ 25.)

B. The Role of Investment Income in Ratemaking

The central question in this case turns on the *investment income* available to an insurer. As discussed below, Ins. Code § 1861.05(a) mandates that an insurer's rate be offset "mathematically" by "the insurance company's investment income." The Commissioner's implementing regulation, 10 CCR § 2644.20(a), calls for investment income to be determined using "the insurer's actual portfolio." The actual percent yield is determined by current market rates for each asset class, such as bonds, real estate, stocks, etc. (AR 6616.) The regulation uses indices tied to current market activity to set the expected percent yield for each asset class—except for stocks, as to which the expected yield is set at the risk-free rate plus 8%. (10 CCR § 2644.20(c).)

At issue here is the Commissioner's reliance on a phrase in 10 CCR § 2644.20(a) that purports to determine asset distribution ("weights") *within* the insurer's "actual portfolio" by reference to the "insurer's most recent consolidated statutory annual statement." California, like other states, requires insurers doing business in the state to file statutory annual statements reporting on that insurer's financial condition, on forms developed by the NAIC.[4] (AR 5251 ¶ 26; see also Ins. Code § 931.) These are *individual* (not "combined") statements filed by *individual* entities, and SFG files such an individual annual statement. (AR 5251–5252 ¶ 27.) The NAIC independently provides for "combined" annual statements to be filed with the NAIC by property/casualty insurers in certain defined circumstances. (AR 5252 ¶ 28 & AR 7395.) This type of "combined" statement was created by the NAIC for its own statistical and analysis purposes (*ibid.*) and is not referenced in or required by the Insurance Code. SF Mutual files with the NAIC a combined annual statement for itself and eight property/casualty affiliates—including SFG, SF Fire, State Farm Florida, and State Farm Lloyds—based on its ownership and/or control of those affiliates. (*Ibid.*) It was the Commissioner's use of this "combined" statement, through the

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stock market losses. (AR 5249–5250 ¶ 20, 7392.) SFG was insulated from such losses due to its bond portfolio and its separation from its affiliates. (*Ibid.*)

[4] "The NAIC is an organization of all insurance regulators from every jurisdiction in the United States. It functions to identify, clarify and state best practices, and to bring some uniformity, to an industry regulated on a state-by-state basis." (AR 5251 ¶ 26.)

reference in 10 CCR § 2644.20(a), that resulted in his imputing income to SFG from a fictitious portfolio of assets that differed radically from SFG's "actual portfolio" and produced an offset to SFG's proposed rate that did not "mathematically reflect" its actual investment income, as specifically required by the statute.

C. Procedural History

On December 4, 2014, SFG filed the rate application at issue here, seeking an overall 6.9% rate increase for SFG's homeowner's contracts (later amended to an overall 6.4% increase). (AR 6303 ¶ 26.) On June 22, 2015, after certain consumer groups had intervened and efforts to resolve the rate issues failed, the Commissioner issued a Notice of Hearing on SFG's application. (AR 40–43.) The Commissioner's Notice—which, notably, was addressed to SFG, but not to SF Mutual or any of SFG's other affiliates—announced that the Commissioner planned the unprecedented action of imposing any new rate retrospectively to July 15, 2015 and that if there were to be a rate reduction, it would be implemented through a refund order.

On August 8, 2016, after an evidentiary hearing before an ALJ, the Commissioner released the ALJ's Proposed Decision and directed further proceedings on the interest rate that would apply to any refunds. On November 7, 2016, the Commissioner adopted the ALJ's new Proposed Decision as his Final Decision, and designated it precedential. The Decision ordered an overall 7% rate decrease, despite SFG's having initiated the proceeding by requesting a rate *increase*.[5]

More than ten points of the 13.4% difference between the proposed rate increase and the resulting decrease derived from the calculation of SFG's presumed investment income using a fictional investment portfolio attributed to the entire so-called "State Farm Group." Although the regulation states that yield must be calculated using the "insurer's actual portfolio" (10 CCR § 2644.20(a))—a calculation that would produce a projected yield of 2.40%[6] based on the yield formula for bonds—the Decision concluded that SFG's investment income would be projected at the rate of 5.84%, based on the combined assets shown for the nine affiliates included in the combined annual statement. (Decision 39, 44.) This resulted in the use of a fictional investment portfolio consisting of about 40% equities (Decision 15; see AR 7401 [line 2/lines 1 through 9 =

[5] The overall 7% decrease is the result of separate orders addressing rates for three forms of insurance offered by SFG: (1) a 5.37% decrease for SFG's form for homeowners living in their homes (a category that covers most of SFG's California insurance); (2) a 20.39% decrease for SFG's renter's form; and (3) a 13.81% decrease for SFG's condominium unit owner form.

[6] 2.40% is the yield at which SFG would be *projected to earn* investment income based on its own portfolio. (AR 6617.) 2.25% is the yield SFG *actually did earn* on assets purchased between July 15, 2015 and August 11, 2016. (AR 8914.)

42.2%]), when SFG's actual portfolio consists of almost 100% bonds. (AR 7076.) The Decision dismissed the reference in the regulation calling for the "insurer's actual portfolio," asserting that the combined annual statement of the "State Farm Group" *was* "Applicant's actual portfolio on a group basis." (Decision 41.) It also brushed aside the undisputed fact that SFG has no access to the assets or investment income of its affiliates, suggesting that "insurers may transfer assets between affiliates." (*Id.* at 43.)

The Commissioner extended a similar rationale to SFG's request for Variance 3—which allows an insurer to show that its formulaic rate should be adjusted based on its concentration risk as a monostate insurer. The Commissioner ruled that the threshold for application of the variance had to be met at the "group" level, rather than the "insurer" level. (Decision 48–49.)

The Commissioner also denied SFG's request for Variance 9, the "constitutional variance" required to avoid a confiscatory rate. He found that the rate for SFG would not be confiscatory because—again measured against the financial condition of the whole "State Farm Group"—it would not place that entire Group in "deep financial hardship." (Decision 62.)

Finally, the Commissioner directed that the 7% rate reduction be retroactive to July 15, 2015, the date that SFG had proposed in its initial rate application, even though the Commissioner had never before established a retroactive effective date for a new rate. (Decision 69.)[7] The Commissioner ordered SFG to refund the difference in rates during the prior period, plus interest at the rate of 2.25% per annum—the rate Petitioner actually earned on assets purchased between July 2015 and August 2016. (*Id.* at 78–79; AR 8908–8914.)

SFG filed a timely petition and complaint on November 23, 2016. Upon SFG's application for a stay of the underlying Decision, this Court entered a stay limited to the "portion of the Commissioner's order requiring refunds to be paid."

III. STANDARD OF REVIEW

SFG's petition presents primarily questions of law. "Interpretation of a statute or regulation is, of course, an issue of law for the court, as is the question of whether a regulation is consistent with the authorizing statute"—both of which are subject to de novo review. (*Spanish Speaking Citiz. Found., Inc. v. Low* (2000) 85 Cal.App.4th 1179, 1214, citation omitted.) "[W]hen an implementing regulation is challenged on the ground that it is 'in conflict with the statute' …, the issue of statutory

[7] On July 24, 2015, SFG filed an amended application (see 10 CCR § 2655.8(b)), which updated the effective date to April 15, 2016. CDI objected, and the ALJ ordered SFG to refile its amended application with July 15, 2015 as the effective date—which SFG did on August 7, 2015, despite the fact that this date preceded the date of the amended application.

construction is a question of law on which a court exercises independent judgment." (*Western States Petr. Ass'n v. Bd. of Equal.* (2013) 57 Cal.4th 401, 415, citation omitted.) Where the Commissioner's legal interpretation is not embodied in a regulation, the court "rel[ies] primarily on [its] own independent judgment." (*Matteo v. California Dep't of Mot. Veh.* (2012) 209 Cal.App.4th 624, 631.) The same de novo rule applies to constitutional questions. (*Starving Students Inc. v. Dept. of Indus. Relations* (2005) 125 Cal.App.4th 1357, 1363; *Mercury Cas. Co. v. Jones* (2017) 8 Cal.App.5th 561, 584.) Finally, in reviewing evidentiary findings, the Court must "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.)

IV. THE COMMISSIONER'S NEW RATE IS UNLAWFUL

A. The Commissioner's Disregard of SFG's Separate Corporate Existence Exceeds California's Regulatory Authority

The Decision turns on the flawed premise that there is a "State Farm Group" with an undifferentiated pool of assets fluidly available to the affiliates in the "Group." This incorrect assumption intrudes into other states' spheres of regulatory authority, contrary to the internal affairs doctrine and the principles governing insurance regulation across the several states.

1. The Decision Implicates Fundamental Principles Governing the Internal Affairs and Corporate Structure of Insurers

By disregarding SFG's separate corporate existence and treating it collectively with its parent and affiliates, the Commissioner ignored the fundamental principle that questions of an entity's internal corporate structure are subject to regulation only by the domiciliary state—here, Illinois. The internal affairs doctrine "recognizes that only one state should have the authority to regulate a corporation's internal affairs" (*Edgar v. MITE Corp.* (1982) 457 U.S. 624, 645), because "state regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law." (*CTS Corp. v. Dynamics Corp.* (1987) 481 U.S. 69, 89–90; accord *Hill I*, 114 Cal.App.4th at 442.) The Court in *Greb v. Diamond Int'l Corp.* (2013) 56 Cal.4th 243, 268, fn. 35, affirmed California's "robust application" of this rule, recognizing that a corporation is "subject to only the law of its state of incorporation" as to its "internal affairs." As the Court noted in *Southern Sierras Power Co. v. Railroad Comm'n of California* (1928) 205 Cal. 479, cited in *Greb*, the doctrine does not just affect choice of law, but acts as a fundamental limitation on "the authority of the state over foreign corporations"—the state lacks power to "regulate and control the *intra vires* acts of such corporations concerning their internal affairs." (*Id.* at 482–483.)

In operation, the "internal affairs" doctrine assigns regulatory authority to the domiciliary

state with respect to certain intra-corporate matters internal to the corporation. (*Hill I*, 114 Cal.App.4th at 443–444.) The structure, relationship, and roles of corporate affiliates, including the design of the corporate structure and the allocation of capital and risk among affiliated entities, are quintessential "internal affairs." (See *Wehleage v. EmpRes Healthcare Inc.* (N.D. Cal. 2011) 821 F.Supp.2d 1122, 1128–1130.)

The system employed in the United States to regulate the business of insurance tracks the internal affairs doctrine. The McCarran-Ferguson Act directs that the business of insurance be regulated by "the several states" (15 U.S.C. §§ 1011, 1012(a)), reflecting Congress's intent to ensure that the states regulate insurance within, and not "beyond," their respective borders. (*FTC v. Travelers Health Ass'n* (1960) 362 U.S. 293, 300–301.) Consistent with this structure, the "complex and interdependent system of regulation" adopted by the several states, working through the NAIC, assigns corporate governance regulation (risk management and financial condition) to the domiciliary state—here, Illinois—and "market regulation" (the conduct of an insurer within a state) to the market state—here, California. (RJN Ex. D at 5–6.)[8] The result is a system of "domiciliary deference" to the state of incorporation with respect to "financial and corporate affairs." (*Id*. at 6.)

It also is a bedrock principle of law—in Illinois, California, and elsewhere—that a separately incorporated company such as SFG has its own corporate existence that must be respected except under narrow circumstances. (See *Main Bank of Chicago v. Baker* (Ill. 1981) 427 N.E.2d 94, 101 [corporate entity treated separately from its affiliates]; *Superior Coal Co. v Dep't of Finance* (Ill. 1941) 36 N.E.2d 354, 358 [same for parent and subsidiary].)[9] As the U.S. Supreme Court has explained in the due process context, "corporate separation, though perhaps merely formal, [is] real." (*Cannon Mfg. Co. v. Cudahy Pkg. Co.* (1925) 267 U.S. 333, 337 [improper to exercise personal jurisdiction over corporation based on contacts of in-state affiliate].) The law on corporate separateness fully applies to insurance companies and their affiliates. (See *Hill v. State Farm Mut.*

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[8] SFG is subject to some duplicative regulation, and must file inter-affiliate agreements with California as well as Illinois, because it falls within California's "commercially domiciled" statute. (Ins. Code § 1215.14; AR 5249 ¶ 18.) But with respect to the "enterprise risk" issue of managing risk vis a vis the affiliates within the holding company system, Illinois is the designated regulator. (See 215 ILCS 5/131.14b; Ins. Code § 1215.4(m).)

[9] (See also *Messler v. Bragg Mgmt. Co.* (1985) 39 Cal.3d 290, 301 [corporate form disregarded only in narrow circumstances]; *Sonora Diamond Corp. v. Super. Ct.* (2000) 83 Cal.App.4th 523, 537–538 [wholly owned subsidiary of Bermuda corporation formed to support parent's business in California was a separate entity, not part of a single, integrated enterprise, despite overlap of directors and officers, parent's issuance of consolidated reports, and payment for professional services to subsidiary]; accord *Laird v. Capital Cities/ABC, Inc.* (1998) 68 Cal.App.4th 727, 737.)

Auto. Ins. Co. (2008) 166 Cal.App.4th 1438, 1495 (*Hill II*) [insurance company's parent "will not be exposed to liability" when it contributes funds to its subsidiary "for the purpose of assisting [it] in meeting its financial obligations'"].)[10] Indeed, insurance regulators rely heavily on corporate governance rules to aid their oversight of insurers' financial condition. For this reason, regulatory statutes—including in Illinois—compel regulated entities to seek regulatory approval for inter-affiliate transactions, and closely monitor (and require approval of) any transfers of funds between and among affiliates. (See 215 ILCS 5/131.20 & 131.20a; see also Ins. Code § 1215.5.)

2. The Commissioner Erred in Disregarding the Internal Corporate Structure of State Farm Mutual and the Separate Existence of SFG

As shown above, SFG operates as a California-only company capitalized with a conservative asset portfolio deemed appropriate to the insurance risk that it faces in California. (AR 5250 ¶ 21, 13042 ¶¶ 2–12; 5383 ¶¶ 39–40.) Its separate status reflects system-wide strategy designed to manage risk for State Farm policyholders throughout the country—matters that are quintessential "internal affairs" regulated by Illinois.[11] (See *Hill I*, 114 Cal.App.4th at 442–452 [internal affairs doctrine applies to decisions weighing issuance of dividends against maintaining surplus]; *Hill II*, 166 Cal.App.4th at 1482–1483 [determinations regarding amount of necessary surplus are for corporate management subject to the business judgment rule].)[12]

The Commissioner's disregard of SFG's separate corporate existence violates the fundamental principles set out above by artificially reducing SFG's rates based on the unsustainable fiction that SFG has access to the investment assets and income of its parent and affiliates. He improperly substituted a portfolio consisting of 40% stocks for SFG's conservative bond portfolio, compounding the risks to which SFG's surplus is exposed, contrary to the risk management plan that State Farm put in place under Illinois's regulatory oversight. The Commissioner's rationale

[10] (See also *Tomiselli v. Transamerica Ins. Co.* (1994) 25 Cal.App.4th 1269, 1283–1286 [parent insurer's assets may not be imputed to subsidiary based on 100% stock ownership, shared offices and policy manuals, common personnel, and consolidated financial statements]; accord *Wady v. Provident Life & Acc. Ins. Co.* (C.D. Cal. 2002) 216 F.Supp.2d 1060, 1068–1070 [same]; *Perez v. State Farm Mut. Auto. Ins. Co.* (N.D. Cal. 2011) 2011 WL 5833636, *4 [same].)

[11] This form of regulation follows a principle called "windows and walls," under a nationally-accepted approach to oversight of insurance risk management. (See AR 11620:1–11621:15.) State Farm's use of three single-state insurance companies exemplifies this approach, viewing potential contagion risk through the "windows" of comprehensive risk assessment and containing that risk by use of corporate "walls."

[12] Plaintiffs in *Hill* alleged that SF Mutual could not wall off its affiliates' surplus, but rather should maintain all surplus as a pool from which it should be obliged to pay dividends. (See *Hill I*, 114 Cal.App.4th at 439; *Hill II*, 166 Cal.App.4th at 1452.) The court disagreed, holding that this and other similar questions were "internal affairs" regulated by Illinois.

for these conclusions—that SFG and/or SF Mutual can or should change their corporate structure to include a "pooling agreement" or similar arrangement by which they could "transfer assets between affiliates," and that SF Mutual somehow acted improperly by "strategically configuring a subsidiary to act as an individual insurer only" (Decision 43, 50)—is a direct affront to Illinois's jurisdiction over such internal matters, including its laws requiring that the Illinois Department approve any such inter-affiliate arrangements or transfers. (See 215 ILCS 5/131.20 & 131.20a.)

It is unlikely that a corporate regulator would advocate for a capitalization distribution that would add extreme market risk (such as an $8.5 billion loss that SF Mutual suffered in 2008, AR 5249–5250 ¶ 20) to the insurance risk for an already catastrophe-exposed line, and certainly the Illinois regulators never advocated such a result. But in any event, it is improper for a California regulator, under the guise of rate regulation, to disregard the distinction between SFG and its affiliates—a decision that would upend the carefully constructed plan, regulated by Illinois, for managing risk between and among the property/casualty affiliates within the State Farm system.

B. The Decision Cannot Be Squared With the Statute

The governing statute—Ins. Code section 1861.05(a)—states that "[i]n considering whether a rate is excessive, inadequate or unfairly discriminatory, … the commissioner shall consider whether the rate *mathematically reflects the insurance company's* investment income." (Italics added.) The Commissioner's treatment of the investment income offset is fundamentally incompatible with the plain command of this statute and the broader scheme created by Proposition 103.

1. The Statute Precludes Reliance on Projected Investment Income Based on the Assets of an Insurer's Corporate Affiliates

Section 1861.05(a) directs the Commissioner to consider "the insurance company's investment income"—not the income of the insurance company's corporate affiliates—in determining whether a "rate is excessive, inadequate, or discriminatory." Absent ambiguity, the Court must "presume the lawmakers meant what they said, and the plain meaning of the language governs." (*People v. Gutierrez* (2014) 58 Cal.4th 1354, 1369, citation omitted.)

Although the term "the insurance company" is not a defined term, its placement next to subdivisions (b) and (c) of section 1861.05—which set out the procedures to be followed by each insurance company seeking to change its rate—confirms that the "insurance company" whose "rate" is referenced in subsection (a) is the same "insurer" and "applicant" that is seeking to change its "rate" in subsections (b) and (c). (See Ins. Code § 1861.05(b) ["Every insurer which desires to change any rate shall file a complete rate application with the commissioner. … The applicant shall have the

burden of proving that the requested rate change is justified"]; *id.* § 1861.05(c) ["The commissioner shall notify the public of any application by an insurer for a rate change"].)

This is precisely how the Supreme Court read section 1861.05(a) in *20th Century*: it is the "individual insurer" whose investment income must be "offset" against the rate sought. (8 Cal.4th at 243, 290; see also *California Auto. Assigned Risk Plan v. Garamendi* (1991) 232 Cal.App.3d 904, 911–912 [section 1861.05 "directs the commissioner, in considering an application by an *individual insurer* to change an insurance rate, to compare the proposed rate with the investment income of *the insurance company making the application*"], italics added.)

This plain meaning is supported by the purpose of section 1861.05(a), as well as its history and structure. A statute is construed not "'in isolation,'" but rather "'with reference to the entire scheme of law of which it is part so that the whole may be harmonized and retain effectiveness.'" (*Spanish Speaking Citiz.*, 85 Cal.App.4th at 1214, quoting *Calatayud v. State of Cal.* (1998) 18 Cal.4th 1057, 1065.) The Court must consider the consequences of a proposed construction and construe the statute "'so as to promote rather than defeat the statute's purpose and policy.'" (*Spanish Speaking Citiz.*, 85 Cal.App.4th at 1214, citation omitted.)

As the Court explained in *20th Century*, the investment income of the individual insurer is to serve as an "offset" against the premium the insurance company collects. (8 Cal.4th at 243, 290.) That is because the amount of premium to which an insurer is entitled "is a function of the other income sources available," so that if the insurer will earn income from other sources related to the business of providing insurance, "the insurer's needed premium should be reduced such that its total income would not result in an unreasonable rate of return." (AR 6297 ¶ 9.) Section 1861.05(a) directs the Commissioner to offset the premium sought by an insurer by the other major source of income—investment income—that is available to that insurer, *i.e.*, the insurance company making the application. (*20th Century*, 8 Cal.4th at 243, 290.) Put another way, the investment income used to offset premium is a projection of the income the individual insurer actually would have available to pay for the costs and reasonable profit otherwise paid by premium.

2. The Commissioner's Attempts to Reconcile His Decision With the Statute are Unavailing

The Commissioner's methodology directly contravenes the text, structure, and purpose of section 1861.05(a), as well as the "internal affairs" and corporate governance rules discussed above. Although it is undisputed that SFG lacks access to the investment assets or income of its parent or affiliates, the Decision in effect declares that SFG *should be provided* such access, either through a pooling agreement that would allow a "transfer of assets between affiliates" or by eliminating

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SFG's separate status as a subsidiary. (Decision 43, 50.) Not only does this rationale improperly disregard Illinois's regulatory control over these matters, but nothing in the statute even suggests that the Commissioner may coerce an insurer to enter into revenue sharing agreements or change its corporate structure in order to seek approval of a rate.

The Decision suggests that the statute is satisfied so long as the mechanical calculations employed in setting a rate are "mathematically accurate." (Decision 42.) But that is demonstrably incorrect: the statute says that the resulting rate must "mathematically reflec[t] the insurance company's investment income." (Ins. Code § 1861.05(a).) "Mathematical accuracy" is not the same as saying that rates "mathematically reflect" investment income: 2+3 always equals 5, but if 2 and 3 are the wrong inputs, then 5 is the wrong answer. Because the Commissioner uses the wrong inputs—namely the "investment income" of entities other than the rate applicant—the resulting rate does not "mathematically reflect" that insurer's investment income, even if equations employed in the process are "accurate."[13]

3. Regulation 2644.20(a) Must be Construed and Applied Consistently With the Authorizing Statute

The Commissioner's principal justification for his methodology is 10 CCR § 2644.20(a), which defines "Projected yield" as:

> the weighted average yield computed using *the insurer's actual portfolio* and yields currently available on securities in US capital markets. The weights shall be determined using the *insurer's most recent consolidated statutory annual statement*, and shall be computed by dividing the insurer's assets in each separate asset class shown on page 2, lines 1 through 9 of the insurer's consolidated statutory annual statement, by the total of lines 1 through 9….

(Italics added.) The regulation requires reference to "the insurer's actual portfolio," and then, in explaining how to achieve that end, specifies that the "weights" be determined by an allocation formula using "the insurer's most recent statutory consolidated annual statement." The "combined" annual statement, developed by the NAIC, shows the financial condition of certain affiliates, and lists the collective (but not the individual) assets of these affiliates using combining methodologies

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[13] The Decision cites various other insurance-related provisions to show that an individual applicant is sometimes treated as part of a "group." (Decision 41–42.) These examples only confirm the correctness of SFG's reading of the provision at issue here. Ins. Code § 1861.16, for instance, allows the Commissioner to address situations where an insurer with multiple affiliates writing auto insurance in California might use that structure to circumvent specific rate regulations applicable to auto insurance. (See RJN Exs. A, B.) The cited provision—which focuses solely on whether multiple affiliates writing the same insurance are actually competitors, thereby warranting an exemption from the rule—has no bearing on the issue here.

rather than any single company's "actual portfolio." (See also AR 5376–5377 ¶¶ 21–22.)

For two reasons, the Commissioner's reliance on the reference to the "consolidated statutory annual statement" in the regulation cannot justify his counterfactual decision, in this proceeding, to treat SFG as though it has access to the investment assets and income of its parent and affiliates.

First, the Commissioner's application of his own regulations must comport with the statute. It is elementary that, like any regulator, the Commissioner has only the powers conferred upon him by statute. (See *Blood Service Plan v. Roddis* (1968) 259 Cal.App.2d 807, 811.) A regulator or agency cannot "vary or enlarge," by regulation or otherwise, the statutes they are bound to enforce. (*Credit Ins. Gen. Agents Ass'n v. Payne* (1976) 16 Cal.3d 651, 656; cf. *Morris v. Williams* (1967) 67 Cal.2d 733, 748 [regulations that "alter or amend the statute or enlarge or impair its scope are void and courts not only may, [but] it is their obligation to[,] strike down such regulations"].) Here, Ins. Code § 1861.05(a) unambiguously calls for a "mathematical" calculation of "the insurance company's" investment income. Applying that command to SFG, the Commissioner cannot use the regulation to impute investment income to SFG based on a fictitious "combined" portfolio that includes assets of other, separate companies to whose assets SFG has no access. The Commissioner's use of the regulation in this way would "alter or amend" the statute as applied to SFG, so it is beyond the Commissioner's authority. (*Morris*, 67 Cal.2d at 748.)

Second, the law is clear that, although a regulator in general may properly prescribe an allocation formula to determine the portion of a regulated company's income that may be attributed to the state, such an allocation formula is presumptive only, and it must yield to evidence showing that the allocation, in any particular case, would violate the underlying legal rule. (See *Hans Rees' Sons v. State of N.C. ex rel. Maxwell* (1931) 283 U.S. 123, 134.) The U.S. Supreme Court explained this principle in the context of constitutional limitations on a state's tax power. A state may create formulaic rules to estimate the amount of income it can reach and tax, but it may not use those rules to ignore "the peculiarities of a given enterprise" that cause the "mathematical formula" to produce a result at odds with the evidence of income actually attributable to the state. (*Norfolk & W. Ry. Co. v. Mo. State Tax Comm'n* (1968) 390 U.S. 317, 325–327, 329; see also *Hunt-Wesson, Inc. v. Franchise Tax Bd.* (2000) 528 U.S. 458, 462–468.) By analogy here, California's Commissioner cannot use a regulatory formula to apply the statutory rule requiring reference to SFG's "investment income" in the face of evidence that SFG cannot actually earn that income on its actual assets.

The Commissioner's use of the "combined statutory annual statement" to calculate an applicant's projected yield might not be problematic as applied to other insurance companies or

affiliate groups. Groups of affiliated insurers do commonly enter into pooling agreements through which they combine premiums, losses, and investment income and then redistribute the results according to predetermined shares. (AR 5252¶ 28; AR 6226 ¶ 45; AR 1180:15–11841:10, 16–21; 11849:4.) In such cases, it may make sense to calculate projected investment income by reference to the combined investments of affiliates in the pooling agreement: because the investment assets and/or resulting income are shared, the nominal investments of one company within the group may not reflect the actual investment income available to that company to offset its requested premium.

By contrast, it is undisputed that SFG has no access to its affiliates' investment income or assets. The combined annual statement filed with the NAIC does not, in this case, reflect "the insurance company's investment income," much less the "actual portfolio" specified by the regulation. Rather, attributing the blended holdings on the combined statement to SFG produces a fictitious portfolio consisting of approximately 40% stocks (see AR 7401), which the regulation assumes generate investment income at the risk free rate plus 8% (here, 1.39% +8%= 9.39%, see AR 6613–6617). But SFG—the "insurance company" within the meaning of the statute—does not own or have access to *any* stocks, and its bond portfolio, by the tacit admission of the yield indices in the regulation (*ibid.*), could not possibly produce investment income at the level that could be projected to be earned by a portfolio of 40% stocks.

In the general case, the Commissioner may adopt a regulatory allocation formula to achieve the intent of the statute—*i.e.* one that "mathematically reflects" the investment income available to an applicant as an offset to premium. But any application of a mechanical formula must yield to evidence demonstrating that the allocation methodology in the particular case produces a result that is contrary to the governing law, whether it be the authorizing statute or applicable constitutional protections. (*Norfolk & W. Ry.*, 390 U.S. at 325, 327, 329.) Here, the Commissioner acknowledged that SFG's own portfolio (its "actual portfolio") produced an actual yield of only 2.25% on assets purchased between July 15, 2015 and August 11, 2016, corresponding to the projected yield of 2.40%. (AR 6617.) This is well below the presumed yield of 5.84% that he calculated for the fictitious portfolio based on investments of SFG and its parent and affiliates. (Decision 78.) Following the cases cited herein, the Commissioner's fictional "State Farm Group" portfolio must give way to the uncontroverted evidence demonstrating SFG's actual 100% bond portfolio, in order to effectuate the governing statute, § 1861.05(a). (See, *e.g.*, Section IV.C.)

C. The Commissioner's Interpretation of the Statute Raises Serious Constitutional Problems

The Commissioner's approach not only contravenes the text of section 1861.05(a), it also

violates fundamental constitutional principles. By basing SFG's rates on the premise that these affiliates will share their investment income with SFG, or that SF Mutual will change its corporate structure to eliminate its separate operating subsidiaries, the Commissioner would apply California's regulatory scheme in a way that transgresses settled limitations on state power. These problems independently warrant setting aside the Decision, but can be avoided by adopting the correct and less problematic interpretation of the statute and regulation offered above. (See *People v. Garcia* (2017) 2 Cal.5th 792, 804 [statute should be construed to avoid constitutional issues].)

1. The Constitution Prohibits a State From Reaching Beyond its Boundaries to Affect Conduct or Transactions in Other States

The Supreme Court has made clear that an individual state may not use its legislative or regulatory power to "impose its own policy choices on neighboring States." (*BMW*, 517 U.S. at 571.) As the Court explained long ago in *Bonaparte v. Tax Court* (1881) 104 U.S. 592, 594, "[n]o State can legislate except with reference to its own jurisdiction," and "[e]ach State is independent of all of the others in this particular."

A state's power to interfere with activities or conduct in other states is constrained by the Constitution's "special concern" with "the autonomy of the individual states within their respective spheres." (*BMW*, 517 U.S. at 571–572, quoting *Healy v. Beer Inst.* (1989) 491 U.S. 324, 335–336, internal quotation marks omitted.) That concern has been expressed as a function of the Commerce Clause (*Healy*, 491 U.S. at 335–336), as a due process limitation (*BMW*, *id*. at 571–573), and as an "inherent limit[]" on "the States' power" (*Edgar*, 457 U.S. at 643, quotation marks omitted). These principles prohibit not only direct efforts by states to regulate conduct in other states, but also state regulation that has the "practical effect" of forcing regulated entities to change their out-of-state behavior. (*Healy*, 491 U.S. at 337–338; *Brown-Forman Dist. Corp. v. N.Y. State Liquor Auth.* (1986) 476 U.S. 573, 583.) And, under the principles described above, state regulators cannot avoid these limitations by simply conflating an in-state corporation with its out-of-state affiliates. (See, e.g., *Cannon Mfg*, 267 U.S. at 337 ["corporate separation" is recognized by the Due Process Clause].)

Relatedly, the Due Process Clause prevents a state from applying its substantive law to transactions or entities that lack a sufficient connection to the state. (See *Phillips Petr. Co. v. Shutts* (1985) 472 U.S. 797, 819–822.) Indeed, it is a "basic principle of federalism" "that each State may make its own reasoned judgment about what conduct is permitted or proscribed within its borders." (*State Farm Mut. Auto. Ins. Co. v. Campbell* (2003) 538 U.S. 408, 422.) Allowing one state to apply its substantive law to transactions or entities in other states would contravene "'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.'" (*Id.* at 421, quoting *New York Life Ins. Co. v. Head* (1914) 234 U.S. 149, 161.)

In addition to these general constitutional limitations on extraterritorial regulation, a specific due process constraint applies to rate regulation: state regulators, when setting rates for regulated entities, are prohibited from taking into account income from out-of-state businesses beyond the regulatory jurisdiction of the state. (See *Smyth v. Ames* (1898) 169 U.S. 466, *disapproved as to separate issue by FPC v. Hope Nat'l Gas Co.* (1944) 320 U.S. 591.)[14] For more than a century, the U.S. Supreme Court has held that due process requires rates to be based on business carried out "wholly within [a state's] limits" and "without reference to the interstate business done by the [regulated entity], or to the profits derived from it." (*Smyth,* 169 U.S. at 541.) Rather, rates must be set so that "one class of customers should be neither burdened by the losses from other service nor benefitted from non-jurisdictional profits"—thus, "with respect to ratemaking, each jurisdiction or class of customers should pay its own way." (*El Paso Elec. Co. v. FERC* (5th Cir. 1982) 667 F.2d 462, 468; accord *Simpson v. Shepard* (1913) 230 U.S. 352, 435.) Although the issue typically arises in confiscation cases—discussed below—the principle also rests on the fundamental constitutional limitations on a state's power to regulate conduct beyond its borders. (*Smyth*, 169 U.S. at 541–542.)

2. The Commissioner's Decision and Rationale Violate The Fundamental Constitutional Principles Limiting a State's Power

The Commissioner tries to defend his imputation to SFG of its affiliates' investment income by pointing to a trend toward assessing insurance risks on an enterprise-wide basis, as well as the fact that some holding company systems (though not State Farm) have created pooling arrangements and other mechanisms through which revenues may be shared. (Decision 13–14, 43–44, 49–50.) The Commissioner goes so far as to fault State Farm for "strategically configuring a subsidiary to act as an individual insurer only" (*id*. at 50), and suggests that "Applicant" must either make a "choice" to have "a pooling agreement, reinsurance contracts, or share services agreements" that will allow such sharing, or suffer regulatory consequences in California (*id*. at 43). The Commissioner concludes that it is appropriate to impose such regulatory consequences—the imputation of affiliate investments to SFG—on the assumptions that "insurers may transfer assets between affiliates" and that SFG can

[14] *Hope* rejected the separate holding of *Smyth* that fair value was the sole measure of a rate base upon which "just and reasonable" rates were to be calculated. (320 U.S. at 601–602; see also *Verizon Comm., Inc. v. FCC* (2002) 535 U.S. 467, 483–484.) *Hope* did not affect *Smyth*'s extraterritoriality rule. (See*, e.g.*, *Francis Hosp. Ctr. v. Heckler* (7th Cir. 1983) 714 F.2d 872, 875 [citing *Smyth* for extraterritoriality principle].)

and should enter into an arrangement that would permit such transfers. (*Ibid*.)

This is precisely the type of overreaching by a state that the "principles of state sovereignty and comity" forbid. (*BMW*, 517 U.S. at 571–573.) There is no support in the law for the Commissioner's apparent view that an insurance holding company system may not properly operate through separate subsidiaries, or that a regulator can disregard the corporate form and impose policy choices as to appropriate corporate structure and revenue-sharing arrangements on entities and regulators in other states. But in any event, the appropriate structure of State Farm Mutual's family of subsidiaries is, under the Insurance Company Holding Act and the "internal affairs" doctrine, governed by Illinois law and subject to regulation, if at all, by that state.

Like other states, Illinois authorizes insurers to employ enterprise-wide risk management methodologies, including the sharing of risk-related data, while at the same time employing corporate "walls" to manage the resulting risk and associated solvency issues. As shown above, the Commissioner's methodology and rationale here are nothing more than an attempt to second-guess the choice made by Illinois regulators to allow such an approach, including by allowing "walls" that separate insurance subsidiaries such as SFG from their affiliates. This effort to change the behavior of out-of-state entities or other states is forbidden by the above principles under the Due Process and Commerce Clauses, as well as by the "internal affairs" rule.

The Supreme Court's analysis in *BMW* is closely on point. In *BMW*, the Court noted that some states require car dealers to make full disclosure of *any* repairs made to vehicles sold as "new," whereas others exempt minor repairs from any such requirement. (517 U.S. at 569–570.) The Court found that it would violate "principles of state comity and sovereignty" for one state to impose its own disclosure policy on others by imposing consequences under its own laws to try to change dealers' conduct in other states. (*Id.* at 572.) Thus, the Court held that a punitive damages award would be improper if an Alabama court imposed it to "induce BMW to change [its] nationwide policy." (*Ibid.*) "[B]y attempting to alter BMW's nationwide policy, Alabama would be infringing on the policy choices of other States." (*Ibid*.)

Likewise, in *Healy*, the Court emphasized that a state cannot enact laws or apply regulations that have the "practical effect" of forcing companies or regulators to change their conduct or policies in other states. As the Court explained, the Commerce Clause is concerned not only with state laws that interfere with the *federal* power over interstate commerce but also with the separate sovereignty interests that each state has in regulating within its own territory, free from interference or regulation by other states. (*Healy*, 491 U.S. at 335–336.) In *Healy* and a series of similar cases, the Court struck

down state laws requiring manufacturers to post prices for their products and affirm that those prices were no higher than those charged in other states, holding that such laws violated the principles of state sovereignty and autonomy embodied in the Commerce Clause. Although a state may "'seek lower prices for its customers'" and regulate economic activity within its borders, it may not do so in a way that causes consumers in other states to lose their competitive advantage or has the "practical effect" of forcing changes to the regulated entities' economic behavior (in those cases, their pricing behavior) in other states. (*Id.* at 332–333, 339–340, quoting *Brown-Forman*, 476 U.S. at 580.) Similarly, in *Edgar*, the Court struck down an Illinois law purporting to restrict tender offers, holding that it would have the impermissible effect of regulating the details and timing of transactions that necessarily affect shareholders not only in Illinois but nationwide. (457 U.S. at 643.)

The Decision has the "practical effect" of controlling "conduct beyond the boundaries of" California. Even though SFG is a separate, Illinois entity with its own assets, the Decision imputes the investment portfolios of other out-of-state companies to SFG as a means of artificially reducing its rates. The Commissioner's premise that SFG should have access to affiliates' investments and related income to pay claims (Decision 43, 50) would improperly force State Farm to change the structure of the companies within the system, including the nationwide allocation of risk reflected by the operation of single-state, conservatively invested insurers in high-risk states, and a multi-state insurer writing insurance elsewhere. By suggesting that State Farm must change this structure to allow asset transfers or pooling among affiliates in order to avoid regulatory consequences, the Decision would undermine Illinois' regulatory scheme, under which any such asset transfers and arrangements must be approved by the Illinois Department of Insurance. (215 ILCS 5/131.20a; 215 ILCS 5/131.20.) The Commissioner's methodology would lead to impermissible double counting, where the investment income of the same affiliate is counted by both California and the state served by that affiliate. And if that methodology were adopted by other state regulators, it would create regulatory gridlock system-wide. (See generally *Edgar*, 457 U.S. at 642–643; cf. *Healy*, 491 U.S. at 336.)

The Commissioner's methodology also violates the prohibition against subsidizing regulated business with income from out-of-state businesses. Under the Commissioner's rationale, California policyholders would benefit from the investment yield and surplus of out-of-state insurers—and the different risks those insurers write against—even though the non-California policyholders who pay premiums to the out-of-state insurers are not subject to California regulations and receive none of the benefits of the California insurance. The Commissioner punishes SFG for income generated by out-

of-state entities—including by assuming that SFG's parent or affiliates could transfer funds to SFG, arrange for a pooling agreement, or eliminate SFG's separate corporate existence to make affiliates' investment assets available to SFG as an offset to premium. (Decision 43.)[15] Under the law set out above, that assumption, and the resulting Decision, are impermissible. (*Smyth,* 169 U.S. at 541.)

D. The Rate Resulting From the Decision Is Confiscatory

1. The Rate Does Not Allow SFG a Fair Rate of Return

Under U.S. Supreme Court jurisprudence, and in California except in the insurance context, the accepted constitutional standard limiting a state's power to regulate price is that the regulation must allow a *fair rate of return*.[16] The Decision does not meet this standard under any of the tests by which courts have articulated it, because it substitutes an artificially high level of investment income for the investment income actually available from SFG's actual portfolio.

The undisputed evidence shows that SFG actually earned 2.25% on assets purchased between July 15, 2015 and August 11, 2016. (AR 8914; Decision 73, 78.) This figure comports with SFG's projection that it will earn 2.40% on its actual assets for the future period of the rate. (AR 7490, 7491; AR 10955:20–24.) Using SFG's actual yield, the rate order allows a total return to SFG on its California homeowner's business of approximately 2.65%. (AR 10955:25–10956:13, 10958:22–25, 16504 ¶ 60.)

The return permitted by the rate order—2.65%—is only a hair's breadth above the 2.40% return generated by SFG's actual portfolio. (AR 6233 ¶ 60.) That is, the marginal return to SFG from its insurance business in California is just .25% greater than the return it would receive *if it did not engage in the business of insurance at all*. (*Ibid*.) A return on investment of a quarter of a percent *is not*, in any sense, a "return to the equity owner … commensurate with returns on investments in other enterprises having corresponding risks." (*Hope,* 320 U.S. at 603.)

2. The Rate is Confiscatory Even Under the "Deep Financial Hardship" Standard Described in *Mercury*

The Third Appellate District, in *Mercury*, recently rejected the settled "fair rate of return"

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[15] The *Mercury* decision rejected the argument that "allowing the commissioner to apply the standard of constitutional confiscation to Mercury as a whole necessarily allows him to consider 'insurers' revenue generated outside his jurisdiction, which 'unconstitutionally extends the powers of a single state.'" (8 Cal.App.5th at 590.) But the court did not discuss the cases discussing the prohibition on extraterritorial cross-subsidies, or the related Due Process or Commerce Clause issues discussed herein. Rather, it held that the Commissioner could apply the "deep financial hardship" test to an insurer. (*Ibid*.)

[16] (See, e.g., *California Bldg. Indus. Ass'n v. City of San Jose* (2015) 61 Cal.4th 435, 464.) Federal cases are to the same effect. (See *Duquesne Light Co. v. Barasch* (1989) 488 U.S. 299, 310, 314.)

standard as the guide for protecting insurers from confiscation through price regulation, instead reading *20th Century* as dictating a financial distress standard. (8 Cal.App.5th at 587–588, 589.) Even under this standard—with which State Farm does not agree—the rate order is confiscatory.

Proposition 103 adopted two phases of regulation, with an initial one-year phase requiring insurers to "roll back" rates for the year 1989 to 80% of 1987 rates, followed by a permanent system of prior approval (Ins. Code § 1861.01(a) & (c)). In *Calfarm Ins. Co. v. Deukmejian* (1989) 48 Cal.3d 805, 818–819, the Court held that the statutory standard in section 1861.01(b) for relief from the prescribed "rollback" rate—precluding relief unless the insurer was "threatened with insolvency"—was invalid because it would allow the state to force insurers to charge unconstitutionally confiscatory rates. The Court stated the constitutional test as requiring "fair and reasonable rates," and found section 1861.01(b) invalid because it did not permit "adjustments necessary" to achieve that standard. (*Ibid.*)

In *20th Century*, the Court considered the constitutional validity of regulations adopted to implement the rollback. In discussing the confiscation standard, the Court stated that "a regulated firm may claim that a rate is confiscatory only if the rate does not allow it to operate successfully," and that "[i]n such circumstances, the firm is not inaptly characterized as experiencing 'deep financial hardship' as a result of the rate." (8 Cal.4th at 296.) The Court repeated: "deep financial hardship" means "the inability of the regulated firm to operate successfully—meaning, again, the inability of the regulated firm to operate successfully during the period of the rate and subject to then existing market conditions." (*Id.* at 297.)

The Court in *Mercury* expressly disagreed with the contention that *20th Century* is inconsistent with *Calfarm* (8 Cal.App.5th at 588–589), and *Calfarm* confirms that an otherwise confiscatory rate does not become lawful simply because the insurer receives revenues from "substantial business outside of California, or in lines of insurance within this state which are not regulated by Proposition 103." (48 Cal.3d at 818–819.) As the Court explained, if "an insurer had substantial net worth, or significant income from sources unregulated by Proposition 103, it might be able to sustain substantial and continuing losses on regulated insurance without danger of insolvency." (*Id.* at 819.) But the "continued solvency of the insurer" in this scenario "could not suffice to demonstrate that the regulated rate constitutes a fair return." (*Ibid.*)

The Decision violates this precept by analyzing confiscation by reference to "the insurer as a group" (Decision 62–63, 65–66)—meaning the property/casualty affiliates listed on the combined annual statement. (See *id.* at 11–12.) The problem with the Commissioner's reasoning is easily

illustrated: The combined annual statement shows Direct Premiums Earned of $57.5B (AR 7477 col. 3 line 59), total assets of $188.5B (AR 7401:28), and total equity capital or surplus of $80B (AR 7402:37). In contrast, SFG's statement shows Direct Premiums Earned of $2B (AR 7172 col. 3:59), total assets of $6.8B (AR 7076 line 28) and total equity capital or surplus of $3.8B (AR 7077:37).[17] If "deep financial hardship" meant that the "State Farm Group" had to suffer a structural impairment from a California rate order directed to SFG, the Commissioner could order SFG to hand out homeowner's insurance *for free* without violating the constitutional prohibition against confiscatory rates. After all, the total premium for the "State Farm Group" would move from about $57B to $55B if SFG could not charge for homeowners' insurance, a reduction of only 2.6%. A regulator would be unlikely to recognize a 2.6% reduction in premium as a financial structural impairment to the State Farm enterprise. But certainly it would be confiscatory to force SFG to write insurance for free.[18]

The Decision tries to justify the rate order by referencing past profits in a prior period, but that, too, is improper, because "[o]therwise, the producer could be deemed to be 'operating successfully' whenever, for example, it was merely in the position to create a 'healthy' cash flow by imprudently liquidating assets amassed in the past." (*20th Century*, 8 Cal.4th at 295 fn. 19; accord *Calfarm*, 48 Cal.3d at 819; see also *Board of Comm'rs v. N.Y Tel. Co.* (1926) 271 U.S. 23, 31–32.) The Decision's use of past profits here illustrates the point. As expert David Appel explained, it is expected that a catastrophe-exposed line will earn "profits" in years in which catastrophe experience is low, enabling the insurer to amass funds that can be used for policyholders in the event of significant catastrophes. (AR 6230–6233 ¶¶ 52–59.) It would certainly be "imprudent" to "liquidate" the "amassed" capital to generate an artificial "healthy" bottom line rather than retain these funds for their intended purpose.

V. THE COMMISSIONER ERRED IN HIS TREATMENT OF VARIANCE 3

The Commissioner abused his discretion by rejecting SFG's application for "Variance 3,"

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[17] The Decision incorrectly states that SFG earned $5.2 billion from its California homeowner's business (Decision 12), when in fact SFG had $1.195 billion in Direct Premiums Earned for that business in 2014. (AR 6304, 6606:1–3.)

[18] Indeed, even if the Commissioner ordered SFG to *pay* policyholders to take insurance, his methodology apparently would not deem the scheme confiscatory because the imputed "return" would be based on the income of the fictitious combined entity. (Cf. *Smyth*, 169 U.S. at 541 [rejecting argument that state "could legally require local freight business to be conducted even at an actual loss, if the company earned on its interstate business enough to give it just compensation in respect of its entire line and all its business, interstate and domestic"].)

which allows an insurer to increase the amount of recognized surplus for purposes of the rate formula. (Decision 46–51.)[19] Specifically, Variance 3 allows the insurer to adjust the "leverage factor"—increasing the recognized surplus and resulting allowed profit—if (1) the insurer writes at least 90% of its direct earned premium in California (as applicable here) and (2) "its mix of business presents investment risks different from the risks that are typical of the line as a whole." (10 CCR § 2644.27(f)(3).) Although SFG met both of these requirements, the Commissioner erroneously (and prejudicially) denied SFG's request for the Variance.

First, it is undisputed that SFG writes more than 90% of its direct earned premium in California. (AR 7172.) Nonetheless, the Commissioner held that the reference to "the insurer" in Variance 3 actually means "the group." (Decision 48–50.) This is similar to the flawed reasoning discussed above, and fails for similar reasons: the "insurer" logically and legally must be the same insurer whose leverage factor produces the recognized surplus under section 2644.17, and the Commissioner's contrary assumption contravenes the plain meaning of the regulation as well as the fundamental legal principles outlined above.

Second, as the Decision recognizes, "since the term 'insurer' in the leverage factor variance applies to both parts, the entire leverage factor variance must be evaluated consistently …." (Decision 53.) The ALJ (and the Commissioner) took that mandated consistency to mean that the second element must look to "the group," because the Decision held that the first element must look to "the group." But, as established above, "the insurer" means the individual insurer applicant, not "the group." This error requires that the Decision be set aside.

VI. THE COMMISSIONER'S RETROACTIVE "EFFECTIVE DATE" AND CORRESPONDING REFUND WERE UNLAWFUL

Even though SFG applied to *increase* its rates, the November 2016 Decision ordered a *reduction* in rates and set an "effective date" of July 15, 2015 for the new rates, as that was the proposed effective date in SFG's original application. On that basis, the Commissioner ordered SFG to refund more than $100 million to policyholders, reflecting the premiums (plus interest) that SFG collected between July 15, 2015 and November 2016, in excess of the new rates. (Decision 66–70.)

This was the first time in the 28-year life of Proposition 103 that the Commissioner has

[19] "Surplus" affects the amount of profit the insurer may earn from rates, because profit derives from the allowed rate of return as applied to the amount of recognized surplus. Section 2644.17 of the regulations determines the amount of recognized surplus upon which the insurer will be allowed to earn a return. (AR 6311–6312 ¶¶ 51, 54, 55.) It sets a ratio of premium to surplus (called the "leverage factor"), and that ratio, applied to the allowed premium, produces the recognized surplus. (*Id.*, ¶¶ 54, 55 & 6620; see Decision A-10.)

(i) retroactively set an "effective date" for rates that predated the "effective date" of the rating decision,[20] and then (ii) ordered the insurer to refund (as too high) the premiums it had charged under an existing, previously approved rate. This sea change—reflected in a "precedential" decision—is invalid under the applicable rate-regulation statutes, and violates the rule against retroactive ratemaking. It also violates the Due Process Clause of the Fourteenth Amendment, depriving SFG of fair notice and fair procedures, for the Commissioner to announce a brand-new interpretation of the law and then apply it retroactively to impose what amounts to a $100 million penalty against SFG for charging rates that the Commissioner had expressly authorized.

A. The Commissioner's Retroactive Ruling Violates California's "Prior Approval" Statute

Proposition 103 made the "prior approval" system the "permanent" system for rate regulation in California from November 8, 1989 forward. (*20th Century*, 8 Cal.4th at 243, 300.) Under this system, an insurer's rates "must be approved by the commissioner prior to their use." (Ins. Code § 1861.01(c).) And the following steps are required by statute before the Commissioner may supplant an insurer's existing approved rate with a new one:

(1) The insurer must file a rate application and CDI must publish notice of the filing.

(2) The Commissioner can review the proposed rate, or allow it to be "deemed" approved by taking no action within 60 days after the statutory public notice.

(3) The Commissioner may either affirmatively approve the proposed rate or call a hearing. But the Commissioner is *not* authorized to disapprove the proposed rate—or to approve a rate other than the proposed rate—without a hearing.

(§ 1861.05(c).) As a result, until such time as the Commissioner approves a new rate, the insurer may charge *only* the existing approved rate.

Nothing in the statute authorizes the Commissioner to impose retroactive changes in rates—whether directly or, as here, indirectly through backdating the "effective date" of a new rate order. Nor does the statute allow the Commissioner to order insurers to disgorge premiums collected under rates he previously approved.[21] This context explains why the Commissioner has *never before* attempted to impose a retroactive change in rates.

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[20] The "effective date" of a final prior approval *order* is controlled by statute and cannot be controverted. (Ins. Code § 1858.6.)

[21] A separate section of Proposition 103 allowed auto insurers to employ an interim rate until the Commissioner adopted a rating plan. (Ins. Code § 1861.16(g).) If that rate exceeded the rate ultimately approved, the insurer would refund the difference between the amount earned and the amount to which it was entitled under the later-approved rate. (*Ibid*.) If the Legislature had wanted to grant the Commissioner broad authority here to impose retroactive rate decreases in the form of refunds, it would have done so expressly. (See generally *People v. Trevino* (2001) 26 Cal.4th 237,

The Commissioner's retroactive rate decrease and refund also cannot be squared with precedent. The Court of Appeal in *MacKay v. Super. Ct.* (2010) 188 Cal.App.4th 1427, held that policyholders could not bring civil claims against an insurer for charging allegedly improper rates because "[i]nsurers are statutorily *prohibited* from charging a rate that has not been preapproved by [CDI]." (*Id*. at 1435 fn. 6, italics added.) Thus, "[w]hen [the prior approval] process has run its course, the insurers *must* charge the approved rate and cannot be held civilly liable for so doing." (*Walker v. Allstate Indem. Co.* (2000) 77 Cal.App.4th 750, 756, italics added.) An approved rate has the imprimatur of CDI; if it is later found (after a hearing) to have been too low or too high, the insurer may no longer charge that rate, but the Commissioner cannot retroactively invalidate his prior approval and compel a refund—just as policyholders cannot sue the insurer for charging an approved rate. (See also Proposition 103 (1988) § 1 [uncodified provision of Proposition 103, stating that "insurance rates *shall be maintained*" unless the Commissioner approves a new rate], italics added.)

The Decision tries to avoid *MacKay* and *Walker* on the theory that they addressed a different issue: whether "the Insurance Commissioner, not the courts, has exclusive jurisdiction over challenges to rates, i.e., that such challenges must first be brought to the agency." (Decision 70.) But the core premise of both cases was that, because the Commissioner had previously approved the challenged rates under the statutory scheme at issue here, the insurers had no choice but to charge those rates—only then did the courts "turn to the heart of the matter," namely how a rate that has been "approved" by CDI may be challenged. (*McKay*, 188 Cal.App.4th at 1440.)

Under the law, SFG was required by statute to charge its prior approved rate until such time as the Commissioner approved a new rate. By retroactively setting the new rate's "effective date," and ordering a refund of the premiums SFG charged under the prior approved rate, the Commissioner violated the plain text of the Insurance Code and the overall structure of Proposition 103's prior approval system. (See, e.g., *MW Erectors, Inc. v. Niederhauser Ornamental & Metal Works Co.* (2005) 36 Cal.4th 412, 426 [plain meaning of statute governs absent an ambiguity].)

B. The Order Violates the Rule Against Retroactive Ratemaking

The Commissioner's retroactive "effective date" and refund order also violate fundamental principles of rate regulation.

"Retroactivity is not favored in the law." (*Bowen v. Georgetown Univ. Hosp.* (1988) 488 U.S. 204, 208.) The prior approval scheme of Proposition 103 reflects the "rule against retroactive

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242 [legislature's use of different language normally implies a different meaning].)

ratemaking," including the principle "that general rate making is legislative in character and looks to the future." (*Southern Cal. Ed. Co. v. PUC* (1978) 20 Cal.3d 813, 816–817; see also *20th Century*, 8 Cal.4th at 277.) Under this rule, a regulator cannot force a regulated entity to "disgorge the proceeds of rates that have been finally approved and collected, as well as the fruits of those proceeds." (*Ponderosa Tel. Co. v. PUC* (2011) 197 Cal.App.4th 48, 62.) As the D.C. Circuit has explained, "ratemaking—'fixing rates or rate limits for the future'—is a legislative function, and [the Supreme Court has] held that once the [regulator] had exercised such a power it could only undo the results prospectively." (*Verizon Tel. Cos. v. FCC* (D.C. Cir. 2001) 269 F.3d 1098, 1108, citing *Arizona Groc. Co. v. Atchison, T. & S. F. Ry. Co.* (1932) 284 U.S. 370.)

The California Supreme Court applied the same rule in *Pacific Tel. & Tel. Co. v. PUC* (1965) 62 Cal.2d 634, in circumstances indistinguishable from those here. In 1964, the PUC held that a rate set in 1958 should be reduced each year beginning in 1962, and for the "first time in its history," it also ordered the utility to refund customers "for amounts collected during the interim in excess of the reduced rates." (62 Cal.2d at 649.) The Court struck down the refund order as setting an impermissible retroactive rate, noting "the rule that general rate making is legislative in character and looks to the future," and finding that the Legislature was "cognizant and approving of this principle" when it gave the PUC authority to set a rate, "after a hearing," that would "be thereafter observed and in force." (*Id.* at 649–50, 650–652.)

The Commissioner's only theory for distinguishing *Pacific Tel.* is that it was "based on entirely different statutory language." (AR 5151.) But he identifies no differences between the two statutes insofar as retroactive effect is concerned, and in fact, as shown above, both statutes are unambiguous in allowing prospective ratemaking only. Moreover, the Court in *Pacific Tel.* expressly relied on statutes from other jurisdictions with "similar language" (62 Cal.2d at 651), as well as the "basic rule of ratemaking," applicable here, that "when the [regulator] determines that existing rates are excessive, it cannot order a refund of past payments under the revoked rate." (*AT&T v. FCC* (D.C. Cir. 1988) 836 F.2d 1386, 1394–1395 (conc. op. of Starr, J.).)

C. *20th Century* Does Not Authorize the Commissioner's Retroactive Ruling

The Commissioner found that his retroactive rate and refund were "consistent with" *20th Century*, because it "upheld the Proposition 103 prior approval system regulations based on the same, current sections of the Insurance Code," and required insurers to refund excess premiums collected above the approved rate. (Decision 69–70.) The Commissioner confuses the temporary "rollback" regime of section 1861.01(a)—which was in place during the first year of Proposition 103 and was

addressed in *20th Century*—with the "prior approval" scheme of section 1861.01(c).

Before Proposition 103, there was no rule that an insurer obtain rate approval. The statutory "rollback" thus sought to reduce rates for the first year following the passage of the initiative (effectively 1989) to 80% of 1987 rates. (Ins. Code § 1861.01(a).) As noted above, insurers challenged the constitutionality of the rollback, and the Court in *Calfarm* fashioned a process to allow an insurer to seek an exemption from the rollback rate if that rate would be confiscatory, and instead charge an interim rate until such time as the Commissioner ruled on the application: "*during the first year of the initiative*, an insurer may apply for rate relief and upon making that application charge the rates it requests, but must refund with interest any premiums collected in excess of the rates ultimately approved." (48 Cal.3d at 815, italics added.) By contrast, if an insurer charged the statutory rollback rate, it would not be subject to later refunds.

The Commissioner conflates the "interim rates" in *Calfarm* with SFG's prior approved rates, asserting that he may order a refund if the so-called "interim rate" is found not "fair and reasonable." (Decision 67.) But there is a fundamental difference between the interim rates charged during the one-year "rollback" period and rates charged under the "prior approval" scheme. In the "rollback" period, there was a statutory rate (80% of 1987 rates), but insurers could charge a higher "interim" rate, subject to a "true up" for the relevant period if it turned out that the non-statutory rate was higher than the minimum constitutional rate. By contrast, in the prior approval context, the rate SFG charged for the entire period May 15, 2014 through December 2016 (the "effective date" of the November 7, 2016 rate order) was the previously approved rate. It was *not* an "interim rate."

The Commissioner also cites *20th Century* for the notion that "[t]he ordering of a refund is prospective." (Decision 67 [quotation marks and alteration omitted].) But this mischaracterizes *20th Century*. The Court there rejected the argument that the rollback-and-refund scheme was impermissibly retroactive, explaining that "even if the rate regulations as to rollbacks might be deemed 'retroactive,'" they were not invalid because they involved only "secondary retroactivity," which "occurs when regulations affect the *future* legal consequences of past transactions." (8 Cal.4th at 281–282.) The Court noted that, under the rollback regime, "the rates in question were charged 'pending a determination of their legality.'" (*Id.* at 281.)

The interim, unapproved rates at issue in *20th Century* had "nothing to do with" the permanent "prior approval" regime that followed the one-year rollback phrase. (8 Cal.4th at 288–289.) Under the prior approval system, the rate SFG charged for the period May 15, 2014 through December 2016 *was* the statutorily compelled, Commissioner-approved rate—indeed, as noted above, it was the *only*

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rate that SFG was legally allowed to charge. And unlike in *20th Century*, SFG's rates were *not* charged pending a decision as to their legality. When the Commissioner ordered SFG to refund portions of the premiums charged under its approved rates, it was textbook, unlawful "primary" retroactivity, which occurs when regulation "alter the past legal consequences of past actions." (*Id.* at 281–282, citing *Bowen*, 488 U.S. at 219.) The Commissioner improperly altered the legal consequences of SFG's past actions at *the time of those actions* by going back in time to disapprove a previously approved rate and ordering SFG to disgorge the difference.

D. The Decision's Rationale For the New Rule Rests on a Fallacy

The Commissioner tried to defend his retroactive "effective date" and refund order by claiming that he was merely enforcing the original "effective date" indicated on SFG's as-filed rate application. (Decision 69–70.) He suggests that it would be too complicated to adjust the "effective date" on the application—even if the need for a hearing or other proceedings means that the rate approval order will occur long after that date. (*Ibid*.) But this rationale ignores the fact that prior approval has been in effect since 1989, and it has been the consistent practice to adjust the effective date when delay makes that date no longer feasible, including by setting a time after the approval order when the new rate will go into effect. (AR 6297–6302 ¶¶ 10–21.)[22]

E. The Retroactive Rate and Refund Violate Due Process

The Commissioner announced his brand-new rule of retroactive ratemaking—and his novel, counter-textual application of the phrase "the insurance company's investment income" in section 1861.05(a)—in an unprecedented proceeding in response to SFG's request for a rate *increase*. He then applied this new rule to impose a rate *decrease* that was improperly backdated, even though the Commissioner had never before imposed a backdated "effective date" or refund in response to a prior approval rate application. This approach violates basic notions of due process, under which SFG should not have been retroactively subjected to a $100 million penalty for charging rates that the Commissioner had expressly approved. (See *Maine Yankee Atom. Pwr. Co. v. U.S.* (1988) 44 Fed.Cl. 372, 378 ["[L]iability that is severely retroactive, disruptive of settled expectations and wholly divorced from a party's experience may not be constitutionally imposed"], relying on *Eastern*

[22] The Commissioner does not even follow his "precedential" Decision. In July 2016, SF Mutual applied for a 6.9% auto rate increase, with an initial projected effective date of November 14, 2016. (RJN Ex. G.) Five months after the projected effective date, the Commissioner approved the full increase, but contrary to the rule announced in the Decision here, he did not retroactively approve the 6.9% increase as of the initial effective date of November 14, 2016. Rather, he approved it prospectively, to be implemented within 90 days of the approval. (*Ibid*.) The difference in effective date cost SF Mutual approximately $125 million. (*Id*. at 4.)

Ent. v. Apfel (1998) 524 U.S. 498; cf. *Bouie v. City of Columbia* (1964) 378 U.S. 347, 352 [due process forbids "an unforeseeable and retroactive judicial expansion of narrow and precise statutory language"]; *U.S. v. Lanier* (1997) 520 U.S. 259, 266 [courts may not apply "novel construction" of statute to punish conduct that neither the statutory text nor any judicial decision suggested was unlawful].)

Indeed, the Commissioner's unlawfully retroactive rate decrease was just one aspect of the "inexcusably cumbersome" rate hearing process here that violated SFG's rights under the California and U.S. Constitutions. (*Birkenfeld v. City of Berkeley* (1976) 17 Cal.3d 129, 171.)[23]

VII. THE DECISION SUFFERS FROM OTHER FATAL FLAWS

First, the ALJ excluded critical evidence of SFG's actual assets and yield pursuant to the "relitigation bar" set forth in 10 CCR § 2646.4(c), under which "[r]elitigation in a hearing on an individual insurer's rates of a matter already determined … by these regulations … is out of order and shall not be permitted." (Decision 42 & fn. 189.) But SFG did not, as the Commissioner claimed, attempt a "piecemeal relitigation of the Regulations" themselves. On the contrary, SFG was attempting to present evidence critical to the correct interpretation and application of § 2644.20(a) here, and to show the application of the regulation to SFG in the manner proposed by the CDI and the intervenors would violate Ins. Code § 1861.05(a). This type of evidence is routinely admitted. (See, e.g., *Spanish Speaking Citiz.*, 85 Cal.App.4th at 1214, 1217 ["We cannot overlook the consequences of different interpretations and must therefore grapple with the evidence presented on their effects."]; *Hans Rees*, 283 U.S. at 134.) The ALJ and ultimately the Commissioner may rule against an insurer, but to bar the insurer from even presenting its evidence violates fundamental principles of due process. (See *Hans Rees*, 283 U.S. at 134.)

Second, the ALJ prejudicially erred in excluding key testimony on Illinois regulatory matters from SFG's expert, Jack Messmore. During trial, the ALJ admitted CDI's and Intervenor Consumer Watchdog's testimony purporting to establish that SFG's shared services contracts and reinsurance treaties with affiliates, along with the existence of a risk management structure for the State Farm holding company system, meant that SFG could be considered a single entity with its

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[23] The other impermissible aspects of the proceedings included (a) the ALJ for the first time ordering that no confidential or trade-secret information can be sealed in the record; (b) the necessity of a hearing to even raise an issue of confiscation (10 CCR § 2644.27(f)(9)); and (c) the unduly burdensome expense and unprecedented treatment of intervenors, including a combined $2.5 million award of "advocacy fees" to the two intervenors here. (RJN Exhs I, J.)

parent and affiliates. (See AR 5377–5379 ¶¶ 23–28, AR 11757–11758.)[24] SFG responded with rebuttal testimony of Jack Messmore—a former Acting Director, former Chief Deputy, and former Deputy Director-Financial and Corporate Regulation of the Illinois Department of Insurance. Mr. Messmore offered a detailed description of Illinois's financial and corporate governance regulation as administered by the Illinois Department of Insurance. (AR 5735–5741 ¶¶ 7–21.) He explained that Illinois does *not* allow affiliates to comingle assets without regulatory approval, and does *not* treat a company's combined annual statement as allowing assets of affiliates included in the statement to be considered a single portfolio. (AR 5738–5740 ¶¶ 16–18.)

After initially overruling the opposing parties' objection to this testimony (AR 2505–2508), the ALJ ultimately excluded it on the ground that Mr. Messmore was not included on SFG's initial witness list, also noting that the ALJ could simply take judicial notice of certain NAIC documents to address these points. (AR 12923–12924, 12833 [ALJ admitting Exs. 906 and 907].) This was prejudicial error. In light of the key disputed issues set out above, this testimony obviously was crucial and highly relevant, and offered by an indisputably qualified witness. SFG had a due process right to a meaningful opportunity to present evidence and have it considered in explanation or rebuttal. (*Gaytan v. Workers' Comp. Appeals Bd.* (2003) 109 Cal.App.4th 200, 219.) It is settled that new witnesses or evidence may be introduced on rebuttal to refute points raised by the opposition. And the NAIC documents cannot substitute for expert testimony explaining how the relevant regulations actually function—as evidenced by the incorrect result here. (See also *Jeffer, Mangels & Butler v. Glickman* (1991) 234 Cal.App.3d 1432 [expert attorney testimony on savings and loan regulatory requirements]; cf. *Jonathan Neil & Associates, Inc. v. Jones* (2004) 33 Cal.4th 917, 935 [in primary jurisdiction context, confirming the necessity of relying on technical expertise to navigate complex regulatory scheme].) SFG therefore requests that this Court admit Mr. Messmore's testimony, pursuant to CCP § 1094.5(e).

VIII. CONCLUSION

For these reasons, the Court should issue a writ commanding the Commissioner to set aside the Decision and directing him to enter a new decision that is consistent with this Court's ruling.

[24] The prejudice from this testimony was compounded by admission of "expert" testimony consisting of speculation, with no foundation, in lieu of actual expert testimony by the witness with knowledge (Jack Messmore). (See, e.g., AR 6156:20–6157:3, 13175:6–22.) Even worse, SFG was prevented from cross-examining CDI's witness as to the basis for this testimony. (See AR 13194:4–13206:19 [attempting cross on prior cited passage].)

Dated: October 4, 2017

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PROOF OF SERVICE

STATE OF CALIFORNIA)
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COUNTY OF SAN MATEO)

I am employed in the County of San Mateo, State of California. I am over the age of eighteen and not a party to this action. My business address is Hogan Lovells US LLP, 4085 Campbell Avenue, Suite 100, Menlo Park, CA 94025.

On October 4, 2017, I caused the foregoing document described as:

STATE FARM GENERAL INSURANCE COMPANY'S PHASE 1 OPENING BRIEF

to be served on the interested parties in this action as follows:

SEE ATTACHED SERVICE LIST

[ ] **BY MAIL.** I placed the document(s) listed above in an envelope, sealed and addressed it as set forth below, and caused it to be delivered to the United States Post Office. I am "readily familiar" with the firm's practice of collection and processing correspondence for mailing. Under that practice it would be deposited with U.S. Postal Service on that same day with postage thereon fully prepaid at Menlo Park, California in the ordinary course of business. I am aware that on motion of the party served, service is presumed invalid if postal cancellation date or postage meter date is more than one day after date of deposit for mailing in affidavit.

[X] **BY E-MAIL.** I served such document(s) in PDF format to the e-mail address(es) indicated above following ordinary business practices.

[X] **BY ONE LEGAL.** I submitted an electronic version of the foregoing document(s) via file transfer protocol to One Legal File & Serve for service on interested parties registered for e-service in the within action.

[ ] **BY PERSONAL SERVICE.** I caused such envelope to be delivered by hand to the individuals listed below

[ ] **BY OVERNIGHT SERVICE.** I caused such document to be delivered by overnight mail to the offices listed below by placing it for collection by UPS / Federal Express following ordinary business practices by my firm, to wit, that packages will either be picked up from my firm by UPS / Federal Express and/or delivered by my firm to the UPS / Federal Express office:

[X] (**State**) I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct. Executed on October 4, 2017, at Menlo Park, California.

[ ] **(Federal)** I declare that I am employed in the office of a member of the bar of this court at whose direction the service was made. Executed on ____________________, at Menlo Park, California.

Ramona Altamirano
Print Name

s/ Ramona Altamirano
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