BEFORE THE
INSURANCE COMMISSIONER OF THE
STATE OF CALIFORNIA

In the Matter of Second Amended Notice of Noncompliance Against: MERCURY INSURANCE COMPANY, MERCURY CASUALTY COMPANY, and CALIFORNIA AUTOMOBILE INSURANCE COMPANY, Respondent.	Case No. NC-03027545 OAH No. 2006040185

PROPOSED DECISION

Administrative Law Judge (ALJ) Michael A. Scarlett, Office of Administrative Hearings, State of California, heard this matter on April 15-19, 24-26, and 29-30, 2013, in Oakland, California, and on May 1 and 6, 2013, June 5 and 20, 2013, and April 30, 2014, in Los Angeles, California.

Jennifer McCune, Alec Stone and James Stanton Bair III, Senior Staff Counsel, California Department of Insurance Legal Division, represented complainant California Department of Insurance (CDI). Steven H. Weinstein and Spencer Y. Kook, Attorneys at Law, Barger & Wolen LLP, represented respondents Mercury Insurance Company, Mercury Casualty Insurance and California Automobile Insurance Company (hereinafter collectively "Mercury"). Arthur D. Levy, Pamela Pressley, and Laura Antonini, Attorneys at Law, represented Intervenor Consumer Watchdog (CWD).[1]

The initial hearing phase of this matter concluded on June 20, 2013. The record remained open until September 27, 2013, to allow post-hearing briefing. On August 1, 2013, the parties requested an extension of the post-hearing briefing schedule to facilitate third-party mediation. Pursuant to stipulation, the post-hearing briefing schedule was extended through November 15, 2013. The parties filed timely post-hearing briefs in accordance with the amended briefing schedule. All three parties submitted exhibits in support of their post-hearing briefs and requested official notice of these post-hearing exhibits pursuant to Government Code section 11515 and California Code of Regulations (CCR), title 10, section

[1] CWD's Petition to Intervene was granted on May 16, 2007.

2614.18.[2] The post-hearing exhibits were marked as follows: CDI (CDI-23 through CDI-38); CDW (I-344 and I-345); and Mercury (R-179 through R-197.)[3]

On December 9, 2013, Mercury submitted a letter to respond to CDI and CWD's post-hearing reply briefs. The ALJ allowed Mercury's December 9, 2013 letter response and gave leave to CDI and CWD to submit responses to Mercury's December 9, 2013 letter on or before January 29, 2014. CDI and CWD submitted timely responses.[4] On February 12, 2014, the parties filed a joint stipulation regarding the post-hearing exhibits submitted with their post-hearing briefs. Pursuant to stipulation, official notice was taken of CDI-24 through CDI-28 and CDI-29 through CDI-35; I-344; and R-179 through R-192 and R-195. On April 30, 2014, a telephonic hearing was convened to allow oral argument on the post-hearing exhibits that were not included in the parties' February 12, 2014 stipulation. Following the parties' arguments on the record, the ALJ took official notice of exhibits R-196 and R-197, and denied the request for official notice of exhibits CDI-23 and CDI-36 through CDI-38, and I-345.[5] This matter was submitted for decision on April 30, 2014.

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[2] Unless otherwise specified, all further references to the regulations are to California Code of Regulations, title 10.

[3] Exhibits are marked and identified with the following designations: "CDI" for the Department of Insurance; "I" for the Intervenor (CWD); and "R" for respondents (Mercury).

[4] CDI's post-hearing briefs are marked for identification as follows: Opening Brief, CDI-46, Response Brief, CDI-47, and Response to Mercury's December 9, 2013 Letter Brief, CDI-48. CWD's post-hearing briefs are marked for identification as follows: Opening Brief, CWD-346, Response Brief, CWD-347, and Response to Mercury's December 9, 2013 Letter Brief, CWD-348. Mercury's post-hearing briefs are marked for identification as follows: Opening Brief, R-206, Response Brief, R-207, and December 9, 2013 Letter Brief, R-208.

[5] Mercury submitted Prepared Direct Testimony (PDT) pursuant to CCR section 2614.13, at hearing for the following witnesses which were admitted into evidence: Irene K. Bass, dated March 13, 2013; Scott Boostrom, dated March 13, 2013; Michael Curtius, dated March 12, 2013; Kenneth G. Kitzmiller, dated March 13, 2013; and Milo Pearson, dated March 12, 2013; and Gabriel Tirador, dated March 12, 2013. Mercury's PDT will be marked as Mercury's next exhibits in order: Exhibits R-200, R-201, R-202, R-203, R-204, R-205, and R-206, respectively. CDI submitted PDT at hearing for Larry Lastofka, dated February 14, 2013, which was admitted and will be marked as CDI's next exhibit in order: Exhibit CDI-39. CDI submitted additional PDT at hearing for Larry Lastofka, dated April 23, 2014, which was admitted and will be marked as CDI-40. CDI submitted Prepared Rebuttal Testimony at hearing for Tracy Stevenson, dated June 3, 2013, which was admitted and will be marked as CDI-41. CWD submitted PDT at hearing for Chris Bremer, dated April 24, 2013, and Lani Elkin, dated April 23, 2013, which were admitted and will be marked as CWD next exhibits in order: Exhibits I-346 and I-347, respectively.

SUMMARY OF ISSUES

CDI issued the Second Amended Notice of Noncompliance seeking to assess civil penalties against Mercury alleging that Mercury allowed its designated "brokers" to charge unapproved and unfairly discriminatory rates in violation of Insurance Code sections 1861.01, subdivision (c), and 1861.05, subdivision (b). The issues to be decided are: (1) whether Mercury's designated "brokers" were de facto agents that transacted personal lines automobile insurance on behalf of Mercury; (2) whether the unapproved "broker fees" charged by these designated "brokers" or de facto agents to Mercury's policyholders constituted premium or rates that were required to be included in Mercury's rate applications to obtain prior approval from the Commissioner before their use; and (3) whether the charged "brokers fees" resulted in an unfair and discriminatory insurance rate that was charged to Mercury's policyholders.

FACTUAL FINDINGS

I. Procedural History

1. On February 2, 2004, CDI issued a Notice of Noncompliance (NNC) pursuant to California Insurance Code section 1858.1, an Accusation (ACC) pursuant to California Insurance Code section 704, and an Order to Show Cause (OSC), Statement of Charges (SOC), and Notice of Hearing (NOH) pursuant to California Insurance Code, sections 790.035 and 790.05.[6] CDI later issued a First Amended NNC/ACC/OSC/SOC/NOH on March 22, 2006 (FANNC), and a Second Amended NNC/ACC/OSC/SOC/NOH on April 11, 2011 (SANNC).

2. On June 7, 2011, Mercury filed a Motion for Bifurcation of Proceedings, which was granted on January 31, 2012, and a separate hearing was ordered for the ACC and OSC. The bifurcation order remained in effect for this hearing.

3. On January 31, 2012, ALJ Steven C. Owyang (ALJ Owyang) issued a proposed decision dismissing the SANNC in this matter without a hearing on the ground that CDI denied Mercury due process and a fair hearing when CDI engaged in impermissible ex parte communications with the California Insurance Commissioner (Commissioner) to promulgate regulations to amend CCR section 2614.13, which required all parties to file, and serve on opposing parties, prepared direct testimony (PDT) in noncompliance proceedings under section 1858.1. CDI sought to amend CCR section 2614.13, to delete the requirement that PDT be prepared for adverse witnesses.

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[6] Unless otherwise specified all statutory references shall be to the California Insurance Code.

4. The circumstances leading up to CDI's decision to pursue the promulgation of regulations to amend CCR section 2614.13 were that on June 5, 2009, ALJ Owyang issued an order requiring CDI and CWD to comply with CCR section 2614.13 and file PDT for all witnesses, including adverse witnesses. On July 6, 2009, in lieu of PDT's for 22 prospective direct witnesses, CWD submitted exhibits, prior trial and deposition transcripts and declarations from a prior action for these witnesses' testimony. On August 21, 2009, ALJ Owyang issued an order finding that CWD's submissions did not constitute PDT. CDI and CWD did not resubmit their PDT, but instead, on August 13, 2010, CDI filed a Notice of Proposed Action to initiate the rulemaking process to amend CCR section 2614.13 to remove the requirement to do PDT for adverse witnesses. The notice indicated that Commissioner Steve Poizner was promulgating the proposed amendments to the regulation. In the August 13, 2010 "Initial Statement of Reasons" for the rulemaking, specific reference was made to "a recent case" in which "an administrative law judge ruled that the PDT requirement applies to adverse witnesses...." (Exh. R-179, p. 7.) The notice specifically provided that the reason for the rulemaking was to "clarify the original intent that section 2614.13 does not apply to adverse witnesses ... and to prevent a future ruling that the section does so apply...." (*Id.*) Alec Stone, CDI Staff Counsel in the SANNC signed the Notice of Proposed Action on behalf of Commissioner Steve Poizner. The notice directed the public to submit written comments on the proposed amendments to Stone. The public hearing on the rulemaking was held on October 25, 2010. The amended regulation, which removed the requirement that PDT be submitted for adverse witnesses in noncompliance proceedings, was adopted on December 30, 2010. Subsequently, on February 24, 2011, ALJ Owyang issued an order ruling that CCR section 2614.13, as amended, did not apply in this SANNC proceeding.

5. In dismissing the SANNC, ALJ Owyang determined that CDI acted as, and in the name of, the Commissioner when CDI sought to amend CCR section 2614.13. ALJ Owyang concluded that CDI had ex parte contacts with the Commissioner's chief of staff and special counsel with the intent to circumvent ALJ Owyang's ruling that CCR section 2614.13 required PDT for adverse witnesses in the pending noncompliance hearing. ALJ Owyang concluded that CDI engaged in ex parte communications with the Commissioner, the ultimate decision-maker in the noncompliance proceedings, to amend CCR 2614.13 to remove PDT for adverse witnesses. ALJ Owyang determined that CDI acted simultaneously as investigator, rule maker, and adjudicator in the noncompliance hearing, in violation of Government Code, sections 11430.10 and 11430.70 of the Administrative Procedures Act (APA). He concluded that this conduct violated the separation of function principles which denied Mercury due process and a fair hearing.

6. Factual Findings 16 through 19, 22, 24, 26 through 28, and 31 through 34 from ALJ Owyang's January 31, 2012 proposed decision are incorporated by reference.

7. On March 30, 2012, Commissioner Dave Jones issued an order rejecting ALJ Owyang's January 31, 2012 proposed decision, remanding the entire matter back with instructions to convene an evidentiary hearing on the allegations in the SANNC and to issue a proposed decision on the merits. On April 19, 2012, Mercury filed a Petition for Writ of Mandate (Petition) pursuant to California Code of Civil Procedure, sections 1085 and

1094.5, and Complaint for Declaratory Relief or Any Other Appropriate Relief, including a Request to Stay the Noncompliance Proceeding.

8. The January 31, 2012 proposed decision dismissed the SANNC on the grounds that the Commissioner and CDI denied Mercury due process by engaging in improper ex parte communications to promulgate regulations regarding PDT requirements for adverse witnesses, an issue in this proceeding. The proposed decision was rejected by the Commissioner and remanded to OAH for a full evidentiary hearing on the merits.

9. On September 14, 2012, Mercury's Petition to set aside the Commissioner's decision was rejected by the Superior Court in *Mercury Insurance Co. v. Jones* (Super. Ct. Los Angeles County, 2012, No. BS137151. The Superior Court ruled that Mercury had not exhausted its administrative remedies because an evidentiary had not been conducted and a final decision on the merits had not been rendered by the Commissioner. The Superior Court, however, preserved Mercury's right to renew its due process claim stating: "[i]f, as Mercury contends here, there has been a defective procedure employed by the Commissioner in the process of this exercise of jurisdiction or discretion, those claims are preserved and shall be included as part of any subsequent petition for administrative mandamus." (*Mercury Insurance Co. v. Jones,* (Super. Ct. Los Angeles County, 2012, No. BS137151) at p. 5.) In response to Mercury's argument that an administrative remedy or hearing would be inadequate because of the Commissioner and CDI's due process violations, the Court concluded that "further notice and an additional opportunity to be heard upon remand does not violate due process." (*Id.*) To the contrary, "[a] hearing to develop further evidence upon which the ALJ's recommendation and proposed decision will rest not only meets the requirement of due process, it embodies it." (*Id.*)

10. The California Court of Appeal, in *Mercury Insurance Company v. Jones* (Apr. 26, 2013, B244204) 2013 WL 1777781, (Cal.App.2Dist.), *review denied* (Jul. 10, 2013), affirmed the Superior Court's judgment dismissing Mercury's Petition, concluding that the Commissioner had not issued a final decision on the merits, and thus, Mercury had failed to exhaust its administrative remedies. Subsequently, this noncompliance proceeding on remanded ensued.

II. Factual Background

11. On April 1, 1980, CDI issued "Bulletin 80-6" to insurance producers and insurers to summarize information relating to "broker fees, service fees, and other fees and charges made to insureds" in California. CDI stated that the opinions expressed in Bulletin 80-6 were "not a new administrative construction of the law, but is a restatement of the law as it exists and as previously interpreted and applied by" CDI. (Exh. I-128, p. 791.) Bulletin 80-6 advised that "all payments by the insured which are part of the cost of insurance are premium, including any and all sums paid to an insurance agent," citing *Groves v. City of Los Angeles* (1953) 40 C.2d 751, and *Allstate v. the State Board of Equalization* (1959) 169 Cal.App.2d 165. (*Id.*) It further advised that California case law "should leave no doubt that

all sums collected by insurance agents constitute taxable premium and must be reported as such." (*Id.*) CDI's Bulletin 80-6 specifically stated that:

> General rules of agency law prohibit an agent from charging sums not authorized by the agent's principal. Should an insurer authorize its agents to collect "fees" such fees would have to be reported as premium by the insurer, and would of course, have to comply with the anti-discrimination statutes. Therefore, an insurer cannot permit each of its agents to determine which fees that agent will charge because to do so would surely result in rate discrimination. This principal applies equally to insurance agents and life agents.

(Exh. I-128, p. 792.)

12. In November 1988 California voters passed Proposition 103 (Prop. 103) which served to strengthen the Commissioner's prohibition against unauthorized agent fees. Prop. 103 proclaimed that "existing laws inadequately protect consumers and allow insurers to charge excessive, unjustified and arbitrary rates." (See *Donabedian v. Mercury Ins. Co.* (2004) 116 Cal.App.4th 968, 981, citing and quoting Prop. 103, § 1 [Findings and Declaration].) Prop. 103 was passed by voters to "protect consumers from arbitrary insurance rates and practices," to "provide for an accountable Insurance Commissioner" and to "ensure that insurance is fair, available, and affordable for all Californians." (*Ibid.*, quoting Prop. 103 § 2 [Purpose]; Exh. I-344, p. 3304.) Prop. 103 required that commencing November 8, 1989, automobile insurance rates in California, along with other applicable insurance policy rates, must be approved by the Commissioner prior to their use. (Prop. 103 as codified in Ins. Code, § 1861.01, subd. (c).)

13. The CDI Rate Regulation Branch reviews and approves rate applications submitted by insurers. The CDI Rate Filing Bureau ensures that rates in an application are not inadequate, excessive or unfairly discriminatory. The Los Angeles CDI Rate Filing Bureau has been responsible for reviewing Mercury's rate applications. CDI's Rate Enforcement Bureau is the legal arm of the agency that is focused on insurers complying with Prop. 103. CDI's Field Rating and Underwriting Bureau (FRUB) is responsible for conducting examinations of an insurer's rate practices. FRUB investigators periodically review an insurer's records to determine whether the insurer's rating practices are in compliance with Prop. 103 and statutory and regulatory provisions governing insurance rates in California. The Rate Enforcement Bureau initiates noncompliance proceedings to enforce the provisions of Prop. 103 when that Bureau has reason to believe that an insurer has violated Prop. 103 and provisions of the Insurance Code related to rate enforcement.

14. Mercury sells personal lines automobile insurance to California residents through independent insurance producers who can place insurance with more than one insurance company, acting as either an agent or a broker. Mercury does not "direct write" automobile insurance by selling to the public through its own employees; nor does it sell

through "captive" or "exclusive" agents. (I-1, p. 2.) Mercury only sells automobile insurance through producers who have entered into written producer contracts with Mercury.

III. Mercury Initially Had An All-Agent Producer Force

15. From 1962 through 1989, Mercury sold personal lines automobile insurance in California only through agents Mercury formally appointed by filing a "notice of appointment" with CDI pursuant to section 1704, subdivision (a), designating the licensee as an agent of Mercury. (Exh. I-1, p. 2.) Mercury's agents entered into an "Agency Contract" which authorized the agent to represent Mercury when selling automobile insurance and to receive specified commissions. (Exh. I-14, p. 99.) The Agency Contract gave the agents the authority to solicit insurance applications, collect, receive and issue receipts for premiums on insurance policies on behalf of Mercury, and to receive commission on paid premiums as full compensation on business placed with Mercury. Mercury's Agency Contracts required agents to submit applications and premiums collected in compliance with Mercury's "Agent's Manual." Mercury's agents were vested with the authority to bind insurance coverage in accordance with Mercury's Agent's Manual. (*Id.*)

16. Per Richard Wolak, Mercury's Vice-President of Agency Operations, Mercury's agents performed "field underwriting" services which he described as gathering information accurately and completely, applying Mercury's underwriting requirements from the Agent's Manual and submitting the insurance application to Mercury in accordance with Mercury's insurance application guidelines.[7] If an insurance applicant did not meet Mercury's eligibility requirements, the agent would not submit the insurance application to Mercury. Mercury's agents were expected to accurately "rate" the risk associated with the particular insurance applicant, and thereby properly price the insurance policy issued. After completing the field underwriting process, Mercury's agents had the authority to, and did, "bind coverage" at the point of sale.[8] Mercury's agents had the authority to issue financial responsibility certificates, endorsements to insurance policies, and to issue insurance identification cards.

17. Mercury's marketing representatives closely monitored and supervised its agents and provided training to the agents to insure that they were in compliance with Mercury's underwriting guidelines and regulations. The marketing representatives periodically visited its agents to discuss "binding errors" associated with incorrect or insufficient underwriting information obtained from the applicant when the agent rated the customer's policy. The marketing representative also monitored the agent's "loss ratios" and

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[7] Richard Wolak worked for Mercury from 1983 until 2010. Wolak became Vice-President for Agency Operations in 1996. Wolak managed Mercury's marketing representatives in California.

[8] Binding coverage at the point of sale, allowed the agent to provide the customer with insurance coverage immediately upon collection of the premium amount.

commission levels. An agent's "loss ratio" is the ratio of losses to premiums generated by the agent, and is a metric of the profitability of the policies an agent places with Mercury. Mercury paid a base 15 percent commission to its agents for personal lines auto insurance policies. The 15 percent commission was adjusted based on an agent's "loss ratio." The lower the loss ratio, the more profitable the agent's business was, and the agent's 15 percent commission could be adjusted upward. If the agent's "loss ratio" for premiums was high, their commission could be adjusted downward. The commission would be adjusted upward by one percentage point if the agent's loss ratio was 55 percent or less, adjusted down one percentage point if the agent's loss ratio was 60 percent or more. A loss ratio of 55 percent meant that an agent's insurance policies resulted in only $55 in claims being paid out per $100 in premiums collected. The lower the loss ratio, the more profitable the agent's business was for Mercury.

IV. Mercury's Shift To A Designated "Broker" Producer Force

18. Beginning in 1989, after the passage of Prop. 103, and continuing through 2003, Mercury converted approximately 700 insurance agents to "broker" status and notified CDI that the agency appointments were terminated. From 1989 to 2003, Mercury moved from an all-agent producer force to a force that was made up of approximately 90 percent "brokers." Mercury's agents were given the option to remain agents, but almost all of the agents opted to convert to "brokers." Those that converted to "broker" status were required to enter into a "Producer Contract" that replaced the agents' Agency Contracts. Mercury's Producer Contracts essentially used the same language that had been used in the Agency Contract except "producer" was defined to mean "broker" and the word "producer" replaced the word "agent" throughout the contract. Bruce Norman, Mercury's Senior Vice-President for Marketing, developed the Producer Contract and stated that it was modeled after the Agency Contract and that both were essentially the same. [9]

19. From 1995 through 2003, over 80 percent of Mercury's producer force was designated "brokers" by Mercury. Norman estimated that Mercury's total producer force, including agents and "brokers," was between 700 to 1,000 producers in the mid-1990s. He estimated that 100 to 200 of the producers were Mercury agents operating under Agency Contracts. Wolak estimated that Mercury had between 800 to 1000 agents and "brokers" in mid-2003, with 80 percent of the producers being designated "brokers" under Mercury's Producer Contracts. Although Mercury's former agents had the option to remain agents in 1989, only "broker" contracts were offered to new producers after 1989. Wolak was not aware of any new producers being appointed by Mercury as agents from July 1996 until

[9] Norman worked in Mercury's Marketing Department from 1971 until 2009. He began working in the Underwriting Department, but after 18 months, moved to Mercury's Marketing Department. In 1977, Norman became the Head of the Marketing Department and remained in that position until he retired in 2009. Norman was supervised by Mike Curtius and Gary Tirador, Mercury's Chief Operating Officers (COO) during Norman's employment with Mercury.

April 2003. Since 1989, Mercury has not filed or maintained agency appointments with CDI for its designated "brokers" pursuant to Insurance Code section 1704, subdivision (a).

20. Mercury's relationship with its designated "brokers" was indistinguishable from the relationship Mercury had with appointed agents. Under the Producer Contracts, Mercury treated its "brokers" the same way it treated "agents" under agency contracts. Mercury's "brokers" and agents used the same Mercury underwriting manual (Agent/Broker Manual) to transact insurance policies on behalf of Mercury. Mercury's "brokers" and agents continued to perform field underwriting services by applying Mercury's underwriting guidelines, rules and regulations. Mercury's "brokers" had the same binding authority under the Producer Contracts that its agents and former agents had under the Agency Contracts. Mercury's "brokers" also had the authority to issue financial responsibility certificates in Mercury's name, to issue endorsements to insurance policies, and to issue insurance identifications cards. Mercury's "brokers" and agents were all required to use blank Mercury application forms and to follow Mercury's insurance application submission procedures. "Brokers" and agents continued to be able to solicit applications for insurance, collect, receive and issue receipts for premiums.

21. Mercury continued to compensate agents and "brokers" with the same sliding scale percentage commission structure it provided to its former appointed agents. Mercury also paid its agents and "brokers" lump-sum contingent commissions based upon the profitability of the premiums they produced on behalf of Mercury.

22. Mercury's marketing representatives continued to monitor and supervise Mercury's agents and "brokers," and provided "brokers" the same training it provided its agents. Mercury sent the same bulletins containing new product, billing and administrative information related to Mercury insurance policies to both agents and "brokers." Mercury's marketing representatives continued to periodically visit agents and "brokers" to ensure that they were complying with Mercury's underwriting manual.

23. Mercury exercised control over its "brokers" and agents by imposing discipline on agents and "brokers" that failed to follow Mercury's rules and regulations, underwriting guidelines, and production expectations. Norman testified that the term "discipline" was not accurate, but admitted if a "broker" or agent violated Mercury's underwriting and regulating guidelines or failed to meet production expectations, Mercury would either terminate, suspend, reduce the commission, place on probation, or simply discuss the problem with the producer and offer alternatives or suggestions to improve the producer's business processes.

24. Mercury continued to work very closely with its agents and "brokers" to address and correct binding errors that resulted from field underwriting. If agents or "brokers" submitted applications that contained incorrect information pertaining to risk calculations, Mercury's Underwriting Department would submit an "M-19" form to Mercury's Marketing Department detailing binding errors made by the "broker" or agent. Mercury's marketing representatives would discuss the M-19 forms and binding errors with

the "brokers" and agents. Mercury continued this procedure with its designated "brokers" from at least July 1996 until November 2005.

A. AUTO INSURANCE SPECIALIST (AIS)

25. AIS, Mercury's largest producer, began doing business as an insurance broker in California in 1968. Mercury had an Agency Contract with AIS and maintained agency appointments with CDI from 1968 until November 21, 1989, when AIS entered into a Producer Contract with Mercury, converting AIS to "broker" status. In a cover letter to Bruce Norman dated January 10, 1989, containing AIS's executed Producer Contract, AIS Vice President Karen A. Sarasalo wrote: "we understand that the relationship between Mercury and A.I.S. is not changed in any material fashion as a result of this change in title and understand that our ability to bind coverage and other essentials of our mutual business relationship including our ability to hold ourselves out as a representative of Mercury Insurance Group is not changed by the execution of this new agreement." (Exh. I-18.) Norman agreed with Sarasalo's statement that the relationship between Mercury and AIS did not change after AIS converted to "broker" status. On January 1, 1990, Mercury submitted action notices to CDI advising that effective January 1, 1990, Mercury was terminating AIS's agency appointments with CDI. Mercury did not maintain agency appointments for AIS from January 1, 1990, until Mercury purchased AIS in January 2009.

26. By 1989, AIS had become one of the largest personal lines automobile insurance producers in California, representing approximately 30 to 40 insurance companies, including Mercury. AIS acted as a producer for these companies both in the capacity of an insurance agent and broker. From 1998 until 2009, AIS was owned by AON, then one of the largest insurance brokers in the world.

27. Patrick Napolitano, an AIS Director of Customer Service, who worked in the capacity of a branch manager for several AIS field offices after being hired in 1994, confirmed that Joe Nunnally, a Mercury field representative, visited his Woodland Hills office approximately once per month from July 2002 through December 2003 to discuss AIS insurance transactions on behalf of Mercury. Nunnally discussed "application issues" including errors in applying Mercury's rating and underwriting guidelines. Nunnally also discussed application volume, binding errors, and loss ratios with Napolitano and his staff.

28. Norman stated that from 1988 through 2009, Mercury kept track of loss ratios for its agents and "brokers", including AIS, in various geographic territories and periodically provided information regarding the loss ratios to the producers. Norman stated reports were used to show where AIS branches had loss ratios that were higher than average in the territories where the branches were located. Norman notified AIS management of loss ratios because they adversely affect Mercury's rates and AIS commission income. If the loss ratios were high, Norman recommended to AIS management measures or changes that were intended to improve the loss ratios. These measures included the cessation of writing new business or writing less new business in a particular territory that had high loss ratios, retention of existing business by writing more policy renewals, versus new business, and

upgrading the quality of the business by improving the accuracy of the underwriting information on applications. Norman acknowledged that from 1988 until he retired in 2009, Mercury also kept agency production reports for its agents and "brokers," including AIS. These reports tracked premium generation, losses and loss ratios, and were provided to the agents and "brokers," including AIS.

29. Scott Boostrom, AIS Corporate Compliance Director since 2001, testified that AIS was not an agent of Mercury. He stated that since AIS's inception in 1968, AIS had been committed to acting as an insurance broker to serve the needs of AIS's clients. He testified that other than agency appointments with Mercury, AIS had no other agency appointments with any other client and acted as a broker on behalf of those clients. AIS required its insurance customers to enter into a "broker agreement" that disclosed that AIS was acting as an insurance broker and that AIS would charge a "broker fee" for the services provided in processing the customer's insurance application with an insurance carrier, including Mercury. Notwithstanding AIS's broker relationship with its other clients, AIS was an appointed agent on behalf of Mercury from its inception in 1968. Consequently, AIS produced personal lines auto insurance on behalf of Mercury in the capacity of an appointed agent from 1968 to 1989. The evidence showed that the overwhelming majority of AIS's personal lines automobile insurance policies were written on behalf of Mercury in an agent capacity. That AIS had a broker relationship with other clients does not establish that it acted as a "broker" in its relationship with Mercury.

30. Boostrom also testified that prior to Mercury's acquisition of AIS in 2009, "Mercury exercised no control over whatsoever over AIS." Boostrom emphasized that AIS placed customer-clients with the insurer that had the most appropriate coverage and/or price, which was not always Mercury. He asserted that AIS refused to do business with carriers that required volume commitments and AIS did not steer business based on commission, bonus agreements of other carriers or insurer factors. Regarding Mercury's requirement that "brokers" comply with Mercury's underwriting and rating guidelines, Boostrom stated that Mercury was entitled to set the type of risks it wanted to insure and that a broker must respect the insurer's guidelines on acceptable and unacceptable risk. Boostrom, as did Wolak and Norman, did not consider adhering to Mercury's underwriting and rating guidelines as "field underwriting or frontline underwriting." They characterized this activity as merely gathering information about the customer's risk characteristics, which is required to correctly rate the insured's risk.

31. Characterizing "field underwriting" activities as merely "gathering information" is not an accurate description. Mercury's designated "brokers" not only gathered information, but they actually underwrote and rated the policy based on Mercury's underwriting guidelines, bound the coverage, and only then forwarded the insurance application to Mercury. This was the process from July 1996 through at least April 2003. Although Boostrom testified that the designated "broker's" binding authority was a misnomer because the authority was limited by Mercury's underwriting and rating guidelines, the evidence established that Mercury's designated "brokers" were vested with the authority to bind coverage at the point of sale once premiums were paid.

32. Boostrom also testified that AIS brokers did not receive training from Mercury's marketing representatives, but instead AIS trained their brokers internally. Boostrom's testimony, however, is contradicted by a June 8, 2005 email from Boostrom to AIS managers regarding the discontinued use of Mercury's Agent/Broker underwriting manual. In the email Boostrom instructs the managers that AIS had to collect all of Mercury's underwriting manuals from its "brokers" pursuant to legal action in the *Krumme* case. (Discussed in more detail in Factual Findings 65-67.) He stated: "[t]here is going to be concern among staff unless you make it very clear that our relationship with Mercury is not changing, this is simply an action Mercury needs to take to bring them into compliance with a legal ruling. ***Revised training materials, etc. are under discussion and should be forthcoming***. Rely on our institutional knowledge and existing reference materials, ***call Mercury when necessary***." (Exh. I-292, p. 1734; emphasis added.) This email showed that AIS considered Mercury's underwriting manuals for training purposes and relied on Mercury for training though at least June 2005.

33. Finally, although Boostrom testified that Mercury exercised no control over AIS "brokers," he admitted that from 2001 to 2007 he continued to engage in email correspondence with Kenneth Kitzmiller, Vice President of Underwriting for Mercury, regarding underwriting and submission issues, i.e. acceptability of risks and rate issues, and some claim issues related to processing Mercury insurance policies. In corresponding with Kitzmiller, Boostrom also discussed questions raised by representatives in AIS's branch offices. Boostrom summarized the content of discussions he had with Kitzmiller and distributed the information to AIS branches.

V. Mercury's Designated "Brokers" Charged Broker Fees

34. In 1989 Mercury's designated "brokers," including AIS, began charging "broker fees" on Mercury personal lines auto insurance transactions. Not all of Mercury's "brokers" charged broker fees for every insurance transaction, and Mercury's appointed agents did not charge "broker fees" at all. Mercury's "brokers" charged "broker fees" on insurance transactions for the same services and coverage that an appointed agent provided, but the agent could not charge any extra fee for the insurance policy beyond the premium amount. Consequently, a customer who purchased a Mercury insurance policy from a "broker" paid more for the policy than if the policy had been purchased from one of Mercury's appointed agents. Mercury was aware that its "brokers" were charging "broker fees." Mercury did not include the "broker fees" charged by its designated "brokers" as part of the rate applications Mercury filed with CDI to obtain prior approval of its rates. Consequently, CDI did not approve the "broker fees" charged by Mercury's designated "brokers" from 1989 through at least 2006.

35. Mercury's "brokers" also charged different "broker fee" amounts for an insurance transaction involving the same services and coverage. Scott Carlson, a CDI Associate Rate Analyst who assisted in conducting the FRUB examination of Mercury's rating and underwriting practices in 1998, testified that Mercury's "brokers" typically

charged "broker fee" amounts that were indeterminable, but ranged from $50, $100, to $150 for Mercury personal lines automobile insurance policies issued by the "brokers." The duties of Lani Elkin, AIS Vice President in the Compliance/Procedure Department, included overseeing AIS's data collections related to broker fee transactions. Elkin testified that from 1996 to 2004, AIS's general business practice was to charge customers a one-time broker fee of less than $100, including customers whom AIS placed with Mercury. Chris Bremer, Vice President and Chief Financial Officer of AIS, testified that from 1996 until the end of 2006, AIS's general business practice was to charge and collect a "broker fee" from Mercury customers on all new applications for private passenger auto insurance.

36. AIS also did not charge "broker fees" on all of the personal lines auto insurance transactions conducted on behalf of Mercury. On rare occasions customers paid Mercury's charged premium amount, but not the "broker fee." For instance, AIS waived the "broker fee" if an AIS employee committed an error in processing the insurance policy. There were also instances when a customer turned in an insurance application after normal business hours at an AIS office and did not include the "broker fee" with the charged premium amount. AIS would bind coverage based on the date the application was received, submit the application and then attempt to collect the "broker fee" later. Mercury did not cancel the insurance policy if a customer did not eventually pay the "broker fee." AIS collected "broker fees" on over 99 percent of the insurance policies it transacted on behalf of Mercury. AIS required customers purchasing Mercury insurance to write two checks when paying for the insurance coverage, one to Mercury for the charged premium, and a second check to AIS for the "broker fee." Mercury did not actually receive the "broker fees" collected by AIS or other designated "brokers." The "broker fees" were retained by AIS and the other "brokers."

37. From September 19, 1999, through August 11, 2004, AIS "brokers" charged approximately $27,593,562 in "broker fees" on personal lines automobile insurance policies produced on behalf of Mercury in California. From 1999 through 2004, between 84 to 91 percent of all of AIS's personal lines automobile insurance premiums produced in California were produced on behalf of Mercury. From 1998 to 2004, AIS produced between 20 to 25 percent of Mercury's personal lines automobile insurance business in California. Chris Bremer of AIS testified to the accuracy of the $27,593,562 in "broker fees" charged by AIS on Mercury automobile insurance from 1999 through 2004, and the percentages of the business transacted on behalf of Mercury by AIS from 1998 through 2004. AIS was Mercury's largest producer of personal lines auto insurance policies in California.

38. Bruce Norman of Mercury testified that although AIS produced a significant percentage of Mercury's personal lines auto insurance policies, this was a result of Mercury's competitive rates, not because AIS had a particular desire to produce business for Mercury. Boostrom of AIS stated that AIS used a "comparative rater" (FSC rater) to process insurance applications for its customers from 1996 through 2006. The "comparative rater" is an insurance software program brokers purchased from third-party companies that allowed brokers to quote multiple insurers' rates simultaneously when processing an insurance application. The comparative rater software typically had the insurance companies' rules

and underwriting guidelines embedded in the software program. This allowed AIS brokers to input the risk factors identified by the customer into the comparative rater program and the program would provide a survey that lists the insurance carriers that could insure the customers and the premium rates charged by each carrier. Napolitano of AIS testified that "many times" Mercury would have the lowest premium rates and AIS would offer the customer the lowest rate provided by the comparative rater. In spite of AIS and Mercury's claim that AIS sold other insurance carriers policies, the weight of the evidence showed that AIS transacted the overwhelming majority of its personal lines automobile insurance policies, over 90 percent, on behalf of Mercury. The amount of business transacted AIS on behalf Mercury is attributed to the very close relationship AIS had with Mercury, and not because Mercury's rates were lower than any other carrier.

39. Prior to 1996, agents and "brokers" submitted written paper applications to Mercury to complete the application process. The producers would manually bind coverage at the point of sale when the premium was paid and then submit the paper applications within seven days of binding coverage. In approximately 1996, Mercury instituted an electronic process to submit insurance applications. Designated "brokers" and agents were required to submit insurance applications electronically. Initially, a program called "Starfish" or "Mercusoft" was used. Later Mercury converted to a program called "Quicksilver," the electronic program currently used by Mercury. By 1998 the "Quicksilver" program was being used predominantly by both designated "brokers" and agents. Mercury's Quicksilver program contained the underwriting guidelines and regulations that had been contained in the Agent/Broker's Manual. Designated "brokers" and agents input the customer's information into the Quicksilver program and the software calculated the premium amount based on the field underwriting information input by Mercury's producer.

40. Insurance coverage was electronically bound by Quicksilver when a binder number, policy number, or other written or electronic acknowledgement was transmitted back to the designated "broker" or agent, effectively providing evidence of coverage at the point of sale. Quicksilver eliminated seven-day manual binding, and by 2003, almost all of Mercury's insurance applications were submitted electronically. However, producers were still required to submit the paper applications to Mercury within seven days of the electronic binding of coverage. Even with the Quicksilver electronic application submission procedure, "brokers" and agents continued to perform field underwriting which provided the basis to bind the insurance coverage. Mercury's Underwriting Department did not review the submitted insurance applications prior to coverage being bound electronically by the Quicksilver software. Consequently, Mercury's designated "brokers" and agents continued to have the authority to effectively bind coverage at the point of sale even after the Quicksilver electronic application submission process was implemented.

VI. Statements By Jon Tomashaff

41. Mercury relies on statements made by former CDI Staff Counsel Jon Tomashoff to assert that there was a lack of clarity in the insurance industry in the 1990's regarding the distinction between "agents" and "brokers" and the concept of "dual agents."

On November 6, 1997, Jon Tomashoff, wrote a letter to an insurance producer responding to questions about Bulletin 80-6 and broker fees. He stated that Bulletin 80-6's statement that "all sums collected by insurance agents constitute taxable premium and must be reported as such" was too broad and did not correctly reflect California case law. (Exh. R-6, p. 1.) Tomashoff believed it was more accurate to say that "all sums collected by Insurance agents, for tasks which an insurer or producer necessarily must perform in order for an insurance contract to be issued and carried out, constitute taxable premium and must be reported as such." (*Id.*) He stated that if a producer was not an appointed agent, the producer could be an agent of an insurer for certain functions, such as collecting and returning premiums and policy issuance, but a broker in all other regards. Significantly, Tomashoff prefaced his statements in the November 7, 1997 letter by stating that the "contents of this letter constitute neither statute, unless specifically referenced, nor regulation," and that the answers to the questions provided could not be relied upon by agents and brokers. (Exh. R-6, p. 1.) He advised the producer that in order for his responses to be relied upon by brokers and agents, there would need to be statutory and/or regulatory changes made to address the questions raised by the producer.

42. On January 27, 1998, in a letter to a deputy city attorney clarifying the term "agent", Tomashoff wrote that a producer by definition is acting as an agent for the insurer when executing a binder on behalf of the insurer, but that the producer was not necessarily the insurer's agent for all purposes. Tomashoff again stated that a producer could be an agent of an insurer for the purpose of collecting premium and binding insurance, "but in all other respects be primarily a representative of the insured, i.e., a broker." (Exh. R-7, pp. 3-4.) He suggested that the distinction between an agent and a broker had become blurred, with many, if not most producers acting as a "hybrid of agent and broker." (*Id.*)

43. On September 28, 1999, Mercury circulated a bulletin to all of its producers notifying them of a public hearing on October 26, 1999, regarding proposed changes to CDI regulations, CCR sections 2189.1 through 2189.8, relating to broker fees. The bulletin stated: "We believe that the Insurance Department may take the position that all Mercury and Cal Auto producers are acting as agents and represent the company even if the producer's contract is a broker contract. This would require the company to file action notices appointing all producers as agents. Under these proposed regulations no broker fee could be charged on any Mercury or Cal Auto personal lines business." (Exh. I-125.) The bulletin advised Mercury's producers to attend the public hearing. On October 26, 1999, while speaking at the public hearing, Tomashoff stated that the "[t]he issue of agent versus broker is one which is riddled with a lot of legal ambiguity and tremendous confusion within the department, within the industry." (Exh. R-22, pp. 20-21.) He stated that CDI hoped to work with the industry to clarify the distinction between an agent and a broker with the proposed regulations.

44. Tomashoff's letters and statements were not addressed to Mercury and did not provide any opinion regarding the validity of Mercury's underwriting and

rating practices and its use of "brokers" to charge "broker fees." Although Bruce Norman of Mercury testified that he was aware of Tomashoff's 1997 and 1998 letters, he was not sure when he became aware of the letters, stating that he believed he saw them in the mid-1990's. Additionally, Norman did not indicate that he or anyone at Mercury contacted Tomashoff to specifically inquire about the letters or to request his or CDI's opinion regarding Mercury's use of "brokers" to charge "broker fees."

VII. The FRUB 1998 Exam Report

45. In July 1998, FRUB began an examination of the rating and underwriting practices of Mercury for the time period January 1, 1995 to July 2, 1998. On February 18, 1999, CDI sent FRUB's examination report (1998 Exam Report) to Mercury.[10] The 1998 Exam Report concluded the following regarding Mercury's use of its designated "brokers":

> The brokers are subject to substantially the same direction and control from Mercury as are the agents. Both the agents and brokers use the same rating and underwriting manuals and follow the same application submission requirements. The agents and brokers also have similar written contracts with Mercury. Moreover, Mercury will not accept applications from any broker who does not have a contract with Mercury.
>
> From a marketing standpoint, Mercury does not make any significant distinction between the brokers and the agents. Mercury represents the brokers as "independent agents" in its print and radio advertisements and has requested that the brokers rebate their broker fees when handling business they know has been generated by Mercury rate comparison advertisements. Moreover, the brokers use the same Mercury application forms as do the agents and have been invested with the same 7-day binding authority. The brokers are also authorized by Mercury to quote premiums and issue financial responsibility certificates on its behalf.
>
> The extent of Mercury's direction and control over the brokers in the submission of applications, Mercury's representations of the brokers as independent agents, and the binding authority that Mercury has invested in the brokers are altogether inconsistent with the CIC Section 1623

[10] CDI refers to the 1998 Exam Report as the "2000 Exam Report" because the report was actually completed in October 2000. The examination report actually refers to the examination as the "Mercury Insurance Group 1998 Exam Report." Consequently, this proposed decision will refer to the report as the "1998 Exam Report."

brokerage definition. The brokers are therefore held to be operating as de facto agents under CIC section 1621.

Mercury's misrepresentation of the brokers has resulted in at least three violations of the insurance statutes.

1) The brokers are charging broker fees for rendering the same services and coverage to Mercury's insureds that the agents provide. This being the case, insureds who purchase insurance coverage through the brokers are likely to pay more for their insurance policies than they would have had they bought their policies through agents. Given that the brokers are operating as de facto agents under CIC section 1621, the cost differential that is created by the added broker fees is inequitable to insured and violates CIC Section 1861.05(a).

2) Mercury's print and radio advertisement advise the reader/listener that he can obtain a quote from one of Mercury's "independent agents." Mercury's portrayal of the producers as independent agents is misleading given that a) Mercury has a brokerage contract with most of the producers, and b) the brokers can charge broker fees for the business that is generated from all non-rate comparison advertisements. When brokers charge broker fees to individuals who have been misled by Mercury advertisements into thinking that they would be transacting business with independent agents, misrepresentations translate into violations of CIC Section 790.03(b).

3) Mercury has not filed notices of appointment with the California Insurance Department (CDI) for the brokers. Given that brokers are operating as de facto agents, Mercury's failure to file the appointments is a violation of CIC Section 1704(a).

These violations will be referred to the CDI's Legal Division for review.

(Exh. R-67, pp. 6-7.)

46. On August 4, 1999, CDI and Mercury representatives met to discuss the 1998 Exam Report. Kathryn Ann Bugh (Gilroy)[11], CDI Associate Insurance Rate Analyst, and Kenneth Kitzmiller of Mercury were present at this meeting. Bugh assisted in conducting the 1998 FRUB examination of Mercury's rating practices and drafting the 1998 Exam Report. Bugh stated that Mercury agreed to respond to the 1998 Exam Report by April 1, 1999, but Mercury did not respond by that date. After

[11] Kathryn Bugh testified as "Kathryn Ann Gilroy," clarifying that "Bugh" is her maiden name.

the August 4, 1999 meeting, the parties agreed to schedule a second meeting on January 27, 2000. Bugh corresponded with Kitzmiller and George Joseph, Mercury's founder and Chief Executive Officer (CEO), on at least two occasions after the August 1999 meeting regarding the 1998 Exam Report. But Mercury preferred to discuss the matter at the scheduled January 27, 2000 meeting.

A. DRAFT NOTICE OF NONCOMPLIANCE AND JANUARY 27, 2000 MEETING

47. On January 21, 2000, Elizabeth Mohr, Senior Staff Counsel of the Rate Enforcement Bureau for CDI, sent a letter to Mercury, which included a draft Notice of Noncompliance (Draft Notice) that addressed the issues in the 1998 Exam Report. The Draft Notice essentially alleged that Mercury violated sections 1861.01, subdivision (c), and 1861.05, subdivision (b), by selling personal line auto insurance through unappointed de facto agents who charged unapproved "broker fees." The Draft Notice additionally alleged that Mercury's designated "brokers" charged "broker fees" for providing the same services and coverage to insureds that Mercury's agents provided, and consequently, an insured that purchased insurance from one of Mercury's "brokers" likely paid more for an insurance policy than they would have paid had they purchased the policy from a Mercury agent. This cost differential was alleged to be inequitable and a violation of section 1861.05, subdivision (a). Mohr advised Mercury that the Draft Notice was a "basis to begin discussions" regarding the 1998 Exam Report and to reach a "workable solution" to the issues in the Draft Notice. She indicated that the Draft Notice would be discussed at the January 27, 2000 meeting.

48. On January 27, 2000, CDI representatives Joel Laucher, then Chief of the Consumer Services Division, Reid McClaran, Rick Gordon, Kathryn Bugh, and Elizabeth Mohr met with Mercury's representatives George Joseph, Michael Curtis, President and Chief Operating Officer (COO), Ken Kitzmiller, and Bruce Norman. The primary issues discussed at the January 27, 2000 meeting were the 1998 Exam Report and the Draft Notice. Joseph expressed a concern that the Insurance Code and case law did not clearly define the terms "agent" and "broker." Norman testified that CDI and Mercury both agreed that the Insurance Code was "at the least vague, if not inconsistent, and did not really contain a statutory definition of a broker." Bugh testified that there was general agreement between CDI and Mercury after the meeting that the difference between a broker and an agent "was not as clear as it should be."

49. At the January 27, 2000 meeting, CDI requested Mercury to prepare a written response to the Draft Notice. Joseph suggested that as part of Mercury's response, Mercury would include a statement that it would pursue legislation to define "agents" and "brokers," and would invite CDI to work with Mercury in drafting the proposed bill. Finally, CDI stated that it would give Mercury "ample notice" if, after receipt of Mercury's response to the Draft Notice, it was determined that other action needed to be taken. On February 18, 2000, Bugh prepared a letter, which was sent to Kitzmiller, summarizing the issues and resolutions discussed, and proposals that were made at the January 27, 2000 meeting. Bugh's letter stated that the following issues were discussed: that 12 percent of Mercury's

producer force had agency appointments and the remaining producers all had "broker" contracts; that Mercury's "brokers" and agents have binding authority, used Mercury's applications, and followed Mercury's application procedures; and Mercury was representing its producer force as "independent local agents" in its advertisements. (Exh. R-9, p. 1.) Bugh stated that based on the 1998 Exam Report, CDI informed Mercury's representatives that CDI considered Mercury's "brokers" to be de facto agents. She also indicated that CDI had delivered the Draft Notice to Mercury and that Joseph had raised concern that case law and the Insurance Code lacked clarity regarding a definition for agent and brokers. Bugh indicated that CDI requested Mercury to write a response to the Draft Notice, and that Mercury intended to propose legislation to define agents and brokers, and would invite CDI to work on the proposed bill. She confirmed that CDI would give Mercury "ample notice" if it determined after receiving Mercury's response to the Draft Notice, that other actions needed to be taken. (Exh. R-9, p. 2.)

50. On March 21, 2000, Kitzmiller responded to Bugh's letter stating that his "recollection" of the January 27, 2000 differed "in only one minor area" – "Notice of Non-coverage of Earthquake," which is not relevant to this proceeding. (Exh. CDI-11.) Michael Curtius also testified that Bugh's summary of the issues discussed at the January 27, 2000 meeting was accurately reflected in Bugh's letter. Norman and Curtis testified that after the January meeting, they believed an agreement had been reached to pursue legislation to clarify the definition of the term "broker" to distinguish the terms "broker" and agent, and that the legislation would resolve the issues in the 1998 Exam Report and the Draft Notice. Kitzmiller testified, however, that CDI did not tell him that the issues in the Draft Notice would be resolved by legislation, but reiterated that CDI did advise Mercury that at some point if the issues in the Draft Notice were not resolved, Mercury would be notified if further action was needed.

51. Mercury supported legislation to amend the definition of the term "broker" under section 1623. On September 30, 2000, Assembly Bill 2639 (A.B. 2639) was enacted to amend section 1623. Section 1623, as amended, provided that an insurance broker is a person that transacts insurance, other than life insurance, for compensation on behalf of another person, with but not on behalf of the insurer. (Amended by Stats. 2000, c. 1074 (A.B. 2639), § 1.) A.B. 2639 provided a presumption, for licensing purposes only, that a person is a "broker" if the application for insurance submitted to the insurer shows that the person is acting as an insurance broker and is licensed as an insurance broker in the state in which the application is submitted. The April 12, 2000 Legislative Analysis for A.B. 2639 stated that the bill sought to clarify an insurance broker's status as a broker by permitting a "broker" to (1) bind coverage on behalf of an insurer, and (2) to establish a presumption that when insurance is submitted by a "broker" who has a contract with an insurer, that person is presumed to be acting as a "broker," not an agent. (Exh. R-12.) This language was proposed by Mercury. Section 1623, as enacted however, did not include this language related to binding coverage or the presumption.

52. A.B. 2639 created a rebuttable presumption, for licensing purpose only, that a broker submitting an application for insurance was a broker. Hence, section 1623, as

enacted, did not provide support for Mercury's position that its "brokers" were traditional brokers, and not de facto insurance agents acting on behalf of Mercury. Mercury asserted that it believed the enactment of A.B. 2639 resolved CDI's findings in the 1998 Exam Report. CDI, however, officially opposed A.B. 2639 because it believed that the bill would "'blur' the long-established legal distinctions between 'agents' and 'brokers' and would create confusion for the consumer and problems for DOI enforcement." (Exh. R-12.) Given CDI's opposition to A.B. 2639, and the language in the final version of the bill that was enacted, Mercury cannot reasonably assert that it believed A.B. 2639 resolved the issues in CDI's 1998 Exam Report and Draft Notice.

53. On October 20, 2000, CDI issued an Addendum to the 1998 Exam Report (Addendum) that briefly summarized the report's "criticisms" or findings, the agreements reached between Mercury and CDI regarding the findings, and any "unresolved" findings or issues. (Exh. R-67.) The Addendum stated CDI and Mercury had engaged in extensive discussions concerning the 1998 Exam Report, and that CDI would "follow up" with Mercury on the unresolved issues in the report. CDI noted that "during the next California Rating and Underwriting Examination," it would "verify that Mercury implemented the resolutions that are described in this addendum and the 1998 Exam Report." (Exh. R-67, p. 10.) The Addendum reiterated that Mercury agreed to write a response to the Draft Notice, and that CDI agreed to notify Mercury if, after receiving Mercury's response, it determined that other action needed to be taken. The Addendum noted that CDI had contacted Mercury on October 20, 2000, to inquire about the status of Mercury's written response to the Draft Notice. As of October 20, 2000, Mercury had not submitted a written response to the Draft Notice, but Mercury informed CDI that Mercury believed its "obligation to send a written response had been fulfilled by the passage of Assembly Bill 2639," and that Mercury believed the enactment of A.B. 2639 had resolved the issues in the 1998 Exam Report and the Draft Notice. (Exh. R-67, p. 11.) Finally, the Addendum specifically indicated that "Mercury will contact CDI's Legal Division to discuss this matter further." (*Id.*)

54. Mercury did not provide a written response to CDI's Draft Notice. On October 20, 2000, FRUB completed its examination and submitted the 1998 Exam Report to the Commissioner. The Commissioner approved the 1998 Exam Report and it was officially filed on December 4, 2000. On November 7, 2000, George Joseph sent a letter to Sheryl Lawrence, then Bureau Chief for FRUB, stating that he believed that the enactment of A.B. 2639 had resolved the issues regarding the "Producer Contracts, pages 4 and 11 of the examination report." (Exh. R-77.) Joseph indicated in the letter that Mercury had tried to contact CDI's Legal Division several times regarding this issue without success.

B. FRUB 2002 EXAM REPORT

55. In 2002, CDI conducted another examination of Mercury's underwriting and rating practices, which resulted in FRUB's 2002 Exam Report. The 2002 Exam Report made no follow-up findings to the 1998 Exam Report regarding Mercury's use of "de facto agents" that charged unapproved "broker fees." Mary Lee Weiss, an Insurance Rate Analyst with CDI, assisted in conducting the 2002 FRUB examination and preparing the 2002 Exam

Report. Weiss testified that the "broker fee" issue was not an issue for her examination of Mercury's rating practices. Weiss remembered she had been advised by Tracy Stevenson or Sheryl Lawrence, her supervisors at CDI, that an "informal arrangement" or "independent agreement" had been reached regarding the "broker fee" issue. Tracy Stevenson, the "Examiner-In-Charge and Senior Insurance Rate Analyst" for the 2002 Exam Report, testified that the "de facto agent issue aka the broker issue" in the 1998 Exam Report "was not settled separately," and she denied telling Weiss that the issued had been resolved. Although Stevenson did not specifically recall discussing the 1998 Exam Report "broker issue" with Weiss, Stevenson stated that the "broker issue" was not included in the 2002 Exam Report because the issued had been referred to CDI's Legal Department and was being handled separately by the Legal Department. Stevenson stated that the 1998 Exam Report specifically referred the violations related to Mercury's "brokers" to CDI's Legal Division, and therefore that issued would not have been subject to the FRUB 2002 examination. Stevenson's testimony is given more weight because Stevenson was Weiss' supervisor and Weiss' testimony was based on her sparse recollection of statements made by Stevenson or Lawrence.

VIII. Mercury's Rate Applications

56. From 1996 through 2006, Mercury submitted rate applications to CDI that were approved and Mercury used those approved rates to sell Mercury personal lines automobile insurance. (Exhs. R-86 to R-158.) During this period, more than 70 Mercury rate applications were approved by CDI. Mercury's rate applications did not include the "broker fees" charged by Mercury's designated "brokers."

57. Mike Edwards, the CDI Rate Filing Bureau Chief for the LA1 Rate Filing Bureau, whose office received and reviewed Mercury's rate applications from 1996 to 2006, testified that Mercury also did not include the "broker fees" as a miscellaneous fee in its rate applications during this period. When asked whether "broker fees" were required to be reported in a rate application, Edwards responded they were not. However, Edwards expressed no opinion whether the "fees" charged by Mercury's "brokers" constituted legitimate "broker fees." Edwards did not discuss Mercury's 1998 Exam Report, or how Mercury was using its "brokers" with anyone from FRUB or anyone else at CDI.

58. Larry Lastofka, CDI Supervising Insurance Rate Analyst, has been employed as an insurance rate analyst with CDI since 1998. He has been a Supervising Insurance Rate Analyst since 2006. Lastofka testified that an insurer is required to report various fees charged as part of their rate applications. Any fees charged are required to be reported in a rate template[12] in the rate application under the heading "earned premium only." Fees

[12] Mike Edwards testified that a "rate template" is a "calculation and algorithm that is essentially pulled from the regulations and that algorithm is specifically stated in the California Code of Regulations as to how a rate will be determined, whether it's adequate." The rate template produces a minimum permitted earned premium and maximum permitted earned premium under the regulations.

charged by insurers were required to be reported on the CA-RA8 and CA-RA5 pages of the May 15, 1996 edition of the CDI rate application. According to Lastofka, fees charged for processing an application for an insurance policy are required to be reported by the insurer in a rate application to CDI.

59. Irene Bass, FCAS, is an expert witness retained by Mercury to provide an actuarial opinion whether the "broker fees" charged by Mercury's "brokers" constituted insurance premiums in the context of insurance rate making. Bass has frequently rendered opinions on the impact of Prop. 103 on the insurance industry's ratemaking, and has more than 39 years of experience as an actuary. Bass explained the very complicated ratemaking principles and process in California that are used to arrive at the premium a customer (the insured risk) must pay to an insurer for insurance coverage. However, it is not necessary to delve into the complexities of California's ratemaking principles and processes for a determination of the issues in this case. As Bass explained, the costs considered in the ratemaking process include the insurer's estimates of future costs of (a) the expected cost of claims; (b) the expected cost of claim settlement; (c) the expected cost of operations and administration; and (d) the expected cost of capital. (Exh. R-200.) This ratemaking process usually yields a *base rate*, which represents the anticipated total future costs (cost of claims plus cost of expenses). (*Id.*) The insurer's base rate is applied to a formula to establish the premium amount an insured customer must pay the insurer for insurance coverage. This formula involves applying the insured's individual risk characteristics and the amount of coverage to be purchased to the insurer's base rate to arrive at the premium amount. The payment of the premium by the insured customer in exchanged for insurance coverage is referred to as the risk transfer. (*Id.*) Bass emphasized that the premium amount includes only those costs related to the risk transfer; i.e, the premium should only include the costs of insurance.

60. Bass opined that the "broker fees" charged by Mercury's designated "brokers" were not a part of the premium paid by Mercury's policyholders for the cost of insurance coverage. Bass reasoned that for the "broker fees" to have been part of Mercury's premium, the fees would have to have been an actual expense of Mercury's in the ratemaking process. She testified that the "broker fees" were not an actual expense of Mercury's and therefore were not included in the ratemaking process, and consequently, could not be considered premium. She further concluded that because Mercury did not actually charge or receive the "broker fees" they were properly omitted from Mercury's rate applications. Bass based her opinion on the fact the "broker fees" were charged and received by the designated "brokers," and thus were not a Mercury expense, and that the "broker fees" were not related to the transfer of risk to Mercury; i.e., the cost of insurance to the insured for Mercury's insurance coverage.

61. Bass further testified that even if Mercury was deemed to have constructively received the "broker fees," because these fees were not actually received by Mercury, they were properly omitted from Mercury's ratemaking calculations. She stated that "constructively received" fees are not part of actuary calculations, but admitted that she had no expertise in agency law or a legal background. Although she referred to the *Krumme*

Court's finding that Mercury's "brokers" were de facto agents, and at times she referred to Mercury's "brokers" as de facto agents, she did not appreciate the difference in fees collected by an agent, versus fees collected by an actual broker. Bass' opinion that "broker fees" should not have been included in Mercury's ratemaking calculations and their rate applications is based on the fact that Mercury did not actually receive the fees. Although Bass has experience as an actuary and the rate making process, her opinion that "broker fees" are not subject to an insurance rate applications is not credited because of her lack of understanding of the significance of the agency relationship that existed between Mercury and its designated "brokers."

62. Milo Pearson, former Deputy Commissioner of the CDI who was instrumental in creating the CDI Rate Regulation Division, also testified as an expert on behalf of Mercury. Pearson worked for CDI from 1986 until 1996. Pearson testified that the "broker fees" charged by Mercury's designated "brokers" are not considered "premium" or "rate" in the context of ratemaking. Pearson testified "premium" or "rate" refers to moneys paid by the insured for the "transfer of risk" to the insurer, or stated differently, in "exchange for insurance coverage." He opined because "broker fees" do not relate to the transfer of risk i.e., does not trigger coverage, the fees would not be considered "premium" or "rate" in the rate making context. Pearson also opined that the "broker fees" at issue here were not required to be included in a rate application because the fees were not revenue received by Mercury. He stated that only actual revenue and actual losses should be used by the insurer in calculating an appropriate rate. However, Pearson testified that agents were not allowed to charge "broker fees" on top of the premium collected.

63. Although both Bass and Pearson testified that "broker fees" should not be included in rate applications and calculated as a part of premium, they both admitted that miscellaneous fees and ancillary income was required to be reported in the rate applications, but that both of these items would be subtracted when calculating a rate in the rate application.

64. On April 25, 2006, then Insurance Commissioner John Garamendi issued an opinion in which he discussed the definitions and usage of the term "premium" and whether premiums included or excluded installment fees. In defining the actuarial definition of "premium," Commissioner Garamendi stated that "premium" generally means "consideration paid an insurer for undertaking to indemnify the insured against a specific peril. The amount of the premium varies in proportion to the risk assumed." (Exh. R-159, p. 3.) He concluded that "installment payment fees generally would not constitute premium because they are unrelated to the risk of loss and to the basis used to determine cost to the policyholder." (*Id.*)

IX. The Krumme Litigation

65. In June 2000, a private citizen filed a complaint for injunctive relief and restitution on behalf of the general public alleging that Mercury's practice of selling personal

lines automobile insurance through "brokers" who charged "brokers fees" was a violation of the Unfair Competition Law (UCL), under Business and Professions Code section 17200 et seq. (*Krumme v. Mercury Insurance Company et al.* (Super. Ct. S.F. County, No. 313367) (hereafter *Krumme*).) On April 11, 2003, the *Krumme* Court issued Findings of Fact and Conclusions of Law (*Krumme* Findings) against Mercury. (Exh. I-1.) *Krumme* concluded, among other things, that from at least July 1, 1996 to April 11, 2003, Mercury's "brokers" transacted insurance on behalf of Mercury, and thus, could not be considered "insurance brokers" for licensing purposes within the meaning of section 1623 and were instead "insurance agents" within the meaning of section 1621. (Exh. I-1, pp. 10 and 13.) The Court rejected Mercury's contention that a "producer" may be both "agent and "broker" i.e, a "dual agent" under California law. (*Id.* at p. 10.) *Krumme* concluded that "dual agency" for licensing purposes only permitted a "broker-agent" to collect premiums and deliver policies pursuant to section 1732, and that Mercury's designated "brokers" exceeded the limited activity permitted by this "safe harbor" in section 1732. (Exh. I-1, p. 10.) The *Krumme* Court essentially concluded that Mercury's designated "brokers" were in fact essentially operating as de facto or ostensible agents in transacting personal lines automobile insurance on behalf of Mercury.

66. The *Krumme* Court further concluded that from July 1, 1996 through April 11, 2003, Mercury's designated "brokers" charged "broker fees" to consumers on the sale of Mercury personal lines automobile insurance. In charging these "broker fees" they were acting in the course and scope of their agency in transacting insurance as "insurance agents" on behalf of Mercury. (Exh. I-1, p. 13.) Mercury did not submit the "broker fees" charged by its "brokers" to CDI for approval as rates or premiums, and CDI did not approve the "broker fees" under its rate approval authority. (Exh. I-1, p. 8.) *Krumme* determined that the charging of these "broker fees" violated the "letter and spirit of the broker fee regulations" and of the common law as interpreted by CDI under Bulletin 80.6. (*Id.*) *Krumme* found that Mercury did not formerly appoint its designated "brokers" with CDI under section 1704, subdivision (a), and that the failure to do so violated "the letter, policy, and spirit of section 1704(a)." (Exh. 1, pp. 12-13.) Finally, *Krumme* concluded that Mercury is vicariously liable for the actions of its designated "brokers" in violating the broker fee regulations and the common law by charging "broker fees" in the course and scope of transacting insurance on behalf of Mercury. (Exh. 1, p. 14.)

67. On May 16, 2003, the *Krumme* Court issued a permanent injunction, effective July 1, 2003, which in relevant part, prohibited Mercury from selling personal lines automobile insurance and/or homeowners insurance policies in California through "broker-agent licensees" who are "de facto unappointed agents" of Mercury. (Exh. I-2, p. 20.) The Court also prohibited Mercury's de facto agents from charging "broker fees." (*Id.*) Effective July 1, 2003, the *Krumme* Court also prohibited Mercury from engaging in comparative rate advertising without disclosing by means of a "conspicuous statement" that a "broker fee" may be charged in addition to the premium quoted in the advertisement. (*Id.* at p. 22.) The Court stayed the permanent injunction pending Mercury's appeal of the judgment, except that the provision enjoining Mercury from publishing comparative advertisements without disclosing the "broker fees" was not stayed and became effective July 1, 2003.

68. On February 2, 2004, CDI filed a NNC/ACC/OSC which incorporated the *Krumme* Findings, specifically: Findings of Fact 1-50, 56 and 57; and Conclusions of Law 1-8, 9 (lines 9-15 up until "license"), and 10-25.[13] CDI delayed issuing the NNC until the *Krumme* case was decided by the Superior Court on April 11, 2003. CDI reasoned that it would have been a waste of resources to bring a noncompliance proceeding against Mercury based on Mercury's brokers being "de facto agents" charging unlawful "broker fees" when those issues were being litigated in the *Krumme* case. Shortly after filing the NNC, on March 3, 2004, CDI and Mercury stipulated to stay the NNC pending Mercury's appeal of the *Krumme* Findings. On March 17, 2004, CDI filed an amicus curiae brief with the California Court of Appeal in the *Krumme* case detailing CDI's position regarding the distinction between agents and brokers and affirmatively disagreeing with Mercury's position regarding this issue. CDI supported the *Krumme* Findings on appeal. On October 29, 2004, the California Court of Appeal upheld the *Krumme* Findings (*Krumme v. Mercury Insurance Company, et al.* (2004) 123 Cal.App.4th 924 (rev. denied January 19, 2005).) The stay of the *Krumme* permanent injunction expired at the end of 2004.

69. On February 19, 2013, an Order was issued in this proceeding granting CDI's Motion for Collateral Estoppel to prohibit Mercury from relitigating issues determined by the *Krumme* Findings. In granting CDI's motion, it was determined that Mercury was collaterally estopped from relitigating the following issues: (1) Mercury's denominated "brokers" were de facto or ostensible agents of Mercury; (2) Mercury's designated "brokers" charged "broker fees;" (3) in charging "broker fees," Mercury's designated "brokers" acted in the course and scope of their agency in transacting insurance as "insurance agents" on behalf of Mercury; (4) Mercury is vicariously liable for the actions of its designated "brokers"; and (5) Mercury did not obtain prior approval to charge or receive the "broker fees" charged by designated "brokers". (Exh. CDI-45.) The collateral estoppel ruling applies to the time period July 1, 1996 through April 11, 2003, the period covered by the *Krumme* Findings.

A. MERCURY'S PRACTICES POST-*KRUMME*

70. Mercury did not materially change its de facto agency relationship with its "designated brokers" after the *Krumme* Court rendered its decision on April 11, 2003, through the end of 2004, when the *Krumme* Findings were upheld on appeal and the stay of the permanent injunction expired. Gabriel Tirador, Mercury's CEO, admitted that Mercury's operation as it related to "brokers," remained the same after the *Krumme* Findings because Mercury did not agree with *Krumme*, and believed its practices were not in violation of the Insurance Code. On June 25, 2003, Mercury circulated an "Agent Bulletin" to its California agents and "brokers" addressing the *Krumme* Decision. The producers were advised that effective July 1, 2003, Mercury would be replacing its existing broker contract and giving

[13] The operative pleading in this proceeding is CDI's SANNC filed on April 11, 2011, which also incorporated the specified *Krumme* Findings.

producers the option to sign the new broker contract or convert their existing broker contract back to an agency agreement. The producers were further advised that effective July 15, 2003, no broker would be permitted to bind coverage unilaterally, but instead would use Mercury's Quicksilver software system to electronically submit insurance applications, and insurance coverage would be bound when the Quicksilver software transmitted a binder number (i.e. policy number). Tirador admitted that this was the only changed made by Mercury while Mercury's appeal of the *Krumme* Findings was pending. Manual binding, however, had essentially been eliminated by Mercury as early as 1998, when the majority of Mercury's insurance applications began being submitted electronically through Mercury's Quicksilver software. Thus, this change was given little weight by the *Krumme* Court in considering Mercury's eventual motions to vacate the permanent injunction.

71. After the *Krumme* decision was upheld on appeal and became final in October 2004, Mercury's relationship with its designated "brokers" continued to be indistinguishable from the relationship it had with its appointed agents. Mercury's designated "brokers" and agents continued to perform field underwriting services when selling personal lines automobile insurance on behalf of Mercury. "Brokers" continued to use the same underwriting manuals that Mercury's agents used. Mercury's designated "brokers" continued to have the same binding authority as Mercury's agents. Mercury's marketing representatives continue to monitor and supervise both the "brokers" and agents, providing training, monitoring loss ratios, and issuing M-19 binding error reports for underwriting errors. Mercury based the "brokers" and agents commission on loss history or the profitability of the business they wrote. Mercury did not maintain section 1704, subdivision (a), agency appointments with CDI for any of its denominated "brokers."

72. On February 24, 2005, Tirador sent a memorandum to all "brokers" listing operational changes Mercury intended to make in its relationship with its designated "brokers" to comply with the *Krumme* Findings. The list of changes included: (1) eliminating "brokers" binding authority; (2) prohibiting "brokers" from advertising that they represent Mercury; (3) prohibiting the exclusive use of Mercury's name or logo by a "broker"; (4) "brokers" names could not be placed on an Agent/Broker locator; (5) Mercury would not approve or control "broker" advertising; (6) Mercury would not provide "brokers" customer leads; (7) Mercury would not discipline "brokers" for inadequate production and shall not secure insurance policy volume commitments. (8) Mercury did not consider itself liable for the conduct of "brokers"; (9) "brokers" were prohibited from participation in print and direct mail cooperative advertising programs; (10) Mercury shall disclose in any comparative rate advertisement that a "broker fee" may be charged in addition to the premium; (11) Mercury's marketing representatives shall not supervise "brokers," but they may assist in training related to Mercury's procedures for placement of business and following Mercury's underwriting guidelines; and (12) Mercury would not provide additional compensation based on volume of business. (Exh. I-140.)

B. *KRUMME* PERMANENT INJUNCTION

73. In February 2005, Mercury filed a motion to vacate *Krumme's* permanent injunction. Mercury's motion essentially asserted that "material changes" in its relationship with its "broker-agents" warranted vacating the permanent injunction. (Exh. I-4, p. 40.) Mercury asserted it had made the following changes: (1) revising its Broker's Contract to eliminate all indicia of an agency relationship; (2) eliminating "broker" binding authority by using the Quicksilver application process; (3) creating a new "broker" manual; (4) "brokers" and agents would continue to be required to use Mercury's proprietary software and application forms to submit insurance applications, but only agents would be allowed to bind coverage before submitting applications; (5) "brokers" could no longer issue financial responsibility certificates, endorsements or insurance identification cards; "brokers" could only provide services on behalf of Mercury pertaining to transmission of premium to Mercury, return of premium to customers, and delivery of policies and evidences of coverage, pursuant to section 1732; (6) eliminated "broker" advertising as a representative of Mercury; (7) eliminated providing leads to "brokers"; (8) no longer discipline "brokers" for any reasons, excluding terminating the "broker" agreement; (9) no longer require volume commitments for "brokers" or pay any compensation to "brokers" based on volume; and (10) it would continue to use the same application form for both "brokers" and agents, but it would only accept applications from experienced agents. (Exh. I-4.) Mercury denied in the motion that it supervised its "brokers" in any way and argued that since the "brokers" act on behalf of their customers, Mercury did not consider itself liable for the "broker's" conduct. (*Id.*)

74. On April 18, 2005, the Superior Court denied Mercury's motion to vacate the permanent injunction. (Exh. I-5.) The Court determined that although Mercury had made some "important changes," the "ostensible agent feature" of Mercury's "broker" business was still present and that's practices were still not adequate to vacate the permanent injunction. (*Id.* at p. 52.) The Court rejected Mercury's assertion that its Quicksilver electronic application submission process was a significant change, noting that Quicksilver had been in operation by Mercury prior to the *Krumme* Findings and permanent injunction order. (*Id.* at p. 48.) The Court specifically noted that Mercury continued to: (1) exercise "significant financial control" over its "brokers" by using commissions and rates of commission to reward effective underwriting practices by its "brokers"; (2) a "high degree of control" in deciding which "brokers" would be allowed to market its products; Mercury continued to utilize only a limited number of "brokers" by providing a very detailed "brokers" manual that specified Mercury's underwriting practices and delegated underwriting and binding functions to these "brokers" based on "informed subjective judgment"; and (3) substantial control over its "brokers" by the threat of financial consequences such as reduced commission and/or termination for poor broker performance in underwriting and prevention of losses on policies written by the brokers. (Exh. I-5, pp. 50-52.)

75. *Krumme's* April 18, 2005 Order specified changes Mercury still needed to make, including in relevant part, that Mercury needed to: (1) base its broker commissions on the volume of sales, not the effectiveness of the broker's front line underwriting; (2) implement an open application procedure allowing any licensed broker to submit insurance

applications; (3) provide simplified brokers manuals without the subjective factors relied upon for underwriting and binding by the brokers; and (4) correct Mercury's continued ability to advance threats of financial consequences for poor performance in frontline underwriting and prevention of losses by Mercury. (Exh. I-5, pp. 50-52.) The Court also ordered Mercury to publish written guidelines that identified standards for broker performance and the effect that poor risk policies would have on Mercury's assessment of that performance. (*Id.*) The Court concluded that although Mercury had converted most of its producer force to appointed agency status, there were still approximately sixty designated "brokers" that remained in an ostensible agency relationship with Mercury, and that additional time would be required to review Mercury's relationship with its "brokers."

76. On July 11, 2005, the *Krumme* Court granted Mercury's Motion for Reconsideration, but reaffirmed the May 16, 2003 permanent injunction with specified modifications. The July 11, 2005 order modified the permanent injunction by requiring Mercury to make the following changes, in relevant part, by June 6, 2005: (1) brokers could not have binding authority; (2) Mercury could not audit broker records or supervise, control, or direct the manner in which brokers conducted their business; (3) Mercury could not compensate brokers based on loss history or profitability of business; (4) Mercury had to eliminate its broker manual, including instruction and guidance to brokers, not assert any underwriting control over brokers, and brokers could not apply Mercury's subjective factors in binding and underwriting insurance policies; and (5) Mercury had to adopt written guidelines that identified objective standards for eliminating broker supervision and discipline. (Exh. I-6, pp. 55-56.) Mercury was also required to accept, under specified circumstances, insurance applications from any licensed broker-agent who had a broker bond ("take all brokers"). (*Id.*) The Court gave Mercury until November 1, 2005, to fully comply with the "take all brokers" provision. Consequently, the Court ordered Mercury to fully comply with the July 11, 2005 Modified Order by November 1, 2005, or in the alternative, comply with the original May 16, 2003 Order which prohibited Mercury's designated "brokers" from selling auto insurance before being appointed as an agent with CDI, and prohibited from charging broker fees.

77. On February 28, 2007, Mercury filed a second motion to vacate and/or modify the May 16, 2003 permanent injunction, as modified by the July 11, 2005 Modification Order. This motion was denied on May 23, 2007. Mercury made a third motion to vacate and/or modify the permanent injunction, as modified, which was also denied on February 10, 2009. The *Krumme* permanent injunction was subsequently dissolved or vacated in 2010.

78. By November 2005 Mercury had not made the operational changes required by the *Krumme* Court's permanent injunction with regards to its relationship with its designated "brokers." Richard Wolak admitted that Mercury did not begin to make operational changes in response to the *Krumme* Findings until November 2005. Although Mercury created a new "broker's manual," the manual was essentially identical to Mercury's "agent's manual," except that the agent's manual had different binding authority provisions. Mercury's "brokers" continued to perform field underwriting services through November 2005. The "brokers" continued to be able to bind coverage at the point of sale using

Mercury's Quicksilver software to electronically submit insurance applications. Mercury's marketing representatives also continued to monitor and supervise "brokers" and agents, and continued to submit binding errors to "brokers" well into 2007. The marketing representatives continued to visit "brokers" and agents to discuss binding errors, loss ratios, and profitability. In other words, Mercury still had not complied with the *Krumme* Court's July 11, 2005 modified permanent injunction order.

79. The *Krumme* Court required Mercury to eliminate its broker's manual by June 5, 2005. In September 2005, in response to the Court's order, Mercury embedded its underwriting guidelines and regulations into the Quicksilver software program. Quicksilver screen prompts or "popups" gave instructions to "brokers" about Mercury's underwriting guidelines and regulations while submitting insurance applications electronically. AIS, along with all of Mercury's agents and "brokers," were required to use the Quicksilver software and adhere to Mercury's underwriting guidelines and regulations in the "screen popups." If a producer did not comply with Quicksilver screen prompts, and errors resulted in assigning risk factors to the insurance policy, the producer was required to indemnify Mercury against losses that resulted from the underwriting errors. Mercury's new broker contract with AIS, effective November 1, 2005, required AIS to follow Mercury's "screen prompts" in the Quicksilver software and to indemnify Mercury against AIS's violations of the screen prompts.

80. By November 2005, Mercury had converted all of its "brokers" to appointed agency status except two, AIS and South Coast. In November 2005, Mercury also began to implement the "take all brokers," provision of the *Krumme* permanent injunction. Mercury reluctantly accepted the "take all brokers" because it was a departure from the its traditional practices of working with only its chosen designated "brokers" or de facto agents. Wolak testified that the "take all brokers" were inexperienced and Mercury was not happy that it had to begin accepting applications from these brokers. Mercury was prohibited from screening and training the "take all brokers" which had been their custom in the past with their designated "brokers." Mercury set a five percent commission rate for the "take all brokers" as opposed to the traditional 15 percent commission rate that had been in place for Mercury's designated "brokers" prior to November 2005. The five percent commission rate was a disincentive for "take all brokers" to apply to Mercury and to write Mercury insurance policies.

81. Mercury's relationship with AIS, its largest "broker," remained unchanged after the *Krumme* Findings. On June 8, 2005, Scott Boostrom assured AIS's managers that AIS's relationship with Mercury would not change as a result of the *Krumme* Court's requirement that AIS discontinue use of Mercury's underwriting manual. On August 1, 2005, in a Mercury General Corporations quarterly earnings telephone conference call, George Joseph of Mercury assured conference call participants that Mercury's relationship with AIS would not change a result of the *Krumme* litigation and that Mercury would continue to work very closely with AIS, their largest "broker." Joseph informed the conference call participants that Mercury had introduced legislation to assist in defining the differences between agents and brokers in California. AIS continued transacting insurance

on behalf of Mercury in its "broker" status until January 1, 2009, when Mercury purchased AIS. AIS continued to charge "broker fees" on insurance transactions on behalf of Mercury until the purchase on January 1, 2009, when Mercury filed appointment notices with CDI designating AIS as an agent of Mercury.

82. On January 27, 2010, pursuant to a Public Records Act (PRA) request by the San Francisco Chronicle, CDI released Mercury's FRUB 1998 Exam Report and its 2002 Exam Report to the newspaper. Prior to the reports being released, on February 6, 2009, Mercury filed a Motion for a Protective Order in this noncompliance proceeding to preclude CDI from producing the reports to CWD through discovery in this proceeding. Darrel Woo, CDI Senior Attorney and Agent and Custodian of Records, is the person at CDI responsible for responding to PRA request. In a letter releasing the two reports on January 27, 2010, Woo stated that the FRUB reports were produced were released because they had been previously been used and disclosed in two noncompliance proceedings, by CDI and Mercury. CDI produced the 1998 Exam Report in this proceeding, and Mercury had produced the 2002 Exam Report in an unrelated 2005 noncompliance proceeding. Woo concluded that because the reports had already been used in these noncompliance proceedings, "any prior confidentiality status of the Requested Reports was relinquished." (Exh. R-75.) Woo testified that he did not recall how he learned that the Mercury's FRUB reports had been used in the noncompliance proceedings.

LEGAL CONCLUSIONS

I. Applicable Law

1. In a noncompliance proceeding under sections 1858.1 and 1858.2, "[t]he Department or intervenor has the burden of proving, by a preponderance of the evidence, every fact necessary to show in what manner and to what extent noncompliance is alleged to exist." (Cal Code Reg., tit. 10, § 2614.6.) As noted above, in this bifurcated proceeding, this proposed decision concerns only the notice of noncompliance.

2. Section 1858.1 provides in relevant that:

> If after examination of an insurer, rating organization, advisory organization, or group, association, or other organization of insurers which engages in joint underwriting or joint reinsurance, or upon the basis of other information, or upon sufficient complaint as provided in Section 1858, the commissioner has good cause to believe that the insurer, organization, group, or association, or any rate, rating plan or rating system made or used by any such insurer or rating organization, does not comply with the requirements and standards of this chapter applicable to it, he or she shall give notice in writing to that insurer, organization, group, or association stating therein in what manner and to what extent that noncompliance is alleged to exist and specifying

therein a reasonable time, not less than 10 days thereafter, in which that noncompliance may be corrected, and specifying therein the amount of any penalty that may be due under Section 1858.07.

3. Prop. 103, as enacted in section 1861, subdivision (c), provided that "[c]ommencing November 8, 1989, insurance rates subject to this chapter must be approved by the commissioner prior to their use." Section 1861.05, subdivision (a), provided that "[n]o rate shall be approved or remain in effect which is excessive, inadequate or unfairly discriminatory or otherwise in violation of this chapter. In considering whether a rate is excessive, inadequate or unfairly discriminatory, no consideration shall be given to the degree of competition and the commissioner shall consider whether the rate mathematically reflects the insurance company's investment income."

4. An "insurance agent," for purposes of the time period covered by the SANNC (July 1996 through 2006), was defined as "a person authorized by and on behalf of an insurer to transact all classes of insurance, except life insurance. The term 'insurance agent' as used in this chapter does not include a life agent as defined in this article." (Ins. Code, § 1621 (as amended by Stats. 1990, c. 1420, (S.B. 2642) § 3 operative Jan. 1, 1992); see also Ins. Code, § 31.) "Transact" as it applies to insurance includes any of the following: solicitation, negotiations preliminary to execution, execution of a contract of insurance, or transaction of matters subsequent to execution of the contract and arising out of it. (Ins. Code, § 35.)

5. An "insurance broker" for purpose of the period covered by SANNC, was defined as "a person who, for compensation and on behalf of another person, transacts insurance other than life insurance with, but not on behalf of, an insurer." (Ins. Code, § 1623 (as amended by Stats. 2000, c. 1074 (A.B. 2639), § 1, operative September 30, 2000.) Section 1623 further required the broker to show that he was acting as an "insurance broker" in every application for insurance submitted to an insurer. If the insurance application showed that the broker was licensed and acting as an insurance broker, it was presumed, for licensing purposes only, that the broker was acting as an insurance broker. (*Id.*)[14] Section 1732 provided that "[a] person licensed as a fire and casualty broker-agent acting as an insurance broker may act as an insurance agent in collecting and transmitting premium or return premium funds and delivering policies and other documents evidencing insurance."

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[14] Mercury argued that its designated "brokers" were presumed to be acting as a broker under section 1623 if the person is a licensed broker, maintains a bond, and makes specified written disclosures to the consumer. Mercury inappropriately relies on a version of section 1623 that included presumption language that was enacted in 2008, after the time period covered by the SANNC, and thus is inapplicable to this noncompliance proceeding. (See Ins. Code, § 1623, subd. (a), as amended by Stats. 2008, c. 304 (A.B. 2956), § 2.) However, even if this version was applicable, it provided that the presumption may be rebutted "based on the totality of the circumstances indicating that the broker-agent is acting on behalf of the insurer." (*Id.*, subd. (d).) The totality of the circumstances in this case established that Mercury's denominated "brokers" were transacting insurance on behalf of Mercury, and thus, were de facto agents of Mercury.

(Ins. Code, § 1732 (as amended by Stats. 1990, c. 1420, (S.B. 2642) § 3 operative Jan. 1, 1992).)

6. Section 1704, subdivision (a), as amended by Stats. 2002, c. 203 (A.B. 2984), § 15, provided in relevant part that "life agents, travel agents, and fire and casualty insurance agents shall not act as an agent of an insurer unless the insurer has filed with the commissioner a notice of appointment, executed by the insurer, appointing the licensee as the insurer's agent."

II. Mercury's Designated "Brokers" Were De Facto Agents

7. CDI and CWD contend that Mercury converted the majority of its producer force to designated "brokers" in 1989 to circumvent Prop. 103 by omitting unlawful "broker fees" from their rate applications for approval by the Commissioner. They assert that Mercury's designated "brokers" transacted insurance on behalf of Mercury, and thus, were de facto insurance agents, and charged the "broker fees" while acting in the course and scope of their agency in transacting personal lines automobile insurance on behalf of Mercury. Consequently, CDI and CWD argue that the "broker fees" are subject to section 1861.01, subdivision (c), requiring prior approval, and the section 1861.05, subdivision (a), prohibition against excessive and unfairly discriminatory rates. Mercury conversely argues that its designated "brokers" were insurance brokers under section 1623 that transacted insurance on behalf of the insured, not Mercury, and the "broker fees" charged were not actually received by Mercury as revenue or an expense, and therefore, are not required to be included in Mercury's rate applications for prior approval by the Commissioner.

8. On April 11, 2003, the *Krumme* Court found that from at least July 1, 1996 to April 11, 2003, Mercury's designated "brokers" transacted insurance on behalf of Mercury within the meaning of section 35 and that Mercury's relationship with these "brokers" was functionally indistinguishable from the relationship it had with its appointed agents under section 1704, subdivision (a). *Krumme* found that "because these 'brokers' have transacted, and do transact, insurance on behalf of Mercury, they cannot be considered 'insurance brokers' for licensing purposes within the meaning of Insurance Code, § 1623 and are instead 'insurance agents' within the meaning of Insurance Code, § 1621." (Exh. I-1, p. 10.) *Krumme* noted that the substance of the activities and the relationship between Mercury and its "brokers" is controlling, not the name "broker" that Mercury used in its Producer Contracts. (*Id.*) *Krumme* also concluded that Mercury is vicariously liable for the actions of its "brokers" or de facto agents. Notwithstanding the *Krumme* Findings, Mercury again argues in this proceeding that *Krumme* did not find that AIS was a de facto agent of Mercury. There is no basis for this assertion. The *Krumme* Findings specifically concluded that Mercury's designated "brokers" transacted insurance on behalf of Mercury and were insurance agents under section 1621, not brokers under section 1623. The *Krumme* Court, if it intended, could have specifically exempted AIS, Mercury's largest designated "broker", but it did not.

9. Pursuant to this ALJ's February 19, 2013 Order granting CDI's Motion for Collateral Estoppel, Mercury is estopped from arguing that its designated "brokers" were not de facto or ostensible agents from July 1, 1996, through April 11, 2003, as determined by the *Krumme* Findings. This issue was fully litigated by the *Krumme* Court and upheld on appeal. Accordingly, from July 1, 1996 through April 11, 2003, the period covered by the *Krumme* Findings, it was established that Mercury's designated "brokers" were de facto or ostensible agents of Mercury and that Mercury is vicariously liable for their actions. (Factual Findings 15 through 69; and Legal Conclusions 3 through 9.)

A. MERCURY'S DESIGNATED "BROKERS" CONTINUED TO ACT AS DE FACTO AGENTS AFTER THE *KRUMME* DECISION

10. Mercury is not precluded from arguing its designated "brokers" were not de facto or ostensible agents after the April 11, 2003 *Krumme* decision. The evidence, however, established that after the *Krumme* Court's decision Mercury continued its de facto agency relationship with its designated "brokers" through at least January 2009. Mercury did not implement any of the changes ordered by the *Krumme* Court's May 16, 2003 permanent injunction, pending its appeal of the *Krumme* Findings. Gabriel Tirador admitted that by the end of 2004, when the *Krumme* permanent injunction stay expired, Mercury had not made any changes to its relationship with its "brokers," except to eliminate the "broker's" authority to manually bind coverage. Thus, Mercury's relationship with its designated "brokers" was indistinguishable from the relationship it had with its appointed agents after the *Krumme* decision through the end of 2004. Mercury's designated "brokers" continued to transact insurance on behalf of Mercury in the capacity of insurance agents from April 2003 through November 2005, and thereafter through at least 2008. Mercury did not significantly change its relationship with its designated "brokers" until November 2005, when Mercury converted all of its "brokers" except two, AIS and one other, to agency status. Mercury's relationship with AIS continued unchanged until Mercury purchased AIS effective January 1, 2009.

11. Mercury's relationship with its designated "brokers" did not comport with the term "broker" as defined in sections 1623 and 1732. Mercury's designated "brokers" or de facto agents transacted insurance on behalf of Mercury both before and after the *Krumme* decision. Section 1732 provides that a person acting as an insurance broker is only permitted to collect and return premiums and deliver policies and other documents evidencing insurance coverage on behalf of an insurer. (Ins. Code, § 1732.) Section 1732 limits the activity a "broker" may engage in on behalf of the insurer when acting as an insurance broker. Mercury's "brokers" performed transactions on behalf of Mercury that far exceeded the allowable activities of a broker under section 1732. The courts have also held that only agents possess the authority to bind the insurer to coverage. In distinguishing whether a producer acts as an agent or a broker, the courts have looked to whether the producer possesses the authority to bind coverage as a primary legal distinction. (*Marsh & McLennan v. City of Los Angeles* (1976) 62 Cal.App.3d 108, 117-119; *Loehr v. Great Republic Insurance Co.* (1990) 226 Cal.App.3d 727, 734.) Mercury's designated "brokers" had the authority to bind insurance coverage on behalf of Mercury just as Mercury's appointed agents. In spite of Mercury's use of the Quicksilver electronic application submission

process, the designated "brokers" continued to have binding authority because they continued to perform field underwriting services on behalf of Mercury, and the underwriting information included in the electronic insurance application was not reviewed or approved by Mercury's Underwriting Department prior to being electronically bound by the Quicksilver software program.

12. Further evidence of Mercury's continued agency relationship with its designated "brokers" after the *Krumme* decision was the *Krumme* Court's reluctance to vacate the permanent injunction. Mercury filed three motions to vacate the *Krumme* Court's permanent injunction which were denied, although the Court did modify the injunction based on some changes Mercury had made. The *Krumme* Court, however, denied Mercury's motions after determining that Mercury continued to have an agency relationship with its de facto agents. The Court gave Mercury until November 2005 to fully comply with its July 11, 2005 modification order. Significantly, the *Krumme* Court did not vacate the permanent injunction until 2010, after Mercury had converted all of its designated "brokers" back to appointed agents pursuant to section 1704, subdivision (a). Mercury purchased AIS and filed agency appointment notices with CDI converting AIS to agency status in January 2009.

13. Consistent with the *Krumme* Court's orders denying Mercury's motions to vacate the permanent injunction, the evidence in this proceeding established that Mercury continued to have an agency relationship with its designated "brokers" after the *Krumme* decision. CDI and CWD presented sufficient evidence to rebut the presumption under section 1623 that Mercury's designated "brokers" were actually insurance brokers. Mercury's designated "brokers" were de facto or ostensible insurance agents transacting insurance on behalf of Mercury within the meaning of sections 1621 and 35. Accordingly, from July 1996 through at least 2006, Mercury continued its de facto or ostensible agency relationship with its designated "brokers." (Factual Findings 15 through 82; and Legal Conclusions 1 through 13.)

III. Mercury's Designated "Brokers" Charged Unapproved "Broker Fees" Which Violated Sections 1861.01 and 1861.05

14. CDI and CWD contend that the "broker fees" charged by Mercury's de facto agents constituted premium because the "broker fees" were paid by policyholders as part of the cost of insurance. CDI and CWD further assert that Mercury constructively received the "broker fees", i.e. premium, collected by its designated "brokers" and did not seek prior approval in its rate applications from July 1, 1996 through 2006 for these fees. Because the "broker fees" were not included in Mercury's rate applications, CDI and CWD contend that Mercury used unapproved and unfairly discriminatory rates in violation of sections 1861.01, subdivision (c), and 1861.05, subdivision (a). Mercury contends that the "broker fees" are not a part of the cost of insurance and did not alter the premium or rate charged to policyholders, and thus, Mercury did not charge an unapproved or unfairly discriminatory rate. They assert that the "broker fees" were neither an expense nor a source of revenue for Mercury, and therefore would not have been required in a rate application. Finally, Mercury argues that the rate statutes are unconstitutionally vague and did not provide adequate notice

that "broker fees" not charged or collected by Mercury could give rise to a violation of the rate statutes.

A. MERCURY'S "BROKER FEES" WERE NOT APPROVED BY CDI

15. Section 1861.01, subdivision (c), provides that all insurance rates must be approved by the Commissioner prior to their use. The *Krumme* Court and the evidence in this noncompliance proceeding established that Mercury did not obtain prior approval to charge or receive the "broker fees" charged by its designated "brokers" in transacting personal lines automobile insurance on behalf of Mercury. (Factual Finding 18 through 37; 45 through 54; 56 through 82.) Mercury is collaterally estopped from contesting that the "broker fees" were not approved by the CDI. (Factual Findings 65 through 69.)

B. MERCURY'S "BROKERS FEES" ARE PREMIUM AND ARE SUBJECT TO PRIOR APPROVAL

16. Mercury does not dispute that premiums or rates are subject to prior approval under sections 1861.01, subdivision (c), or 1861.05, subdivision (b). Rather, Mercury argues that the "broker fees" at issue in this proceeding did not constitute an insurance rate (i.e., premium) or fees that were subject to prior approval by Commissioner. The contention is not supported by the evidence. Mercury asserts that even if its designated "brokers" are determined to be de facto insurance agents, the "broker fees" charged by the designated "brokers" were not a part of the "cost of insurance" for the insured and therefore did not alter the premium or rate charged by Mercury and consequently was not an unapproved or unfairly discriminatory rate that was required to be reported to the Commissioner in an rate application. Mercury's assertion is not supported by CDI's interpretation of the definition of "premium" or "rate," the legislative intent of Prop. 103, or California case law defining "premium" or "rates" for purpose of establishing what payments by insureds should constitute premium or rate.

17. CDI has consistently maintained that "broker fees, service fees, and other fees and charges" charged by an insurer's agent are premium and must be reported to CDI as premium by the insurer. CDI issued Bulletin 80-6 in April 1980 to advise insurance producers and insurers that "all payments by the insured which are a part of the cost of the insurance are premium, including any and all sums paid to an insurance agent." (*Id.*) CDI's Bulletin 80-6 further advised that "general rules of agency law prohibit an agent from charging sums not authorized by the agent's principal," and that if an insured authorized an agent to collect "fees," such fees would have to be reported to CDI as premium and have to comply with the anti-discrimination statutes. CDI opined that an insurer could not permit each of its agents to determine the fees to charge to an insured because to do so would result rate in discrimination. At the time Bulletin 80-6 was issued by CDI, insurers were not required to submit their rates to the Commissioner for prior approval. However, consistent with Bulletin 80-6, former section 1852 (now codified in section 1861.05) then provided that insurance "[r]ates shall not be excessive or inadequate..., nor shall they be unfairly discriminatory." Bulletin 80-6 has been generally accepted in the industry as prohibiting

insurance agents from charging "broker fees." CCR section 2189.3 provides that only a "broker-agent" acting in the capacity of an "insurance broker" may charge a "broker fee," but that a "broker" could not be an "appointed agent of the insurer with which the coverage is or will be placed." (Cal. Code Regs., § 2189.3, subd. (c).)

18. In 1998, California voters passed Prop. 103 which proclaimed that existing laws inadequately protected consumers and allowed insurers to "charge excessive, unjustified and arbitrary rates." (See *Donabedian v. Mercury Ins. Co., supra,* 116 Cal.App.4th 968, 981, citing and quoting Prop. 103, § 1 [Findings and Declaration].) Prop. 103 required all insurance rates to be approved by the Commissioner prior to their use. (Ins. Code § 1861.01, subd. (c).) "No rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise violation of this chapter." (Ins. Code, § 1861.05, subd. (a).)

19. Both Bulletin 80-6 and Prop. 103 sought to address the practice by insurers of allowing their agents to charge excessive or arbitrary fees that unfairly increased the amount of premium or rates that an insured must for the cost of insurance. Explicitly stated in Bulletin 80-6 is the requirement that fees charged to the insured by an insurance agent must be reported as premium to avoid charging insured consumers arbitrary, excessive, or unfairly discriminatory insurance rates. (Exh. I-128, p. 792.) Prop. 103 required that any amount charged to the insured that could be considered part of the rate or premium charged for insurance coverage must be approved prior to that rate or premium being charged to the insurance customer. (Ins. Code, § 1861.01, subd. (c).)

20. Prop. 103 and the CDI's regulations provide that an insurer must obtain prior approval before changing or charging an insurance rate for personal lines automobile insurance coverage in the State of California. Section 1861.05, subdivision (b), as enacted by Prop. 103, provides that "[e]very insurer which desires to change any rate shall file a complete application with the commissioner. A complete rate application shall include all data referred to in sections 1857.7, 1857.9, 1857.15 [FN2] and 1864 and such other information as the commissioner may require." (Ins. Code, § 1861.05, subd. (b).) Section 1857.7 provides that a rate application under section 1861.05, subdivision (b), shall include, among other information not relevant here, premiums written, earned premiums, unearned premiums, and expenses incurred, including commission and brokerage expenses. As a part of a complete rate application under section 1861.05, subdivision (b), an insurer must file a Rate Making Data form (form CA-RA5) which provides the data necessary to compile a base rate, which includes earned premiums collected from all policyholders for the period covered by the rate application. (Cal. Code Regs., tit. 10, § 2648.4, subd. (a).) A complete rate application under section 1861.05, subdivision (b), would also include a Miscellaneous Data form (form CA-RA8) which reports miscellaneous fees charged to policyholders by the insurer or the insurer's agent. (*Id.*)

21. CCR section 2360.0, subdivision (c), defines "premium" as "the final amount charged to an insured for insurance after applying all applicable rates, factors, modifiers, credits, debits, discounts, surcharges, fees charged by the insurer and all other items which

change the amount the insurer charges to the insured." A "rate" as used in sections 1861.01, 1861.02, and 1861.05 "represents the total amount annual of premium that an insurer must charge in order to cover expenses and obtain a reasonable rate of return." (*Donabedian, supra,* 116 Cal.App.4th at 992.) Consequently, when referring to sections 1861.01, subdivision (c), and 1861.05, subdivision (b), requirements that a "rate" is subject to prior approval by the Commissioner before any rate may be used and changed, the term "rate" includes the "premium" and represents the total amount of premium that an insurer collects from all of its policyholders. (*Id.*)

22. California case law interpreting Prop. 103 and CDI's regulations have consistently held, with limited exceptions, that all amounts charged by an insurer or an insurer's agent to the insured for the cost of insurance coverage are "premium" which must be reported in an insurer's rate application for prior approval by the Commissioner. This definition is consistent with CDI's Bulletin 80-6 and Prop. 103. California case law has consistently defined "premium" to include all cost paid by an insured for insurance coverage, including fees charged by insurance agents include all payments made by the insured as part of the cost of insurance. (*Groves v. City of Los Angeles* (1953) 40 Cal.2d 751; *Allstate v. State Bd. of Equalization* (1959) 169 Cal.App.2d 165; *Metropolitan Life Ins. Co. v. State Bd. of Equalization* (1982) 32 Cal.3d 649; *Troyk v. Farmers Group, Inc.* (2009) 171 Cal.App.4th 1305.)

23. In *Groves, supra,* 40 Cal.2d 751, at p. 754, the California Supreme Court held that the entire amount paid to a bail agent, which included the agent's expenses and a profit, on behalf of a surety company for a bail bond was the gross premium, not just the portion remitted by the bail agent to the surety. The Court held:

> The fact remains that whatever plaintiff receives from the customer or client for a bond, he is authorized to obtain it, and does so as agent of National [the surety]. *The question should not turn on whether the amount charged for the bond is broken down to specific items for their convenience. The situation should be the same as where National paid plaintiff's expenses incurred in writing bonds, because those expenses would be reflected in the gross premium paid-the amount charged the applicant for a bond.* Nor is it persuasive that plaintiff-agent does not pay all of the 10 per cent he receives to Associated or National. *There is little difference whether he uses it to defray the expenses of conducting the bail bond business and pay himself a commission or whether all of it is paid to National which in turn pays him a commission and meets the expenses.* The essence of the matter is that ***the amount paid by the insured for the bonds is the premium*** and it has been so recognized by the courts. [Citations omitted.] And a mere booking method cannot thwart the law.

(*Groves, supra,* at p. 760, emphasis added.)

Groves, in distinguishing two cases that determined that certain fees were not a part of the premium (*State Farm etc. Ins. Co. v. Carpenter* (1939) 31 Cal.App.2d 178 [membership fee to become a member of insurance organization not part of premium]; and *Mutual Benefit L. Ins. Co. v. Richardson* (1923) 192 Cal. 369 [amount of premium stated in policy was above the cost of policy and declared a dividend to insured, not premium], concluded that:

> In both the basic theory is that ***the amount paid by the insured for the insurance is the premium.*** Here, as the bail agent is the insurer's agent, what he receives from the applicant for the insurance--that is, what the applicant pays for the bail bond is the premium. What the agent receives, in legal effect the insurer receives. The so-called "fees" received by the bail agent do not result in a reduction of the cost to the insured.

(*Groves, supra,* at p. 761, emphasis added.)

24. Courts following *Groves* have similarly held that "premium" refers to "how much the policyholder is charged." (*Spanish Speaking Citizens' Foundation v. Low* (2000) 85 Cal.App.4th 1179, 1186.) "Premium" in the law of insurance means the amount paid to the company for insurance. It has been defined as "the sum the insured is required to pay." (*Metropolitan Life Ins. Co. v. State Bd. of Equalization, supra,* 32 Cal.3d at p. 660.) In *Troyk, supra*, auto insurance policyholders sued their insurer for violating section 381, subdivision (f), when the insurer omitted the monthly service charge for processing premium payments from the stated premium amount in the policy. (*Troyk v. Farmers Group, Inc., supra,* 171 Cal.App.4th at p. 1317.) The insurer claimed it was not required to include the service charge as part of the premium because it was received by a third party billing agent instead of the insurer. (*Id.* at 1319.) The Court did not find the insurer's claim persuasive, finding that "it is irrelevant that [the third party billing agent], instead of [the insurer], directly received that service charge." (*Id.* at 1324.) The court reasoned that "[b]ecause section 381 'presumably is a consumer protection statute' [citation omitted], the meaning of 'premium,' as used in section 381, subdivision (f), is interpreted from the perspective of the consumer (i.e., the insured)." (*Id.*) "Therefore, from the *insureds'* perspective ..., 'premium,' for purposes of section 381, subdivision (f), is the total amount the insureds were required to pay to obtain insurance coverage...." (*Id.*) Significantly, *Troyk* also concluded that:

> [f]rom an insurer's perspective, the premium charged an insured for insurance coverage for a certain period presumably includes, and generally exceeds, all costs associated with providing that coverage. Therefore, an insurance premium includes not only the "net premium," or actuarial cost of the risk covered (i.e., expected amount of claims payments), but also the direct and indirect costs associated with providing that insurance coverage and any profit or additional assessment charged (e.g., "loading").

(*Id.*, at p. 1325.)

25. The evidence established that the "broker fees" charged by Mercury's designated "brokers" were charged in the course and scope of their agency in transacting insurance on behalf of Mercury. (Factual Findings 11 through 82; Legal Conclusions 3 through 14.) Because Mercury's designated "brokers" of de facto insurance agents collected the "broker fees" in transacting insurance on behalf of Mercury, the "broker fees" cannot be construed, as Mercury argues, as a fee charged by a traditional "broker" for services performed on behalf of the insured. The "broker fees" must be deemed agent fees, and pursuant to CDI's Bulletin 80-6 and CCR section 2360.0, agent fees are considered "premium" and must be reported in a rate application for prior approval. (Cal. Code Regs. § 2360.0; Ins. Code, § 1861.05, subd. (b).) Consequently, simply calling the agent fees "broker fees" does not render the fees traditional broker fees that would be charged by a broker transacting insurance on behalf of the insured under section 1623.

26. The "broker fees" charged by Mercury's designated "brokers" or de facto insurance agents were paid by policyholders as part of the cost of obtaining Mercury's personal lines automobile insurance coverage. These fees were compensation paid directly to Mercury's de facto insurance agents to cover their costs. Not unlike the fees charged by the bail agent for a bail bond in *Groves*, the "broker fees" were part of the amount paid for insurance coverage by Mercury's policyholders, and "what the agent receives, in legal effect the insurer receives." (*Groves, supra,* at pp. 760-761.) Thus, the "broker fees" charged and collected by Mercury's designated "brokers" or de facto agents constituted premium which were required to be reported to the Commissioner in a rate application. (Ins. Code, §§ 1861.01, subd. (c), and 1861.05, subd. (b).) It mattered not that the designated "brokers" or de facto agents collected the "broker fees" to cover their expenses, or whether all of the "broker fees" had been paid to Mercury and then paid back to the designated "brokers" as commission. What is determinative is that the insured paid the "broker fee" as part of the cost of obtaining an insurance policy from Mercury. (*Groves, supra,* at p. 760.)

27. Mercury argued that the "broker fee" were not a part of the cost of insurance because Mercury issued the insurance policy once the charged premium was paid even if the "broker fee" was not paid to its designated "brokers." However, AIS, Mercury's largest designated "broker," collected a "broker fee" on approximately 99 percent of the personal lines automobile insurance policy transactions it processed on behalf of Mercury. Other than the rare exceptions where the "broker fee" was waived, the customer was required to pay the "broker fee" as part of the cost of obtaining insurance coverage. Moreover, there is no evidence that a policyholder who purchased insurance from Mercury's designated "brokers" was informed that he or she could obtain Mercury insurance coverage without paying the "broker fee." Accordingly, Mercury's argument that a policy would be issued regardless of whether the "broker fee" was paid is not persuasive.

28. Mercury also argued that the "broker fees" were neither an expense nor a source of revenue for Mercury, and therefore was not required to be included in a rate application for approval by the Commissioner. However, the courts in both *Groves* and

Troyk found that it is irrelevant the insurer did not directly receive the fee charged by an agent or a third party. (See *Groves, supra,* at pp. 760-61; *Troyk, supra,* at p. 1324.) What is determinative is the actual amount the insured pays for insurance coverage, and that amount is "premium." (*Id.*) Mercury's expert witnesses, Irene Bass and Milo Pearson, both opined that because Mercury did not actually receive the "broker fees" charged by its de facto insurance agents, the fees could not be considered a factor in the actuarial costs for calculating a rate in a rate application. Consequently, they opined, Mercury was not required to seek approval for the "broker fees" in a rate application. *Troyk*, however, rejected the notion that "insurance premium" only included "net premium" or "actuarial cost of the risk covered," finding that "premium" also included the direct and indirect costs associated with insurance coverage, as well as any profit or additional assessment charged by the insurer. (*Troyk, supra,* at p. 1325.) The "broker fees" charged by Mercury's de facto agents were an indirect cost or additional assessment passed on to the insured as a cost of obtaining Mercury personal lines automobile insurance. Again, these fees constituted "premium" and were required to be included in Mercury's rate applications, which they were not.

29. Mercury cited two cases, *In re Ins. Installment Fee Cases* (2012) 211 Cal.App.4th 1395, and *Interinsurance Exch. of the Auto. Club v. Sup. Ct.* (2007) 148 Cal.App.4th 1218, which found that installment fees do not constitute "premium," to support its argument that "broker fees" are not required to be reported in a rate application. Mercury's attempt to analogize the "broker fees" at issue in this proceeding to installment fee charges is based on a faulty premise. The holdings in the *In re Ins. Installments Fee* and *Interinsurance Exch. of the Auto Club* were based on the fact that the installment fees benefited the insured and not the insurer, and therefore were not part of the cost of insurance, i.e. "premium." (See *In re Ins. Installment Fee Cases, supra,* 211 Cal.App.4th at p. 1407; *Interinsurance Exch. of the Auto. Club v. Sup. Ct., supra,* 148 Cal.App.4th at p. 1238.) The "broker fee" charged by Mercury's designated "brokers" did not benefit the policyholder. The fee was charged to cover the designated "broker's" costs and expenses. Mercury's policyholders did not receive any benefit, other than insurance coverage, for the "broker fees" charged.

30. Finally, even if the "broker fees" charged by Mercury's designated "brokers" were not considered "premium", these fees nonetheless were required to be reported as miscellaneous fees, under CCR section 2648.4, subdivision (a) (Miscellaneous Data form (CA-RA8), as part of a complete rate application. Mercury failed to report the "broker fees" as miscellaneous fees, or to obtain prior approval for such fees, as required by sections 1861.01, subdivision (c), and 1861.05, subdivisions (a) and (b).

C. MERCURY IS VICARIOUSLY LIABLE FOR THE CONDUCT OF ITS DESIGNATED "BROKERS" AND IS DEEMED TO HAVE CONSTRUCTIVELY RECEIVED THE "BROKER FEES"

31. Any discussion of whether "broker fees" charged by Mercury's designated "brokers" constituted premium or rates or miscellaneous fees must begin with the premise that Mercury's designated "brokers" were insurance agents acting on Mercury's behalf. As

stated above, Mercury's "brokers" were de facto or ostensible insurance agents transacting insurance on behalf Mercury. The *Krumme* Court concluded that Mercury is vicariously liable for the actions of its "brokers." Mercury is collaterally estopped from relitigating this *Krumme* Finding in this noncompliance proceeding. (Exh. I-1, p.14; FF 79.) Fundamental agency law provides that acts of an agent in the course and scope of his or her agency are attributable to the principal, and the principal is bound by the agent's acts. (*Burgess v. Security First Nat. Bank of Los Angeles* (1941) 44 Cal.App.2d 808, 819; *Lippert v. Bailey* (1966) 241 Cal.App.2d 376, 382; see also Civ. Code, § 2330.) Accordingly, Mercury is vicariously liable for any violations of the Insurance Code that results from its de facto or ostensible insurance agents charging unapproved "broker fees" to consumers purchasing personal lines automobile insurance from Mercury in California.

32. Mercury is deemed to have constructively received the "broker fees" charged by its de facto insurance agents. The *Krumme* Court concluded that Mercury designated "brokers" charged the "broker fees" while acting as insurance agents on behalf of Mercury in the course and scope of their agency. Mercury is collaterally estopped from relitigating this issue. Where an insurance agent, acting in the course and scope of his or her agency, receives payment from an insured the principal is deemed by operation of law to have constructively received the payment. (*Burgess v. Security First Nat. Bank of Los Angeles, supra,* 44 Cal.App.2d at p. 819; *Groves, supra,* at p. 761.) It is irrelevant that Mercury did not directly receive the fee charged by its de facto insurance agents. The amount received by an agent or third party for the cost of insurance for a policyholder is deemed to be received by the insurer, here Mercury. (See *Groves, supra,* at pp. 760-761; *Troyk, supra,* at p. 1324.)

D. THE UNAPPROVED "BROKER FEES" CHARGED BY MERCURY'S DESIGNATED "BROKERS" WERE UNFAIRLY DISCRIMINATORY

33. Section 1861.05, subdivision (a), provides that "[n]o rate shall be approved or remain in effect which is ... unfairly discriminatory or otherwise in violation of this chapter." Although the Insurance Code does not include a definition of the term "unfairly discriminatory" (see *King v. Meese* (1987) 43 Cal.3d 1217, 1222.), the plain language of section 1861.05, subdivision (a), and the intent of Prop. 103, i.e., to protect insurance consumers from arbitrary insurance rates and practices (See *Donabedian v. Mercury Ins. Co, supra*, 116 Cal.App.4th at p. 981; Prop 103, §§ [Findings and Declarations and Purpose]), establishes that the unapproved "broker fees" arbitrarily charged by Mercury's designated "brokers" in varying amounts over and above Mercury's approved premium or rate is prohibited by the Insurance Code. CDI's Bulletin 80-6 also cautioned against unfair rate discrimination by specifically stating that fees collected by an insurer's agent was required to be reported as premium by the insurer, and that allowing agents to determine what fees to charge would result in rate discrimination.

34. The "broker fees" charged to Mercury policyholders by its designated "brokers" were for the same services and coverage that Mercury's appointed agents provided without charging the "broker fee." Consequently, Mercury's policyholders were likely to pay more for their insurance policies when purchased from a "designated "brokers."

Additionally, the evidence established that Mercury's designated "brokers" did not all charge the same "broker fee" amount when providing the same services and coverage to Mercury policyholders. The "broker fees" charged varied from $50 to $150 for each personal lines automobile insurance policy regardless of the level of coverage provided or service rendered, with no relation to the risk of loss posed by the policyholder or Mercury's approved premium or rate amount. In some instances there was no "broker fee" charged at all or the fee was waived due to errors in processing the insurance application. Thus, the cost differential that was created by the added unapproved "broker fees" resulted in unfairly discriminatory insurance rates being paid by policyholders who purchased insurance from Mercury's designated "brokers."

35. The unapproved "broker fees" charged and collected by Mercury's designated "brokers" were collected in violation of the Insurance Code rate statutes, CDI's regulations, California case law and Bulletin 80-6. The designated "brokers" charged and collected the "broker fees" in the course and scope of their agency as insurance agents in transacting insurance on behalf of Mercury. The "broker fees" constituted premium, and as such were required to be reported in Mercury's rate applications for prior approval by Commissioner, which Mercury did not. The charging of these unapproved "broker fees" by Mercury's designated "brokers" resulted in unfairly discriminatory insurance rates being charged to Mercury's policyholders.

36. Accordingly, from at least July 1, 1996 through 2006, Mercury violated sections 1861.01, subdivision (c), and 1861.05, subdivision (a), when it allowed its designated "brokers" to charge and collect unapproved and unfairly discriminatory "broker fees" to Mercury's policyholders. (Factual Findings 11 through 82; Legal Conclusions 3 through 35.)

IV. Mercury's Defenses

A. VIOLATION OF MERCURY'S DUE PROCESS RIGHT TO A FAIR HEARING

37. On remand from the Commissioner's decision rejecting ALJ Owyang's January 31, 2012 proposed decision, and the September 14, 2012, Superior Court order denying Mercury's Petition, Mercury renewed its Motion for a Proposed Decision for Summary Disposition of Proceedings. Mercury again seeks to dismiss the SANNC on the ground that it was denied due process by CDI. Mercury's motion is denied because both the Commissioner and the Superior Court remanded this matter back for a full evidentiary hearing.[15] Although the Superior Court preserved Mercury's right to reassert its claim that it was denied due process, Mercury's Motion for a Proposed Decision for Summary Disposition of Proceedings is necessarily rejected because a full evidentiary hearing on the

[15] Mercury also sought to limit the remand hearing to whether Mercury's due process rights were violated by ex parte communications between the Commissioner and CDI. This request was also denied.

merits and a final decision by the Commissioner is required for Mercury to exhaust its administrative remedies.

38. In considering the merits of Mercury's due process claims, however, there is insufficient evidence to establish that Mercury was denied due process in this noncompliance proceeding. On remand Mercury claimed that CDI and the Commissioner violated its due process of rights in the following regards: (1) CDI engaged in impermissible ex parte communications with the Commissioner to amend CCR section 2614.13 to eliminate the necessity to provide PDT for adverse witnesses, thereby failing to keep separate the agency's investigatory, prosecutorial, rulemaking and adjudicatory functions; (2) CDI publicly disclosed Mercury's confidential 1998 Exam Report and 2002 Exam Report by producing these reports to the San Francisco Chronicle newspaper in response to a Public Records Act (PRA) on January 27, 2010; and (3) ALJ Owyang's January 31, 2012 proposed decision was improperly routed to CDI's prosecuting attorney on February 10, 2012, before the 30-day time period proscribed by statute for distribution to the parties. For the reasons articulated below, it is determined that Mercury was not denied due process and a fair hearing on these grounds.

(1) EX PARTE COMMUNICATIONS REGARDING RULEMAKING

39. Mercury argues that CDI engaged in improper ex parte communications with Commissioner Steve Poizner to promulgate regulations to amend CCR section 2614.13 to eliminate the PDT requirement for adverse witnesses, thereby circumventing an order in a pending noncompliance hearing before the Commissioner. ALJ Owyang's factual findings regarding the ex parte communications are incorporated by reference and left undisturbed by this proposed decision. (Factual Finding 3 through 6.) Neither CDI nor CWD presented new evidence regarding the rulemaking process for the amendment of CCR section 2614.13 or communications between CDI and former Commissioner Poizner.

40. Even if improper ex parte communications occurred, as ALJ Owyang's decision concluded, these communications did not deny Mercury due process and a fair hearing. The Administrative Procedure Act's (APA) Administrative Adjudication Bill of Rights provides that an administrative agency's "adjudicative function shall be separated from the investigative, prosecutorial, and any advocacy functions within the agency as provided in section 11425.30." (Govt. Code, § 11425.10, subd. (a)(4).) "Section 11425.10 specifies the minimum due process and public interest requirements that must be satisfied in a hearing that is subject to this chapter, including a hearing under Chapter 5 (formal hearing)." (Govt. Code, § 11425.10 (Law Revision Commission Comments (1995).) "Ex parte communications shall be restricted as provided in Article 7 (commencing with Section 11430.10)." (Govt. Code, § 11425.10, subd. (a)(8).) Government Code section 11430.10, subdivision (a), provides that "[w]hile the proceeding is pending there shall be no communication, direct or indirect, regarding any issue in the proceeding, to the presiding officer from an employee or representative of an agency that is a party . . . , without notice and opportunity for all parties to participate in the communication." Government Code

section 11430.70, subdivision (a), provides that the provisions governing "ex parte communications" pertain to the "agency head or other person or body to which the power to hear or decide in the proceeding is delegated." "Receipt by the presiding officer of a communication in violation of this article *may* be grounds for disqualification of the presiding officer." (Govt. Code, § 11430.60; emphasis added.)

41. Mercury relies on three cases to argue that ex parte communications between CDI and the Commissioner was a denial of due process: *Department of Alcoholic Beverage Control v. Alcoholic Beverage Control Appeals Bd.* (2006) 40 Cal. 4th 1 (*Quintanar*); *Chevron Stations, Inc. v. Alcoholic Beverage Control Appeals Board* (2007) 149 Cal. App. 4th 116 (*Chevron Stations*); and *Rondon v. Alcoholic Beverage Control Appeals Board* (2007) 151 Cal. App. 4th 1274 (*Rondon*). In *Quintanar*, the California Supreme Court concluded that the APA did not "permit ex parte contacts between an agency's prosecutor and its ultimate decision maker or his or her advisors about the substance of the case, prior to the ultimate decision maker rendering a final decision[.]" (*Mercury Ins. Co. v. Jones, supra,* 2013 WL 1777781, pp. 6-7; citing *Quintanar, supra,* 40 Cal.4th at p. 8.) In the *Quintanar* line of cases, the prosecutors for the Department of Alcoholic Beverage Control (ABC) had a practice of preparing a report of the hearing, after a full evidentiary hearing, and submitting the report to the ABC director's chief counsel along with the proposed decision from the administrative law judge. The reports prepared by the prosecutor were not noticed to the opposing parties and, thus, were ex parte communications. The reports were improper extra records in the case that were considered by the ABC director without opposing parties having an opportunity to respond.

42. The Court of Appeal in distinguishing the ex parte communications that occurred in this case from the *Quintanar* line of cases stated that "All of the aforementioned cases were based on ex parte communications concerning the merits of a final decision by an administrative agency to revoke a license. These cases addressed the appropriate remedy for a final decision in which ex parte communications were made about the *merits* to the decision maker following full blown hearings. This case, however, raises two different issues: (1) an ex parte communication in the rulemaking process concerning the presentation of evidence; and (2) an exhaustion of administrative remedies for failure to obtain a final decision." (*Mercury Ins. Co. v. Jones, supra,* 2013 WL 1777781, at p. 7.) In finding that Mercury's reliance on the *Quintanar* line of cases was "misplaced" the Court of Appeal further reasoned that "the cited cases did not hold an ex parte communication in the rulemaking process concerning the use of evidence excuses a party from exhausting available administrative remedies. The cited cases also did not purport to hold that, once an administrative law judge makes due process and Administrative Procedure Act findings, the decision maker is bound by them." (*Id.* at pp. 6-7.)

43. The ex parte communications complained of here by Mercury pertained to CDI's decision to initiate the rulemaking process to amend a regulation to effect the presentation of evidence in the case, i.e., PDT's for adverse witnesses. Although the ex parte

communication between CDI and Commissioner Poizner involved a pending issue in this case, and such communication is prohibited by Government Code section 11430.10, subdivision (a), ex parte communications regarding rulemaking with the intent to effect the presentation of evidence is not the same as ex parte communications to the ultimate decision maker regarding the merits of a final decision. The latter, although an improper ex parte communication, does not rise to the level of a due process violation requiring the dismissal of the entire proceeding. (*Quintanar, supra*, 40 Cal.4th at p. 8.)

44. The above conclusion is further justified in light of the fact that Mercury has now been afforded a full evidentiary hearing. Although Mercury argues that CDI's ex parte communications to amend CCR section 2614.13 substantively affected the presentation of evidence in the case, ALJ Owyang's February 24, 2011 order determining that CCR section 2614.13, as amended, did not apply in this proceeding was not disturbed. All parties were required to prepare PDT for adverse witnesses and serve on the opposing side as required by the original regulation. However, this ALJ ruled that, if either party was unable to secure a signed PDT from the adverse witness, the party was allowed to prepare a declaration stating that the PDT had been prepared and after reasonable attempts, the party was unable to secure a signed PDT from the adverse witness. Subsequently, the party preparing the adverse witness PDT was allowed to subpoena the adverse witness to testify at the hearing. The adverse witnesses were available to testify at hearing for both direct and cross examination for all parties in this proceeding.

45. Finally, the remedy to cure the prejudice that flows from an ex parte communication between the investigative or prosecutorial employee of an agency and the presiding officer or decision maker for that agency is the disqualification of the presiding officer or decision maker. (Govt. Code, § 11430.60.) Here, ALJ Owyang determined that improper ex parte communications were made by CDI, either directly or indirectly, to Commissioner Poizner's office to effectuate the promulgation of regulations to amend CCR section 2614.13. The rule making process occurred between August 13, 2010, and December 30, 2010. In January 2011, Commissioner Poizner left office and Commissioner Dave Jones was appointed as the new Insurance Commissioner. The hearing in this matter commenced in April 2013 with a final decision to be rendered by Commissioner Jones thereafter. Consequently, Commissioner Poizner, to whom the ex parte communications were directed, will not be the Commissioner who will decide the final decision in this noncompliance proceeding. Accordingly, the disqualification of the decision maker subject to the improper ex parte communication was effectuated by Commissioner Poizner's leaving office prior to the commencement of the evidentiary hearing or issuance of the final decision on the merits in this noncompliance proceeding.

(2) CDI'S PUBLIC RELEASE OF THE 1998 AND 2002 FRUB EXAM REPORTS

46. Mercury further argues that CDI's "loose practices" resulted in a violation of due process when CDI publicly released the 1998 Exam Report and the 2002 Exam Report to the San Francisco Chronicle after a January 5, 2010, Public Records Act (PRA) request. Mercury filed a motion to prevent CDI from producing the reports to CDW in this

noncompliance proceeding. While this motion was pending, CDI released the reports pursuant to the PRA request. Mercury contends that CDI prosecuting attorneys facilitated processing the PRA request which resulted in the release of the reports.

47. Public records are open to inspection at all times during office hours of the state or local agency and every person has a right to inspect any public record, with limited specified exceptions. (Govt. Code, § 6253, subd. (a).) Unless expressly prohibited, an administrative agency must disclose publicly requested documents. (*Id.*, subd. (b).) "The agency shall justify withholding any record by demonstrating that the record in question is exempt under express provisions of this chapter or that on the facts of the particular case the public interest served by not disclosing the record clearly outweighs the public interest served by disclosure of the record." (*Id.*, § 6255, subd. (a).) Insurance Code section 735.5, subdivision (a), provides:

> Nothing contained in this article shall be construed to limit the commissioner's authority to use and, if appropriate, to make public, any final or preliminary examination report, any examiner or company workpapers or other documents, or any other information discovered or developed during the course of any examination in the furtherance of any legal or regulatory action which the commissioner may, in his or her discretion, deem appropriate.

Insurance Code section 735.5, subdivision (c), provides:

> All working papers, recorded information, documents, and copies thereof produced by, obtained by, or disclosed to the commissioner or any other person in the course of an examination made pursuant to this article shall be given confidential treatment and are not subject to subpoena and shall not be made public by the commissioner or any other person, except to the extent provided in subdivision (a) or (b).

48. Here, on January 27, 2010, pursuant to the PRA request, while Mercury's Motion for Protective Order was pending, CDI released Mercury's FRUB 1998 and 2002 Exam Reports to the San Francisco Chronicle. (Factual Finding 82.) Darrel Woo of CDI released the reports to the newspaper based on the reports being used and disclosed in two noncompliance proceedings, this SANNC proceeding and another unrelated 2005 noncompliance proceeding by CDI against Mercury. CDI produced the 1998 Exam Report and Mercury produced portions of the 2002 Exam Report in the 2005 noncompliance proceeding. Woo determined that the confidential status of the reports had been relinquished when the reports were used in the noncompliance proceedings.

49. Under section735.5, subdivision (a), the Commissioner has the authority to use and make public the 1998 Exam Report in the SANNC proceeding. Once the Commissioner, and CDI by extension, decided to produce the 1998 Exam Report in this noncompliance proceeding, the report became a public document, notwithstanding Mercury's Motion for

Protective Order. Mercury's use of the 2002 Exam Report in the 2005 noncompliance proceeding also rendered that report a public document. Consequently, Woo's release of the FRUB reports pursuant to a PRA request was not inappropriate. Moreover, there is no evidence that Mercury was denied due process by the public release of these FRUB reports. It was not established that ex parte communications between CDI prosecuting attorneys in this proceeding and Woo's office resulted in the release of the reports. However, even had there been such communication, it was not established that the communication was prohibited by Government Code section 11425.30, subdivision (a). Woo is CDI's Custodian of Records and Agent for Service of Process. He testified that he "knew nothing about noncompliance actions" and that such proceedings "were not within my experience." Woo had no role as prosecutor, investigator, or decision maker in this noncompliance proceeding.

50. Finally, Mercury argued that the release of the FRUB reports to the San Francisco Chronicle resulted in the 1998 Exam Report being produced on the websites for the news agency and CWD.[16] This noncompliance proceeding is not decided by jury or public opinion. The ALJ is the trier of fact and the Commissioner makes the final decision on the merits of the evidence produced at hearing. The release of the two FRUB Exam Reports through a PRA request does not offend the notion of due process in this noncompliance proceeding.

(3) IMPROPER ROUTING OF PROPOSED DECISION

51. Finally, Mercury contends that ALJ Owyang's January 31, 2012 proposed decision was improperly routed to a CDI prosecuting attorney prior to the 30 days prescribed by Government Code section 11517, subdivision (c)(1), before a proposed decision may be provided to the parties. Mercury argues that although the proposed decision was specifically addressed to the Commissioner, CDI's "loose practices" resulted in the decision being forwarded to a CDI prosecuting attorney, and thus, was further evidence of CDI's inability to maintain a separation between its prosecutorial and adjudicative and decision making functions as required by the APA to insure due process. Mercury did not establish that the error in routing the proposed decision altered or impacted this noncompliance hearing or the Commissioner's decision in this case. A mere clerical error that does not affect a party's substantial rights is not a violation of due process. (*People v. Camacho* (2009) 17 Cal.App.4th 1269, 1275; see also *Dami v. Dept of Alcoholic Beverage Control* (1959) 176 Cal.App.2d 144 (administrative agency's failure to serve a copy of the proposed decision at all prior to its adoption did not violate licensee's due process rights (applying former Gov. Code § 11517).)

52. There is insufficient evidence on this record to conclude that Mercury was denied due process in the noncompliance proceeding. The Superior Court and the Commissioner remanded this matter back to OAH to provide an evidentiary hearing on the merits of the allegations in the SANNC. Accordingly, Mercury's renewed Motion for a

[16] Mercury states that CWD placed the 1998 Exam Report on its website "in connection with its campaign against a Mercury sponsored proposition."

Proposed Decision for Summary Disposition is denied. Mercury of course retains the right to raise this issue in any subsequent Petition for Writ of the Commissioner's final decision in this noncompliance proceeding.

B. GOVERNMENT ESTOPPEL IS NOT A BAR TO CDI IMPOSING CIVIL PENALTIES IN THIS NONCOMPLIANCE PROCEEDING

53. Mercury contends that CDI is barred or estopped from imposing penalties against Mercury because: (1) CDI approved Mercury's rate applications with full knowledge of the issues alleged in the NNC, i.e., that Mercury's "brokers" were de facto agents and were charging unapproved "broker fees"; (2) CDI delayed issuing the NNC until February 2004, although CDI was aware of Mercury's conduct in 1998, thus permitting conduct it was statutorily obligated to enjoin; (3) CDI made public statements that insurers could use "dual agents" and that agents, not just brokers, were permitted to charge fees for services; and (4) CDI expressly advised Mercury that it would give Mercury "ample notice" if further action would be taken regarding the "broker" issue. CDI and CWD contend that equitable estoppel does not apply in this case because estoppel only applies against a governmental body in unusual circumstances when necessary to avoid grave injustice and the application would not defeat a strong public policy. They assert that Mercury failed to establish the requisite elements of estoppel in light of the strong public policy inherent in enforcing the insurance rates statutes.

54. The doctrine of estoppel "ordinarily will not apply against a governmental body except in unusual instances when necessary to avoid grave injustice and when the result will not defeat a strong public policy." (*Hughes v. Board of Architectural Examiners* (1998) 17 Cal.4th 763, 793 [finding that plaintiff had "not demonstrated that grave injustice would result from the delay that occurred in imposing discipline" and that "[a]pplication of the equitable estoppel doctrine would work to defeat the strong public policy...."]; see also *County of Orange v. Carl D.* (1999) 76 Cal.App.4th 429, 438; *Smith v. County of Santa Barbara* (1992) 7 Cal.App.4th 770, 772 [holding that "a public entity may be estopped from enforcing the law only in extraordinary cases"].) "The doctrine of equitable estoppel may be applied against the government where justice and right require it," but "estoppel will not be applied against the government if to do so would effectively nullify a strong rule of policy, adopted for the benefit of the public." (*City of Long Beach v. Mansell* (1970) 3 Cal.3d 462, 493.) "The government may be bound by an equitable estoppel in the same manner as a private party when the elements requisite to such an estoppel against a private party are present and, in the considered view of a court of equity, the injustice which would result from a failure to uphold an estoppel is of sufficient dimension to justify any effect upon public interest or policy which would result from the raising of an estoppel." (*Id.* at pp. 496-497.)

55. "Generally speaking, four elements must be present in order to apply the doctrine of equitable estoppel: (1) the party to be estopped must be apprised of the facts; (2) he must intend that his conduct shall be acted upon, or must so act that the party asserting the estoppel had a right to believe it was so intended; (3) the other party must be ignorant of the

true state of facts; and (4) he must rely upon the conduct to his injury." (*City of Long Beach v. Mansell, supra,* 3 Cal.3d at p. 489 (quoting *Driscoll v. City of Los Angeles* (1967) 67 Cal.2d 297, 305); see also *County of Orange v. Carl D., supra,* at p. 438, fn. 4 ["to find estoppel, the public entity must have misrepresented or concealed material facts with knowledge of the truth, and with intent to induce the other party's reliance. Conversely, the other party must have been permissibly ignorant of the true facts, and must have been induced to act or rely on the public entity's statement or concealment"].) There can be no estoppel where any one of these elements is missing. (*Johnson v. Johnson* (1960) 179 Cal.App.2d 326, 330; *California Cigarette Concessions v. Los Angeles* (1960) 53 Cal.2d 865, 869.)

(1) CDI'S APPROVAL OF MERCURY'S RATE APPLICATIONS

56. CDI approved Mercury's rate applications from 1996 through 2006 and Mercury used those approved rates in the marketplace. Section 1858.07, subdivision (b), provides that "no penalty shall be imposed by the commissioner if a person has used any rate, rating plan, or rating system that has been approved for use by the commissioner in accordance with the provisions of this chapter." However, section 1861.05, subdivision (b), requires every insurer prior to changing its rates to file a complete rate application with CDI. This section specifies that a "complete rate application" must include, but is not limited to, all premiums written, premiums earned, unearned premiums, and expenses incurred, including commission and brokerage expenses. (Ins. Code, §§ 1861.05, subd. (b), and 1857.7.) A complete rate application must also include miscellaneous fees collected by the insurer. (Cal. Code Regs., tit. 10 § 2648.4, subd. (a).) Each rate application is submitted under penalty of perjury with the insurer/applicant declaring that the information contained in the rate application is true, complete and correct.

57. Although CDI approved Mercury's rate applications, Mercury's rate applications were not complete as required by the Insurance Code. Mercury did not include the "broker fees" charged by its designated "brokers" in its rate applications to obtain prior approval from CDI for these fees. The "broker fees" constituted "premium" and/or miscellaneous fees which are required to be included in the rate applications. Because Mercury did not include the "broker fees" in their rate applications, the rate applications were not "true, complete or correct" as Mercury declared in each rate application. Thus, the "broker fees" were never approved in accordance with sections 1861.01, subdivision (c), 1861.05, subdivision (b), and 1858.07 as Mercury contends. Mercury cannot assert that it relied on CDI's approval of its rate applications to conclude that its designated "broker's" "broker fees" were not unlawful when the "broker fees" were actually omitted and never approved by CDI. Mercury may not avoid the penalties imposed for noncompliance with the rate statutes if its own omissions and false rate applications resulted in CDI's approval of the rate applications.

58. Even if CDI was aware that Mercury did not include the "broker fees" in the rate applications, it cannot be concluded that CDI's approval of the rate applications was intended to induce, or did induce, Mercury's conduct in allowing its de facto agents to collect

and charge unapproved "broker fees." (*City of Long Beach v. Mansell, supra,* 3 Cal.3d at p. 489; *Driscoll v. City of Los Angeles, supra,* 67 Cal.2d at p. 305; *County of Orange v. Carl D., supra,* 76 Cal.App.4th at p. 438, fn. 4.) To the contrary, CDI's 1998 Exam Report specifically alleged and advised Mercury that its "brokers" were de facto agents under section 1621, and that the "broker fees" violated section 1861.05, subdivision (a). Thus, Mercury was also not permissibly ignorant of the fact that CDI believed the "broker fees" charged by the de facto agents violated the rate statutes. Mercury failed to establish at least two elements required to establish government estoppel based on CDI's approval of Mercury's rate applications. (*Johnson v. Johnson, supra,* 179 Cal.App.2d at p. 330; *California Cigarette Concessions v. Los Angeles, supra,* 53 Cal.2d at p. 869.) Consequently, CDI's approval of Mercury's incomplete rate applications may not serve as a basis to bar CDI from imposing penalties against Mercury for the rate violations alleged in the SANNC.

(2) THE FILING OF THE NNC IN FEBRUARY 2004 DOES NOT PROVIDE A BASIS TO APPLY GOVERNMENT ESTOPPEL

59. Mercury contends that CDI is estopped from imposing penalties against Mercury for rate violations because CDI failed to file the NNC in 1998, when it was statutorily required to do so. Mercury argues that CDI was required to file the NNC when it had good cause to believe that the rate statutes were being violated based on CDI's 1998 Exam Report, but did not file a NNC until February 2004. Mercury argues the delayed filing of the NNC unfairly and prejudicially permitted statutory penalties to accrue and accumulate and become grossly excessive, in violation of the United States Constitution Eighth Amendment's prohibition against excessive fines and cruel and unusual punishment. CDI and CWD contend that Mercury was placed on notice that CDI believe Mercury's conduct violated the Insurance Code and that CDI intended to issue a notice of noncompliance action against Mercury. They contend that, CDI in its discretion, could file the NNC in February 2004, after the completion of the *Krumme* litigation, to avoid wasting State resources by litigating the same issues in the NNC that were being adjudicated against Mercury in the *Krumme* case.

60. Section 1858.1 requires the Commissioner to issue a notice of noncompliance "[i]f after examination of an insurer ... or upon the basis of other information ... the commissioner has good cause to believe that the insurer .... Or any rate, rate plan or rating system made or used by the insurer, ... does not comply with" the rating laws. There is no statutory time period by which the Commissioner must issue an NNC after he or she has established "good cause" to believe a violation has occurred. The 1998 Exam Report was the basis for CDI and the Commissioner to believe Mercury was violating the rating laws. CDI did not complete the 1998 Exam Report until it issued an Addendum to the report on October 20, 2000, and the official 1998 Exam Report was not filed by Commissioner until December 4, 2000. Consequently, the earliest CDI would have issued a NNC against Mercury would have been after December 4, 2000, not 1998 as suggested by Mercury. CDI eventually filed its NNC on February 2, 2004, three years and two months after the official 1998 Exam Report was filed by the Commissioner.

61. CDI consistently advised Mercury that it believed Mercury's underwriting and rating practices violated the Insurance Code, although CDI in initially attempted to resolve the issues in the Draft Notice through informal discussions prior to filing a formal notice of noncompliance. (Factual Findings 45 through 54.) CDI placed Mercury on notice that it was violating the rate statutes as early as February 1999, when CDI issued the 1998 Exam Report and sent the report to Mercury. The 1998 Exam Report found that Mercury's designated "brokers" were de facto insurance agents who were charging "broker fees" in violation of section 1861.05, subdivision (a). (Factual Finding 45.) On January 21, 2000, CDI sent Mercury the Draft Notice, which contained allegations based on the 1998 Exam Report. On January 27, 2000, CDI met with Mercury representatives regarding the 1998 Exam Report and the Draft Notice. Furthermore between August 1999 and October 2000, CDI and Mercury engaged in frequent communications regarding the 1998 Exam Report and the Draft Notice. On October 20, 2000, CDI issued an Addendum to the 1998 Exam Report and on December 4, 2000, the Commissioner officially filed the final 1998 Exam Report.

62. In spite of the multiple instances that CDI notified Mercury that it was in violation of the insurance rate statutes between 1998 and 2000, Mercury asserts that it believed the issues in the 1998 Exam Report and the Draft Notice had been resolved by legislation in 2000. Mercury argues that CDI provided no notice to Mercury, as it had agreed, that the issues in the Draft Notice remained unresolved after the passage of A.B. 2639, and that CDI did not consider the issues in the 1998 Exam Report and Draft Notice an "open" issue in CDI's subsequent 2002 Exam Report. On this basis, Mercury argues that it had no reason to believe that penalties for violations of the rate statutes were accumulating until CDI filed the NNC in February 2004.

63. CDI and Mercury discussed the 1998 Exam Report and the Draft Notice at the January 27, 2000 meeting and CDI advised Mercury that its designated "brokers" were de facto agents charging unlawful "broker fees." Although there was general agreement that the distinction between a "broker" and an "agent" was not as clear as it should in the Insurance Code or case law, CDI requested Mercury to prepare a written response to the Draft Notice. Mercury indicated that it would pursue legislation to clarify the definitions of the terms "agent" and "broker," and invited CDI to work on the proposed legislation. Mercury ultimately supported legislation, A.B. 2639, which amended the definition of "broker" in section 1623, which Mercury asserts it believed resolved the issues in the Draft Notice. However, CDI officially opposed the bill on the ground that it would not clarify, but "blur the long established distinction between 'agents' and 'brokers' and would create confusion for the consumer and problems for DOI enforcement." (Factual Finding 51 and 52.) A.B. 2639, as enacted, did not allow a "broker" to bind insurance coverage and there was not a "conclusive presumption" that a "broker" who submits an insurance application to an insurer is acting as a broker, both provisions Mercury had proposed as amendments to section 1623 to clarify the definition of "broker" and purportedly resolve the issues in the Draft Notice. Section 1623, as amended by A.B. 2639 in 2000, merely included a rebuttable presumption that a "broker" was acting as a "broker," for licensing purposes only, if an application for insurance submitted to an insurer by the broker showed that the person was acting as an insurance broker and was licensed as a broker. The presumption that Mercury's designated

"brokers" were acting as an insurance broker on behalf of Mercury was sufficiently rebutted by the evidenced in this proceeding.

64. On October 20, 2000, CDI issued an addendum to the 1998 Exam Report. The Addendum indicated that CDI contacted Mercury to inquire about the status of Mercury's written response to the Draft Notice and Mercury advised that it thought the passage of A.B. 2639 had resolved the issues in the Draft Notice. However, there is no evidence that CDI informed Mercury that the Draft Notice was resolved by this legislation or otherwise. Mercury did not provide a written response to the Draft Notice as had been requested by CDI and the Addendum stated that Mercury was expected to contact CDI's Legal Division to further discuss the 1998 Exam Report and the Draft Notice, a clear indication that CDI did not consider the matter resolved. CDI's filing of the official 1998 Exam Report on December 4, 2000, which contained the report's original findings, further placed Mercury on notice that CDI did not consider the Draft Notice resolved as of December 2000. Consequently, Mercury's assertion that it believed the Draft Notice was resolved by the passage of A.B. 2639 is disingenuous.

65. Mercury also claimed that CDI's omission of the designated "broker" and "broker fee" issue in CDI's subsequent FRUB 2002 Exam Report, which examined Mercury's rating and underwriting practices for the period from January 1, 2001, through August 31, 2002, induced Mercury to believe that the issues in the 1998 Exam Report and the Draft Notice had been resolved. The evidence established, however, that the 2002 Exam Report did not include the designated "broker" and "broker fee" issue from the 1998 Exam Report because those matters had been referred to the CDI Legal Division to initiate enforcement proceedings. (Factual Finding 55.)

66. In June 2000, the *Krumme* litigation was initiated by a private citizen raising essentially the same issues that CDI alleged in the Draft Notice, i.e., that Mercury's "brokers" or de facto insurance agents were charging unapproved "broker fees" to Mercury's personal lines automobile insurance policyholders in California. *Krumme* litigation again placed Mercury on notice that Mercury's underwriting and rating practices were under legal challenge. CDI choose to delay filing the NNC against Mercury pending the *Krumme* Court's decision, to avoid expending State resources to litigate the same issues that would be adjudicated by *Krumme*. Based on the *Krumme* Findings decided on April 11, 2003, CDI filed its NNC against Mercury on February 2, 2004, just over three years following the Commissioner's filing of the official 1998 Exam Report.

67. Consequently, since February 18, 1999, when the 1998 Exam Report was sent to Mercury and December 4, 2000, when the Commissioner filed the official 1998 Exam Report, through the initiation of the *Krumme* litigation in June 2000 and the *Krumme* Court's decision in April 2003, Mercury has been on notice that CDI believed Mercury's conduct violated the Insurance Code rate statutes and could result in CDI filing of a notice of noncompliance, which it ultimately did on February 4, 2004.

68. Mercury also argued that CDI's delay in filing the NNC violated the United States Constitution Eighth Amendment prohibition against excessive and arbitrary penalties because CDI allowed Mercury to accumulate penalties for the rate statute violations before deciding to file in February 2004, five years after it notified Mercury of the 1998 Exam Report. Mercury cites *Walsh v. Kirby* (1974) 13 Cal.3d 95 and *People ex rel Lockyer v. R.J. Reynolds Tobacco Co., supra,* 37 Cal.4th at pp. 728-732 for the proposition that CDI should not be permitted to impose penalties if CDI's delay in filing the NNC caused statutory penalties to unfairly and prejudicially accrue and accumulate against Mercury. Both *Walsh* and *Lockyer* are distinguishable.

69. In *Walsh,* a governmental agency (Department of Alcoholic Beverage and Control) filed its accusation without providing any prior notice to the licensee. (*Walsh v. Kirby, supra,* 13 Cal.3d at p. 98.) The court noted that the Department had a practice of accumulating evidence of recurring sales of distilled spirits below minimum retail prices, each constituting a different but essentially identical violation, before it filed its accusation charging the licensee with the whole series of violations and assessing concomitant cumulative penalties. (*Id.*) Here, CDI provided sufficient notice to Mercury regarding its unlawful conduct, i.e., the 1998 Exam Report and the Draft Notice, and engaged in informal discussions with Mercury to resolve the issues contained therein without the filing of a NNC. CDI does not have a practice of delaying the filing of an NNC to accumulate penalties. In fact, the delay in this noncompliance proceeding was due to discussions in an attempt to resolve the issues in the Draft Notice, which placed Mercury on notice of its violations, and CDI's decision to issue the NNC after conclusion of the *Krumme* litigation, neither of which involved a concerted effort or practice by the CDI to intentionally allow the accumulation of penalties without notice.

70. In *Lockyer* RJ Reynolds wrote a letter to the Attorney General seeking confirmation that its planned promotion complied with the law. The Attorney General replied stating that RJ Reynolds had addressed its concerns, and that the Attorney General's office appreciated the company's change in marketing and promotional practices. (*People ex rel Lockyer v. R.J. Reynolds Tobacco Co., supra,* 37 Cal.4th at p. 727.) Subsequently, the Attorney General changed its position, which took RJ Reynolds by surprise, and filed a law suit against RJ Reynolds for the specific acts that it had affirmatively approved in the prior letter, seeking accumulated penalties based on the violations. (*Id.* at pp. 727-28). In this case, Mercury did not affirmatively seek an opinion from CDI regarding its underwriting and rating practices and CDI did not communicate to Mercury that it thought Mercury's practices were lawful. To the contrary, CDI consistently maintained that it believed Mercury's practices violated the Insurance Code rate statutes.

71. Thus, unlike in *Walsh* and *Lockyer,* CDI placed Mercury on notice that it believed Mercury's conduct violated the Insurance Code prior to the filing of the NNC in February 2004, and CDI did not delay filing the NNC with the intent of allowing penalties to accumulate. CDI's decision to delay filing the NNC until after the *Krumme* case involved considerations of judicial economy and conserving State resources by avoiding the necessity to fully litigate issues in the NNC, that were currently being adjudicated against Mercury in

the *Krumme* case. As such, the delay in filing the NNC did not constitute a prejudicial delay by allowing penalties for the rate violations to accumulate.

(3) STATEMENTS BY CDI AND JON TOMASHOFF DO NOT ESTABLISH A BASIS FOR ESTOPPEL

72. Mercury also contends that CDI should be barred or estopped from imposing penalties against Mercury because statements by CDI and Jon Tomashoff lead Mercury to believe that its de facto agents or "brokers" were allowed to charge "broker fees." The evidence established, however, that these statements did not induce reliance by Mercury that CDI believed Mercury's practices were no longer in violation of the Insurance Code.

73. Mercury claims that at the January 27, 2000 meeting between CDI and Mercury, CDI stated that the Draft Notice was regarded as a "basis to begin discussions" and hopefully reach a workable solution to the "broker issues," and that there was agreement that a legislative solution was the appropriate way to resolve the issues in the Draft Notice. Mercury asserts that CDI expressly advised Mercury at the meeting, and thereafter in a February 18, 2000 letter from Kathryn Bugh and the October 20, 2000 Addendum, that CDI would give Mercury "ample notice" if further action needed to be taken with respect to the "broker issue" in the Draft Notice. Mercury asserts that it relied on CDI's statements and when CDI did not notify Mercury of any further action that was needed, Mercury believed it did not need to take further action to resolve the broker issue.

74. At the January 27, 2000 meeting CDI requested Mercury to prepare a written response to the Draft Notice, and that after CDI received Mercury's response, CDI would provide "ample notice" to Mercury if further action was needed. Mercury did not prepare a written response to the Draft Notice. When CDI contacted Mercury on October 20, 2000, to inquire about the status of the written response to the Draft Notice, Mercury informed CDI that it believed its obligation to submit a written response to the Draft Notice had been fulfilled by the passage of A.B. 2639. There was no basis for such belief because CDI opposed A.B. 2639 and the bill, as enacted, did not include binding authority for brokers or the conclusive presumption regarding brokers as Mercury had sought. Mercury could not reasonably have believed the issues in the 1998 Exam Report and Draft Notice had been resolved after passage of A.B. 2639, and it did not receive notice from CDI that further action was required. Such reliance is misplaced when the condition precedent to receiving the such notice was Mercury's agreement to file a written response to the Draft Notice, which it did not. Consequently, Mercury's claim that statements made at the January 27, 2000 meeting by CDI induced its belief that the "broker issues" were resolved is not persuasive.

75. Mercury also argues that it relied on two letters written by CDI's Jon Tomashoff in 1997 and 1998 that confirmed the validity of the concept of "dual agency" in continuing its practice of designating its producers as "brokers" and permitting such "brokers" to charge "broker fees." Of note in Mercury's assertion is that it relied on these letters to *continue* a practice it had already started in 1989, when it converted all of its

appointed agents to designated "brokers." Thus, Mercury cannot claim it relied on Tomashoff's letters to make its initial decision to convert its producer force to "broker" status. Mercury's claim is also not convincing because neither of the letters by Tomashoff was sent to Mercury or specifically addressed Mercury's designated "broker" practices. It is unclear when Mercury became aware of Tomashoff's letters, as Bruce Norman testified that he became aware of the letters sometime in the mid 1990's. Additionally, in the November 7, 1997 letter, Tomashoff specifically stated that the information provided could not be relied upon by an agent or a broker, and that statutory or regulatory changes would be required before the statements made in the letter could be relied upon.

76. Even if Mercury was aware of the 1997 and 1998 letters as it asserts, CDI's 1998 Exam Report, which Mercury received in February 1999, expressly advised Mercury that CDI believed Mercury's designated "brokers" were operating as de facto agents, and not brokers under section 1623. Thus, Mercury would have had no basis to continue to rely on Tomashoff's November 7, 1997, and January 27, 1998, letters after it received CDI's 1998 Exam Report on February 18, 1999. CDI made no affirmative misrepresentations or concealment of material facts that could reasonably be found to have induced Mercury to continue to allow its de facto insurance agents to charge unapproved "broker fees" in violation the Insurance Code and the applicable rating statutes and regulations. Mercury also did not establish that it was ignorant of the fact that CDI considered Mercury's practices unlawful. (*City of Long Beach v. Mansell, supra,* 3 Cal.3d at p. 489; *Driscoll v. City of Los Angeles, supra,* 67 Cal.2d at p. 305; *County of Orange v. Carl D., supra,* Cal.App.4th at p. 438, fn. 4.) At no time did CDI inform or represent to Mercury that the issues in the 1998 Exam Report and the Draft Notice had been resolved or abated. CDI's position that Mercury's underwriting and rating practices violated sections 1861.01 and 1861.05 remained consistent from 1998 through February 2004 when it filed the NNC.

77. The doctrine of estoppel "ordinarily will not apply against a governmental body except in unusual instances when necessary to avoid grave injustice and when the result will not defeat a strong public policy." (*Hughes v. Board of Architectural Examiners* (1998) 17 Cal.4th 763, 793.) Mercury failed to establish that a grave injustice would result if CDI is allowed to impose penalties in this noncompliance proceeding. Mercury was given sufficient notice by CDI of the violations contained in the February 2, 2004 NNC. Mercury chose to defend its practices in the *Krumme* case rather than work with CDI to resolve the allegations in the 1998 Exam Report and the Draft Notice. Mercury may not now claim that CDI should be estopped from imposing penalties because it was not aware that CDI considered Mercury's conduct a violation of the Insurance Code. The application of the equitable estoppel doctrine would work to defeat a strong public policy, i.e., Prop. 103's legislative intent to protect California insurance consumers from excessive and unfairly discriminatory insurance rates. (See *County of Orange v. Carl D., supra,* 76 Cal.App.4th at p. 438; *Smith v. County of Santa Barbara, supra,* 7 Cal.App.4th at p. 772; *City of Long Beach v. Mansell, surpa,* 3 Cal.3d at p. 493.)

78. Accordingly, it was not established that CDI's conduct provided a basis to apply government estoppel to bar CDI from imposing civil penalties in this proceeding. (Factual Findings 11 through 82; Legal Conclusions 1 through 77.)

C. THE DOCTRINE OF LACHES DOES NOT APPLY

79. Mercury contends that CDI is barred by the doctrine of laches from pursuing the NNC because CDI conducted an examination of Mercury's rating practices in 1998, but did not file the NNC until February 2004. Mercury asserts that CDI's delay in filing the NNC was unreasonable and resulted in prejudice to Mercury. Mercury further asserts that, although there is no statute of limitations period for a noncompliance proceeding, a one year statute of limitations period applicable to other analogous actions should be applied. CDI and CWD respond that there is not a statute of limitations period for noncompliance proceedings and that laches does not apply in actions by a state agency to protect the public welfare. They further assert that CDI's delay in issuing the NNC was not unreasonable and that Mercury was not prejudiced by the delay.

80. Courts have applied the doctrine of laches in administrative proceedings. Laches is established by a showing of unreasonable delay in initiating a disciplinary action which results in prejudice to the party affected by the disciplinary action. (*Gates v. Department of Motor Vehicles* (1979) 94 Cal.App.3d 921, 925.) Prejudice is not presumed. The party asserting the laches defense has the burden of establishing unreasonable delay and prejudice. (*Green v. Bd. of Dental Examiners* (1996) 47 Cal.App.4th 786, 792; *Miller v. Eisenhower Med. Ctr.* (1980) 27 Cal.3d 614, 624; *Conti v. Board of Civil Serv. Comm'rs* (1969) 1 Cal.3d 351, 362.) In administrative proceedings with no statute of limitations, if a statute of limitations governing an analogous action at law exists, that "period may be borrowed as a measure of the outer limit of reasonable delay in determining laches." (*Fountain Valley Regional Hosp. & Med. Ctr. v. Bonta* (1999) 75 Cal.App.4th 316, 324; *Brown v. State Personnel Bd.* (1985) 166 Cal.App.3d 1151, 1159-1160; *Fahmy v. Medical Bd. Of Calif.* (1995) 38 Cal.App.4th 810, 815.) "Whether or not such a borrowing should occur depends upon the strength of the analogy." (*Fountain Valley Regional Hosp. & Med. Ctr. v. Bonta, supra,* 75 Cal.App.4th at p. 324, quoting *Brown v. State Personnel Bd., supra,* 166 Cal.App.3d at p. 1160.) If it is determined that an analogous statute of limitations period applies, expiration of such period does not automatically constitute laches, but the effect is to shift the burden to the government agency to prove that the delay was excusable and that the party asserting the laches defense was not prejudiced. (*Brown, supra,* at p. 1161.) However, courts have disfavored applying laches within the context of an administrative enforcement action concerning the practices of a licensee. (See *Fahmy v. Medical Bd. Of Calif., supra,* 38 Cal.App.4th at p. 817-818, fn 5.)

81. The applicable Insurance Code provisions, sections 1858.1 and 1861.01, subdivision (c), do not provide a limitations period by which time CDI must commence a noncompliance proceeding. Courts have not borrowed an analogous statute of limitations for laches purposes when a government agency is taking action to protect the public rather than for its own financial gain. (*Fahmy v. Medical Bd. Of Calif., supra*, 38 Cal.App.4th at p.

816.) Administrative agencies should not be hampered by time limits in the execution of their duty to take protective remedial action. (*Id.*) Here, CDI is taking an administrative action, the SANNC, to enforce the Insurance Code rate statutes which were enacted by Prop. 103 to protect insurance consumers from arbitrary insurance rates and practices. The application of an analogous statute of limitations period, where the Legislature has declined to impose such a statute in a noncompliance proceeding, would undermine CDI's ability to protect the public's welfare.

82. Mercury argues that a statute of limitations period of one year for actions brought "upon a statute for a forfeiture or penalty to the people of this state," in Civil Code section 340, subdivision (b), is analogous to this noncompliance proceeding and should be imposed. It asserts that this one year statute of limitations period was applied to a governmental action brought under California's Unfair Competition Law claim, which was the body of law used by the private citizen in the *Krumme* case. Even if it could be determined that actions in which the statute of limitation period in Civil Code section 340, subdivision (b), apply are analogous to noncompliance proceedings, a conclusion which is not clearly established, CDI established that the delay in filing the NNC was reasonable and Mercury was not prejudiced by the NNC filed in February 2004. (See *Brown v. State Personnel Bd., supra*, 166 Cal.App.3d at p. 1161.)

83. A summary of the relevant facts support these conclusions. In July 1998, CDI began an examination of Mercury's underwriting and rating practices. On February 18, 1999, CDI sent its FRUB 1998 Exam Report to Mercury outlining the results of its examination and advising Mercury of the report's findings. CDI and Mercury engaged in informal discussions to attempt to resolve the issues in the 1998 Exam Report, but were unsuccessful. On January 21, 2000, CDI sent Mercury the Draft Notice which stated the alleged violations that were found in the 1998 Exam Report including allegations that Mercury had violated sections 1861.01 and 1861.05 by allowing its de facto insurance agents to charge unapproved "broker fees" to Mercury's policyholders purchasing personal lines automobile insurance through the de facto agents. At the meeting on January 27, 2000, to discuss the 1998 Exam Report and the Draft Notice, CDI requested Mercury to respond in writing to the Draft Notice, which Mercury never did. When contacted by CDI in October 2000 to inquire about the status of Mercury's response to the Draft Notice, Mercury informed CDI that it believed it was no longer obligated to respond to the Draft Notice, although CDI had given no reason to Mercury to reach this conclusion. On October 20, 2000, CDI completed the 1998 Exam Report and submitted the report to the Commissioner, which he approved on December 4, 2000.

84. Although Mercury argued that CDI waited over six years to file the NNC, the 1998 Exam Report, which provided the basis for the allegations in the NNC, was not officially issued until December 4, 2000. CDI filed the NNC just over three years (38 months) after the issuance of the official 1998 Exam Report. Furthermore, in June 2000, the *Krumme* case was filed against Mercury in the San Francisco Superior Court raising essentially the same issues in a UCL proceeding that were alleged in CDI's Draft Notice. CDI decided to delay filing the NNC in this matter until after the *Krumme* case had been

litigated and a decision issued. CDI reasoned that it could preserve state resources by delaying the noncompliance proceeding until after the *Krumme* Court's decision to ensure judicial economy and to avoid conflicting decisions. On April 11, 2003, the *Krumme* Court rendered its decision, and on February 4, 2004, CDI filed the NNC in this noncompliance proceeding. Consequently, CDI's delay in filing the NNC was not unreasonable. Delay alone ordinarily will not constitute laches. Laches will be found only when the delay is unreasonable. (*Green v. Bd. of Dental Examiners, supra,* 47 Cal.App4th at p. 792; *Miller v. Eisenhower Med. Ctr., supra,* 27 Cal.3d at p. 624; *Conti v. Board of Civil Serv. Comm'rs, supra,* 1 Cal.3d at p. 362.)

85. There was also insufficient evidence that Mercury was prejudiced by CDI filing the NNC in February 2004. CDI placed Mercury on notice that the agency believed Mercury's practices violated the Insurance Code's rate statutes in February 1999, after FRUB completed an examination of Mercury's underwriting and rating practices. The 1998 Exam Report, the 2000 Draft Notice, informal discussions CDI had with Mercury between August 1999 and January 2000, the October 2000 Addendum, the filling of the official 1998 Exam Report in December 2000, and the February 2004 NNC, all notified Mercury of CDI's belief that its practices were unlawful. CDI was unequivocal in its position that Mercury's practices violated the rate statutes. There is no basis for Mercury to contend that it was prejudiced by CDI filing the NNC in February 2004 because it was unaware that CDI considered its practices to be violations of the Insurance Code.

86. Mercury was further placed on notice in June 2000 that the legality of its practices was being legally challenged when the *Krumme* case was filed. Mercury litigated essentially the same issues alleged in the NNC in the *Krumme* case, which negates its claim that the delay in filing the NNC prejudiced its ability to prepare evidence for this noncompliance proceeding. Moreover, CDI submitted letters and briefs in 2003 and 2004 in the *Krumme* case opposing Mercury's position, again notifying Mercury that CDI believed its practices were in violation of the Insurance Code. Finally, the record shows that Mercury stipulated to stay or continue this noncompliance proceeding pending its appeals of the *Krumme* Court's decision.

87. Accordingly, there is insufficient evidence to establish that CDI unreasonably delayed the filing of the NNC, or that Mercury was prejudiced in any way by CDI filing the NNC in February 2004. (Factual Findings 45 through 55 and 65 through 68; and Legal Conclusions 2, and 60 through 72.)

D. CONSTITUTIONALITY OF THE RATE STATUTES

88. Finally, Mercury argues that the rate statutes are unconstitutionally vague because the term "rate" is not defined. California Constitution, Article III, section 3.5, prohibits a state agency form declaring a statute unconstitutional. (*Cowan v. Myers* (1986) 187 Cal.App.3d 968, 975; *Chevrolet Motor Div. v. New Motor Vehicle Bd.* (1983) 146 Cal.App.3d 533, 539.) Accordingly, Mercury's challenge to the constitutionality of the rate statutes is not considered or ruled upon in this administrative noncompliance proceeding.

V. Mercury Is Subject to Civil Penalties For the Violations of Sections 1861.01 and 1861.05

89. Section 1858.07, subdivision (a), provides:

> Any person who uses any rate, rating plan, or rating system in violation of this chapter is liable to the state for a civil penalty not to exceed five thousand dollars ($5,000) for each act, or, if the act or practice was willful, a civil penalty not to exceed ten thousand dollars ($10,000) for each act. The commissioner shall have the discretion to establish what constitutes an act. However, when the issuance, amendment, or servicing of a policy or endorsement is inadvertent, all of those acts shall be a single act for the purpose of this section.

90. Section 1850.5 provides that "[i]n this chapter 'wilful' or 'wilfully' in relation to an act or omission which constitutes a violation of this chapter means with actual knowledge or belief that such act or omission constitutes such violation and with specific intent to commit such violation." CCR section 2695.2, subdivision (y), in considering intent in the context of "willfull" or "willfully" provides that:

> "Willful" or "Willfully" when applied to the intent with which an act is done or omitted means simply a purpose or willingness to commit the act, or make the omission referred to in the California Insurance Code or this subchapter. It does not require any intent to violate law, or to injure another, or to acquire any advantage.

91. Mercury is subject to a civil penalty for "each act," or instance in which it charged its policyholders an unapproved rate in violation of section 1861.01, subdivision (c), and an unfairly discriminatory rate in violation of section 1861.05, subdivision (a). (Ins. Code § 1858.07, subd. (a).) All of the "broker fees" charged and collected by Mercury's designated "brokers" were unapproved by CDI and the Commissioner. Each time Mercury's designated "brokers" charged a "broker fee" in addition to Mercury's approved rate or premium, it resulted in an unfairly discriminatory rate being charged to the policyholder. Mercury is vicariously liable for the conduct of its designated "brokers" and is deemed to have constructively received the "broker fees." Accordingly, from July 1996 through 2006, Mercury violated sections 1861.01, subdivision (c), and 1861.05, subdivision (a). (Factual Findings 11 through 82; and Legal Conclusions 3 through 36.)

92. CDI seeks to assess civil penalties against Mercury based on the "broker fees" charged and collected by Mercury's largest designated "broker," AIS, from September 19, 1999 to August 11, 2004. AIS charged and collected $27,593,562 in unapproved "broker fees" on personal lines automobile insurance policies transacted on behalf of Mercury. Although AIS charged $100 or less as a "broker fee," Mercury's designated "brokers" as a whole collected from $50 to $150 as a "broker fee" on each personal lines automobile

insurance policy transacted on behalf of Mercury. To determine the minimum number of violations committed by Mercury, CDI divided the total amount of "broker fees" charged by AIS from September 1999 to August 2004 ($27,593,562), by the maximum "broker fee" ($150) charged by any of Mercury's designated "brokers." By dividing the $27,593,562 in "broker fees" by the $150 "broker fee," a minimum number of violations or acts committed by Mercury would be 183,957. (Ins. Code § 1858.07, subd. (a).) If the minimum "broker fee" charged of $50 is used, the estimated number of acts or violations would increase dramatically. Each time a "broker fee" was charged it violated both sections 1861.01, subdivision (c) (failing to obtain prior approval for a rate), and 1861.05, subdivision (a) (charging unfair discriminatory rates). Thus, the minimum number of acts committed by Mercury's designated "brokers" could be as high as 367,914 violations.

A. MERCURY WILLFULLY VIOLATED THE RATE STATUTES

93. To establish that Mercury "willfully" violated sections 1861.01 and 1861.05, it must be shown that, from July 1996 to 2006, Mercury had actual knowledge that its designated "brokers" were charging illegal unapproved "broker fees" in violation of sections 1861.01, subdivision (c), and 1861.05, subdivision (a). Mercury was aware of CDI's Bulletin 80-6, which from at least 1980, established that all fees collected by an agent on behalf of an insurer constituted premium and were required to be reported as such. In 1989, in response to the passage of Prop. 103 which required prior approval by the Commissioner of any rate charged the consumer by an insurer, Mercury began converting its all-agent force producer to "brokers." Prior to 1989 Mercury had filed agency appointments with CDI pursuant to section 1704, subdivision (a), for all of its agents. In converting the appointed agents to "brokers," Mercury merely changed the name on their Agency Contracts to Producer Contracts, but in fact, from 1996 through at least 2006, Mercury's relationship with its designated "brokers" was indistinguishable from the relationship it had with its appointed agents. The only advantage or difference in Mercury's appointed agents and its designated "brokers" or de facto agents, was Mercury's perceived belief that the designated "broker" could charge "broker fees" without Mercury obtaining prior approval for such fees in a rate application.

94. By 2003, Mercury had converted almost 90 percent of its producer force to de facto agents of Mercury. Mercury was aware that there was essentially no difference in its relationship with its appointed agents and its designated "brokers" and that the designated "brokers" were charging and collecting "broker fees" that were not included in Mercury's rate applications for prior approval by the Commissioner. Consequently, Mercury knew or should have known that the "broker fees" charged by its designated "brokers" were required to be reported in its rate applications as premium to obtain prior approval for the rates including the "broker fees." (Factual Findings 11 through 40.)

95. Mercury was placed on actual notice by CDI that its practices violated the Insurance Code rate statutes. CDI issued the 1998 Exam Report which was sent to Mercury in February 1999, which concluded that Mercury's practices violated sections 1861.01, subdivision (c), and 1861.05, subdivision (a). In January 2000, CDI sent Mercury a Draft

Notice further notifying Mercury that its conduct violated the Insurance Code. CDI and Mercury had informal discussion from 1999 to 2000 regarding the 1998 Exam Report and the Draft Notice, but the issues were not resolved and Mercury continued the practices unabated that had been cited in CDI's 1998 Exam Report. Finally, in June 2000, the *Krumme* litigation was initiated against Mercury which further alerted Mercury that its practice in allowing designated "brokers" to charge unapproved "broker fees" violated the Insurance Code. In 2003 the *Krumme* Court rendered a decision against Mercury finding that Mercury's designated "brokers" were in fact insurance agents within the meaning of section 1621, and not "brokers" within the meaning of section 1623. Mercury nonetheless continued its unlawful practices until November 2005, and did not discontinue the practice of charging unlawful unapproved "broker fees" until the end of 2008.

96. Consequently, there is sufficient evidence to conclude that from at least 1996 through 2006, Mercury willfully violated the rate statutes when it failed to obtain prior approval from the Commissioner for the unfairly discriminatory "broker fees" charged by its de facto insurance agents in violation of sections 1861.01, subdivision (c), and 1861.05, subdivision (b). (Factual Findings 11 through 82.)

97. CDI's decision to base its civil penalty assessment on the $27,593,562 in "broker fees" charged and collected by AIS from September 1999 to August 2004 is not unreasonable given Mercury's designated "brokers" charged unlawful "broker" fees from 1989 to at least 2008, and Mercury was aware that such fees were being charged. CDI only seeks to impose civil penalties for unlawful "broker fees" charged and collected by AIS for five of the 10 years covered by the SANNC, July 1996 through 2006. Moreover, the evidence established that personal lines automobile insurance transacted by AIS on behalf of Mercury constituted on 25 percent of such insurance policies written by Mercury in California for this period. Consequently, the estimate of the number of acts or violations of the rate statutes committed by Mercury is a conservative estimate.

98. The Commissioner has the discretion to establish what "constitutes an act." (Ins. Code § 1858.07, subd. (a).) Because the same conduct is used to establish violations of both sections 1861.01, subdivision (c), and 1861.05, subdivision (a), for purposes of calculating the number of acts committed, each "broker fee" charged will only be considered a single act for assessment of the civil penalty. Consequently, Mercury is found to have committed 183,957 acts or violations of the rate statutes from September 1999 through August 2004, based on dividing the $27,593,562 in broker fees by $150, the maximum "broker fee" charged by Mercury designated "brokers." Even if Mercury could show that it did not willfully violate the rate statutes, Mercury would still be exposed to civil penalties of up to $5,000 for each act or violation committed. (Ins. Code § 1858.07, subd. (a).) Mercury will be assessed a civil penalty of $150 for each act or violation committed from September 1999 to August 2004 (183,957), for a total civil penalty of $27,593,550. Accordingly, the assessment of a civil penalty of $27,593,550 against Mercury is reasonable given the totality of the evidence in this noncompliance proceeding. (Factual Findings 11 through 82; and Legal Conclusions 1 through 36.)

ORDER

1. From July 1, 1996, through 2006, Mercury's de facto insurance agents charged and collected unapproved "broker fees" that constituted premium in excess of the rates approved for Mercury by the Commissioner, in violation of Insurance Code section 1861.01, subdivision (c).

2. From July 1, 1996, through 2006, Mercury's de facto agents charged "broker fees" of varying amounts over and above the rate or premium approved for Mercury by the Commissioner, which resulted in unfair rate discrimination, in violation of Insurance Code section 1861.05, subdivision (a).

3. Mercury shall be assessed a civil penalty in the amount of $27,593,550, pursuant to Insurance Code section 1858.07, subdivision (a).

DATED: December 5, 2014

MICHAEL A. SCARLETT
Administrative Law Judge
Office of Administrative Hearings