In the Supreme Court of the State of California

ASSOCIATION OF CALIFORNIA INSURANCE COMPANIES and PERSONAL INSURANCE FEDERATION OF CALIFORNIA,

Plaintiffs and Respondents,

v.

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

Defendant and Appellant.

Case No. S226529

Court of Appeal, Second Appellate District, Case No. B248622
Los Angeles County Superior Court, Case No. BC463124
The Honorable Gregory W. Alarcon, Judge

OPENING BRIEF ON THE MERITS

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TABLE OF CONTENTS

Page

Issues Presented 1

Introduction 1

Background 4

I. The Insurance Code and the Commissioner 4

II. The Chronic Problem of Unintended Underinsurance 7

Statement of the Case 13

I. The Replacement Cost Regulation 13

II. Industry Challenge and Lower Court Decisions 15

Standard of Review 17

Argument 18

I. Section 790.10 Grants to the Commissioner Broad Authority to Issue Regulations to Administer the Unfair Insurance Practices Act 20

II. The Commissioner's Power to Administer the Act Includes the Power to Deem Specific Practices to Be Inherently Misleading 22

III. The Court of Appeal's Reading of the Act to Limit the Commissioner's Rulemaking Authority Is Inconsistent with Legislative Intent 28

A. The legislative history supports the Commissioner's authority 28

B. The Legislature's subsequent actions do not call the Commissioner's rulemaking authority into question 30

C. The Act's distinction between defined and undefined prohibited acts, and the existence of administrative enforcement tools, do not curtail the Commissioner's rulemaking authority 32

Conclusion 37

TABLE OF AUTHORITIES

Page

CASES

Agricultural Labor Relations Bd. v. Superior Court
(1976) 16 Cal.3d 392 ..... 6, 37

Bixby v. Pierno
(1971) 4 Cal.3d 130 37

California School Bds. Assn. v. State Bd. of Education
(2010) 191 Cal.App.4th 530 21

Chern v. Bank of America
(1976) 15 Cal.3d 866 25

Credit Ins. General Agents Assn. v. Payne
(1976) 16 Cal.3d 651 ..... 17, 22, 32

Day v. AT & T Corp.
(1998) 63 Cal.App.4th 325 25

Day v. City of Fontana
(2001) 25 Cal.4th 268 19

Even Zohar Construction & Remodeling, Inc. v. Bellaire Townhouses, LLC
(2015) 61 Cal.4th 830 19

Ford Dealers Assn. v. Dept. of Motor Vehicles
(1982) 32 Cal.3d 347 ..... 17 *et passim*

General Development Co., L.P., v. City of Santa Maria
(2012) 202 Cal.App.4th 1391 37

Kasky v. Nike, Inc.
(2002) 27 Cal.4th 939 25

Mejia v. Reed
(2003) 31 Cal.4th 657 25

Moore v. California State Bd. of Accountancy
(1992) 2 Cal.4th 999 ..... 21, 22

Morris v. Williams
(1967) 67 Cal.2d 733 24

National Petroleum Refiners Assn. v. FTC
(D.C. Cir. 1937) 482 F.2d 672 ..... 32, 34, 35

People ex rel. Lockyer v. R.J. Reynolds Tobacco Co.
(2005) 37 Cal.4th 707 31

Ralphs Grocery Co. v. Reimel
(1968) 69 Cal.2d 172 ..... 22, 31, 32

San Diego Nursery Co. v. Agricultural Labor Relations Bd.
(1978) 100 Cal.App.3d 128 34

Securities and Exchange Com. v. Chenery Corp.
(1947) 332 U.S. 194 34

Smith v. Superior Court
(2006) 39 Cal.4th 77 ..... 18, 19

U.S. Dept. of Treasury v. Fabe
(1993) 508 U.S. 491 4

Western States Petroleum Assn. v. Bd. of Equalization
(2013) 57 Cal.4th 401 20

Yamaha Corp. of America v. State Bd. of Equalization
(1998) 19 Cal.4th 1 ..... 17, 18

STATUTES

15 U.S.C. § 41 et seq. 4

15 U.S.C. § 1011 4

15 U.S.C. § 1012 4

Bus. & Prof. Code, § 17500 25

Civ. Code, § 3537 37

Gov. Code, § 11340 et seq. 20

Gov. Code, § 11342.1 21

Gov. Code, § 11342.2 29

Gov. Code, § 11342.600 21

Gov. Code, § 11374 29

Health & Safety Code, § 123280 21

Ins. Code, §§ 1-48 4

Ins. Code, § 41 4

Ins. Code, §§ 100-1879.8 4

Ins. Code, §§ 779.21-779.24 6

Ins. Code, § 790 ..... 4, 5

Ins. Code, § 790.03 ..... 5 *et passim*

Ins. Code, § 790.03, subd. (a) 28

Ins. Code, § 790.03, subd. (b) ..... 3 *et passim*

Ins. Code, § 790.03, subd. (d) 28

Ins. Code, § 790.03, subd. (e) 5

Ins. Code, § 790.03, subd. (f)(1) 28

Ins. Code, § 790.03, subd. (h) 17, 29, 30

Ins. Code, § 790.04 ..... 4, 5, 11

Ins. Code, § 790.05 ..... 4 *et passim*

Ins. Code, § 790.06 ..... 4 *et passim*

Ins. Code, § 790.10 ..... 2 *et passim*

Ins. Code, § 790.034 30

Ins. Code, § 790.035 6

Ins. Code, § 790.036, subd. (a) 28

Ins. Code, § 1749.1 9

Ins. Code, § 1749.85 ..... 9, 31

Ins. Code, §§ 1880-12880.5 4

Ins. Code, § 2051.5 ..... 8, 31

Ins. Code, § 10101 ..... 2, 31

Ins. Code, §§ 10101-10107 ..... 7, 17

Ins. Code, § 10102 ..... 2, 12, 30

Ins. Code, § 10103 8

Ins. Code, § 10234 21

Ins. Code, §§ 12900-13813 4

Ins. Code, § 12921, subd. (a) 4

Ins. Code, §§ 13900-13907 4

Ins. Code, §§ 14000-16032 4

Stats. 1957, ch. 916, p. 2124 21

Stats. 1978, ch. 797, p. 2563 32

Stats. 1992, ch. 1089, § 1 7

Stats. 2004, ch. 385, § 2 8

Veh. Code, § 11713 ..... 23, 32

Veh. Code, § 11713, subd. (a) 22

Veh. Code, § 34600 21

REGULATIONS

Cal. Code Regs., tit. 10, § 2695.1 et seq. 29

Cal. Code Regs., tit. 10, § 2695.180, subd. (b) 2

Cal. Code Regs., tit. 10, § 2695.183 ..... 2, 3, 13

Cal. Code Regs., tit. 10, § 2695.183, subd. (i) 15

Cal. Code Regs., tit. 10, § 2695.183, subd. (g) 15

Cal. Code Regs., tit. 10, § 2695.183, subd. (j) 3, 15

Cal. Code Regs., tit. 13, § 262.03 23

OTHER AUTHORITIES

Bonfield, *State Administrative Policy Formulation and the Choice of Lawmaking Methodology* (1990) 42 Admin. L. Rev. 121 34

Snyder, *"Preserving" Civil RICO: How the Model Unfair Trade Practices Act Affects RICO's Private Right of Action under the McCarran-Ferguson Act* (2011) 86 Notre Dame L.Rev. 1767 5

Webster's Collegiate Thesaurus (1976) 24

ISSUES PRESENTED

As stated in the petition for review, this case presents the following issue: "Did the Commissioner act within his statutory authority in promulgating regulations designed to prevent insurers from providing homeowners purchasing or renewing insurance policies with 'replacement cost' estimates that the Commissioner reasonably concluded would be incomplete and potentially misleading?"

More specifically, the Court's order granting review directs the parties to address "whether the Commissioner has the statutory authority to promulgate a regulation specifying that the communication of a replacement cost estimate which omits one or more of the components in subdivisions (a)-(e) of section 2695.183 of title 10 of the California Code of Regulations is a 'misleading' statement with respect to the business of insurance. (Cal. Code of Regs., tit. 10, § 2695.183, subd. (j).)"

INTRODUCTION

Catastrophic wildfires, which put lives at risk and destroy thousands of homes, are a recurring problem in California. So too is the problem of unanticipated underinsurance. Over the past two decades, after every major wildfire, lawmakers and the Commissioner have been inundated with complaints. Post-fire, homeowners tell a familiar story. They reasonably relied on the expertise of their insurers to provide them with estimates for what it would cost to rebuild their homes—often their single most valuable asset—and used those estimates to select coverage limits. After the loss, however, they discovered that the estimates did not include necessary expenses, such as the cost to replace the foundation, or take into account the features and circumstances of their homes that substantially affect the cost of rebuilding. These homeowners learned too late that their

"replacement cost" policies were insufficient to allow them to replace their homes.

Together, the Legislature and the Commissioner have worked to understand the problem of unintended underinsurance and taken various steps to remedy it. The Legislature has, for example, mandated that insurers provide customers with standardized disclosures that define the available types of replacement cost insurance, warn of the risks of underinsurance, and encourage homeowners to obtain current estimates of the cost to rebuild. (Ins. Code, §§ 10101, 10102.)[1] And, relevant to this case, the Commissioner promulgated California Code of Regulations, title 10, section 2695.183—the replacement cost regulation— exercising his authority "as conditions warrant" to "promulgate reasonable rules and regulations, and amendments and additions thereto, as are necessary to administer" Article 6.5 of the Insurance Code, the Unfair Insurance Practices Act (§§ 790-790.15). (§ 790.10.)

The Commissioner's replacement cost regulation is designed to prevent homeowners from being misled into underinsuring their homes by incomplete estimates that fail to consider all the costs reasonably expected to be incurred in rebuilding. The regulation requires the insurer to consider and include a list of minimum costs and factors, such as demolition and debris removal, type of foundation, and geographic location; base the estimate on what it will actually cost to rebuild; and take steps annually to

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[1] All statutory references are to the Insurance Code unless otherwise noted. As used in this brief, "insurer" has the same meaning as "licensee" in section 2695.180, subdivision (b) of title 10 of the California Code of Regulations—specifically, any person or entity holding a license or certificate of authority issued by the Department of Insurance, a broker-agent, or any other entity for whom the Commissioner's consent is required before transacting business in the State of California or with California residents.

ensure that estimating tools reflect current conditions. (Cal. Code Regs., tit. 10 (Regs.), § 2695.183, subds. (a)-(e).) The regulation further provides that failing to follow these steps in providing an estimate of replacement cost constitutes a misleading statement, which is a violation of the Unfair Insurance Practices Act. (Regs., § 2695.183, subd. (j); see § 790.03, subd. (b) [prohibiting, among other things, "any statement . . . which is untrue, deceptive, or misleading, and which is known, or which by the exercise of reasonable care should be known, to be untrue, deceptive, or misleading"].) The regulation thus helps to ensure that when homeowners request replacement cost estimates to inform their insurance decisions—as the standardized disclosures encourage them to do—the information they receive from insurers is complete and not misleading.

The court of appeal struck down the replacement cost regulation, concluding that the Commissioner had exceeded his statutory authority in promulgating it, and that the existence of the Commissioner's other statutory powers, such as his power to institute enforcement proceedings, limits his rulemaking powers in this area. (Opinion (Opn.) 23-25.) In so doing, the court failed to properly apply the rules of statutory construction and to give effect to the Legislature's intent that the Commissioner, exercising his expert judgment, should have broad, quasi-legislative rulemaking authority to act without delay or the need for specific legislative direction to protect consumers, create a level and well-defined playing field for the insurance industry, and fill the statute's gaps. This Court should reverse the court of appeal's decision, confirm the Commissioner's broad rulemaking authority, and uphold the replacement cost regulation.

BACKGROUND

I. THE INSURANCE CODE AND THE COMMISSIONER

"All insurance in this State is governed by the provisions of [the Insurance C]ode." (§ 41.) In addition to its general provisions (§§ 1-48), the Insurance Code consists of five divisions setting out general rules governing insurance (Division 1, §§ 100-1879.8) and addressing classes of insurance, including residential property insurance (Division 2, §§ 1880-12880.5); the powers and duties of the Commissioner (Division 3, §§ 12900-13813); affordable housing entities' pooling of self-insured claims or losses (Division 4, §§ 13900-13907); and insurance adjusters (Division 5, §§ 14000-16032). As set out generally in Division 3, "[t]he commissioner shall perform all duties imposed upon him or her by the provisions of this code and other laws regulating the business of insurance in this state, and shall enforce the execution of those provisions and laws." (§ 12921, subd. (a).)

Among the Commissioner's duties is the responsibility to ensure that the purposes of the code's Unfair Insurances Practices Act, Division 1, Part 2, chapter 1, article 6.5, sections 790-790.15, are carried out. (See §§ 790.04, 790.05, 790.06, 790.10.) Enacted in 1959, the Unfair Practices Act codified certain provisions of the Uniform Fair Trade Practices Model Act developed by the National Association of Insurance Commissioners following Congress's enactment of the McCarran-Ferguson Act (15 U.S.C. § 1011 et seq.). (§ 790.) The McCarran-Ferguson Act declared the business of insurance to be a subject of state regulation and exempted state law enacted for the purpose of insurance regulation from federal preemption. (15 U.S.C. §§ 1011, 1012; see *U.S. Dept. of Treasury v. Fabe* (1993) 508 U.S. 491, 499-500 [discussing history of McCarran-Ferguson Act].) The Model Act closely paralleled the Federal Trade Commission

Act (15 U.S.C. § 41 et seq.) to avoid potential federal preemption of state regulation of unfair or deceptive insurance trade practices. (Snyder, *"Preserving" Civil RICO: How the Model Unfair Trade Practices Act Affects RICO's Private Right of Action under the McCarran-Ferguson Act* (2011) 86 Notre Dame L.Rev. 1767, 1777.) The purpose of the Unfair Insurance Practices Act is to "regulate trade practices in the business of insurance in accordance with the intent of Congress as expressed in the [McCarran-Ferguson Act], by defining, or providing for the determination of, all such practices in this State which constitute unfair methods of competition or unfair or deceptive acts or practices and by prohibiting the trade practices so defined or determined." (§ 790.)

Section 790.03 defines and prohibits certain acts "as unfair methods of competition and unfair and deceptive acts or practices in the business of insurance." For example, it specifically prohibits "[m]aking any false entry in any book, report, or statement of any insurer with intent to deceive any agent or examiner lawfully appointed to examine into its condition or into any of its affairs . . . ." (§ 790.03, subd. (e).) More broadly, section 790.03 also prohibits

> making or disseminating . . . any statement containing any assertion, representation, or statement with respect to the business of insurance or with respect to any person in the conduct of his or her insurance business, which is untrue, deceptive, or misleading, and which is known, or which by the exercise of reasonable care should be known, to be untrue, deceptive, or misleading.

(§ 790.03, subd. (b).)

The Unfair Insurance Practices Act provides the Commissioner with certain investigative and enforcement tools. Section 790.04 empowers the Commissioner to examine and investigate the business affairs of any person to determine compliance with the Act. The Commissioner may bring

enforcement actions under section 790.05 against any person alleged to have engaged in a prohibited act or practice defined in section 790.03. Upon a determination that the person has engaged in prohibited conduct, the Commissioner may assess monetary penalties under section 790.035 and may enjoin the conduct. Further, section 790.06 permits the Commissioner to initiate an administrative proceeding against a person suspected of engaging in any act or practice that is unfair or deceptive, but is not defined in section 790.03. Section 790.06 provides that after an administrative hearing, if the Commissioner determines the act or practice is unfair or deceptive, he must issue a report so declaring. (§ 790.06, subd. (a).) Under section 790.06, the Commissioner cannot directly assess monetary penalties or order the conduct to cease as he can when proceeding under section 790.05. The Commissioner must instead apply to the superior court for an injunction. (§ 790.06, subd. (b).)

In addition, section 790.10 vests the Commissioner with quasi-legislative rulemaking authority.[2] Section 790.10 provides that "[t]he commissioner shall, from time to time as conditions warrant, after notice and public hearing, promulgate reasonable rules and regulations, and amendments and additions thereto, as are necessary to administer this article." In delegating rulemaking authority to the Commissioner, the Legislature intended for him to clarify and fill in the details of the broad provisions of the prohibited acts or practices defined in section 790.03, "'for the benefit of the public without having to wait for the Legislature to

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[2] The Legislature commonly grants agencies both adjudicatory and rulemaking authority. (See, e.g., *Agricultural Labor Relations Bd. v. Superior Court* (1976) 16 Cal.3d 392, 399-400 [Board has enforcement powers under Labor Code, § 1160 et seq. and rulemaking authority under Labor Code, § 1144]; see also §§ 779.21-779.24 [granting Commissioner both adjudicatory and rulemaking authority with respect to credit life and disability insurance].)

act at a later date.'" (Opn. 28-29, quoting Assem. Com. on Finance and Insurance, summary of Assem. Bill No. 1353 (1971 Reg. Sess.) p. 1.)

II. THE CHRONIC PROBLEM OF UNINTENDED UNDERINSURANCE

The Legislature and the Commissioner have worked for over two decades to address the problem of unintended underinsurance.

The severity of the underinsurance problem first became evident after the 1991 Oakland hills fire, which destroyed more than 3,000 homes. Facing what had become essentially empty lots, homeowners turned to their insurers and were shocked to learn that their "replacement cost" policies were not sufficient to cover the actual cost of rebuilding. (Appellant's Motion for Judicial Notice (MJN), Ex. A, pp. 2-3 [Assem. Com. on Insurance, Bill Analysis of Sen. Bill No. 1854 (1991-1992 Reg. Sess.) as amended Aug. 11, 1992].) Many homeowners complained that misleading sales and marketing tactics by insurers led them to believe they were adequately insured to completely rebuild following a catastrophic event, when in fact their coverage was substantially inadequate. (*Id.*, at p. 3; MJN, Ex. B, p. 5 [Sen. Rules Com., Off. of Sen. Floor Analyses, analysis of Sen. Bill No. 1854 (1991-1992 Reg. Sess.) as amended Aug. 11, 1992].)

In response, the Legislature added to Division 2 of the Insurance Code a set of new provisions referred to as the California Residential Property Insurance Disclosure Act (Disclosure Act). (§§ 10101-10107.) These new provisions required that insurers provide homeowners with a standard disclosure form that encouraged homeowners to read their policies, and provided certain general information related to property insurance, such as the meaning and types of "replacement cost coverage." (Stats. 1992, ch. 1089, § 1.) The Disclosure Act was intended to ensure that homeowners were provided with "full and accurate information" to make informed decisions about coverage. (MJN, Ex. A, p. 2 [Assem. Com. on Insurance,

Bill Analysis of Sen. Bill No. 1854 (1991-1992 Reg. Sess.) as amended Aug. 11, 1992].)

The problem of homeowners finding themselves unexpectedly underinsured in the wake of catastrophic fires persisted, as evidenced by the complaints that followed the 2003 wildfires in southern California. (Rulemaking File (RF [volume]:[page]) IV:1081; V:1320-1322; VI:1431, 1524.) The disaster brought to light a related problem—that underinsurance could result from cost increases occurring between the time the home is destroyed and the time that rebuilding can commence. In response, the Legislature enacted section 2051.5, which was designed to provide homeowners adequate time to rebuild or repair and to account for the fact that the cost at the time of rebuilding may be higher than at the time of the actual loss. (MJN, Ex. C, pp. 9-13 [Sen. Com. on Insurance, Bill Analysis of Assem. Bill No. 2199 (2003-2004 Reg. Sess.) as amended May 17, 2004].) The Legislature also amended section 10103 of the Disclosure Act to require the declarations page of every policy to state that the limit of liability is based on an estimate of the cost to rebuild the insured home. (Stats. 2004, ch. 385, § 2; § 10103, subd. (a)(2).)

The Senate Banking, Finance and Insurance Committee also identified underinsurance as a significant, continuing problem. (MJN, Ex. D, pp. 16-17 [Sen. Banking, Finance and Insurance Com., Bill Analysis of Sen. Bill No. 2 (2005-2006 Reg. Sess.) as amended Mar. 29, 2005].) The Committee noted that homeowners' lack of knowledge about construction costs, and improperly trained insurance industry personnel estimating replacement costs, contributed to underinsurance. The Committee declared that it is "critical that initial policy limits be set accurately and updated regularly." (*Id.* at p. 176, original underscoring.) The Committee noted that the Commissioner (the Department of Insurance) had also held hearings "to educate the public and to determine if market conduct exams needed to be

commenced," and that in these hearings, "underinsurance was a major issue." (*Ibid.*)

The Senate Committee's hearings led the Legislature in 2005 to enact section 1749.85, designed in part to educate those members of the industry who interact with homeowners "in proper methods of estimating the replacement value of structures, and of explaining various levels of coverage under a homeowners' insurance policy." (§ 1749.85, subd. (a).) The section required the Department of Insurance's curriculum committee to make recommendations to the Commissioner on such methods by 2006. (*Ibid.*; see MJN, Ex. E, pp. 24-26 [Sen. Rules Com., Third Reading of Sen. Bill No. 2 (2005-2006 Reg. Sess.) as amended August 30, 2005].)[3]

In 2007 and 2008, large wildfires again struck the State. (See, e.g., RF V:1301-VI:1387 [news articles documenting fire].) Once again, the Commissioner received numerous complaints from affected homeowners who had realized too late that they were seriously underinsured. (See, e.g., RF II:276-292 [summary of insurer actions contributing to underinsurance in Lake Tahoe and San Diego regions].) For example, a Lake Tahoe resident affected by the 2007 Angora fire reported that she was shocked to learn that she was "grossly under-insured" on two residences. (RF II:432, 436.) She was "led to believe" by her agent that her level of insurance was "'in the ballpark'" when in fact one home was forty percent underinsured, and the other fifty percent underinsured. (RF II:432, 436.) Another fire victim relied on his agent's expertise to estimate replacement costs, and the agent's assurance that the limits would be adequate to rebuild his home, only to find out that the agent estimated the replacement cost based only on

[3] Pursuant to section 1749.1, the Commissioner appoints a curriculum board to develop and recommend pre-licensing and continuing education courses of study for insurance licensees.

his prior experience with construction costs and neglected to include many necessary expenses. (RF II:460, 481, 484.) As a result of his reliance, the homeowner was almost fifty percent underinsured. (RF II:481.)

These stories are typical. The vast majority of the underinsurance complaints were from homeowners who believed they had sufficient coverage, but learned after a major fire that the replacement cost estimates that they relied on to set policy limits did not consider costs for such routine and necessary steps as replacing foundations, debris removal, demolition, overhead and profit, engineering reports and architect plans. (RF V:1173.) Many homeowners reported that they had relied on the expertise of their insurers, insurance agents and brokers to prepare the replacement cost estimates and had purchased policies with limits based on those estimates. (See, e.g., RF I:79-80, 124-125, 139, 217; II:351, 421, 503; III:584, 720-721, 822, 826; IV:961.) Further, some homeowners reported that when they had asked to confirm the sufficiency of their insurance coverage, their agents or brokers reassured them that their policy limits were sufficient to rebuild. (See, e.g., RF I:168, 200; II:436, 484; III:790-792; IV:872, 906.) Other homeowners asked to increase coverage, but were dissuaded by their agents from doing so based on assurances that their existing coverage was sufficient. (See, e.g., RF III:582, 831.) Some also reported that their insurers had failed properly to account for the particular characteristics of their homes, leading to underestimates. (See, e.g., RF I:55-56, 166-176, 190-210; III:582-583, 643, 672, 743, 810; IV:869, 904-915, 1024-1026.) In many cases, there was a lack of documentation establishing how the insurer determined the replacement cost estimate. (See RF II:276-292.) And these problems were widespread; in a June 2008 survey of homeowners conducted by a nonprofit consumer advocate group, 74% of the respondents stated that the limits were not sufficient to cover their post-fire costs of rebuilding. (RF IV:1059-1062 [United Policyholders' survey].)

Pursuant to his investigative authority under section 790.04 of the Unfair Practices Act, the Commissioner conducted examinations of four insurers that, together, account for fifty percent of the homeowners' insurance policies issued in California. (RF IV:1027-1030; see § 790.04 [examination power].) The resulting examination report determined that despite insurers' attempts to place the responsibility to select appropriate coverage limits on homeowners, homeowners in fact relied on insurers' estimates of replacement cost to determine the amount of coverage to buy, and, as a result of insurers' failure to include all reasonable and necessary expenses in their estimates, a large number of homeowners were underinsured. (RF IV:1030.)[4] The examination report concluded that "the insurers' processes and tools for estimating replacement cost are inadequate for formulating a realistic dwelling rebuilding cost" and their use "result[s] in insureds who believe they are adequately covered for the full reconstruction cost of their dwelling . . . ." (*Ibid.*)

In 2010, the Commissioner and the Legislature continued to work on the problem of underinsurance and its relationship to replacement cost estimates.

In April 2010, a bill was introduced in the California State Assembly to amend the Disclosure Act—Assembly Bill No. 2022 (2009-2010 Reg. Sess.). The amendments were designed to reflect changing market conditions and to "help homeowners in reviewing the adequacy of their insurance coverage in the event of a catastrophe such as a wildfire." (MJN,

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[4] As part of these examinations, Department of Insurance staff reviewed a total of 188 policies on which a loss had been claimed. (RF IV:1029.) The limitation of liability on the structure was lower than the cost to rebuild in 102 cases. (*Ibid.*) Factoring in any extended replacement cost coverage that applied, 72 cases were still be underinsured for the total loss. (*Ibid.*)

Ex. F, p. 29 [Sen. Banking, Finance and Insurance Com., Bill Analysis of Assem. Bill No. 2022 (2009-2010 Reg. Sess.) as amended May 11, 2010].) The amendments revised the standard disclosure form to highlight ways for homeowners to protect themselves against unintended underinsurance. (*Id.* at p. 28.) Among other things, the amended disclosure form alerts homeowners that "[t]he coverage limit on the dwelling structure should be high enough so you can rebuild your home if it is completely destroyed[,]" and encourages homeowners to obtain estimates of replacement cost from insurers. (§ 10102, original underscoring.) Assembly Bill No. 2022 became law on September 30, 2010.

At roughly the same time that Assembly Bill No. 2022 was introduced, the Commissioner proposed new regulations to address underinsurance. (RF IV:1101-1109.) The Commissioner's Notice of Proposed Action observed that wildfires had destroyed "a high number of residential structures[,]" causing a substantial number of homeowners to turn to their insurers for help; only then did "they learn[ ] that the replacement value estimates made in setting coverage limits for their homes w[ere] too low, causing underinsurance issues to arise during efforts to rebuild or replace their residences." (RF IV:1103.) The Commissioner explained that the proposed regulation would, among other things, "set out requirements applicable to replacement value and replacement cost estimates to create a more consistent, comprehensive and accurate replacement cost calculation . . . ." (RF IV:1101.)

The Commissioner conducted a public hearing, accepted and responded to public comments, made changes to the proposed regulation in response to comments, and issued a Final Statement of Reasons for the replacement cost regulation on November 17, 2010. (RF V:1111-1164, 1165-1257, 1258-1273.) The Office of Administrative Law approved the regulation pursuant to Government Code section 11349.3 on December 29,

2010. (RF I:2.)[5] On June 26, 2011, the replacement cost regulation became effective. (*Ibid.*)

STATEMENT OF THE CASE

I. THE REPLACEMENT COST REGULATION

The replacement cost regulation, California Code of Regulations, title 10, section 2695.183 provides in relevant part:

> No licensee shall communicate an estimate of replacement cost to an applicant or insured in connection with an application for or renewal of a homeowners' insurance policy that provides coverage on a replacement cost basis, unless the requirements and standards set forth in subdivisions (a) through (e) below are met: . . . .

Subdivision (a) provides that "[t]he estimate of replacement cost shall include the expenses that would reasonably be incurred to rebuild the insured structure(s) in its entirety," and must include at least the following five items: cost of labor; overhead and profit; cost of demolition and debris removal; cost of permits and architect's plans; and "[c]onsideration of components and features of the insured structure[.]" (Regs., § 2695.183, subd. (a)(1)-(5).) Such components and features include eleven specific items relevant to a typical rebuild, which include type of foundation; type of frame; roofing and siding materials; size of living space; and the structure's geographic location. (Regs., § 2695.183, subd. (a)(5)(A)-(K).) These components reflect not only the Department of Insurance's expertise and experience, but also its extensive investigation and research into the costs of rebuilding and consideration of comments from the industry and other affected parties.

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[5] The specifics of the final replacement cost regulation are discussed in greater detail in the next section.

Subdivision (b) provides that the estimate must "tak[e] into account the cost to reconstruct the single property being evaluated, as compared to the cost to build multiple, or tract, dwellings"—meaning that it must not include discounts that might be available to developers but not to individual homeowners. Moreover, under subdivision (c), the estimate cannot be based on the resale value of the land, or on the amount or outstanding balance of any loan, and under subdivision (d), it "shall not include a deduction for physical depreciation."

Subdivision (e) further provides that, at least annually, the insurer must "take reasonable steps to verify that the sources and methods used to generate the estimate of replacement cost are kept current to reflect changes in the costs of reconstruction and rebuilding, including changes in labor, building materials, and supplies, based upon the geographic location of the insured structure[,]" and the estimate "shall be created using such reasonably current sources and methods."

As the Commissioner noted in response to comments, the purpose of the regulation is to ensure that "if a licensee communicates an estimate of replacement cost, the estimate must be complete and contain all the components that a reasonable consumer would assume to be part of a complete rebuild of the structure." (RF VI:1419.) As evidenced by post-fire homeowner complaints, "[t]o do otherwise, creates consumer confusion and is misleading." (*Ibid.*) The regulation is designed to "end any ambiguity" about "what components are included in making the [replacement cost] estimate." (RF VI:1430.)

Consistent with the Commissioner's view of the need for and purpose of the regulation, the regulation provides that if an insurer communicates an estimate of replacement costs that does not comport with subdivisions (a) through (e), this "constitutes making a statement with respect to the business of insurance which is misleading and which by the exercise of