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No. S226529

IN THE SUPREME COURT OF CALIFORNIA

ASSOCIATION OF CALIFORNIA INSURANCE COMPANIES AND
PERSONAL INSURANCE FEDERATION OF CALIFORNIA,
Plaintiffs and Respondents,

v.

DAVE JONES IN HIS CAPACITY AS COMMISSIONER OF THE CALIFORNIA
DEPARTMENT OF INSURANCE,

Defendant and Appellant.

After A Decision By The Court Of Appeal
Second Appellate District, Case No. B248622
Los Angeles County Superior Court Case No. BC463124
The Honorable Gregory W. Alarcon, Judge Presiding

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I. QUESTION PRESENTED

This Court granted review of the following question: “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 calculated would be incomplete and potentially misleading?”

The Court was also interested in “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 § 2695.183 of tit. 10 of the Cal. Code Regs. is a ‘misleading’ statement with respect to the business of insurance.”¹

II. INTRODUCTION

The Court of Appeal and the trial court both correctly held that the Commissioner’s attempt to promulgate a regulation defining new unfair insurance practices exceeds the power granted to the Commissioner by the Legislature in the Unfair Insurance Practices Act (the “UIPA”). (Ins. Code, § 790 et seq.) Title 10, Section 2695.183 of the California Code of

¹ An Addendum excerpting the text of the relevant statutory and regulatory provisions is attached hereto.

Regulations (the “Replacement Cost Regulation”² or the “Regulation”) seeks to impose detailed and cumbersome new content and format requirements on insurers in providing their insureds or prospective insureds with estimates of replacement costs for their homes. The effect of the Replacement Cost Regulation is to deem insurance practices unfair or deceptive, expanding the legislatively-prescribed list of unfair or deceptive acts or practices spelled out in the UIPA beyond the authority granted to the Commissioner by the UIPA. It also sidesteps the more limited, case-by-case process the Legislature specified in the UIPA for the Commissioner to address particular instances of allegedly unfair or deceptive practices not covered by the detailed and very specific list of “[p]rohibited acts” delineated by the Legislature. (Cal. Code Regs., tit. 10, § 2695.183.) There is simply no statutory authority for the Commissioner to do this.

To be valid, a regulation must be encompassed within the scope of authority conferred by the Legislature, consistent with the terms of the governing statute, and reasonably necessary. (Gov. Code §§ 11342.1 & 11342.2.) The challenged Regulation here is not valid: as the plain language of the UIPA makes clear, the Commissioner is not authorized to define new categories of unfair insurance practices or “[p]rohibited acts.”

² The Commissioner has referred to § 2695.183 as the “Replacement Cost Regulation” in his Opening Brief on the Merits. (Opening Brief on the Merits (“OBM”) at p. 2.)

The UIPA reserves the authority to “define” new unfair insurance practices to the Legislature. It only authorizes the Commissioner to “determine,” with the concurrence of a superior court judge and on a case-by-case basis, whether particular instances of conduct alleged to be unfair should be treated as such for purposes of the UIPA. The statute does not authorize the Commissioner to unilaterally do so in an across-the-board quasi-legislative fashion that effectively adds new subdivisions and “[p]rohibited acts” to those set forth and defined by the Legislature in section 790.03.

The Commissioner not only concedes, but trumpets, the fact that the Regulation does just that, claiming that “it is questionable whether the adjudicatory process could ever result in a set of required replacement cost estimate components that are as clear and comprehensive as provided in the [Regulation].” (OBM at pp. 35-36.) But the UIPA does not provide the authority for the Commissioner to take this action.

The Legislature not only prescribed a very detailed, specific list of unfair or deceptive practices and a method for the Commissioner to address additional instances of allegedly novel unfair or deceptive practices that might fall outside that list—in sections 790.03 and 790.06, respectively—but also clearly delineated the scope of the Commissioner’s powers and authority in a manner that the Commissioner has exceeded by promulgating the Replacement Cost Regulation.

Moreover, the unlawfulness of the Commissioner's unwarranted attempt to expand the scope of his authority is also confirmed by the terms of section 790.10, which authorize the Commissioner only to "administer" the statute.

The Regulation is either pointless or an unlawful expansion of the Commissioner's power. If the Regulation does not constitute an expansion of, or addition to, the detailed list of unfair practices proscribed by the Legislature in section 790.03, then it would be pointless and unnecessary. Any unfair practices covered by section 790.03 can already be addressed by the Commissioner without need for the Regulation through enforcement proceedings authorized by section 790.05. And if the Regulation does define new categories of unfair or deceptive insurance practices, then it represents an improper attempt by the Commissioner to sidestep the method provided by the Legislature for addressing novel instances of allegedly unfair or deceptive practices not clearly covered by section 790.03's legislatively-prescribed list of "[p]rohibited acts"—namely, section 790.06's case-by-case order-to-show-cause proceedings before a superior court. The Commissioner's extra-statutory attempt to arrogate more powers than allowed by the Legislature should be disapproved by this Court, as it was by the courts below.

The well-established canon of avoidance of constitutional doubts also militates against the Commissioner's expansive reading of his

authority under the UIPA. Such a reading would raise serious constitutional doubts, including under the First Amendment to the United States Constitution and under article I, section 2 of the California Constitution, by both impermissibly restricting some speech and unconstitutionally compelling other speech.

Public policy considerations also do not support the Commissioner's attempted overreach. The Commissioner has claimed that the Replacement Cost Regulation was necessary to guard against underinsurance. Of the 40,000 claims that resulted from the 2007 wildfires, "the department received only 70 complaints related to underinsurance," amounting to complaints on only 0.175% of filed claims. (Administrative Record ("AR") 1254.) Assuming, arguendo, that all these complaints had merit, the statutory scheme already provides the Commissioner with the tools needed to address any perceived instances of unfair practices engaged in by insurance companies, again through sections 790.05 and 790.06 (among other provisions).

For these reasons, set forth more fully below, this Court should affirm the Court of Appeal's (and trial court's) judgment invalidating the Commissioner's challenged Replacement Cost Regulation as exceeding his authority under the UIPA.

III. FACTUAL AND PROCEDURAL HISTORY

A. The Statutory Scheme

The Unfair Insurance Practices Act (“UIPA”) begins with section 790, which provides that “[t]he purpose of this article is to regulate trade practices in the business of insurance . . . 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.” (Ins. Code § 790,³ italics added.) Section 790 draws a distinction between unfair practices that are “defined” in the statute and particular instances of those that may be “determined” to be such (on a case-by-case basis).

Section 790.03 defines what constitute “unfair methods of competition or unfair or deceptive acts or practices” under the UIPA. It states that “[t]he following *are hereby defined* as unfair methods of competition and unfair and deceptive acts or practices in the business of insurance,” and provides a detailed, lengthy list of specific “[p]rohibited acts,” many of which in turn have detailed sub-parts. (§ 790.03.) Section 790.03 contains subdivisions (a) through (j), several of which have their own numerous subparts. (See generally § 790.03; *see also id.* at subd. (h) [listing 16 separate subparts].)

³ All references are to the Insurance Code unless indicated otherwise.

This detailed list includes specific prohibitions on failing to acknowledge and act reasonably promptly upon claims-related communications with insureds (§ 790.03, subd. (h)(2)), advising a claimant not to obtain the services of an attorney (*id.* at subd. (h)(14)), misleading a claimant as to the applicable statute of limitations (*id.* at subd. (h)(15)), and cancelling or refusing to renew a policy in violation of another section of the Insurance Code (*id.* at subd. (i)). By enacting such a meticulously detailed list, the Legislature made clear that in this particular statute, no need exists nor would it be appropriate for the Commissioner himself to add to or modify this legislatively-prescribed list in the quasi-legislative fashion he has with his Replacement Cost Regulation.

Subdivision (b) of section 790.03 defines as an unfair practice “Making or disseminating or causing to be made or disseminated before the public in this state, in any newspaper or other publication, or any advertising device, or by public outcry or proclamation, or in any other manner or means whatsoever, 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.” (*Id.* at subd. (b).) It is this section on which the Commissioner relies in promulgating the Replacement Cost Regulation.

The UIPA also provides enforcement mechanisms to redress violations of section 790.03. It provides for civil penalties (§ 790.035), authorizes the Commissioner to “examine and investigate into the affairs of every person engaged in the business of insurance in the State in order to determine whether such person has been or is engaged in any unfair method of competition or in any unfair or deceptive act or practice” (§ 790.04), and grants the Commissioner authority to initiate enforcement proceedings to remedy the commission of “[p]rohibited acts” under section 790.03 (§ 790.05).

Complementing section 790.03, section 790.06 provides a procedure, anticipated by section 790, for “determining,” on a case-by-case basis and with the concurrence of a superior court judge, whether particular conduct constitutes an instance of a novel unfair or deceptive practice not covered by section 790.03’s detailed list. Specifically, section 790.06 provides that:

Whenever the commissioner shall have reason to believe that any person engaged in the business of insurance is engaging in this state in any method of competition or in any act or practice in the conduct of the business that is not defined in section 790.03, and that the method is unfair or that the act or practice is unfair or deceptive . . . he or she may issue and serve upon that person an order to show cause . . . for the purpose of *determining* whether the alleged methods, acts or practices or any of them should be declared to be unfair or deceptive within the meaning of this article.

(§ 790.06, subd. (a), italics added.)

This section provides the Commissioner with a mechanism to address any unfair practices that do not fall squarely within the detailed list of “[p]rohibited acts” proscribed by the Legislature in section 790.03 without creating an entirely new category of prohibited acts. The authority granted by section 790.06 is also clearly circumscribed by the language of that section, which limits the determination of unfair practices to acts that “should be declared to be unfair or deceptive *within the meaning of this article.*” (*Ibid.*, italics added.)

Finally, section 790.10 provides that “[t]he [C]ommissioner 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.” (§ 790.10, italics added.)

The statute’s terms and structure clearly delineate the bounds of the Commissioner’s authority. The Legislature has reserved to itself the authority to define unfair or deceptive insurance practices. The Commissioner is not authorized to create, in quasi-legislative fashion, whole new categories of unfair or deceptive practices; only the Legislature may add to or modify section 790.03’s highly specific and lengthy list of “[p]rohibited acts” in that manner. (Cal. Const., art. III, § 3 [“The powers of state government are legislative, executive, and judicial. Persons charged with the exercise of one power may not exercise either of the

others except as permitted by this Constitution.”].) While the Commissioner may investigate instances of novel practices not specifically enumerated in section 790.03 that he contends should also be considered unfair or deceptive, and while he also has the authority to seek relief from a superior court, on a case-by-case basis, under section 790.06, the Commissioner may not add to or modify section 790.03’s legislatively-prescribed list of prohibited acts. The Commissioner is limited, in other words, to exercising only the authority that has been conferred on him to “administer” the UIPA.

B. The Regulation At Issue

The Replacement Cost Regulation, codified at California Code of Regulations, Title 10, section 2695.183, imposes on all providers of homeowners’ insurance a single set of highly detailed content and format requirements for providing insureds and prospective insureds with estimates of the cost of replacing a house or other dwelling damaged by a natural disaster or other covered occurrence. The Regulation 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.” (Cal. Code Regs., tit. 10, § 2695.183.)

Subdivisions (a) through (e) of section 2695.183 set out the following “requirements and standards” for replacement cost estimates:

- (a) The estimate of replacement cost shall include the expenses that would reasonably be incurred to rebuild the insured structure(s) in its entirety, including at least the following:
- (1) Cost of labor, building materials and supplies;
 - (2) Overhead and profit;
 - (3) Cost of demolition and debris removal;
 - (4) Cost of permits and architect’s plans; and
 - (5) Consideration of components and features of the insured structure, including at least the following:
 - (A) Type of foundation;
 - (B) Type of frame;
 - (C) Roofing materials and type of roof;
 - (D) Siding materials and type of siding;
 - (E) Whether the structure is located on a slope;
 - (F) The square footage of the living space;
 - (G) Geographic location of property;
 - (H) Number of stories and any nonstandard wall heights;
 - (I) Materials used in, and generic types of, interior features and finishes, such as, where applicable, the type of heating and air conditioning system, walls, flooring, ceiling, fireplaces, kitchen and bath(s);
 - (J) Age of the structure or the year it was built; and
 - (K) Size and type of attached garage.

(*Id.* at subd. (a).)

Subdivisions (b) through (e) provide as follows:

- (b) The estimate of replacement cost shall be based on an estimate of the cost to rebuild or replace the structure taking into account the cost to reconstruct the single property being evaluated, as compared to the cost to build multiple, or tract, dwellings.

(c) The estimate of replacement cost shall not be based upon the resale value of the land, or upon the amount or outstanding balance of any loan.

(d) The estimate of replacement cost shall not include a deduction for physical depreciation.

(e) The licensee shall no less frequently than annually take responsible 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. The estimate of replacement cost shall be created using such reasonably current sources and methods.

(Id. at subds. (b)-(e).)

The Regulation continues in subdivision (g)(2)⁴ and makes explicit that an estimate, to be acceptable, must be broken out in four parts:

An estimate of replacement cost provided in connection with an application for or renewal of a homeowners' insurance policy that provides coverage on a replacement cost basis must itemize the projected cost for each element specified in paragraphs (a)(1) through (4), and shall identify the assumptions made for each of the components and features listed in paragraphs (a)(5), of this Section 2695.183.

(Id. at subd. (g).)

⁴ Subdivision (f) of the Replacement Cost Regulation makes the provisions of the Regulation binding on all persons or entities licensed by the Commissioner to act as insurance agents, brokers, or solicitors. Subdivision (g)(1) requires that replacement cost estimates be provided to applicants. Subdivision (h) requires that if replacement cost estimates are updated or revised, copies must be provided to the applicant. Subdivision (i) requires licensees to maintain certain records relating to replacement costs. Subdivisions (k) through (q) address how the Replacement Cost Regulation should be construed. (See Addendum.)

Subdivision (j) purports to render any estimate calculated or communicated in any manner different than that specified by the Commissioner's very detailed Replacement Cost Regulation to be misleading as a matter of law (i.e., an unfair or deceptive insurance practice). It provides:

To communicate an estimate of replacement value not comporting with subdivisions (a) through (e) of this Section 2695.183 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 constitutes making a statement with respect to the business of insurance which is misleading and which by the exercise of reasonable care should be known to be misleading, pursuant to Insurance Code section 790.03.

(Id. at subd. (j).)

Section 2695.183 repeatedly uses the phrase "estimate of replacement cost." That phrase is defined in section 2695.180(e) as follows:

'Estimate of replacement value' shall have the same meaning as 'estimate of replacement cost' and means any estimate, statement, calculation, approximation or opinion, whether expressed orally or in writing, regarding the projected replacement value of a particular structure or structures.

(Id. at subd. (e).)

The overall effect of the Replacement Cost Regulation is to create a long, detailed list of new purported unfair or deceptive insurance practices, none of which are enumerated in section 790.03. Subdivisions (a) through (e), even taken by themselves, thus create new standards, in quasi-

legislative fashion, governing the primary conduct of all licensees, including insurers, brokers, and agents (see Cal. Code Regs., tit. 10, §2695.180), in making replacement cost estimates, above and beyond the already specific and detailed list of standards and “[p]rohibited acts” prescribed by the Legislature in section 790.03. (Cal. Code Regs., tit. 10, § 2695.183, subs. (a)-(e).)

C. Procedural History

1. Rulemaking History

On April 2, 2010, the Commissioner gave notice of his proposal to adopt a series of regulations in response to complaints of underinsurance by homeowners following catastrophic wildfires. (AR 1101.) Included in the proposal was the original text of what would become the Regulation challenged here—section 2695.183, Standards for Estimates of Replacement Value. (AR 1077-1079.)

The Commissioner claimed that the Replacement Cost Regulation was necessary because in some instances homeowners had claimed that their insurance was inadequate to cover the cost of rebuilding their homes after a total loss caused by wildfires. The Commissioner supported this assertion by pointing to a scattering of unsubstantiated and unverified homeowner complaints. (AR 1081.)

Respondents—the Association of California Insurance Companies and the Personal Insurance Federation of California (“Respondents” or “the

Associations”)—submitted comments to the Commissioner, highlighting the Commissioner’s lack of authority to define new categories of unfair or deceptive insurance practices or to regulate homeowners’ insurance in the manner that section 2695.183 purports to. (AR 1185-1196, 1204-1207.) Numerous other parties submitted comments as well. (AR 1165-1233.)

The Commissioner promulgated revised regulations, but did not make any changes addressing the Associations’ concerns about the Commissioner’s lack of authority to promulgate section 2695.183. (AR 1258-1262, 1269-1273.)

Respondents submitted additional comments to the revised regulation, again asserting that the Commissioner lacked authority to adopt the proposed regulations. (AR 1239-1247, 1253-1257.)

The Commissioner did not address the Associations’ comments regarding his lack of authority in the final version of the Regulation (AR 12-15) and adopted it on November 16, 2010. (AR 5.) In adopting the Regulation, the Commissioner also prepared a Final Statement of Reasons in which he responded to comments submitted by interested parties, but again did not address comments regarding his lack of authority, except to cite sections 790.10 and 790.03. (AR 1388-1542.)

The Commissioner’s Replacement Cost Regulation became effective on June 27, 2011. (AR 2.)

2. Procedural History Of This Litigation

The Associations filed a complaint for declaratory relief pursuant to Government Code section 11350 on June 8, 2011, challenging the validity of the Regulation on three grounds:

1. The Commissioner has exceeded his authority under the UIPA by purporting to define new categories of unfair or deceptive insurance practices extending beyond those specifically proscribed by the Legislature in section 790.03 of the Insurance Code;
2. The Regulation unlawfully restricts insurers' underwriting of homeowners insurance, which the Commissioner has no authority to regulate; and
3. The Regulation contravenes the First Amendment to the United States Constitution.

(Joint Appendix ("JA") 1-17.)

On March 25, 2013, the trial court issued its statement of decision granting the relief sought by the Associations. (JA 292-297.) The trial court held that "[p]ursuant to Government Code section 11350, the regulation section 2695.183 is invalid [in] that the Commissioner exceeded his authority by attempting to define additional acts or practices as unfair or deceptive by regulation rather than by the procedure set out in section 790.06." (JA 296.) The court reasoned that "[b]y characterizing all estimates of replacement costs as misleading (save the one provided by section 2695.183) Defendant in exercising its authority under Cal. Ins. Code § 790.10, expands the meaning of something 'known' or which 'should be