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Another Step Towards the Policyholder: California Supreme Court Revives Effort to Regulate Replacement Cost Underwriting

By Andrew B. Downs

As we've discussed in recent advisories, the California Supreme Court has been moving towards more pro-plaintiff and pro-policyholder positions in its recent decisions. This week, the Court took another step in that direction, reversing lower courts' rejection of the Insurance Commissioner's regulations dictating how personal lines property insurers calculate replacement cost for underwriting purposes. *Association of California Insurance Companies v. Jones* is not the end of the story for these regulations because the case was remanded for consideration of the insurance industry's other challenges to the regulations. If enforced, these regulations apply only to the underwriting of homeowners policies, not to commercial property policies.

Between the overall high cost of living, the seismic risks, the terrain, and the climate, California is an expensive place to construct homes. Since at least the 1991 Oakland Hills fire, residential policyholders and their insurers have often experienced sticker shock when faced with the cost of rebuilding homes. In late 2010, shortly before the current Commissioner took office, the California Department of Insurance issued regulations dictating when and how homeowners insurers were to calculate the replacement cost of insured dwellings for underwriting purposes. Those regulations are codified commencing at 10 Cal. Code of Regulations § 2695.180. The insurance industry challenged those regulations on multiple grounds, including that the Insurance Commissioner did not have the authority to issue them. A trial court and the Court of Appeal agreed, invalidating the regulations. The Supreme Court saw things differently, reversing the lower court decisions and remanding for consideration of the industry's remaining challenges.

What's interesting is not so much that the Supreme Court sided with the Insurance Commissioner, but why it did so. The Commissioner contended his regulatory authority stemmed from the Unfair Insurance Practices Act, Insurance Code § 790 *et seq*. Section 790.03, whose subsection (h) has a long history in extracontractual jurisprudence, also prohibits insurers from making "untrue, deceptive, or misleading" statements. The Supreme Court concluded the regulations were within the authority of the Insurance Commissioner because he had the authority to issue regulations to enforce the prohibition on untrue, deceptive or misleading statements. To do that, the Court first had to treat inaccurate replacement cost estimates as misleading communications. The Court also invoked the Commissioner's statutory power under section 790.06 to identify new categories of deceptive acts or practices not previously prohibited by statute. This could lead to a further growth via the regulatory rulemaking process of new classes of prohibited acts and practices.

Insurers should also be concerned about the Court's comment that an accurate replacement cost estimate could nevertheless be misleading because of offsetting inaccuracies in the individual components that make up the replacement cost estimate. In other words, being right from a big picture perspective is no longer good enough.

Courts typically give great deference to decisions made by regulatory agencies, and that standard and the associated presumptions of validity were used by the Supreme Court here. But, what should concern insurers, whether or not they issue homeowners policies in California, is the Court's expansive view of the Insurance Commissioner's ability to create new categories of untrue, deceptive and misleading conduct through the regulatory process.

We've commented in recent advisories on the attorney-client privilege and the exercise of

jurisdiction over the claims of out-of-state plaintiffs, that the California Supreme Court is swinging from a position of relative neutrality towards a more pro-plaintiff and pro-policyholder outlook. *Association of California Insurance Companies v. Jones* is another step in that direction. But, just the other day the United States Supreme Court granted review of the out-of-state jurisdiction case, *Bristol-Myers*. The vast majority of decisions of the California Supreme Court of interest to insurers, however, will never be reviewed by the United States Supreme Court.