Harvey Rosenfield, SBN 123082
Pamela Pressley, SBN 180362
Laura Antonini, SBN 271658
CONSUMER WATCHDOG
2701 Ocean Park Blvd., Suite 112
Santa Monica, CA 90405
Tel. (310) 392-0522
Fax (310) 392-8874

Arthur D. Levy, SBN 95659
445 Bush Street
Sixth Floor
San Francisco, California 94108
Tel. (415) 702-4550
Fax (415) 814-4080

Attorneys for Intervenor
CONSUMER WATCHDOG

BEFORE THE INSURANCE COMMISSIONER

OF THE STATE OF CALIFORNIA

In the Matter of: MERCURY INSURANCE COMPANY; MERCURY CASUALTY COMPANY; AND CALIFORNIA AUTOMOBILE INSURANCE COMPANY, Respondents.	CDI File No.: NC03027545 OAH No.: N2006040185 ALJ Assigned: Michael A. Scarlett **CONSUMER WATCHDOG'S POST-HEARING OPENING BRIEF**

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INTRODUCTION

The purpose of this administrative noncompliance action is to assess statutory penalties against Mercury Insurance Company, Mercury Casualty Company, and California Automobile Insurance Company (collectively, "Mercury") for charging illegal agent fees to California consumers purchasing Mercury automobile insurance policies from July 1, 1996 through 2006, in violation of Proposition 103.

The Insurance Code has long banned "unfairly discriminatory" rates. In 1980, the Commissioner issued an official Bulletin (No. 80-6) specifically putting all insurers on notice that all agent fees must be reported as premium and comply with the anti-discrimination statutes. With the passage of Proposition 103 in 1988, insurers' unfairly discriminatory rating practices became subject to even more scrutiny. Declaring that "the existing laws inadequately protect consumers and allow insurers to charge excessive, unjustified and arbitrary rates," (Prop. 103, § 1 [Findings and Declaration]), the voters adopted the initiative to "protect consumers from arbitrary insurance rates and practices" and "ensure that insurance is fair, available, and affordable for all Californians." (Prop. 103 § 2 [Purpose].) Proposition 103 requires insurers to open their books and submit their rates and premiums to public evaluation and approval by the Commissioner (Ins. Code §§ 1861.01(c), 1861.05(b)). The Commissioner's regulations and rate filing instructions implementing these statutes expressly require disclosure of all fees charged by agents, which must be reported as premium in insurers' rate filings.

To circumvent regulation of agent fees and the downward pressure on rates under Proposition 103, Mercury implemented a scheme purporting to allow independent agents to convert to "broker" status and charge "broker" fees on top of the premiums now regulated by the California Department of Insurance ("CDI" or "Department") as a financial incentive for the "broker" to sell Mercury insurance, at the consumer's expense. The Department put Mercury on notice in 2000 that its illegal "broker" rating system violated Proposition 103 and initiated this noncompliance proceeding in 2004 following the court's findings in *Krumme v. Mercury*, rendered after a full court trial and extensive post-trial briefing and upheld on appeal. (Ex. I-1 [Findings of Fact and Conclusions of Law After Trial, *Krumme v. Mercury Insurance Company et al.* (Super. Ct. S.F. County, Apr. 11, 2003, No. 313367) ("*Krumme* Findings")]; *Krumme v. Mercury Ins. Co.* (2004) 123 Cal. App. 4th 924.) The *Krumme* court concluded that Mercury's "broker" relationships were "functionally indistinguishable from the relationships

between Mercury and its agents" (*id.* at I9-10 (¶2)), and that these so-called "brokers" were acting as agents of Mercury in charging illegal "broker" fees (*id.* at I-13 (¶15)). The court found that "[t]he primary advantage to a producer to having a 'broker' agreement rather than agency agreement is the perceived ability to charge 'broker fees,' and there is no advantage to an agency agreement over a 'broker' agreement." (Ex. I-1 at I3 (¶13).)

In this noncompliance proceeding, the Administrative Law Judge ("ALJ") has held that the *Krumme* Findings are binding on Mercury under the collateral estoppel doctrine from July 1, 1996 through April 11, 2003. Thus, Mercury cannot challenge here that its "brokers" were actually agents during that time period and that they charged illegal "broker" fees.

The *Krumme* Findings and the evidence admitted in the record in this proceeding conclusively establish that Mercury never disclosed the agent fees to the Commissioner, nor did it obtain the Commissioner's approval for these fees. Further, testimony from Mercury and AIS witnesses establishes that Mercury insurance applicants were arbitrarily charged the illegal agent fees in varying amounts, resulting in illegal rate discrimination in violation of Insurance Code section 1861.05(a).[1]

Moreover, Consumer Watchdog submits that the evidence it presented in this proceeding amply establishes that Mercury *knowingly and intentionally* maintained its illegal "broker" system in order to evade Proposition 103's prior approval requirement and prohibition on unfairly discriminatory rates. The witness testimony and documentary evidence presented by Consumer Watchdog clearly show that, following the *Krumme* Findings through at least 2006, Mercury's "brokers" continued to be "functionally indistinguishable" from agents. For example, the evidence shows that from July 1, 1996 through 2006, Mercury required "brokers" to provide Mercury the exact same gatekeeping services – that is, field underwriting – as it had always required historically from its agents. Mercury gave "brokers" the same "binding authority" as agents. Mercury supervised and disciplined "brokers," just as it had always done with agents, for poor field underwriting though the "M19" system and, ultimately, by firing "brokers" who did not tow the Mercury line. There was no material detail in which Mercury treated "brokers" differently from agents during the period covered by this noncompliance proceeding.

[1] All further statutory references are to the Insurance Code unless otherwise designated.

For 20 years, Mercury enabled and promoted its sham "broker" system to avoid California's rate regulation laws and bilk consumers out of millions of dollars in illegal fees. Mercury's intransigence reveals its true intent was to maintain the benefit of its sham rating system in the form of increased sales and profits. Even after Mercury was put on notice by the Department in 2000 that its illegal "broker" fee system violated Proposition 103, Mercury continued business as usual. Once the *Krumme* Findings confirmed that Mercury's "broker" fees were illegal agent fees, Mercury continued to respond in a foot-dragging, perfunctory, and grudging manner, attempting to evade the court's orders and keep its core "broker" system intact to protect its revenue stream.

Mercury's willful corporate misconduct and years of abusing the system should not go unpunished. The ALJ and the Commissioner should send a clear message to Mercury, and other insurers tempted to engage in similar abuses, that the Department will not tolerate corporate misconduct and will mete out a just penalty, lest others be encouraged by a ruling letting Mercury off with little or no consequences.

BACKGROUND AND SUMMARY OF EVIDENCE

A. Mercury Maintained an All-Agent System Prior to Proposition 103.

From Mercury's founding in 1962 until just after the passage of Proposition 103, "Mercury sold its personal lines auto insurance in California only through agents whom Mercury formally appointed and for whom it filed 'Action Notices' with the [CDI] pursuant to Insurance Code section 1704(a)."[2] (Ex. I-1 at I2 (¶8); 4/19/13 RT at 11:1-13 [Norman Direct Examination].) Each of Mercury's appointed agents had an "Agency Contract" which authorized the agent to represent Mercury when selling an auto insurance policy and to receive commissions at an indicated rate. (Ex. I-1 at I2 – I3 (¶9); Ex. I-14 at I101 [Agency Contract].) The Agency Contract required agents to submit applications in compliance with the Mercury underwriting manual and gave agents the authority to bind insurance coverage at the point of sale, provided they followed the rules in the underwriting manual. (Ex. I-14 at I99 (¶¶3, 4, 6).) Under this all-agent system, Mercury never utilized brokers to market and sell its policies. (Ex. I-1 at I2;

[2] Insurance Code section 1704(a) prohibits an insurance agent from acting on an insurer's behalf unless the insurer has filed a formal agency appointment, or "Action Notice," with the California Department of Insurance.

4/17/13 RT at 63:8-9 [Wolak Cross-Examination] ["[P]rior to 1989 and prior to Proposition 103, Mercury had agent appointments only"].)

The hallmark of Mercury's all-agent system was "field underwriting." Mercury agents performed "field underwriting" services for Mercury, which required agents to understand the eligibility requirements set out in the underwriting manual, gather complete and accurate information from the customer, evaluate that information to properly rate the customer in accordance with Mercury's requirements, and submit the application in accordance with Mercury's application system rules. (4/15/13 RT at 198:24 - 200:13, 201:13 - 203:14, 207:10 - 208:21, 210:4-15 [Wolak Direct Examination].)

Field underwriting requires the agent to accurately "rate" the risk according to the Mercury manual, meaning to properly price the policy. (4/16/13 RT at 41:14 - 43:2, 44:21 - 46:6 [Wolak Direct Examination].) Improper rating would result in "not match[ing] the risk characteristic[,]" or underpricing the policy, and agency "loss ratio issues." (*Id.* at 41:14 - 42:15.)

To monitor agents' pricing performance, Mercury kept track of its agents' "loss ratios." (4/16/13 RT at 105:15 - 107:22 [Wolak Direct Examination]; Exs. I-116 - 119.) An agent's loss ratio is the ratio of losses to premiums generated, and is a metric of the profitability of the policies an agent places with Mercury. (4/15/13 RT at 191:6-8 [Wolak Direct Examination].) For example, a loss ratio of 55% means that the agent's policies resulted in only $55 being paid out per $100 in premium collected. The lower the loss ratio, the more profitable the agent's business for Mercury.

Mercury's commissions for agents were 15% initially and then varied upward or downward depending on the agency's loss ratio performance. (4/19/13 RT at 14:19 - 15:23 [Norman Direct Examination].) In general, an agency loss ratio below 55% would be rewarded with a commission percentage increase of 1%, and a loss ratio above 60% would be punished with a decrease of 1%. (4/15/13 RT at 186:12 - 192:9 [Wolak Direct Examination].) In addition, Mercury implemented "contingent commission" bonuses, which provided agents lump-sum profit-sharing bonuses. (*Id.* at 181:10 - 183:11, 192:7-9.)

After completing the field underwriting process, agents "bound coverage" at the point of sale. (4/15/12 RT at 179:18 - 181:4 [Wolak Direct Examination]; 4/16/13 RT at 7:21 - 8:5 [Wolak Direct

Examination].) Binding coverage enabled the customer to walk out of the insurance agency with temporary insurance coverage in place from Mercury. (4/16/13 RT at 8:6 - 9:8 [Wolak Direct Examination].)

The Mercury underwriting manual contained Mercury's eligibility requirements, underwriting rules, and binding procedures. (4/16/13 RT at 23:21 - 25:7 [Wolak Direct Examination].) In order to validly bind coverage, the agent had to follow these rules, requirements, and binding procedures. (*Id.* at 9:9-18.) Binding coverage in violation of the Mercury underwriting manual was beyond the agent's authority, and considered a "binding error." (*Id.* at 11:9-18, 12:11-20.) Mercury kept track of binding errors in the agency "short-term" ratio, which was the percentage of the agent's applications that were rejected by Mercury's underwriting department. (*Id.* at 100:24 - 102:23; Ex. I-118.) Binding errors were also reflected in the agent's loss ratio, which Mercury kept close tabs on. (*Id.* at 84:8 - 87:25; 4/15/13 RT at 105:15 - 107:22 [Wolak Direct Examination]; Exs. I-116 - 119.)

Mercury's Marketing Department field representatives periodically visited the agents. (4/16/13 RT at 38:5 - 39:15 [Wolak Direct Examination].) Part of the field representatives' duties was to discuss "M-19" reports with the agents. (*Id.* at 51:8-17; Ex. I-66.) Mercury's underwriting department issued M-19s for binding errors. (*Id.* at 51:18 - 53:10; Ex. I-67.) The field representatives also reported and reviewed agency loss ratio performance with the agents. (*Id.* at 41:14 - 43:2.)

The Marketing Department disciplined agents who violated Mercury's underwriting and binding rules. (Ex. I-1 at I5.) Discipline could include outright termination of the agent. (4/19/13 RT at 40:11-20 [Norman Direct Examination]; Ex. I-26 at I169-171.) Lesser measures included suspension of authority to write new business, reduction in commission rates, probation, and suspension. (*Id.* at 40:21 - 41:17.)

In sum, Mercury's agency system delegated field underwriting and binding authority to the agents. This enabled Mercury to outsource marketing of its products while meeting competition by providing customers instant coverage at the point of sale. In order to field underwrite and properly price the policy for Mercury, the agent had to abide by rules in the underwriting manual, evaluate the risk, and properly "rate" the policy before "binding" — that is, putting a driver on the road with Mercury temporary coverage in place. They were subject to discipline and termination if they consistently

committed binding errors, or wrongly bound coverage or underpriced the policy. For proficiency in rating and binding, reflected by superior agency loss ratio performance, agents were rewarded with higher commission rates through the adjustable commission rate feature, and lump-sum contingent commissions.

B. Mercury Created a Sham "Broker" System in the Wake of Proposition 103.

All of that changed in the wake of Proposition 103. The voter initiative, passed in 1988, required for the first time that insurers open their books and submit their rates and premiums to public evaluation and approval by the Insurance Commissioner (Ins. Code §§ 1861.01(c), 1861.05(b)). As Mercury's expert witness testified, there was a concern by insurance companies that Proposition 103 would lead to lower premiums, and this in turn would mean lower profits for insurance companies. (4/30/13 RT at 152:25 – 153:3 [Bass Cross Examination].) For insurance agents being paid commissions contingent on the dollars of premiums they produced for the insurer, lower premiums meant less compensation, since Mercury commissions were based on a percentage of premium. (4/19/13 RT at 14:19 - 15:23 [Norman Direct Examination].)

In response to its expected loss of premium revenue and the resulting erosion of commission compensation for its agents, beginning in 1989, to evade Proposition 103's strict rate regulation and downward pressure on agent commissions, Mercury implemented a system that purported to allow its agents to convert to "broker" status. (4/19/13 RT at 11:14-19 [Norman Direct Examination] ["the decision was to offer a broker contract to our producers who had a choice whether or not they wanted to be a broker"].) Mercury knew that that its agents could not lawfully charge "broker" fees; but a bona fide broker could add on those charges. (4/15/13 RT at 138:15 - 139:9 [Wolak Direct Examination].)

The conversion to "brokers" was a sham. In 1989, Mercury tasked Bruce Norman, its Senior Vice-President of Marketing, with developing the "broker" program. (4/19/13 RT 11:1-22 [Norman Direct Examination].) Mr. Norman obtained a word processing version of Mercury's Agency Contract. (*Id.* at 11:20 - 12:2, 12:12 - 13:7; Ex. I-14.) To create the "broker" contract ("Producer Contract"), he simply changed the word "agent" in the Agency Contract to "producer" (defined as "broker") throughout. (Exs. I-1 at I3, I-12 [Producer Contract], I-14 [Agency Contract]; 4/19/13 RT at 11:25 - 14:7 [Norman Direct Examination].) As the evidence in this case revealed, Mercury initiated this strategy so an agent

who converted to "broker" status could add "broker" fees on top of the premiums now regulated by Proposition 103, as a financial stimulant for the "broker" to sell Mercury insurance. (4/19/13 RT at 32:18-23 [Norman Direct Testimony] ["charging the customer a fee … is the reason why an independent producer would want to be a broker as opposed to being an agent"]; Ex. I-315 at I1874; Ex. I-1 at I3 ["The primary advantage to a producer to having a 'broker' agreement with Mercury rather than an agency agreement is the perceived ability to charge broker fees, and there is no advantage to an agency agreement over a 'broker' agreement"].)

Mercury's Producer Contract treated "brokers" identically with agents: "brokers" had the exact same authority as agents to sell and submit Mercury products, were subject to the identical Mercury manual and rules, had the same binding authority, and received the same commission compensation and profit-based financial incentives for these services. (Ex. I-1 at I3-6; 4/19/13 RT at 14:8 - 15:19, 37:1-23 [Norman Direct Examination]; 4/15/13 RT at 179:18 - 181:4, 181:10 - 183:11, 187:3 - 191:18, 192:7-9 [Wolak Direct Examination]; Exs. I-10, I-12, I-14.)

"Brokers" performed the same field underwriting services for Mercury as agents. (4/15/13 RT at 210:4-15 [Wolak Direct Examination]; 4/17/13 RT at 123:23 - 124:15 [Kitzmiller Direct Examination].) Mercury required "brokers" to comply with the same underwriting manual ("Agent/Broker Manual") as agents, and to follow the same underwriting rules. (4/16/13 RT at 22:22 - 23:10 [Wolak Direct Examination], Ex. I-30; Ex. I-9 at I82; 4/17/13 RT at 145:18-25 [Kitzmiller Direct Examination]; 4/19/13 RT at 37:5-23 [Norman Direct Examination].)

Mercury sent "brokers" the same "Bulletins" that it sent to agents, and expected "brokers" and agents to follow instructions or guidance in the Bulletins. (Exs. I-47 - I-65; 4/16/13 RT at 128:15-17 [Wolak Direct Examination].)

Mercury's Marketing Department field representatives visited "brokers," identically as they did agents. (4/16/13 RT at 16:9-15 [Wolak Direct Examination]; 4/15/13 RT at 124:10-125:4 [Wolak Direct Examination]; 4/19/13 RT at 155:21 156:2 [Napolitano Direct Examination].) The field representatives disciplined "brokers" in an identical manner as agents, for Mercury rule violations, including Agent/Broker Manual violations and inadequate production. (4/19/13 RT at 38:20 - 42:2 [Norman Direct Examination]; Ex I-26 at I170-71.)

Mercury rewarded "brokers" and agents alike for "sound underwriting" practices and for submitting their "best business" to Mercury. (Exs. I-77, I-81; 4/15/13 RT at 194:13 - 195:12, 195:20 - 197:11 [Wolak Direct Examination].)

Mercury compensated "brokers" for their skill and proficiency in providing field underwriting services to Mercury with the same sliding scale percentage commission structure as agents. (4/15/13 RT at 187:24 - 192:10 [Wolak Direct Examination]; 4/19/13 RT at 14:19-15:22 [Norman Direct Examination]; Ex. I-10, I-12, I-14.)

Mercury also paid "brokers" and agents lump-sum "contingent commission" bonuses based on a percentage of the profitability (the "net result") of the business they sent to Mercury. (4/15/13 RT at 181:10 - 183:11 [Wolak Direct Examination]; Ex. I-10; 4/16/13 RT at 158:21 - 160:6 [Wolak Direct Examination]; Exs. I-82, I-189.)

Conversion from agent to "broker" was up to the agent. (4/19/13 RT at 44:24 - 45:14 [Norman Direct Examination].) Between 1989 and 2003, Mercury converted its all-agent force to a producer force consisting of 10% agents and 90% "brokers." (See Ex. I-1 at I2 (¶¶ 5, 6); 4/15/13 RT at 136:8-10, 137:2-19 [Wolak Direct Examination].) Approximately 700 of Mercury's 800 appointed agents had terminated their formal agency appointments to become Mercury "brokers." (Ex. I-1 at I3 (¶10); Ex. I-26 at I160, I172-173; 4/19/13 RT at 26:3 – 30:12 [Norman Direct Examination].)

From July 1, 1996, until at least April 11, 2003, Mercury did not appoint any new agents; all new producers became "brokers." (4/15/13 RT at 155:20-24 [Wolak Direct Examination]; 4/19/13 RT at 45:15 - 46:5 [Norman Direct Examination]; Ex. I-26 at I160 [Response to Interrogatory No. 1] and I163 [Response to Interrogatory No. 3].) This reflected that the decision for a producer as to whether to become a Mercury "broker" versus an agent was a no-brainer – the only difference was the ability of a "broker" to charge "broker fees."

C. AIS's Conversion from Agent to "Broker" Was Central to Boosting Mercury's Profits Under its Illegal "Broker" Fee Rating Scheme.

Mercury's relationship with its highest producing agent, Auto Insurance Specialists ("AIS"), exemplifies the sham nature of the "broker" conversion. Going as far back as 1968, Mercury had an agency agreement with AIS. (4/19/13 RT at 42:3 - 43:23 [Norman Direct Examination]; Ex. I-16.) Mercury maintained formal agency appointments for AIS with the Department of Insurance. (4/19/13

RT at 49:4 - 50:3 [Norman Direct Examination]; Ex. I-17.)

Notwithstanding this 20-year agency history, for no apparent advantage or reason other than to charge "broker" fees, AIS entered into Producer Contracts with Mercury in 1989, right after the passage of Proposition 103. (4/19/13 at 47:20 - 48:6, 48:16 - 49:3, 56:4 - 57:3 [Norman Direct Examination]; Ex. I-19; Ex. I-20.) In January 1989 – almost two months exactly after the passage of Prop 103, AIS sent Mercury its executed Producer Contracts, with a cover letter stating, "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 writing Mercury business will not change." (Ex. I-18, emphasis added.) Further, "*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 [broker] agreement." (*Ibid.*, emphasis added.) AIS's formal agency appointments with Mercury were terminated on January 1, 1990. (4/19/13 at 50:14 - 51:20, 52:45 - 53:4 [Norman Direct Examination]; Ex. I-21.)

This 1989 AIS letter contemporaneously and directly confirms that Mercury's "broker" conversions were form over substance transactions that did not change the essential agency relationship between Mercury and its producers, but were intended simply to allow them "cover" to charge "broker" fees.

By the late 1990s, AIS had become a huge contributor to Mercury's auto insurance market share in California and nationwide. Between 1998 and 2004, AIS produced premiums for Mercury accounting for approximately 20-25% of Mercury's California auto business. (4/18/13 RT at 25:10-14 [Tirador Direct Examination], Exs. I-176 - 185; see Ex. I-277 at I1691 [Interrogatory No. 6]; Ex. I-291 at I725.) Nationwide, between 1998 and 2006, AIS's percentage contribution to Mercury was about 13-17%. (4/18/13 RT at 21:8 - 23:1, 41:22 - 42:21, 42:22 - 44:4 [Tirador Direct Examination], Ex. I-175 at I1312.) AIS sent approximately 90% of its business to Mercury. (Ex. I-277 at I691-2 [Interrogatory No. 7]; Ex. I-120 at I754 [Interrogatory No. 7]; Ex. I-291 at I1725-6 [Interrogatory Nos. 5, 7]; Exs. I-177, I-178, I-179.)

AIS's contribution and influence on Mercury's business was *increasing* in the years leading up to the *Krumme* decision, and beyond. (See Ex. I-291 at I725; Ex. I-277 at I691.) AIS's premium production

for Mercury jumped from approximately $225 million in 1999 to $400 million in 2003 and 2004. (Ex I-291 at I725 [Interrogatory No. 5]; Ex. I-277 at I691 [Interrogatory No. 6].) Over the same period, Mercury's total California auto premiums grew from $1.0 billion to $1.8 billion. (Ex. I-177 at I181.) Clearly, AIS was a major driver behind Mercury's growth.

As Mercury's Bruce Norman put it in a May 2004 email to AIS's Director of Marketing, "there is already plenty of risk for both of us without drawing unnecessary attention to the magnitude of the [Mercury-AIS] relationship." (Ex. I-86 at I168.)

AIS's growing influence and dominance required Mercury to disclose AIS's percentage contribution in Mercury's securities filings. (4/18/13 RT at 41:22 - 42:21 [Tirador Direct Examination]; Ex. I-175 at I1312.) Mercury expressly disclosed to investors in its "Form 10-K" securities filing that "loss of all or a substantial portion of the business provided by [AIS] could have a material adverse effect on [Mercury's] business." (*Id.* at 47:11-24, Ex. I-175 at I1330.) To maintain its relationships with its producers, the Mercury Form 10-K explained, Mercury "must pay competitive commissions" as "independent agents may find it preferable to do business with [Mercury's] competitors." (*Id.* at 46:11 - 47:10.)

AIS was charging consumers "broker" fees at the rate of approximately *$6,000,000* annually during 2002 through 2004. (Ex. I-277 at I1692-3 [Interrogatory No. 8].) This boosted AIS's revenues from commission by approximately 10%. (*Id.* at I1693 [Interrogatory No. 9].) The "broker" fees for the prior years, 1999 through 2001, were significant but lower, again underscoring the growing volume and financial advantage of "broker" fees to AIS (and indirectly to Mercury) in the four years leading up to the *Krumme* Judgment, and beyond. (Ex. I-291 at I1727 [Interrogatory Nos. 8, 9].)

Mercury knew AIS was charging "broker" fees. (4/15/13 RT at 141:14-19 [Wolak Direct Examination]; 4/18/19 RT at 28:18-21 [Tirador Direct Examination].) Although Mercury disclaims knowing the dollar volume of AIS's "broker" fees, Mercury closely tracked AIS's policy production over the years, and could easily "do the math" to estimate the scale of AIS's "broker" fee charges. (4/16/13 RT at 84:8 - 87:25 [Wolak Direct Examination]; 4/19/13 RT at 105:15 - 107:22 [Norman Cross-Examination], Exs. I-116 - 119.) As a publicly traded company with such close interdependency on AIS, it is incredible that Mercury's CEO, Mr. Tirador, "had no idea" of AIS's "broker" fee volumes, even if

the AIS top brass did not tell him the number directly. (4/18/13 RT at 28:22 - 31:17 [Tirador Direct Examination].)

Perhaps the most telling proof that AIS was driving Mercury's "broker" fee scheme is that even after Mercury collapsed its entire "broker" force under the weight of the Superior Court's rulings in *Krumme* and converted them to agents by November 2005, AIS stubbornly resisted. AIS alone, save for one token other, remained a "broker" and not an agent for four more years, until Mercury acquired AIS, and it converted to agency status effective January 1, 2009. (4/17/13 RT at 28:24 - 29:5 [Wolak Cross-Examination]; 4/18/13 RT at 154:7 - 155:25 [Tirador Direct Examination].)

D. The California Department of Insurance Initiated an Investigation of Mercury's "Broker" Fee Practices.

After conducting an in-house examination of Mercury's practices covering the period from January 1, 1995 to July 2, 1998, the Department's Field Rating and Underwriting Bureau completed a report, which concluded that Mercury's "brokers" were illegally operating as de facto agents and illegally charging consumers "broker" fees in violation of the Insurance Code. (Ex. R67 [1998 Report of the Examination of the Rating and Underwriting Practices of the Mercury Insurance Companies as of July 2, 1998 ("FRUB Report")].) Specifically, the FRUB Report found that "the cost differential that is created by the added broker fees is inequitable to insureds and violates [Insurance Code] section 1861.05(a)." (*Id.* at R67_7.) The FRUB Report was sent to Mercury on February 18, 1999. (Ex. R66 at R66_ 1.)

CDI "engaged in extensive discussions with Mercury on August 4, 1999" regarding the issues raised in the FRUB Report, which included the "broker" fee issue. (Ex. R67 at R67_10; 4/29/13 RT at 27:15-19 [Gilroy Direct Examination].) After the August 4, 1999 meeting, CDI and Mercury exchanged letters regarding the FRUB Report and CDI asked Mercury's founder, George Joseph, "to take another look at the issues that remained to be resolved from the August meeting and also offering him the option of having another discussion. He opted for another discussion." (4/29/13 RT at 28:1-8 [Gilroy Direct Examination].)

In January 2000, CDI issued a draft "Notice of Noncompliance" to Mercury, charging that Mercury was selling insurance through unappointed, de facto agents who were charging "broker" fees and that its practices violated, among other statutes, Insurance Code sections 1861.01 and 1861.05. (Ex. R-8.) CDI's draft Notice of Noncompliance included allegations that Mercury had violated the same rate

statutes as alleged in this matter as follows:

> 15. ***Respondents' brokers are charging brokers' fees for rendering the same services and providing the same coverage to [Mercury's] insureds as [Mercury's] agents provide***. Consequently, ***insureds who purchase coverage through [Mercury's] brokers are likely to pay more for their insurance policies than they would have paid had they purchase their policies through [Mercury's] agents. This cost differential is inequitable to insureds and violates section 1861.05(a)***.
>
> 16. The fees charges [sic] by [Mercury's] brokers ***were not part of an approved rate application, as required by California Insurance Code Section 1861.01(c) and 1861.05(b)***. Nor did [Mercury's] brokers provide additional services beyond the customary services of a routine transaction for which a commission was also paid.

(Ex. R-8 at R-8_5, emphasis added.)

On January 27, 2000, a meeting took place between CDI and Mercury to discuss issues identified in the FRUB Report, including the "broker" issue. (Ex. R9 [Feb. 18, 2000 Letter from Kathy Bugh to Kenneth G Kitzmiller].) On February 18, 2000, CDI sent a letter to Mercury summarizing the January 27, 2000 meeting. (*Ibid*.) The letter stated that at the meeting, CDI "requested that Mercury write a response to the draft Notice of Noncompliance." (*Id.* at R9_2.) Mercury responded by letter on March 21, 2000, confirming that it understood CDI's summary of the January 27, 2000 meeting to be accurate, except with respect to one issue unrelated to the "broker" fee issue. (Ex. CDI-11.)

On October 20, 2000, CDI attached an Addendum to the FRUB report, which stated that CDI still had not received Mercury's written response to the draft Notice of Noncompliance. (Ex. R67 at R67_10-11.) The FRUB Report was "Approved for Official Filing" on December 4, 2000. (Ex. R66 at R66_ 1.) No written response to the draft Notice of Noncompliance was ever provided by Mercury.

E. The *Krumme v. Mercury* Court Ordered Mercury to Stop its Illegal "Broker" Scheme, But Mercury Continued to Evade the Court's Judgment.

In June 2000, an individual consumer filed suit on behalf of the public under Business and Professions Code section 17200 et seq. seeking an injunction to stop Mercury's illegal marketing practices and restitution of the illegal "broker" fees charged to consumers. (*Krumme v. Mercury Insurance Company et al.* (Super. Ct. S.F. County, No. 313367) (hereafter, "*Krumme*").) *Krumme* went to trial in July 2002. In April 2003, the Superior Court entered extensive Findings of Fact and Conclusions of Law against Mercury. (Ex. I-1.) The Superior Court found, among other things, that Mercury's "brokers" were illegally operating as de facto agents and that these agents were charging

illegal "broker" fees on Mercury's behalf. (*Id.* at I-13 (¶15).)

Based on its Findings, the Superior Court rendered a permanent injunction against Mercury in May 2003. (Ex. I-2 at I20-1 ["*Krumme* Judgment"].) The *Krumme* Judgment required Mercury to formally appoint all of its personal lines auto producers as agents pursuant to Insurance Code section 1704(a) and prohibited Mercury from facilitating illegal "broker" fees. (*Ibid.*) Mercury obtained a nearly two-year stay of the *Krumme* Judgment by pursuing an appeal. The Court of Appeal affirmed the *Krumme* Judgment in late October 2004. (*Krumme v. Mercury Insurance Co.* (2004) 123 Cal App. 4th 924.) In so doing, the Court of Appeal affirmed that Mercury is vicariously responsible for the actions of its de facto agents. (*Krumme*, *supra*, 123 Cal.App.4th at 946 ["These undisputed findings are sufficient to establish that the brokers are the ostensible agents of Mercury (Civ. Code, §§ 2298, 2300, 2315, 2317) and Mercury is therefore vicariously responsible for them"].)

1. Mercury's Entrenchment Continued Following the *Krumme* Judgment.

Mercury's actions in appealing and staying enforcement of the *Krumme* Judgment revealed the entrenchment of its "broker" system and Mercury's business imperative to defend the system nearly at all costs, especially for AIS. Keeping the "broker" fee floodgate open was the only justification for Mercury to fight the *Krumme* Judgment, continue to utilize the Producer Contracts, and not simply to convert all "brokers" to agents. Mercury's decision to appeal and obtain the stay, rather than comply, reflects Mercury's intransigence, driven by its sale force's dependency on "broker" fees and AIS's dominance of Mercury's business.

Nothing changed after the stay of the *Krumme* Judgment expired at the end of 2004; Mercury had not filed formal agency appointments for its producers and it had not stopped selling insurance through "brokers" who were charging "broker" fees. (4/18/13 RT at 59:18-60:9 [Tirador Direct Examination].)

The sole operational change Mercury implemented between the *Krumme* Judgment and the expiration of the appeal stay at the end of 2004 was to eliminate "manual" binding for "brokers" in June 2003. (4/18/13 RT at 53:7-14; Ex. I-3 at I30.) As Mercury itself stated, the elimination of manual binding had little, if any, "practical impact" on Mercury's relationship with its "brokers." (Ex. I-3 at I29.) Manual binding had already long been an anachronism. By 1998, most applications were being submitted electronically using the Mercury software programs. (4/16/13 RT at 118:8-119:20 [Wolak

Direct Examination].) By the time of the *Krumme* Judgment five years later, in 2003, it was very rare to see an application submitted manually, as opposed to being electronically transmitted. (*Id.* at 125:4-11; 4/24/13 RT at 20:20 – 21:10 [Boostrom Direct Examination].) Thus, technology had long ago rendered Mercury's June 2003 "change" in "broker" binding meaningless.

Like the sham "broker" system itself, the June 2003 change eliminating "manual" binding for "brokers" was pure form over substance. Mercury agents and "brokers" continued to perform field underwriting services for Mercury long after the 1998 conversion from manual to electronic submissions, and long after the *Krumme* Judgment.[3] (4/15/13 RT at 210:4-15 [Wolak Direct Examination]; 4/16/13 RT at 122:12 - 123:17 [Wolak Direct Examination]; 4/17/13 RT at 130:9-131:8 [Kitzmiller Direct Examination].) This is clearly established by the following evidence:

- After the *Krumme* Judgment, Mercury continued to insist on the right to enforce the rules in the manuals. (4/16/13 RT at 11:9 - 12:20 [Wolak Direct Examination].) It insisted on the ability to "train" "brokers" in "Mercury's procedures for placement of business and following Mercury's underwriting rules." (Ex. I-140 (section 11).)
- Mercury continued the practice of issuing M-19s and listing "binding errors" for "brokers," and AIS in particular. (4/17/13 RT at 158:18 - 160:22 [Kitzmiller Direct Examination]; Exs. I-66, I-67, I276, I-279, I-285, I-286, I305, I-307, I-309.)
- Mercury continued its market supervision practices of visiting agents and "brokers," to discuss binding errors, loss ratios, and profitability. (4/16/13 RT at 38:5 - 39:15, 41:14 - 42:15; 56:5 - 57:8; 61:11 - 62:21 [Wolak Direct Examination]; 4/19/13 RT at 155:21 - 167:19 [Napolitano Direct Examination]; Exs. I-251, I-260, I-261, I-262, I-271, I-273, I-278, I-288, I-289, I-290, I-310, and I-312.) It continued to insist on the power to terminate "brokers," a threat that effectively maintained Mercury's continued power to impose "broker" discipline for binding errors and poor loss ratios. (Ex. I-4 at I43.)

[3] As late as 2007, ten years after the full implementation of Mercury's electronic application system and four years after the *Krumme* Judgment, Mercury's web page for investors continued to vaunt its brokers and agents as its "front-line underwriting partners": "Since its formation in 1961, Mercury has concentrated on building and improving the foundation on which long-term shareholder value is created. First and foremost is the careful underwriting, strict cost control and efficient claims management which support affordable, competitive automobile insurance rates. Highly motivated managers and employees working with Mercury's independent brokers and agents (its front-line underwriting partners) make the Mercury system work." (Ex. I-174.)

- Mercury continued to track "broker" "short term" and "loss" ratios, the key metrics of field underwriting performance. (4/16/13 RT at 100:24 - 102:23 [Wolak Direct Examination]; Ex. I-118.)
- Mercury continued to reward skill and proficiency in field underwriting with higher commission rates using its sliding scale formula, as well as lump-sum contingent commissions. (4/15/13 RT at 191:18 - 192:18 [Wolak Direct Examination]; Ex I-139 (section 5); 4/18/13 RT at 68:15-18, 69:17-70:6 [Tirador Direct Examination]; I-146, I-149.)

In sum, Mercury's intransigence in continuing its same system of "broker" rules, performance tracking, supervision, discipline, performance-based compensation, underwriting practices, and public proclamations regarding the importance of "broker" field underwriting cannot be reconciled with its unsubstantiated claim eliminating "brokers'" manual binding authority for the electronic application submission software rendered producer field underwriting obsolete.

2. The Court Recognized Mercury's 2005 Motion to Vacate As An Attempt to Evade the *Krumme* Judgment and Again Ordered Mercury to Change Its Practices.

Mercury came back to the Superior Court in February 2005 after the appeal stay expired, asking the Superior Court to vacate the *Krumme* Judgment *in its entirety* based on "operational changes" it implemented, primarily in the advertising and lead sourcing arenas. (Ex. I-4 ["2005 Motion to Vacate"].) But, as the evidence set forth above shows, Mercury refused to change any of the core aspects of its "broker" system — all of which remained identical with the Mercury agency force.

Mercury had no good faith intention of giving up its "broker" system. Instead, Mercury proposed to dissolve the *Krumme* Judgment, while keeping the key features of the "broker" system intact. Under Mercury's proposal to the Superior Court, Mercury would utilize separate, but virtually identical, "Agent" and "Broker" manuals (4/18/13 RT at 70:24 - 71:13, 72:11-16 [Tirador Direct Examination]; Ex. I-4 at I41, I-32, I-33; see also 4/16/13 RT at 9:13-10:1 [Wolak Direct Examination]), continue to utilize identical sliding scale and contingent commissions for "brokers" and agents, and continue to use marketing representatives to supervise and discipline "brokers" and agents alike. (Ex. I-4 at I40-44; see 4/18/13 RT at 61:10 –81:23 [Tirador Direct Examination].)

The Superior Court saw through Mercury's evasion and issued a stern ruling in April 2005 denying Mercury's 2005 Motion to Vacate. (Ex. I-5 ["April 2005 Ruling"].) In its April 2005 Ruling, the

Superior Court criticized Mercury for failing to make operational changes to its core system in the nearly two years since the *Krumme* Judgment. (*Id.* at I47:20-24.)

The Superior Court dismissed Mercury's emphasis on the supposed automatic character of its electronic submission software by noting that the same system had been in place for at least three years prior to the *Krumme* Judgment. (Ex. I-5 at I49:8-22, 51:3-7.)

The Superior Court noted that Mercury's expert, Irene Bass (who also testified for Mercury in this case), had acknowledged that Mercury "brokers" engaged in "front line underwriting" for Mercury, and rewarded them for their skill and proficiency in providing this service. (Ex. I-5 at I50:1-13.) The Superior Court expressly disapproved Mercury's continued use of sliding scale and contingent commissions. (Ex. I-5 at I50.)

The Superior Court ruled that the detailed "broker" and agent manuals Mercury proposed to use were substantially identical, and the "broker" manual was inconsistent with Mercury's assertion that the "brokers" were not performing underwriting. (Ex. I-5 at I50-51.)

The Superior Court criticized Mercury's continued *de facto* control over its "brokers" through its closed application process and directed Mercury to implement the "open application procedure allowing any licensed broker, as well as Mercury agent, to submit insurance applications," which became known as "take all brokers." (Ex. I-5 at I50:14-23.)

Finally, the Superior Court directed Mercury to end the marketing supervision system that "advance[s] threats of financial consequences such as reduced commissions and/or termination as a sanction for poor broker performance in 'front line underwriting' and prevention of losses by Mercury." (Ex. I-5 at I51:15-22.)

In July 2005, the Superior Court ordered Mercury to either comply with the *Krumme* Judgment by converting all "brokers" to agents, or to implement changes consistent with its April 2005 Ruling by November 1, 2005. (Ex. I-6 ["July 2005 Modification Order")].)

3. Mercury Evaded the Court's July 2005 Modification Order.

The July 2005 Modification Order prompted the collapse of Mercury's "broker" system with respect to all "brokers" — except, very notably, for AIS. By the November 1, 2005 effective date of the July 2005 Modification Order, Mercury had converted all remaining "brokers" back to appointed agent

status, except for AIS (and a token second). (4/17/13 RT at 28:24 – 29:5 [Wolak Direct Examination].)

In late 2005, more than ever, AIS was the elephant in the living room. Unwilling to give up $6,000,000 in its annual "broker" fee income, AIS refused to convert to agent status. Mercury had to continue its sham system to accommodate AIS's massive "broker" fee appetite.

Despite the mandates of the July 2005 Modification Order, less than a month after it was issued, in an August 1, 2005 quarterly earnings conference call, Mercury's founder, George Joseph, personally assured Wall Street analysts who followed Mercury's stock, "We don't see our relationship with AIS changing. We are working very closely with them. They are our largest broker as you know." (Ex. I-150 at I971.) In other words, the July 2005 Modification Order requiring the withdrawal of the manual, the elimination of performance-based commissions, and the elimination of Marketing Department supervision of AIS was not going to change the Mercury-AIS relationship.

And it didn't: contrary to the letter and spirit of the July 2005 Modification Order, Mercury continued "business as usual" with AIS, enabling AIS to charge consumers millions in "broker" fees for another four years:

Mercury replaced its 1989 and 1990 broker contracts with AIS, effective November 1, 2005. (4/18/13 RT 102:16 - 103:18 [Tirador Direct Examination]; 4/19/13 RT at 56:2 - 57:3 [Norman Direct Examination]; Ex. I-24.) The new AIS contract required AIS to follow Mercury's "screen prompts" in its electronic submissions software and *to indemnify Mercury against AIS's violations of the screen prompts*. (Ex. I-24 at I157.)

Simultaneously, in September 2005, in anticipation of withdrawing its underwriting manual from AIS, Mercury kept the manual available to AIS by embedding the manual's provisions in "popup windows" — the screen prompts — in Mercury's electronic application submission software. (4/17/13 RT at 35:19 - 36:18; 37:11 - 39:9 [Wolak Direct Examination; Ex. I-46.) AIS's Scott Boostrom instructed AIS personnel that they were "responsible for reading and understanding the electronic prompts and underwriting guidelines provided by Mercury in the Quicksilver system; don't just breeze through them." (Ex. I-300 [displaying the "screen prompt" indemnity that AIS had to "click" with each application]; see also Ex. I-295, I-296 ["Mercury's Quicksilver (QS) program now displays important underwriting guidelines that may be helpful to you when processing applications and U2s"; "Using this

review function is mandatory"].)

Further, Mr. Boostrom continued his regular and ongoing direct email channel on underwriting issues with Mercury's Vice-President of Underwriting, Ken Kitzmiller. (4/17/13 RT at 170:25 - 171:12; 174:4 - 175:7 [Kitzmiller Direct Examination]; Exs. I-88 - I-115, I-193 - I-202, I-212-14, I-217-18, I-220, I-222-23, I-225; I-228-33, I-236, I-238-39, I-241-43, I-247-50, I-252-53, I-256-59, I-265-68, I-270, I-275-76, I-293-94, I-297, I-302-04, I-306, I-308, see also Exs. I-85, I-86.) This direct Mercury-AIS underwriting information channel continued on a regular basis through at least July 2007, long after the manual was withdrawn in November 1, 2005. (4/17/13 RT at 174:4 - 175:7, 178:19 - 180:5 [Kitzmiller Direct Examination]; Ex. I-308.)

Contrary to the July 2005 Modification Order, Mercury continued direct marketing supervision of AIS by maintaining Stacey Berkman, AIS's former field representative, as a "liaison," and by continuing to issue M-19s and emails listing AIS "binding errors," at least well into 2007. (4/16/13 RT at 71:9 - 72:9 [Wolak Direct Examination]; 4/17/13 RT at 158:18 - 159:18 [Kitzmiller Direct Examination]; 165:1-167:11; Ex. I-66, I-67, I-301, I-305, I307, I-309.) Mercury undermined the Superior Court's "take all brokers" requirement by cutting their commissions to 5% (in contrast with Mercury's customary 15% starting commission rate), discouraging and effectively deterring this broker group from submitting significant business to Mercury because the July 2005 Modification Order disabled Mercury from direct supervision and control over these producers' field underwriting practices. (4/17/13 RT at 57:22 - 58:4 [Wolak Direct Examination]; 4/19/13 RT at 65:17 - 67:18 [Norman Direct Examination], Ex. I-186; 4/18/13 RT at 44:5 - 46:12 [Tirador Direct Examination].)

Finally, in late 2008, Mercury acquired AIS and appointed it as an agent. (4/18/13 RT at 154:7-155:25 [Tirador Direct Examination].) At that point, AIS ceased charging "broker" fees. (See 4/17/13 RT at 59:25 – 61:12 [Wolak Direct Examination].) Thus, almost exactly 20 years after Mercury began the sham "broker" system in early 1989, Mercury finally shut it down.

F. Procedural History of this Noncompliance Proceeding.

During the pendency of Mercury's appeal in *Krumme*, CDI initiated the present noncompliance action under Insurance Code section 1858.1, which applies to "any rate, rating plan or rating system made or used by any [] insurer" that "does not comply with [Chapter 9 of Part 2 of Division 1 of the

Insurance Code]." CDI filed and served a Notice of Noncompliance on February 2, 2004. On March 3, 2004, CDI and Mercury stipulated to stay the proceeding while the *Krumme* litigation was pending. (Ex. CDI 5 at CDI 5-86.) Consumer Watchdog sought and was granted leave to intervene by order of the ALJ dated March 16, 2007.[4] CDI filed and served a First Amended Notice of Noncompliance ("FANNC") on March 22, 2006, and a Second Amended Notice of Noncompliance ("SANNC") on April 11, 2011.

The SANNC alleges violations of Insurance Code sections 1861.01(c) and 1861.05(a) as follows:

> From July 1, 1996, through 2006, Respondents willfully permitted their insurance agents to charge "broker" fees to Respondents' policyholders. In charging these fees, Respondents' agents acted in the course and scope of their agency. Under California law, all payments by policyholders that are a part of the price of insurance, including all sums paid to an insurance agent, are considered premium. Consequently, Respondents constructively received the "broker" fees (i.e. premium) collected by their agents. Respondents did not receive the Commissioner's prior approval to charge or receive the moneys constituting the "broker fees." As a result of permitting its agents to charge and collect the broker fees, Respondents constructively charged and collected premium in excess of the rates approved for them by the Commissioner, in violation of section 1861.01(c). (SANNC, ¶3.)
>
> Because Respondents' agents charged broker fees of varying amounts, Respondents['] insureds were subjected to unfair rate discrimination, in violation of section 1861.05(a). Respondents willfully permitted the rate discrimination to occur. (SANNC, ¶4.)

The SANNC further alleges that the foregoing allegations "establish that Respondents willfully used a rate, rating plan or rating system in violation of Chapter 9 of Part 2 of Division 1 of the Insurance Code, and provide grounds for a fine of $10,000 for each policy in which a Respondent permitted a broker fee to be charged by one of its agents, pursuant to section 1858.07(a)." (SANNC, ¶5.)

Without holding an evidentiary hearing on the substantive issues raised in the SANNC, ALJ Owyang submitted a Proposed Decision to the Commissioner on January 31, 2012. (Proposed Decision, Jan. 31, 2012.) Judge Owyang's Proposed Decision purported to dismiss the SANNC on the erroneous grounds that CDI "violated separation of function principles and denied Mercury due process and a fair hearing" when it initiated a separate rulemaking proceeding to amend a procedural regulation that had

[4] Consumer Watchdog's intervention is limited to the Notice of Noncompliance issues relating to Mercury's violations of the rating statutes (Ins. Code §§ 1861.01 and 1861.05). By order of the ALJ, this proceeding was bifurcated with the Department's Order to Show Cause allegations regarding Mercury's false advertising under Insurance Code sections 790.035 and 790.05 to be heard at a later date. (Bifurcation Order, Feb. 1, 2012.)

been in dispute in this proceeding. (*Id.* at 2.) Judge Owyang's Proposed Decision contained no analysis or findings regarding the substantive issues raised in the SANNC. (*Ibid.*)

On March 30, 2012, the Commissioner *rejected* Judge Owyang's Proposed Decision and referred the matter back to the Office of Administrative Hearings to convene an administrative hearing, take substantive evidence on the allegations in the SANNC, and issue a proposed decision on the SANNC. (Order Rejecting Proposed Decision; and Order of Referral, Mar. 30, 2012 ("Commissioner's March 30 Order").)

Even though no evidence had been taken in the noncompliance proceeding, on April 19, 2012, Mercury filed a petition for writ of mandate in the trial court, seeking to vacate the Commissioner's March 30 Order and dismiss the SANNC entirely. (Verified Petition for Writ of Mandate Pursuant to Code of Civil Procedure sections 1085 and 1094.5, and Complaint for Declaratory Relief or Any Other Appropriate Relief, *Mercury Insurance Company, et al. v. Dave Jones, etc.* (Super. Ct. Los Angeles County, Apr. 19, 2012, No. BS137151) ("*Mercury v. Jones*").) The trial court denied Mercury's attempt to " 'jump the line' and demand a hearing in superior court of a not-yet-final adjudicative proceeding[,]" on the grounds that Mercury failed to adequately exhaust administrative remedies before seeking relief in the trial court. (Court's Ruling on Respondent's Demurrer Heard on September 12, 2012, *Mercury v. Jones,* Sep. 14, 2012, at 4, 7.)

On September 25, 2012, Mercury appealed the trial court's order. (Notice of Appeal, *Mercury v.* Jones, Sep. 25, 2013, No. B244204).) On April 26, 2013, the Court of Appeal affirmed the trial court's denial of Mercury's petition. (*Mercury v. Jones* (Apr. 26, 2013, B244204) [nonpub. opn.].) Mercury then filed a Petition for Review in the Supreme Court of California, which was denied. (Order, *Mercury v. Jones*, Jul. 10, 2013, No. S211207.)

Meanwhile, following the Commissioner's March 30 Order, an evidentiary hearing commenced in this proceeding on April 15, 2013, and continued over 13 days between April and June, 2013. An extensive evidentiary record was developed through the written and oral testimony of current and former Mercury and AIS officers and current and former CDI employees, and documentary evidence.

ARGUMENT

I. COLLATERAL ESTOPPEL APPLIES TO CONCLUSIVELY ESTABLISH THE PRINCIPAL FACTUAL ALLEGATIONS IN THIS PROCEEDING.

In response to the Department's motion with the benefit of briefing by all parties, the ALJ found that the extensive Findings of Facts and Conclusions of Law issued in *Krumme* are binding on Mercury in this proceeding, under the collateral estoppel doctrine. (Ruling on the Department's Motion for Collateral Estoppel, Feb. 19, 2013 at 3-17 [hereafter, "ALJ's Collateral Estoppel Ruling"]; Ex. I-1.) The ALJ's Ruling on Collateral Estoppel conclusively establishes in this proceeding the *Krumme* Findings that Mercury's insurance "brokers" operated as de facto agents and that their "broker" fees were illegal. Specifically, the following allegations are conclusively established pursuant to the ALJ's Collateral Estoppel Ruling :

1. From July 1 1996, through April 11, 2003, Mercury's denominated "brokers" were in fact their ostensible agents. (SANN, p. 2, lines 20-21; see the *Krumme* trial court's "Findings of Fact and Conclusions of Law After Trial," Findings of Fact (hereinafter "FF") Nos. 1-36, 56, 57 [incorporated by reference in SANN, p. 2, lines 14-15]; Conclusion of Law Nos. 1-9, 13-17 [incorporated by reference in SANN, p. 2, lines 17-18]; see also, *Krumme,* 123 Cal.App.4th at 946 ["*These undisputed findings are sufficient to establish that the brokers are the ostensible agents of Mercury and Mercury is therefore vicariously responsible for them.*"].)

2. Mercury's ostensible agents charged "broker" fees. (SANN, p. 2, lines 20-21; see Concl. of Law Nos. 14, 15, 16, 17 [incorporated by reference in SANN, p. 2, lines 17-18]; see also, *Krumme,* 123 Cal.App.4th 924, *affirming*.)

3. In charging "broker" fees, these "brokers" were acting in the course and scope of their agency in transacting insurance as "insurance agents" on behalf of Mercury. (SANN, p. 2, lines 21-22; FF Nos. 1-36, Concl. of Law 15-16 [incorporated by reference in SANN, p. 2, lines 17-18]; see also, *Krumme,* 123 Cal.Ap.4th 924, *affirming*.)

4. Mercury is vicariously liable for the actions of its agents. (FF Nos. 1-36, 56, 57; Concl. of Law No. 17 [incorporated by reference in SANN, p. 2, lines 14-18]; see also, *Krumme,* 123 Cal.App.4th at 946 [*"These undisputed findings are sufficient to establish that the brokers are the ostensible agents of Mercury and Mercury is therefore vicariously responsible for them"*].)

5. Mercury did not obtain the Commissioner's prior approval to charge or receive "broker" fees charged by its agents. (SANN, p. 2, lines 25-26; FF Nos. 49-50 [incorporated by reference in SANN, p. 2, lines 14-15]; see also, *Krumme,* 123 Cal.App.4th 924.)

(Motion for Collateral Estoppel at 3:12-4:8, citations in original; ALJ's Ruling on Collateral Estoppel at

3-17.) Collateral estoppel applies to the *Krumme* Findings for the period of July 1, 1996 to April 11, 2003. (ALJ's Collateral Estoppel Ruling at 17.)

II. MERCURY'S RATING SYSTEM OF CHARGING CONSUMERS UNAPPROVED, ILLEGAL AGENT FEES VIOLATED INSURANCE CODE SECTIONS 1861.01 AND 1861.05.

Throughout this proceeding, Mercury has argued that the illegal fees charged by its agents under the guise of "broker" fees are not "premium" and are therefore not subject to the prior approval and anti-discrimination rate statutes (Ins. Code §§ 1861.01(c), 1861.05(a)). This position is wholly undermined by the Insurance Commissioner's and the Department's interpretation of the rate statutes, the plain language and underlying purposes of Proposition 103, the Commissioner's regulations, California case law, the testimony of Mercury's own witnesses in this proceeding, and Mercury's position in the *Krumme* litigation, all of which establish that fees paid to agents are premium and that the rates that are subject to review and prior approval and the prohibition against unfair rate discrimination (§§ 1861.01(c), 1861.05(a)) must include all premiums charged by an insurer. (See sections II.A-E below.) In totality, the weight of the authority and the evidence presented in this proceeding conclusively establish that Mercury's illegal agent fees were additional premium charged to its insureds, and as such should have been submitted for review and approval under Insurance Code section 1861.01(c) and were unfairly discriminatory under section 1861.05(a). (See sections II.F and G below.)

A. The Commissioner Has Historically Maintained, Consistent With Holdings of the California Supreme Court, that All Fees Paid By an Insured to an Insurance Agent are Premium and that the Collection of Unauthorized Fees Results in Illegal Rate Discrimination.

In 1980, the Insurance Commissioner issued Bulletin 80-6, an official bulletin to the insurance industry addressing producer practices in charging "broker fees, service fees, and other fees and charges made to insureds in this state." (Ex. I-128 at I791.) Citing California Supreme Court case authority, the bulletin stated that "[t]he California Courts have held 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.***" (*Ibid*., emphasis added, citing *Groves v. City of Los Angeles* (1953) 40 Cal.2d 751; *Allstate v. the State Board of Equalization* (1959) 169 Cal.App.2d 165.[5]) The Bulletin further directed that an insurance

[5] The definitions of premium from *Groves v. City of Los Angeles* (1953) 40 Cal.2d 751 and *Allstate v. the State Board of Equalization* (1959) 169 Cal.App.2d 165 were cited and quoted with approval by the California Supreme Court in *Metropolitan Life Ins. Co. v. State Bd. of Equalization* (1982) 32 Cal.3d 649. These cases are discussed further under section II.D below.

company may not permit its "agents" to collect any unauthorized fees because that would result in "rate discrimination." In this regard, Bulletin 80-6 stated:

> 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***.

(*Id.* at I792, emphasis added.)

In other words, according to the Commissioner's Bulletin 80-6, "insurance agents" cannot charge an insured fees for services because that would result in the *insurance company* charging that insured a higher premium than another insured who did not pay the fee or who paid a fee of a different amount. The difference would result in rate discrimination.

The anti-discrimination statute in effect at the time that Bulletin 80-6 was enacted, former Insurance Code section 1852, stated (as now codified in section 1861.05), that "[r]ates shall not be excessive or inadequate ... , nor shall they be unfairly discriminatory." At that time, insurers were not required to submit rates to the commissioner prior to their use, but it was still a violation of law to charge rates that were "unfairly discriminatory."

Bulletin 80-6 became generally accepted in the industry as prohibiting "insurance agents" from charging broker fees; only true "insurance brokers" may charge broker fees. (10 CCR § 2189(c).) No one in recent memory has questioned that "insurance agents" cannot charge broker fees. As stated by Mercury's own expert witness, "[G]enerally agents, as opposed to brokers can't charge fees unless they have a special arrangement with their carrier." (4/30/13 RT at 91:12-14 [Pearson Cross-Examination].)

B. Under Proposition 103, All Automobile Insurance Rates Must Be Approved Prior to Their Use and Insurers are Prohibited from Charging Unfairly Discriminatory Rates.

The voters passed Proposition 103 in November 1988 to end a range of discriminatory rating practices, which served to strengthen the Commissioner's prohibition against unauthorized agent fees. Proposition 103 found that "the 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].) The voters exercised their power of initiative to "protect consumers from arbitrary insurance rates and practices,"

"provide for an accountable Insurance Commissioner" and "ensure that insurance is fair, available, and affordable for all Californians." (*Ibid.,* quoting Prop. 103 § 2 [Purpose].)

Among other things, Proposition 103 required that "[c]ommencing November 8, 1989, insurance rates subject to this chapter must be approved by the commissioner ***prior to their use***." (Ins. Code § 1861.01(c), emphasis added; see also Ins. Code § 1861.05(b) ["[e]very insurer which desires to change any rate shall file a complete rate application with the commissioner"].) As stated by the California Supreme Court, "the apparent purpose of the prior approval provisions ... is to prevent future abuses in setting insurance rates by requiring the Commissioner to determine whether a proposed rate change is fair and reasonable ***before it is implemented***." (*Amwest Ins. Co. v. Wilson* (1995) 11 Cal. 4th 1243, 1263, emphasis added.)

Proposition 103 also enacted stringent limitations on rate discrimination. (Ins. Code §§ 1861.05(a), 1861.02(a)(4).) Insurance Code section 1861.05(a) provides:

> No rate shall be approved or remain in effect which is excessive, inadequate, ***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.

(Emphasis added.) Moreover, automobile premiums must be determined by factors specifically set forth by statute or regulation, and ***"the use of any criterion without approval shall constitute unfair discrimination."*** (Ins. Code § 1861.02(a)(4), emphasis added.)

As the California Supreme Court has noted, the language of section 1861.05 "echoes similar language in the laws of most states, as well as former section 1852 which it replaces." (*Calfarm Ins. Co. v. Deukmejian* (1989) 48 Cal.3d 805, 822; see also *Amwest Surety Ins. Co. v. Wilson, supra,* 11 Cal.4th 1243, 1257-1258.) Proposition 103's institution of strict pre-marketing rate regulation and approval (Ins. Code § 1861.01) and its continuation of former section 1852's prohibition against "excessive, inadequate, and unfairly discriminatory" rates (Ins. Code §§ 1861.05(a); 1861.02(a)) reflected the voters' overriding purposes that the Commissioner would closely regulate insurance rates and ensure that rates are "fair" and not "arbitrary." (Consumer Watchdog's Request for Official Notice, Oct. 16, 2013 ["Consumer Watchdog RON"], Ex. I-344, Prop. 103, § 2 [Purpose].)

With these underlying purposes in mind, it would be an absurd result if Mercury's unauthorized

agent fees that the Commissioner had nearly ten years before banned as rate discrimination were not considered premium subject to the prior approval requirements and prohibitions against unfairly discriminatory rates under Proposition 103. To accomplish this result, as Mercury advocates, one would have to conclude that the voters intended to leave insurance companies and their agents entirely free of Departmental regulation in deciding the amount of additional fees to charge consumers at the point of sale, which fees had not been disclosed and approved in their rate filings. In other words, one would have to find that, even though Proposition 103 erected a barrier against unapproved, arbitrary, and discriminatory rates, the initiative nevertheless overruled Bulletin 80-6 and left a gaping hole through which insurers could charge unapproved and discriminatory rates via illegal fees charged by their agents.

"Where more than one statutory construction is arguably possible, our policy has long been to favor the construction that leads to the more reasonable result." (*Commission on Peace Officer Standards and Training v. Superior Court* (2007) 42 Cal.4th 278, 290, citations omitted.) As the California Supreme Court explained:

> This policy derives largely from the presumption that the Legislature intends reasonable results consistent with its apparent purpose. Thus, our task is to select the construction that comports most closely with the Legislature's apparent intent, with a view to promoting rather than defeating the statutes' general purpose, and to avoid a construction that would lead to unreasonable, impractical, or arbitrary results.

(*Ibid*., citations omitted; *see also Catholic Mutual Relief Society v. Superior Court* (2007) 42 Cal.4th 358, 372; *Flannery v. Prentice* (2001) 26 Cal.4th 527, 578 ["[W]e avoid any construction that would produce absurd consequences"].) Moreover, Proposition 103 itself requires that its provisions "shall be liberally construed and applied in order to fully promote its underlying purposes." (Consumer Watchdog RON, Exh. I-344, Prop. 103, § 8 [Technical Matters].)

Thus, according to Bulletin 80-6 and Proposition 103's requirement that insurers may only charge rates that have been approved by the Commissioner (Ins. Code § 1861.01(c)) and prohibition against unfair rate discrimination (Ins. Code §§ 1861.02(a); 1861.05(a)), any fees an insurer authorizes its agent to collect must be reported as premium and be subject to the prior approval and anti-discrimination statutes. Otherwise, a failure to report these fees as premium in a rate filing while allowing agents to charge any amount of fees they want without review or approval would result in an insurer charging rates that were not approved and unfair rate discrimination.

C. Case Law Interpreting Proposition 103 and the Commissioner's Regulations Make Clear that All Fees Charged by an Insurer are Premium Which Must be Included in an Insurer's Rates that are Submitted for Prior Approval.

"Premium" refers to "how much the policyholder is charged." (*Spanish Speaking Citizens' Foundation v. Low* (2000) 85 Cal.App.4th 1179, 1186.) In this regard, 10 CCR § 2360.0 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***." (Emphasis added.) The fees charged to Mercury policyholders by Mercury's de facto agents were premium under this definition as they clearly were a part of "the final amount charged to an insured for insurance" and "change[d] the amount the insurer charge[d] to the insured." (10 CCR § 2360.0.)

A "rate" as used in sections 1861.01 and 1861.05, in turn, "represents the ***total amount of annual premium*** that the insurer must charge in order to cover expenses and obtain a reasonable rate of return." (*Donabedian*, *supra*, 116 Cal.App.4th at 992, emphasis added.) In other words, the "rates" that must be submitted to the Commissioner for review and approval prior to their use under Insurance Code sections 1861.01(c) and 1861.05(b) represent the total amount of premium that an insurer collects from all of its policyholders. It is undisputed by Mercury that premiums are subject to prior approval under sections 1861.01(c) and 1861.05(b) and the Commissioner's regulations. (Prepared Direct Testimony of Irene K. Bass, FCAS, Apr. 29, 2013 ["Bass PDT"] at 10:1-2 ["Insurance regulations in California require an insurer to obtain prior approval for the rates (and, hence, the premiums) it charges for private passenger auto insurance"].)

Proposition 103 and the Commissioner's regulations specifically set forth the forms, exhibits, data, and documentation that must be submitted as part of a complete rate application. (Ins. Code § 1861.05(b), cross referencing Ins. Code § 1857.7; 10 CCR § 2648.4(a).) Among the required forms that must be included in a complete rate application is one that sets forth the necessary Ratemaking Data (form CA-RA5) that must be reported. (10 CCR § 2648.4(a); e.g., Ex. R161, p.5, [form CA-RA5, Application for Approval of Insurance Rates].) On page 2 of that form, the insurer is required to include the earned premium it has collected from all policyholders for the last three years. (See *ibid*; 4/30/13 RT at 125:18-19 [Bass Cross Examination] ["The insurer's required to report all the premium that it writes and that it earns and that it has unearned"]; see also Ins. Code § 1857.7 ["The application referred to in subdivision

(b) of Section 1861.05 shall include, but shall not be limited to, all of the following information: (1) Premiums written. (2) Premiums earned. (3) Unearned premiums. …".) Also among the forms that must be included in a complete rate application is one that sets forth Miscellaneous Data, including the miscellaneous fees charged to policyholders (form CA-RA8) that must be reported. (10 CCR § 2648.4(a); e.g., Ex. R90 at R90_3 [form CA-RA8, Application for Approval of Insurance Rates]; see also Additional Prepared Direct Testimony of Larry Lastofka, Apr. 23, 2013 ["Lastofka Additional PDT"] at 3:8-10 ["during the time period at issue here, the fees were reported on an earlier version of the rate application, the 05-15-96 ed. On the 05-15-96 edition, the fees were reported on pages CA-RA8 AND CA-RA5"]; 4/26/13 RT at 42:3-6 [Lastofka Cross-Examination] ["Q. In your experience, what fees do insurance companies or what fees are insurance companies required to report in their rate applications? [¶] A. All the fees that the company would receive"].)

As is clear from the Ratemaking Data and Miscellaneous Data forms CA-RA5 and CA-RA8 that were required to be submitted to the Commissioner as part of a complete rate application under Insurance Code section 1861.05(b) and 10 CCR § 2648.4(a), during the relevant time period, any amounts collected as part of premium or charged to policyholders as miscellaneous fees, including the illegal agent fees charged by Mercury, must be disclosed in a complete rate application submitted to the Department for prior approval.

D. California Case Law Establishes that Agent Fees Are Part of Premium.

California case law, including the pre-Proposition 103 case law cited by the Commissioner in Bulletin 80-6 and post-Proposition 103 case law, defines "premium" to include all costs paid by the insured for insurance, including fees charged by agents.

In *Groves* v. *City of Los Angeles* (1953) 40 Cal.2d 751 ("*Groves*"), a bail agent remitted to the surety company only a portion of what he charged clients for bail bonds. (*Id.* at 754.) The agent retained the remainder to cover the agent's expenses and as profit. (*Ibid.*) The California Supreme Court held that the entire amount paid to the agent was gross premium, not just the portion received by the surety:

> 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 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 bond is the premium*** and it has been so recognized by the courts. [Citations omitted.] And a mere bookkeeping method cannot thwart the law.

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

The fees charged by Mercury's agents were producer compensation paid directly to its agents to cover their costs. Thus, like in *Groves*, Mercury cannot thwart the law just because the fees went to its agents directly to defray their expenses and pay themselves a commission rather than being paid to Mercury to in turn pay as commission to its agents. As the Court concluded:

> [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 761, emphasis added.)

In *Metropolitan Life Ins. Co. v. State Bd. of Equalization* (1982) 32 Cal.3d 649 ("*Metropolitan*"), Metropolitan issued a group health insurance plan that required employers to pay all employee claims up to a certain "trigger-point" amount while Metropolitan remained obligated for paying claims in excess of the "trigger-point." (*Id*. at 653.) Metropolitan retained control over many aspects of the administration of the plan, including administering claims below the "trigger-point." (*Id*. at 657.) If an employer failed to make funds available for the payment of pretrigger-point claims in any month, the insurer remained obligated to cover those claims, subject to reimbursement from the delinquent employer. (*Ibid*.) Metropolitan argued that it should only have to pay gross premium tax on the portion of premium it received directly from the employers. (*Id.* at 661.)

The Court rejected that argument and held that the employers acted as agents of the insurer, and that the total cost of the plan was taxable as gross premium, including both the amount paid directly to the insurer as a premium for the policy, and the amount paid on claims below the trigger-point amount. (*Metropolitan*, *supra*, 32 Cal.3d 649, 661-662.) In reaching this conclusion, the Court cited *Groves* and quoted the definition of premium from *Allstate Ins. Co.* v. *State Board of Equal*. (1959) 169 Cal.App.2d

165, 168: "'[p]remium' in the law of insurance means the amount paid to the company for insurance. [Citation.] It has been defined as 'the sum which insured is required to pay.'" (*Id.* at 660.) As the Court explained in *Metropolitan*, gross premiums include both "the expected level of claims payments" and a "loading…composed of miscellaneous charges, including administrative costs of the insurer, a charge for assuming the risk that claims outlays will exceed the expected level, and an element of profit or dividends." (*Id*. at 660, quoting *Allstate Ins. Co.* v. *State Board of Equal*., *supra*, 169 Cal.App.2d 165, 168; see also *Allstate Ins. Co.* v. *State Board of Equal*., *supra*, 169 Cal.App.2d 165, 173 ["[t]he expense of administering the insurance is a component of premium"].) Thus, under this definition of premium, the total cost of insurance provided to a policyholder would necessarily include not only the amount that insureds paid for covering the costs of expected claims, but also the miscellaneous charges, including the administrative costs, whether or not those were paid directly to the insurer or to its agents in the form of fees. (See *ibid*.)

Finally, *Troyk v. Farmers Group, Inc.* (2009) 171 Cal.App.4th 1305 ("*Troyk*"), supports a conclusion that the fees charged by agents are part of the premium. In *Troyk*, auto insurance policyholders sued their insurer for violating the requirement of Insurance Code section 381, subdivision (f), that an insurance policy specify the premium, because the insurer failed to include a monthly service charge for processing premium payments as part of the premium stated in the insurance policy. (*Id.* at 1317.) The insurer claimed it was not required to include the service charge as part of the premium since a third party billing agent received the payments. (*Id.* at 1319.) The Court of Appeal rejected the insurer's argument and concluded that the service charge was premium, stating "it is irrelevant that [the third party billing agent], instead of [the insurer] directly received the service charge." (*Id.* at 1324.) The court reasoned that "[b]ecause Insurance Code section 381 'presumably is a consumer protection statute' [citation], the meaning of 'premium,' as used in section 381, subdivision (f), is interpreted from the perspective of the consumer (i.e., the insured)" and, "from the insureds' perspective in this case, 'premium,' for purposes of section 381, subdivision (f), is the total amount the insureds were required to pay to obtain insurance coverage." (*Ibid*.) The court also determined 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 1325, emphasis added.) Thus, the court concluded, whether interpreted from the insured's or insurer's perspective, premium includes additional charges that the insured must pay to an insurer's agent in order to obtain the coverage purchased, including "indirect costs" and "additional assessments" like agent fees.

There is no question that Proposition 103, like Insurance Code section 381, is a consumer protection statute since one of its primary purposes as explicitly set forth in the 1988 Ballot Pamphlet presented to voters is to "protect consumers from arbitrary insurance rates and practices." (*Donabedian*, *supra*, 116 Cal.App.4th at 981, quoting Prop. 103 § 2 [Purpose].) Accordingly, similarly to the Insurance Code provision at issue in *Troyk*, sections 1861.01(a) and 1861.05(a) must be "interpreted from the perspective of the consumer (i.e., the insured)." (*Troyk*, *supra*, 171 Cal.App.4th at 1324.)

From the perspective of Mercury's insureds who paid the illegal agent fees, the premium they were charged included such fees as part of the total amount that they were required to pay to obtain an insurance policy. ***There is no evidence in the record to establish that a policyholder who paid an illegal agent fee was informed that he or she could still have received a policy without paying the fee***.

E. Mercury's Position in *Krumme* Was that All Fees Paid to Agents are Part of Premium, and Mercury's Own Witnessses in this Proceeding Confirmed that Premiums are Included in Rates Under Sections 1861.01 and 1861.05.

Mercury's arguments in this proceeding regarding the nature of the illegal agent fees at issue are wholly contrary to its position in the *Krumme* case. Prior to the finding in *Krumme* that Mercury's so-called "brokers" were de facto agents vicariously liable for Mercury's acts, Mercury itself set forth the very argument that it now opposes:

> "***It has long been settled that amounts paid to the insurer's agents as part of an insurance transaction constitute part of the price for the insurance: i.e., part of the premium***. *See, Groves v. City of Los Angeles,* 40 Cal. 2d 751, 760-61 (1953); *see also* CDI's draft Notice of Noncompliance, ¶10, RJN at ¶4. Thus, ***whether the brokers collected fees as "agents" of Mercury or Mercury collected the fees itself, the fees unquestionably constitute part of the premium as a matter of law.*** *See, also, e.g.,* 10 C.C.R. § 2644.14 (Exhibit B to Appendix of Authorities), including agent commissions in the rate as part of the rate formula's variable expense factor." (Ex. I-327 at I3017, emphasis added.)

> "Plaintiff attempts to tie Mercury to the broker fees by claiming the brokers were acting as

> Mercury's 'agents'. But ***if the brokers were acting as Mercury's agents so that the fee is attributable to Mercury, it is part of the premium, and all of the issues raised by plaintiff concerning the fee must be raised by proper complaint before the Insurance Commissioner.***" (Ex. I-327 at I3019, emphasis added.)

Thus, Mercury argued in *Krumme*, the illegal "broker" fees at issue here are subject to Proposition 103: "Plaintiff has directly challenged insurance premiums - clearly an issue related to ratemaking[.]" (Ex. I-326 at I2996.) "It takes little mental effort to discern that this case is about a rate/premium issue covered by Chapter 9 [of Part 2 of Division 1 of the Insurance Code]." (*Id.* at I2989.)

In this proceeding, Mercury's expert witness provided written testimony confirming that "Insurance regulations in California require an insurer to obtain prior approval for the rates (and, hence, the premiums) it charges for private passenger auto insurance." (Bass PDT at 10:1-2; see also 4/30/13 RT at 132:21-25 [Bass Cross Examination].) Mercury's expert witness also explained: "[t]he premium is the amount actually charged to an individual insured risk in exchange for a particular insurance coverage. … The total [premium] is what the risk actually pays, bottom line." (Bass PDT at 4:25 - 5:1.)

F. The Rulings and Evidence in this Proceeding Conclusively Establish that Mercury Violated Insurance Code Section 1861.01 When It Charged Policyholders Unapproved Agent Fees.

As discussed above, all fees charged to Mercury policyholders by Mercury's de facto agents, including the illegal "broker" fees at issue here, are considered part of the premiums (and thus the rates) that must be approved by the Commissioner prior to their use pursuant to section 1861.01.

By the ALJ's Collateral Estoppel Ruling, it is conclusively established in this proceeding that "Mercury did not obtain the Commissioner's prior approval to charge or receive 'broker' fees charged by its agents. (SANN, p. 2, lines 25-26; FF Nos. 49-50 [incorporated by reference in SANN, p. 2, lines 14-15]; see also, *Krumme,* 123 Cal.App.4th 924, *affirming*.)" (Motion for Collateral Estoppel at 3:12-4:8, citations in original; ALJ's Ruling on Collateral Estoppel at 3.) Consistent with the *Krumme* Findings, which Mercury is collaterally estopped from relitigating here, the undisputed evidence presented in this proceeding confirms that Mercury did not include the "broker" fees in its rate applications, and the Commissioner never approved the illegal "broker" fees in the rate approval process. (See, e.g., Ex. I-1 at I8 ["Mercury does not submit the "broker" fees charged by charged by "brokers" who sell Mercury personal lines auto insurance to the [CDI] for approval as rates or premiums, and the [CDI] has not approved these fees under its rate approval authority"].)

Mercury's rate applications filed between 1998 and 2006 clearly do not list the illegal "broker" fees as a "Miscellaneous Fee." (Exs. R90 - 154 [Mercury Rate Applications filed between 1998 and 2006].) This was confirmed by Mike Edwards, CDI's Rate Filing Bureau Chief responsible for Mercury's rate applications during the relevant time period from 1996 through 2006, who testified that he was not aware of any rate application where Mercury included "broker" fees as a "Miscellaneous Fee." (4/30/13 RT at 47:14-16 [Edwards Direct Examination]; see *id.* at 45:10-2 [Mercury's September 2006 rate application did not reference "broker" fees].) Additionally, Mercury's expert witness testified that she "reviewed the Mercury private passenger auto rate filings approved by the CDI starting in 1998" and "[n]one of Mercury's approved rate filings contains any mention of broker fees either as an item of premium or of expense." (Bass PDT at 10:2-6.)

Because the illegal agent fees charged to Mercury policyholders are premium, which was required to be (but was not) submitted for review and approval prior to the fees being charged, Mercury violated Insurance Code section 1861.01(c).

G. The Evidence in this Proceeding Establishes that Mercury Violated Insurance Code Section 1861.05 When It Charged Unapproved Fees Through Its Agents in Varying Amounts, Subjecting Insureds to Unfair Rate Discrimination.

As set forth above, Insurance Code section 1861.05(a) provides that "[n]o rate shall be approved or remain in effect which is … unfairly discriminatory or otherwise in violation of this chapter." It has been noted that California's Insurance Code does not contain a definition of "unfairly discriminatory." (*King v. Meese* (1987) 43 Cal.3d 1217, 1222.) However, the plain language of section 1861.05(a) and the larger context of Proposition 103 within which section 1861.05(a) resides confirm that it forbids Mercury from charging some of its policyholders illegal agent fees in varying amounts to increase the premiums that they would have otherwise paid under Mercury's approved rates in the arbitrary manner it did here. Indeed, there is no need to parse the phrase "unfairly discriminatory" to determine that it intrinsically forbids an insurer from charging some applicants unapproved fees on top the premiums that corresponded to their individual risk characteristics under Mercury's approved rating plans. Such a practice is inherently "unfair." Moreover, such arbitrary discrimination completely undermines the integrity of the insurance function. In this case, the violation is obvious because the premiums charged to certain consumers violated Mercury's own approved rating plans.

As noted above, the "excessive, inadequate and unfairly discriminatory" standard was widely adopted decades ago. As our Supreme Court has noted, the language "echoes similar language in the law of most states, as well as former section 1852 which it replaces." (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d 805, 822; see also *Amwest Surety Ins. Co. v. Wilson, supra,* 11 Cal.4th 1243, 1257-1258.) However, Proposition 103 expanded its scope and application as part of the voters' comprehensive revision of the Insurance Code. The California Supreme Court has emphasized that "fairness" is one of Proposition 103's explicit purposes. Citing Proposition 103's purpose of "ensur[ing] that insurance is fair," the Court stated: "[A]rticle 10 is not limited in scope to rate regulation. It also addresses the underlying factors that may impermissibly affect rates charged by insurers and lead to insurance that is unfair, unavailable, and unaffordable." (*State Farm Mutual Auto. Ins. Co. v. Garamendi* (2004) 32 Cal.4th 1029 at 1041-1042.)

Other provisions of Proposition 103 confirm that arbitrarily tacking on illegal fees at the point of sale – fees that have no relationship to the risk of loss for a particular consumer – is "unfairly discriminatory." Section 1861.03(a), for example, references and incorporates the Unruh Civil Rights Act to establish that the use of discriminatory classifications forbidden by that law, such as race or gender, would constitute "unfair discrimination" for purposes of section 1861.05(a). Further, section 1861.02(a)(4) instructs that improper classification of insureds – motorists, in that statutory context – constitutes "unfair discrimination."

Reference to other authorities confirms that the plain meaning of the prohibition is to prevent insurers from singling out certain consumers for disparate treatment. For example, one noted insurance authority describes "unfairly discriminatory" as follows:

> Different treatment of persons or groups; failure to treat individuals equally when no reasonable distinction can be made between them. Treating or classifying consumers differently when they have objectively similar risks is prohibited by state insurance laws….

(http://insurance.cch.com/rupps/discrimination.htm, last visited November 5, 2005.)

This general formulation can be found in cases discussing the cognate provisions of the pre-Proposition 103 Insurance Code. (See, e.g., *King v. Meese*, *supra,* 43 Cal.3d 1217, 1241-1242 (Broussard, concurring) ["One can argue that it is unfairly discriminatory to use classifications which result in charging good drivers in some areas much more than bad drivers in others parts of the state…"].)

Indeed, as discussed above, Mercury's practice of allowing its agents to charge some of its applicants fees in varying amounts at the point of sale is the exact conduct addressed as being illegal rate discrimination in the Commissioner's Bulletin 80-6. (Ex. I-128 at I792 ["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"].)

Mercury's own expert witness agrees: "unfairly discriminatory would mean that a risk is paying more than or less than is expected in anticipated future costs for that insurance." (4/30/13 RT at 161:20 – 162:6 [Bass Re-cross Examination].)

The evidence presented in this proceeding conclusively establishes that Mercury applicants were treated dissimilarly without regard to the individual's risk characteristics in that some, but not all, de facto agents arbitrarily charged the illegal fees (4/15/13 RT at 139:9 [Wolak Direct Examination]), and agents for which Mercury filed formal agency appointments under Insurance Code section 1704(a) did not charge them. (4/19/13 RT at 141:13-18 [Norman Redirect Testimony] [AIS had a practice of charging "broker" fees from the point it was converted from agent to "broker"].) AIS witnesses testified at the hearing that there were instances where an automobile insurance applicant would pay the premium for a policy but not a "broker" fee. (4/24/13 RT at 120:2-13 [Boostrom Cross-Examination] ["In certain circumstances we would choose to waive the fee"]; 4/19/13 RT at 184:24 - 185:4 [Napolitano Redirect Examination] ["Q. So in each case, the customer would be charged a broker fee; is that correct? A. Yes. Now there could have been an exception here where perhaps during the quoting process we made a really grievous errors, and there might have been times when we agreed to waive the fee as a gesture of goodwill"]; *id.* at 186:1-6 [AIS did not charge a broker fee to a customer purchasing a Mercury policy on a "small percentage" of transactions].)

Further, the "broker" fees were arbitrarily charged in varying amounts with no relation to the risk of loss posed by the individual, the services provided to an individual consumer, or Mercury's approved rates and premiums. (See 4/26/13 RT at 62:3-11 [Carlson Direct Examination] ["And the broker-issued policies typically were charging broker fees of which the amounts were indeterminable. [¶] Sometimes there would be, like, a $50 fee, $100 fee, $150 fee, and then the independent agents on the other hand, there were no fees being charged to the policies. And yet based on what we could see in the underwriting

files, we couldn't see anything distinguishable that would make one different than the other as far as what services were being rendered to just justify the fee"]; see also Ex. R67 at R67_7 [FRUB Report] ["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 … the cost differential that is created by the added broker fees is inequitable to insureds and violates [Insurance Code] Section 1861.05(a)"].)

Accordingly, Mercury violated the prohibition against unfairly discriminatory rates under section 1861.05(a) by allowing its agents to indiscriminately charge consumers fees in varying amounts that were not included in Mercury's rates and premiums submitted for prior approval.

III. MERCURY IS LIABLE TO THE STATE FOR A SUBSTANTIAL CIVIL PENALTY.

A. The Evidence Establishes Mercury Charged Well Over 183,000 Illegal Agent Fees.

Insurance Code section 1858.07(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.

Here, Mercury is subject to a civil penalty for "each act," or each instance in which it charged its policyholders an unapproved rate in violation of section 1861.01(c) and an unfairly discriminatory rate in violation of section 1861.05(a). (See SANNC, ¶5 [Mercury is subject to a penalty "for each policy in which [Mercury] permitted a broker fee to be charged by one of its agents"].) It is incontestable that during the period from September 18, 1999 through August 11, 2004, Mercury agent *AIS alone charged well in excess of 183,000 unlawful "broker" fees*. This figure is generous to Mercury because it does not include the entire period of the SANNC, materially understates the actual number of "broker" fee events by Mercury agent AIS, and does not include all of Mercury's producers who charged an illegal "broker" fee.

During the period from September 18, 1999 through August 11, 2004, the total dollar amounts of

"broker" fees Mercury agent AIS charged California consumers purchasing Mercury personal lines automobile insurance policies, by calendar year, are as follows:

Year	"Broker" fees charged by Mercury agent AIS
1999 (from 9/18/99 – 12/31/99)	$1,026,172
2000	$3,930,734
2001	$5,077,556
2002	$6,786,093
2003	$6,992,466
2004 (from 1/1/04 – 8/11/04)	$3,780,541
Total:	$27,593,562

(Ex. 1-277 [AIS Defendants' Supplemental Responses to Plaintiff's First Set of Specially Prepared Interrogatories, *Porter v. AIS*, Sep. 17, 2004] at I1692-I1693 and Ex. I-291 [AIS Defendants' Supplemental Responses to Plaintiff's First and Second Sets of Specially Prepared Interrogatories, *Porter v. AIS*, Feb. 18, 2005] at I1727.)

According to the written testimony of AIS Vice President and Chief Financial Officer Chris Bremer, during the period from July 1, 1996 until the end of 2006 (the period covered by the SANNC), "AIS's general business practice was to charge customers and to collect from them a broker fee on all new applications for Mercury private passenger auto insurance." (Prepared Direct Testimony of Chris Bremer, Apr. 24, 2013, 1:9-11.) According to the written testimony of AIS Vice-President Lani Elkin, "[d]uring the period from 1996 to 2004, AIS's general business practice was to charge customers a one-time broker fee [on Mercury policies] of less than $100." (Prepared Direct Testimony of Lani Elkin ["Elkin PDT"], Apr. 23, 2013, 1:7-8.)

From September 19, 1999 through August 11, 2004, Mercury agent AIS charged an unlawful "broker" fee a ***minimum*** of ***183,957*** times. This figure is calculated by dividing the total "broker" fees charged by AIS on Mercury automobile policies during that period ($27,593,562) by a maximum per transaction "broker" fee of $150.

The 183,957 figure is a ***minimum***. First, the 183,957 figure covers only the period from

September 19, 1999 through August 11, 2004, and therefore excludes approximately 5 years, 8 months, from the period covered by the SANNC. Second, the 183,957 figure materially understates the number of illegal "broker" fee transactions by AIS because it assumes that AIS charged $150 for each "broker" fee per transaction. In fact, the "broker" fee charged per transaction was much lower, less than $100. (Elkin PDT at 1:7-8.) Using a "broker" fee amount of less than $100 in the calculation would yield a higher number of transactions. Finally, the calculation focuses solely on AIS and does not factor in the "broker" fees charged by other Mercury agents.

On this basis, Mercury's total number of illegal "broker" fee transactions during the relevant period in this case (July 1, 1996 through December 31, 2006) far exceeds the conservative estimate of 183,957 for the period from September 18, 1999 through August 11, 2004.

In each instance where Mercury charged an illegal "broker" fee, Mercury charged an unapproved rate in violation of Insurance Code section 1861.01(c) and an unfairly discriminatory rate in violation of Insurance Code section 1861.05(a). Accordingly, Mercury committed well over ***183,000*** violations *of each rating statute*, each of which constitutes a separate "act" for purposes of assessing a penalty under Insurance Code section 1858.07(a).

B. Mercury Acted Willfully in Using a Rate or Rating System in Violation of Insurance Code Sections 1861.01 and 1861.05.

Under Insurance Code section 1858.07(a), "*if the act or practice was willful,* [an insurer is liable to the state for] *a civil penalty not to exceed ten thousand dollars ($10,000) for each act*. (Emphasis added.) " '[W]ilful' or 'wilfully' in relation to an act or omission which constitutes a violation of [chapter 9 of Part 2 of Division 1 of the Insurance Code] means with actual knowledge or belief that such act or omission constitutes such violation and with specific intent to commit such violation." (Ins. Code § 1850.5) Insurance Code sections 1861.01 and 1861.05 are within chapter 9 of Part 2 of Division 1 of the Insurance Code.

1. Mercury Knew That Its Agents Were Illegally Charging Fees In Violation of Insurance Code sections 1861.01(c) and 1861.05(a).

Mercury had actual knowledge that, from July 1, 1996 through 2006, its de facto agents were illegally charging fees in violation of Insurance Code sections 1861.01(c) and 1861.05(a).

First, Mercury knew that its "brokers" were charging "broker" fees to consumers at the point of

sale. Bruce Norman, Mercury's Senior Vice-President of Marketing during the relevant time period, testified that AIS had a practice of charging "broker" fees from the point it was converted from agent to "broker" in late 1989. (4/19/13 RT at 141:13-18 [Norman Redirect Testimony]; see 4/15/13 RT at 141:17-19 [Wolak Direct Examination].)

Second, Mercury knew that its "brokers" were de facto agents. As set forth in the Summary of Evidence section above, Mercury created and maintained the same relationship with its "brokers" as with its agents from 1989 through 2009. Additionally, Mercury knew that its "brokers" were de facto agents based on court rulings in *Krumme* between April 11, 2003 through 2006: the *Krumme* Findings (Ex. I-1), the *Krumme* Judgment (Ex. I-3), the Court of Appeal decision in *Krumme v. Mercury Insurance Co.* (2004) 123 Cal App. 4th 924, the April 2005 Ruling (Ex. I-5), and the July 2005 Modification Order (Ex. I-6).

Third, the evidence shows that Mercury knew that its practice of allowing its de facto agents to charge "broker" fees violated Insurance Code sections 1861.01 and 1861.05. The Department sent Mercury the FRUB Report on February 18, 1999, which concluded that during the period from January 1, 1995 to July 2, 1998, Mercury's "brokers" were illegally operating as de facto agents and illegally charging consumers "broker" fees in violation of the Insurance Code, specifically section 1861.05(a). (Ex. R67 at R67_7; Ex. R66 at R66_ 1.) In January 2000, CDI sent Mercury a draft Notice of Noncompliance, charging that Mercury was selling insurance through unappointed, de facto agents who were charging "broker" fees in violation of Insurance Code sections 1861.01 and 1861.05. (Ex. R-8.) The cover letter to Mercury specifically noted: "Enclosed is a draft Notice of Noncompliance concerning the charging of brokers' fees by insurance producers operating as de facto agents." (Ex. R8 at R8_1.)

Further, based on the Insurance Commissioner's and the Department's interpretation of the rate statutes, the text and underlying purposes of Proposition 103, the Commissioner's regulations, California case law, the testimony of Mercury's own witnesses in this proceeding, and the position it took in the *Krumme* litigation (see sections II.A-E above), Mercury had knowledge that agent fees are premium and that the rates that are subject to review and prior approval and the prohibition against unfair rate discrimination (§§ 1861.01(c), 1861.05(a)) must include all premiums charged by an insurer. (Ins. Code §§ 1861.01(c), 1861.05(a)).

Thus, because Mercury knew that, from July 1, 1996 through 2006, its "brokers" were charging fees to consumers at the point of sale, its "brokers" were de facto agents and that its de facto agents were illegally charging fees in violation of Insurance Code sections 1861.01(c) and 1861.05(a), Mercury had sufficient knowledge to establish that its violations were willful under section 1850.5.

2. Mercury Designed the Sham "Broker" System With the Specific Intent to Evade Proposition 103.

The intent and essence of Mercury's "broker" system was to facilitate illegal "broker" fees. The testimony elicited from witnesses and documentary evidence admitted into the record at the evidentiary hearing unmistakably establish that Mercury specifically intended to evade Proposition 103 by creating and maintaining a sham "broker" system in order to facilitate illegal agent fees. No other explanation exists for Mercury's illusory distinction between agents and "brokers," which it maintained for 20 years (1989-2009).

The evidence here establishes that Mercury designed its "broker" system with the specific intent to evade rate regulation under Proposition 103:

1. Mercury had a well-established system, dating back to 1962, where it sold insurance exclusively through appointed agents. (Ex. I-1 at I2 (¶8); 4/19/13 RT at 11:1-13 [Norman Direct Examination].) The hallmark of Mercury's system was agent field underwriting in accordance with the Mercury's underwriting manual. (4/15/13 RT at 198:24 - 200:13, 201:13 - 203:14, 207:10 - 208:21, 210:4-15 [Wolak Direct Examination].) Mercury rewarded agent underwriting skill and proficiency with increased loss ratio commissions, and punished systematic "binding errors" with commission reductions and, ultimately, direct disciplinary measures, including termination. (E.g., 4/15/13 RT at 186:12 - 192:9 [Wolak Direct Examination]; 4/16/13 RT at 23:21 - 25:7 [Wolak Direct Examination]; 4/19/13 RT at 40:11-20 [Norman Direct Examination]; Ex. I-26 at I169-171.)

2. Immediately after the passage of Proposition 103, in early 1989, Mercury suddenly started offering its agents the option to convert to "brokers." (4/19/13 RT at 11:14-19 [Norman Direct Examination].) It was known that Proposition 103 would exert downward pressure on Mercury premiums, and accordingly, on Mercury agent commissions. (See 4/30/13 RT at 152:25 – 153:3 [Bass Cross Examination].) To illegally increase producer compensation, Mercury took its agent contract, changed "agent" to "broker" throughout, and presented it as a "broker" contract. (Exs. I-1 at I3, I-12

[Producer Contract], I-14 [Agency Contract]; 4/19/13 RT at 11:25 - 14:7 [Norman Direct Examination].) As the evidence here clearly shows, every significant aspect of Mercury's historical agency system was carried over to "brokers" with this form over substance "change." (Ex. I-1 at I3-6; 4/19/13 RT at 14:8 - 15:19, 37:1-23 [Norman Direct Examination]; 4/15/13 RT 179:18 - 181:4, 181:10 - 183:11, 187:3 - 191:18, 192:7-9 [Wolak Direct Examination]; Exs. I-10, I-12, I-14.)

3. In a letter drafted two months after the passage of Proposition 103, AIS confirmed with Mercury that the "broker" agreement it was entering into with Mercury left "the relationship between Mercury and A.I.S. [un]changed in any material fashion as a result of this change in title," that AIS's "ability to bind coverage and other essentials of our writing Mercury business will not change," and that "other essentials of our mutual business relationship including our ability to hold ourselves out as a representative of Mercury Insurance Group is not changed." (Ex. I-18.)

4. After the "broker" system was in place, no "broker" ever converted to agent. (4/15/13 RT at 155:20-24 [Wolak Direct Examination]; 4/19/13 RT at 45:15 - 46:5 [Norman Direct Examination]; Ex. I-26 at I160, 163.) In ten years, Mercury converted its an all-agent sales force to a producer force consisting of 10% agents and 90% "brokers." (See Ex. I-1 at I2 (¶¶ 5, 6); 4/15/13 RT at 136:8-10, 137:2-19 [Wolak Direct Examination].)

5. In the late 1990s, leading up to the *Krumme* Judgment, AIS took the wheel of the "broker" fee bus. AIS had exploded as Mercury's single dominant producer. By the time of the *Krumme* Judgment, AIS accounted for $400 million in annual auto premiums for Mercury, a full 25% of Mercury's entire California auto volume. (Ex I-291 at I725; Ex. I-277 at I691; I-180, I-181, I-182.) AIS was so big Mercury had to disclose in federal securities filings the risk that AIS might withdraw its business. (Ex. I-175 at I1312.) By then, AIS was making a handy $6,000,000 a year in "broker" fees. (Ex. I-277 at I1692-3.) The "broker" system was entrenched; AIS was not going to walk away from that profit.

6. As such, Mercury had to listen to AIS – and Mercury did. After the Superior Court in *Krumme* found the "broker" system illegal, Mercury had no intention of doing away with the "broker" system. Mercury had to retain it to placate AIS. Unsurprisingly, Mercury's 2005 Motion to Vacate proposed to do away with the *Krumme* Judgment, while leaving all of the essentials of Mercury's

"broker" field underwriting system intact. (Ex. I-4.)

7. The Superior Court refused Mercury's 2005 invitation, instead ordering Mercury to abolish the "broker" manual and "take all brokers." (Ex. I-6.) This resulted in the collapse of the entire "broker" system – *except for AIS*, which needed "broker" status to continue to reap it millions in "broker" fee revenue.

8. Mercury undermined the Superior Court's July 2005 Modification Order directing elimination of the "broker" manual by having Mercury Underwriting (Ken Kitzmiller) communicate directly with AIS by email and by writing the manual into "screen prompts" in its electronic submission software. (Ex. I-24 at I157; 4/17/13 RT at 35:19 - 36:18; 37:11 - 39:9 [Wolak Direct Examination]; Ex. I-46; Ex. I-300; Ex. I-295, I-296.)

9. Mercury evaded the "take all brokers" mandate by cutting the new, unwanted brokers' commissions to 5%, effectively "discouraging" any significant business from these unvetted strangers to the Mercury agency system. (4/17/13 RT at 57:22 - 58:4 [Wolak Direct Examination]; 4/19/13 RT at 65:17 - 67:18 [Norman Direct Examination], Ex. I-186; 4/18/13 RT at 44:5 - 46:12 [Tirador Direct Examination].)

10. Ultimately, Mercury acquired AIS, formally appointed it as an agent and ceased charging "broker" fees. (4/18/13 RT at 154:7-155:25 [Tirador Direct Examination]; See 4/17/13 RT at 59:25 – 61:12 [Wolak Direct Examination].) Effective January 1, 2009, Mercury finally abandoned the "broker" fiction it had started 20 years earlier and returned to a legal, all appointed agent sales force – with no "broker" fees.

The evidence in the administrative record is compelling that Mercury acted willfully. Mercury changed a single word in the Agency Contract in 1989, and then maintained its completely form-over substance sham "broker" system for 20 years thereafter. Even after the Superior Court in *Krumme* found the sham system illegal and ordered Mercury to change, Mercury remained intransigent. Mercury tried to get out from under the *Krumme* Judgment with its 2005 Motion to Vacate, which simply proposed more form over substance. When the Superior Court rejected that attempt, Mercury evaded the July 2005 Modification Order with screen prompts and emails with AIS and by freezing out the "take all brokers" group.

Mercury offers no good faith justification for its sham system, and there is none. Its genesis, at the dawn of Proposition 103, was to evade the new law in order to facilitate the illegal fees. That was and remained the essence of the sham system. Mercury could have dismantled the sham system at any time. At virtually every step, Mercury defended and maintained the sham system, even after the Superior Court ruled it illegal and the Court of Appeal affirmed. The evidence supports a finding that Mercury developed, maintained, and defended its illegal "broker" system with the specific intent to permit illegal agent fees to be charged to California consumers in violation Insurance Code sections 1861.01(c) and 1861.05(a).

Therefore, Mercury acted "willfully" with "knowledge or belief that such act or omission constitute[d] a violation and with specific intent to commit such violation." (Ins. Code §§ 1858.07(a), 1850.5)

C. The Commissioner Should Order Mercury to Pay a Civil Penalty to the State in the Range of $20 million.

As the evidence discussed above establishes, Mercury willfully charged well over 183,000 illegal "broker" fees to its policyholders during the timeframe from July 1, 1996 through 2006. In each instance, Mercury engaged in illegal rate discrimination to the detriment of consumers in violation of Insurance Code section 1861.05(a), and also violated the pre-marketing approval requirements of Insurance Code section 1861.01(c).

Therefore, at $5,000 per transaction (the maximum non-willful statutory penalty), using the conservative estimate of 183,957 policies charged an illegal "broker" fee, Mercury is liable for a penalty of over $919 million. At the maximum of $10,000 per willful violation, the penalty would be over $1.8 billion. Since each of the illegal "broker" fee transactions constituted two separate violations – charging an unapproved rate in violation of section 1861.01(c) and charging an unfairly discriminatory rate in violation section 1861.05(a), these penalty amounts would be doubled.

Consumer Watchdog is realistic and does not expect that a penalty award that high be assessed in this case. However, it would be a miscarriage of justice and a travesty if Mercury were to escape this potential liability with what amounts to a parking fine in the context of Mercury's financial resources. The force of law and the ability of the Commissioner to command public respect and to enforce his mandate to protect California consumers is severely weakened whenever known violators go unpunished.

The Commissioner cannot allow Mercury to "walk" on a 20-year history of "broker" fee violations.

The purpose of a penalty is to not just to punish, but also to set an example that deters others from the temptation to profit by breaking the law. The goal of deterrence applies with special force in the context of corporate wrongdoing, such as Mercury's. Corporate wrongdoing is calculated and carried out to make a profit. If insurers are caught, but left unpunished for illegal charges, why would any company abide by the law? A substantial fine is essential to show the rest of the industry that crime really doesn't pay.

Consumer Watchdog submits that a penalty in the range of $20 million would meet law enforcement imperatives and satisfy the public that justice has been done in this case. The following chart illustrates various penalty scenarios:

Penalty per violation	$5,000	$10,000	$100	$150
Total penalty for 183,957 violations	$919 million	$1.8 billion	$18.39 million	$27.5 million

A penalty of $100-$150 per "broker" fee transaction, using the conservative number of 183,957 transactions, would lead to a substantial penalty against Mercury, but within the realm of reason. Although a penalty is not intended to be compensatory, $100-$150 per violation bears a reasonable relationship to the broker fees themselves.

The reasonableness of $20 million can be cross-checked against Mercury's financial data from 1999 through 2004. The following chart summarizes Mercury's reported net operating income and shareholder's equity for the period 1999 - 2004, which roughly approximates the period covered by the evidence discussed above. Figures are in 1,000s (that is, the total income for the ten year period is $885 *million* and total).

	1999	2000	2001	2002	2003	2004	Total
Net operating income	$133,709	$109,366	$105,339	$66,105	$184,321	$286,208	$885,048
Shareholder equity	$909,591	$1,032,905	$1,069,711	$1,098,786	$1,255,503	$1,459,548	

(Source of 1999, 2000, 2001 data: Consumer Watchdog RON, Exh. I-345 at I3307 [Mercury General

Corporation Annual Report (Form 10-K) for the year ending December 31, 2001]; source of 2002, 2003, 2004 data: Ex. I-175 at I1342-3 [Mercury General Corporation Annual Report (Form 10-K) for the year ending December 31, 2006].)

A penalty approximating 2% of total income during the period or 2% of average shareholder equity during the period would result in a penalty in the $20 million range:

	1999	2000	2001	2002	2003	2004	2% Total Income/Average Shareholder Equity
2% income	$4,011	$3,281	$3,160	$1,983	$5,530	$11,448	$17,700
2% shareholder equity	$18,191	$20,658	$21,394	$21,975	$25,110	$29,190	$22,753

CONCLUSION

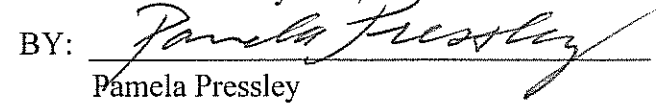
Based on the foregoing and the entire record and argument submitted in this proceeding, Consumer Watchdog respectfully urges the ALJ and the Commissioner to hold Mercury accountable once and for all for its willful evasion of the requirements of Insurance code sections 1861.01(c) and 1861.05(a) perpetrated through its illegal "broker" fee rating scheme. Given every opportunity by the Department and the courts to correct its wrongdoing, Mercury persisted in defending and maintaining its profit-driven scheme until January 2009. While the evidence in this case supports a penalty of over $1.8 billion, Consumer Watchdog submits that a penalty in the range of $20 million would serve the interests of justice.

Dated: October 16, 2013

Respectfully Submitted,

Harvey Rosenfield
Pamela Pressley
Laura Antonini
CONSUMER WATCHDOG

Arthur D. Levy

BY: 

Pamela Pressley
Attorneys for Intervenor CONSUMER WATCHDOG