MICHAEL J. STRUMWASSER (SBN 58413)
DALE K. LARSON (SBN 266165)
CAROLINE CHIAPPETTI (SBN 319547)
JULIA MICHEL (SBN 331864)
STRUMWASSER & WOOCHER LLP
10940 Wilshire Boulevard, Suite 2000
Los Angeles, California 90024
Telephone: (310) 576-1233
Facsimile: (310) 319-0156
Email: mstrumwasser@strumwooch.com
Email: dlarson@strumwooch.com
Email: cchiappetti@strumwooch.com
Email: jmichel@strumwooch.com

CYNTHIA J. LARSEN (SBN 123994)
JUSTIN GIOVANNETTONE (SBN 293794)
ORRICK, HERRINGTON & SUTCLIFFE LLP
400 Capitol Mall, Suite 3000
Sacramento, California 95814-4497
Telephone: (916) 447 9200
Facsimile: (916) 329 4900
Email: clarsen@orrick.com
Email: jgiovannettone@orrick.com

Attorneys for Insurance Commissioner of the State of California as Conservator of California Insurance Company

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SUPERIOR COURT OF THE STATE OF CALIFORNIA

FOR THE COUNTY OF SAN MATEO – UNLIMITED JURISDICTION

INSURANCE COMMISSIONER OF THE STATE OF CALIFORNIA,

Applicant,

v.

CALIFORNIA INSURANCE COMPANY, a California corporation,

Respondent.

Case No. 19-CIV-06531

CONSERVATOR'S MEMORANDUM IN SUPPORT OF APPLICATION FOR APPROVAL OF REHABILITATION PLAN

(Ins. Code, § 1043)

Hearing Date:	March 4, 2021
Time:	2:00 p.m.
Dept.:	28
Judge:	Hon. George A. Miram

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CONSERVATOR'S MEMORANDUM IN SUPPORT OF APPLICATION FOR APPROVAL OF REHABILITATION PLAN

The Insurance Commissioner of the State of California (Commissioner) as Conservator (Conservator) of California Insurance Company (CIC) moves the Court for an Order Approving his proposed Rehabilitation Plan (Plan).[1]

OVERVIEW OF THE APPLICATION

The Conservator seeks the Court's approval of the Plan, which creates a path for CIC to leave California and, in due course, for the present conservation to be concluded while protecting the rights of policyholders. The Plan requires that CIC's existing California policies be assumed by another insurer authorized to do business in California, with such conditions as are necessary to protect policyholders from past practices of CIC that led to regulatory action and threatened policyholders' rights. It provides a means to resolve pending and future litigation arising out of CIC's illegal conduct. Upon completion of the Plan's terms, CIC will surrender its certificate of authority to transact business in California and will merge into a New Mexico affiliate.

CIC has been the object of the Commissioner's recurring regulatory attention for several years. In 2016, in the *Shasta Linen* case,[2] he ruled that the company had been charging policyholders under an illegal, unfiled, and unapproved side-agreement to its insurance policies, called a Reinsurance Participation Agreement (RPA). In that decision, the Commissioner also found that CIC was materially misrepresenting the terms of the policy and RPA to prospective policyholders. Three months after *Shasta Linen*, CIC and its affiliates agreed, among other things, to cease and desist from issuing new RPAs or renewing RPAs until the RPAs had been submitted to the California Workers' Compensation Insurance Bureau and approved the California Department of Insurance (the Department or CDI). (RJN, Ex. 2, p. 3.) In June 2017, CIC and the Department reached a settlement agreement addressing prospectively the *Shasta Linen* RPA issues, in which the company and affiliates agreed to certain modifications to the RPA and fuller disclosures to prospective policyholders. (RJN, Ex. 3, p. 2.) A CDI

[1] The Plan is presented as Exhibit A to the Declaration of Joseph B. Holloway (Holloway Dec.). It includes, as an exhibit, an Assumption Reinsurance and Administration Agreement.

[2] *Matter of Shasta Linen Supply, Inc.* (June 22, 2016) Cal. Ins. Comm'r, No. AHB-WCA-14-31 (*Shasta Linen*), Request for Judicial Notice (RJN) Ex. 1.

market conduct examination that year found violations of the agreement. (RJN, Ex. 4, pp. 2-3.)

From the commencement of the conservation, the Conservator has been working with CIC to agree on terms for CIC to exit California without harming its policyholders, other creditors, or the public. (Declaration of Joseph A. Holloway (Holloway Dec.), ¶ 8.) While formulating the Plan and investigating the company's operations, the Conservator reviewed a body of approximately 50 pending lawsuits, arbitration proceedings, and administrative hearings to which CIC and its affiliates are parties, all of which concern claims against and by CIC or its affiliates arising out of the RPA found to be unlawful over four years ago in *Shasta Linen*. As detailed below, the Conservator has determined that CIC and its affiliates continue to seek to enforce claimed rights under the unlawful RPA, and that they have leveraged their size and resources to overwhelm policyholders in lengthy and costly litigation and have failed to comply with the laws governing insurers in California.

The Conservator proposes, under the authority granted by this Court in paragraph 6 of the Conservation Order and by statute, including Insurance Code sections 1037 and 1043, to complete CIC's exit from the state on terms that protect policyholders and satisfy the concerns regarding ongoing litigation that held up the Form A approval. (Conservation Order, ¶ 6.) Upon this Court's approval, (1) CIC's existing California policies will be assumed by another insurer authorized to do business in California, with such conditions as are necessary to protect policyholders from repetition of past CIC practices that led to regulatory action and threatened policyholders' rights; (2) CIC and policyholders will have a just and reasonably expedient means to resolve pending and future litigation arising out of CIC's illegal conduct; and (3) CIC will surrender its certificate of authority to transact business in California and will merge into a New Mexico affiliate. The Conservator's Plan is within his broad discretion to rehabilitate conserved insurers and should be approved.

BACKGROUND

A. CIC and Its Affiliates.

CIC is a property and casualty insurance company that holds a certificate of authority issued by the Commissioner authorizing it to transact workers' compensation business in the State of California. It is a subsidiary of North American Casualty Company (NACC), which in turn is owned by AU Holding Company. Stephen M. Menzies is the founder, president, and sole shareholder of AU Holding.

As explained below, CIC marketed the RPA product at the center of the Commissioner's regulatory actions material to the conservation principally through its affiliate Applied Underwriters Inc. (AUI). Another affiliate, Applied Underwriters Captive Reinsurance Assurance Co. (AUCRA), is an admitted insurer, the sole purpose of which is to serve as the purported "reinsurer" under the RPA. AUI and AUCRA are sometimes the named plaintiffs against policyholders in litigation seeking to enforce the RPA. (Holloway Dec., ¶ 15; RJN, Ex. 1, pp. 49-50 [*Shasta Linen*].)

CIC and these affiliates have worked collectively under shared management to implement the illegal RPA scheme. Under the Management Services Agreement (MSA) between CIC and AUI (Holloway Dec., Exs. B and C), AUI provides actuarial and claims services in connection with CIC's policies; provides underwriting services; pays CIC's bills and collects its receivables; manages CIC's investments; performs accounting services, including the filing of CIC's statutory financial statements and tax returns; and owns the computer equipment and software used for these functions. AUI provides CIC "necessary and appropriate personnel, administrative, office and building services." (*Id.*, Ex. B, p. 3.) In other words, the personnel who conduct the insurance business for CIC are not employees of CIC but rather of AUI. In addition, under the MSA, AUI is subject to the direction and supervision of CIC. (*Id.*, p. 1.) As of this date, the Nebraska Secretary of State's website lists the only directors of AUI as Menzies, the indirect owner of CIC, and Jeffrey Silver, CIC's Secretary and General Counsel. (Holloway Dec., ¶ 11.)

In *Shasta Linen*, the Commissioner found that CIC, AUI, and AUCRA were so intertwined that they should not be considered separate entities. (*Shasta Linen*, p. 49.) The Commissioner found that AUI generated the marketing material used to convince policyholders to purchase the illegal insurance product consisting of a guaranteed-cost policy sold to them by CIC, and AUCRA executed the RPA as a "profit-sharing" plan to override critical terms of the CIC-provided guaranteed-cost policy. (*Id.*, pp. 26-31.) As discussed below, CIC and its affiliates constitute a joint enterprise and, as alter egos of each other, are jointly and severally liable under the CIC policies and the RPAs. (See *id.*, pp. 49-50.)

B. The CIC Guaranteed-Cost Policy and the Illegal RPA.

Workers' compensation insurance is usually purchased as a guaranteed-cost policy in which the policyholder pays a fixed premium and the insurer covers all losses. In loss-sensitive policies, on the other hand, premium for the policy year depends on the insured's actual cost of claims. (Declaration of Giovanni Muzzarelli (Muzzarelli Dec.), ¶ 12.) As the Commissioner explained in *Shasta Linen*:

> "Loss sensitive programs are ones in which the premium for the policy year is impacted by the actual cost of claims incurred during the policy year. By definition, loss sensitive plans are 'profit-sharing.' Generally, carriers market loss sensitive programs exclusively to large employers. In fact, many jurisdictions restrict the sale of loss sensitive programs to employers whose annual premiums exceed $500,000. Large employers are typically better able to cope with loss and experience modification variations and are in a better position to control claims costs. … Loss sensitive programs are issued as endorsements to guaranteed cost policies and require the Insurance Commissioner's approval." (*Id.*, pp. 15-16.)

The RPA was such a loss-sensitive program (albeit one lacking the Commissioner's approval), sold in conjunction with the CIC Guaranteed-Cost Policy.

The failure to file and obtain approval of the RPA was not an oversight but by design. The RPA was literally patented as a vehicle to avoid insurance regulation (*Shasta Linen*, p. 24), with that feature touted in the patent application, and the Commissioner found that AUI "structured EquityComp and the RPA to circumvent state regulators." (*Id.*, p. 50.) As the court held in *Luxor Cabs, Inc. v. Applied Underwriters Captive Risk Assurance Co.*, *et al.* (2018) 30 Cal.App.5th 970, 986 (*Luxor Cabs*):

> "Obviously, allowing an insurer to circumvent the comprehensive regulatory structure applicable to the issuance of workers' compensation insurance in this state simply by amending its approved policy forms through a side agreement with a subsidiary is contrary to the public policy underlying California's workers' compensation law and cannot be countenanced."

(See also *Nielsen Contracting, Inc. v. Applied Underwriters, Inc.* (2018) 22 Cal.App.5th 1096, 1118 (*Nielsen Contracting*) [finding that, by failing to file the RPA, CIC and AUCRA "prevents crucial regulatory oversight and thus renders the unfiled agreement unlawful and void as a matter of law"]; *Minnieland Private Day School, Inc. v. Applied Underwriters Captive Risk Assurance Company, Inc.* (4th Cir. 2019) 913 F.3d 409, 423.) The design of the EquityComp program sold by AUI and CIC affiliates attracted regulators' attention around the country; regulators in Wisconsin, Vermont, New Jersey, and New York each took steps to stop sales of the RPA products, some citing the companies for violating prior orders halting those sales, and imposing penalties ranging from $140,000 to $3 million. (Holloway Dec., ¶¶ 18.a-d.)

The EquityComp program, of which the RPA was the instrument driving the policyholders' charges, departed in material ways from the structure of industry-standard loss-sensitive programs. It was structured differently than a typical loss-sensitive plan, employing nonstandard terminology,[3] and granted to CIC "sole discretion" to determine various quantities and conditions crucial to the policyholder's liability. (*Id.*, pp. 22-23 ("non-linear retrospective plan" resulting in a "'fundamentally new premium structure,'" quoting CIC, 29-31 ("loss pick containment amount," different formula for fees, yielding astronomical fees on low-loss policies), 31-32 (unusual three-year term, with severe penalties for early cancellation and for non-renewal), choice-of-laws and dispute resolution procedures superseding Guaranteed-Cost Policy provisions and requiring application of Nebraska law and binding arbitration in the British Virgin Islands), 33-34 (newly coined term, "run-off loss development factors," comprising a valuation method "not used by other carriers"), 34-35 (close-out distribution precluding return of amounts due policyholders for up to seven years after policy expiration at CIC's "sole discretion").) The Commissioner found the RPA had not resulted in any distributions at all to policyholders. (*Id.*, p. 35.)

It is fair to say that policyholders that executed the RPA were unlikely to be fully aware of its terms, which they often did not see before the coverage had begun, at which time a refusal to sign the RPA would have resulted in cancellation of their workers' compensation coverage. (*Shasta Linen*, pp. 25, 27-28; Declaration of Larry J. Lichtenegger (Lichtenegger Dec.), ¶ 26, 32.) And the RPA they signed differed materially from the representations made in the marketing materials. (*Shasta Linen*, pp. 25-29.)

The RPA was also plagued by undefined terms and non-standard terms, obfuscating the methodology for calculating premiums, deposits, or other payments due, and making it virtually impossible for policyholders to calculate their monthly premiums, budget for workers' compensation insurance, or verify charges based on the RPA. (See *Shasta Linen*, pp. 29-30; *id.*, p. 34 ["AU coined the term 'run-off LDF' for purposes of the RPA. It is not a term used in the insurance industry or a valuation method used by other carriers."]; Lichtenegger Dec., ¶¶ 15, 20, 28-29.) The lack of transparency in billing is especially concerning in light of the potential for billing errors; indeed, in *Shasta Linen*, AUI ultimately conceded the bill it submitted to the employer was based on a calculation

[3] In fact, the name "Reinsurance Participation Agreement" is itself false. CIC conceded in *Shasta Linen* that the RPA was not in fact a reinsurance agreement. (*Id.*, p. 25.)

error. (*Shasta Linen*, p. 38.) Company representatives were unable or unwilling to explain how the bills were calculated, claiming the information was proprietary. (Lichtenegger Dec., ¶¶ 20, 29.) This forced policyholders to either pay the monthly bill or face cancellation of their workers' compensation insurance. (See *id*., ¶¶ 6, 29-30, 47.) Policyholders that were unable to pay—a possibility made even more likely because the lack of transparency in monthly billing that made budgeting "extremely difficult" (*Shasta Linen*, p. 38)—often had no choice but to execute promissory notes extended by AUI to spread out payments. (See *Shasta Linen*, p. 38; Lichtenegger Dec., ¶¶ 6, 47.)

The RPA's structure also creates incentives for CIC, AUI, and AUCRA to settle claims related to employee injuries for more money than they should have been paid according to industry practices or setting case reserves at amounts higher than was warranted. (Muzzarelli Dec., ¶ 29.)[4] Indeed, policyholders' requests for CIC to pursue subrogation efforts or investigate employees' claims of injury have gone unmet. (Lichtenegger Dec., ¶¶ 55, 58, 62; *Shasta Linen*, p. 38.) In fact, in at least one case, CIC apparently continued to pay claims of a former employee for over a year after learning the employee's lost-wages claim was fraudulent. (Lichtenegger Dec., ¶¶ 59-61.) The RPA created incentives for CIC, AUI, and AUCRA to avoid closing open claims and thereby delay eventual return of premium to the policyholders and extending the time for CIC and its affiliates to reap the investment income on the policyholder funds they were holding. (See *id*., ¶¶ 43, 56-57; Muzzarelli Dec., ¶ 19.)

The RPA also penalized policyholders that were dissatisfied with the EquityComp program by applying much higher "loss development factors" (LDFs) to the claims of employers that chose not to renew their policies after the three-year active term—in effect a stiff penalty for non-renewal. (*Shasta Linen*, p. 58.) In *Shasta Linen*, the ALJ considered such a penalty "contrary to public policy," akin to the practice of restricting payment of a policyholder dividend on account of the policyholder's failure to renew a policy, which it considered a "coercive and illegal and constitutes an unfair practice." (*Shasta Linen*, p. 58.)

The unbridled discretion and undefined terms frustrated policyholders' profit-sharing expectations. In *Shasta Linen*, the ALJ twice ordered CIC to provide the number of participants which

[4] Further, claims are paid with funds provided by the policyholder, maintained in a separate account. (*Shasta Linen*, p. 30; Lichtenegger Dec., ¶¶ 10-13.)

had received profit-sharing distribution, but CIC refused to comply, leading the Commissioner to infer that there never had been any profit-sharing distributions. (*Shasta Linen*, p. 35.)

In marketing this program, CIC went to such lengths to obfuscate its terms that prospective policyholders generally did not even receive a copy of the RPA until *after* they were locked in to the EquityComp program and paid their deposit, when their refusal to sign the RPA would threaten their insurance coverage altogether. (*Shasta Linen*, pp. 25, 28-29; Lichtenegger Dec., ¶¶ 26, 32-33.)[5] And in the documents that CIC *did* provide to prospective policyholders, CIC made misrepresentations, including the amounts a participant could expect to pay. (*Shasta Linen*, p. 27 [explaining the Program Summary & Scenario document provided to potential policyholders included a "single-year table [that] does not represent the one-year cost of the program."].) Because the probability a policyholder is able to maintain low losses for three years is lower than over a one-year period (Muzzarelli Dec., ¶ 24), and because it is the policyholder's three-year loss history that ultimately guides the cost of the program (*Shasta Linen*, p. 27), this misrepresentation has "clear implications for the potential of a policyholder to have a premium near the minimum under the RPA." (Muzzarelli Dec., ¶ 24). CIC also characterized the EquityComp program as one that can provide "immediate cash flow benefits and financial reward unlike other plans that require waiting for cumbersome retrospective or uncertain dividend calculations that can run for years beyond policy expiration" when, in actuality, the *earliest* possible time to receive a profit-sharing distribution occurs three years after the termination of the program, provided all claims are closed and AUCRA decides "in its sole discretion" to do so (Lichtenegger Dec., ¶¶ 30-31).

C. The RPA Litigation.

The Conservator has reviewed the substantial body of pending litigation arising out of the EquityComp program and materially affecting California policyholders. (Holloway Dec., ¶ 15.) This litigation falls into three categories. First are policyholder-initiated lawsuits, arbitrations, and appeals initiated in the Department's Administrative Hearing Bureau alleging the illegality of the RPA, and

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[5] If a policyholder decided to purchase the EquityComp program based on the two marketing materials provided, it would execute a "Request to Bind" and send a deposit check to AUI. After it received the check, AUI would send insureds the RPA for the policyholder's signature, often after the coverage had begun. By then, the policyholder would have no choice but to sign the RPA or risk losing coverage retroactively. (*Shasta Linen* at pp. 28-29; Lichtenegger Dec., ¶¶ 26, 32-33.)

seeking to cancel their policies and receive a refund of their excess premium. (Lichtenegger Dec., ¶¶ 6, 25, Holloway Dec., ¶ 15.) Because of the discretion reserved to AUCRA to grant a refund of policyholders' excess premium, policyholders are virtually compelled to initiate litigation to receive a return of dollars. (Lichtenegger Dec., ¶¶ 18, 22, 33.) And then, once litigation begins, CIC and its affiliates typically file costly and lengthy appeals of awards in favor of policyholders until all possible appeals are exhausted. (See Lichtenegger Dec., ¶¶ 37, 51.)

Next are the cross-complaints filed by AUCRA, seeking to enforce the terms of the RPA (Lichtenegger Dec., ¶¶ 6)—despite multiple courts and the Commissioner's *Shasta Linen* decision concluding the RPA is illegal. (E.g., *Jackpot Harvesting, Inc. v. Applied Underwriters, Inc.* (2019) 33 Cal.App.5th 719, 736 (*Jackpot Harvesting*) [finding the RPA required regulatory approval]; *Luxor Cabs*, 30 Cal.App.5th at p. 986; *Nielsen Contracting*, 22 Cal.App.5th at p. 1118.) Along with AUCRA's cross-complaints, CIC generally files cross-complaints to enforce the underlying guaranteed-cost policy, should the RPA be found unenforceable. (Lichtenegger Dec., ¶¶ 6.)

The third category of litigation is generally initiated by AUI as parallel litigation—most frequently in Nebraska—against policyholders seeking to enforce the promissory notes explained above. (Lichtenegger Dec., ¶¶ 6, 47.) This parallel litigation in an out-of-state forum is often dismissed for lack of personal jurisdiction. (Lichtenegger Dec., ¶ 49.) Nevertheless, from the perspective of policyholders, the practice of bringing retaliatory suits against policyholders in Nebraska forces policyholders to spend precious resources litigating meritless cases, and could reasonably be expected to deter them from asserting the illegality of the RPA. (Lichtenegger Dec., ¶¶ 46-47.) AUI maintains that amounts due under a promissory note are independent of the profit-sharing distribution to which a policyholder would be entitled under the RPA. (Lichtenegger Dec., ¶¶ 31.)

Taken together, the Commissioner's findings in *Shasta Linen* show an illegal policy rider that contained unfair and illegal terms and that was misleadingly sold to small and medium-sized companies. These terms, and the abusive practices they enabled, have continued to be deployed for years after the RPA was declared unlawful. For example, counsel for many of the policyholders presently engaged in pending litigation recounts that CIC's general counsel agreed not to invoke certain provisions of the RPA to induce the policyholder to execute a promissory note, but the affiliates failed to abide by the promise. (Lichtenegger Dec., ¶ 34.) A different policyholder settled its case with CIC and affiliates, but after executing the settlement agreement, the affiliates contended the agreement was ambiguous and refused to comply, forcing the policyholder to file another declaratory relief action and accept an even lower settlement figure because the policyholder no longer had the financial resources to fight. (Lichtenegger Dec., ¶ 33.) In appealing a judgment confirming an arbitration award in favor of a policyholder, counsel for AUCRA filed a notice of posting a supersedeas bond but did not actually do so; now, after the judgment was affirmed in favor of the policyholder and AUCRA's appeals are exhausted, the judgment remains unsatisfied because there is no bond. (Lichtenegger Dec., ¶ 38.)

D. CIC's Attempt to Merge Into a New Mexico Affiliate and Evade California Jurisdiction

As the Conservation Application[6] attested, Menzies, founder, president, and sole shareholder of AU Holding Company, parent company of NACC, of which CIC is a subsidiary, filed with the Commissioner multiple applications (called "Form A applications") in 2019, seeking the necessary prior approval of the Commissioner for Menzies to acquire full indirect control of CIC, among other insurers, from Berkshire Hathaway, Inc. (Conservation Application, ¶¶ 5-8, pp. 3-4.)

Menzies filed a series of insufficient responses to CDI's requests for information and concerns about the large number of ongoing lawsuits that involved considerable potential liability to CIC. His planned acquisition of CIC had raised serious questions about the accounting, premium audit, legal, actuarial, and claims-related services covered by then-existing agreements with affiliates AUCRA and AUI, as described in CDI's September 13, 2019, letter to Silver. (RJN, Ex. 5, p. 2.[7]) CDI sought additional information to ensure the protection of policyholders, asking how the re-structuring would impact services provided by CIC affiliates, noting Menzies' and Silver's personal involvement with the handling of claims and related litigation, and expressing concerns that, with the departure of Berkshire Hathaway, the interest of California's policyholders "may be in jeopardy" should AUI face solvency concerns. (*Id.*, pp. 2-3 ["[b]ased on current financials, the valuation of AUI appears excessive"].) CDI

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[6] Verified Ex Parte Application for Order Appointing Insurance Commissioner as Conservator .

[7] Form A communications with applicants are confidential under section 1215.8. However, on October 2, 2020, CIC made RJN Exhibits 5 and 6 public by filing them unredacted with the Court of Appeal in connection with its petition for interlocutory review of two of this Court's rulings.

specifically sought a plan for strengthening internal controls post-sale, in part because an examination completed in mid-2018 raised several concerns about CIC's weak corporate governance and internal controls, but noted a degree of comfort due to Berkshire's role as the ultimate parent company of CIC at the time, comfort which would be lost if Menzies completed the acquisition. (*Id.*, p. 3.) Regarding the large body of RPA-related pending litigation and resulting potential liability, CDI informed CIC on September 27, 2019, that "[n]umerous questions still exist concerning the pending litigation, the potential liability and financial impact that it will have upon the insurer" and that the Department could not complete its review of the application to determine whether the proposed sale would jeopardize the financial stability of the insurer or prejudice the interests of the policyholders by the September 30, 2019, deadline imposed by Berkshire. (RJN, Ex. 6, p. 1.)

Unwilling to wait for the Commissioner's approval and for the regulatory process to play out, CIC attempted an end-run around California law via New Mexico. On or before October 8, 2019, Menzies created a New Mexico insurance company, California Insurance Company II (CIC II), and filed an application with the New Mexico Superintendent of Insurance to merge CIC into CIC II, which is not licensed to transact insurance in California. (Conservation Application, ¶¶ 9-10, p. 4.) The effect of the merger, if consummated, would have been to extinguish CIC's certificate of authority to transact business in California by operation of law, leaving CIC's policyholders and beneficiaries of those policies without coverage from a licensed insurer as required by California law. (*Id.*, ¶ 11, p. 4, citing §§ 700, 701, 760.1.) Like its attempted acquisition, this merger also required CDI approval, but CIC ignored this requirement and sought to consummate the merger.

At this point, on November 4, 2019, the Commissioner sought and obtained the Order Appointing Insurance Commissioner as Conservator and Restraining Orders (Conservation Order), initiating these proceedings and preventing the consummation of the merger. Despite the lack of legal merger with the out-of-state entity *and* the lack of regulatory approval through the Form A process, Menzies proceeded with the illegal transaction, closing on or before October 16, 2019. (RJN, Ex. 8.)

E. The Conservation Order and Denial of the Application to Vacate.

The Court's November 4, 2019, Conservation Application recited the statutory prohibition against any person entering into an agreement to merge with or otherwise to acquire or cede control of a domestic insurer unless the Commissioner has approved the transaction. (*Id.*, p. 2, ¶¶ 3-4 & 15-16, pp. 2-3, 15, citing § 1215.2.) Attempting to merge without the Commissioner's permission is among the specified grounds in the Insurance Code for conserving an insurer. (Ins. Code, § 1011, subd. (c).)[8] The Court granted the Conservation Application, and the following day, the Conservator effected service of the Conservation Order on the Secretary of the Company, Jeffrey Silver, at CIC's offices in Omaha, Nebraska. (Affidavit of Service, Nov. 12, 2019.)

On January 22, 2020, the pre-conservation management filed a Verified Application to Vacate the November 4 Conservation Order Appointing Insurance Commissioner as Conservator (Application to Vacate), which the Court heard and denied on August 6, 2020. The Court stated that "Respondents attempted to take CIC and its assets out of California via a merger without adequate protection of policyholders and the public …. Respondents have failed to demonstrate that the conditions necessitating conservation no longer exist." (Aug. 11, 2020, Minute Order.)

F. Operations Under Conservation Order.

From the commencement of the conservation, the Conservator has sought to conduct the conservation in such a way as to allow the normal operations of CIC to proceed without undue interruption. While the Conservator has deployed staff to CIC's headquarters in Omaha at various times, he has authorized the day-to-day operation of the company to be conducted by its pre-conservation personnel, subject to his supervision. While under the oversight of the Conservator, CIC has continued to renew business, write new policies, and adjust and pay claims. (Holloway Dec., ¶ 7.)

Conservation Order, paragraph 17, enjoins all persons from instituting or maintaining any action against CIC, from pursuing any other legal proceedings against any CIC property, and from performing any other act interfering with the Conservator's conduct of the conservation, except upon order of the Court. Pursuant to paragraph 17, the Conservator has requested that all judicial, administrative, and arbitral tribunals stay any action against CIC or its affiliates, and, so far as the Conservator is aware, all such proceedings in California have been stayed. (Holloway Dec., ¶ 17.)

Since the Conservation Order, CIC's financial status has remained stable. CIC's AM Best credit

[8] Subsequent statutory references are to the Insurance Code unless noted otherwise.

rating remains at its pre-conservation A (Excellent) level.[9]

G. Ongoing Concerns About CIC's Management and Its Past and Future Compliance with the Law.

The Conservator remains concerned whether CIC and its affiliates' common management can be trusted to operate its business in compliance with the Conservation Order, California law, and this Court's orders. Two examples merit mention. First, on March 31, 2020, and without notice to the Conservator, CIC made a $20 million, uncollateralized loan to AUI. This transaction—clearly beyond the ordinary scope of business—was never brought to the attention or approved by the Conservator as required by paragraph 15 of the Conservation Order. (Holloway Dec., ¶ 7.) This incident has undermined the Conservator's confidence in pre-conservation management's willingness to abide by this Court's Conservation Order and California law.

Equally troubling was CIC's pre-conservation management's initiation and prosecution of RPA litigation in federal district court against O'Connell Landscaping. Counsel for the Conservator had appeared in numerous cases around the country involving CIC and its affiliates to ensure paragraph 17 of the Conservation Order—the stay of litigation—was enforced to preclude litigation against CIC and its affiliates. (RJN, Ex. 9, p. 3.) Nevertheless, the same law firm representing CIC in this proceeding filed, in the name of AUI, a case against O'Connell Landscaping and propounded extensive discovery, until the Conservator appeared. (RJN, Ex. 10, p. 2; Lichtenegger Dec., ¶¶ 46.) The Conservator pointed out that staying the AUI lawsuit was necessary to ensure equitable treatment—if policyholders were prevented from initiating litigation against CIC and its affiliates, fairness required litigation against policyholders to be frozen, too. (RJN, Ex. 9, p. 3.) The Court agreed. (RJN, Ex. 10, p. 2.)

Coming on the heels of the attempt to evade California jurisdiction with the unapproved merger

[9] Before the Conservation Order, the AM Best credit-rating agency had downgraded its ratings of NACC, CIC's parent company, and NACC's affiliates, including CIC, and placed their ratings "under review with negative implications," citing the sale of the companies by Berkshire Hathaway Inc. to Menzies—an issue that was also before the Commissioner in the Form A process. On June 10, 2020, AM Best announced that it had "removed [CIC and the other affiliates] from under review with negative implications and affirmed the Financial Strength Rating of A and Long-Term Issuer Credit Ratings of 'a.'" AM Best cited this Court's Conservation Order, said it was watching how CIC's regulatory issues are resolved, and observed that "the company does continue to operate unencumbered by" the conservation. (See Holloway Dec., ¶ 8.)

and CIC's track record of deliberately ignoring the regulatory review process for its insurance product, these events reinforce the Conservator's concerns about the candor and reliability of the Menzies organization and its treatment of policyholders, which forms an important basis of the Conservator's exercise of discretion to rehabilitate CIC on terms that fully protect policyholders and the public.

STANDARD OF REVIEW

The Commissioner, as Conservator, has broad authority to carry on and conduct the business and affairs of CIC in the interest of the conserved entity, creditors, interested parties, and the general public. (§§ 1037, 1043; *State of California v. Altus Finance* (2005) 36 Cal.4th 1284, 1302; *Jones v. Golden Eagle Ins. Corp.* (2011) 201 Cal.App.4th 139, 146.) Specifically, section 1037, subdivision (a) authorizes the Conservator to take all actions "necessary or expedient to collect, conserve or protect [the conserved company's] assets, property, and business, and to carry on and conduct the business and affairs of [the company] . . . as to him or her may seem appropriate." Subdivision (d) vests the Conservator with authority to enter into transactions for the sale or transfer of estate property with the conservation court's authorization, subdivision (f) allows the Conservator to execute such instruments necessary for the administration or disposition of assets of the conserved company on the company's behalf, and the final paragraph of section 1037 provides the Conservator with broad authority "to perform and to do such other acts not herein specifically enumerated, or otherwise provided for, which the commissioner may deem necessary or expedient for the accomplishment or in aid of the purpose of such proceedings." In addition, section 1043 authorizes the Conservator to rehabilitate the insurer by entering into, with court approval, either reinsuring or rehabilitation agreements. (See *Carpenter v. Pacific Mut. Life Ins. Co. of California* (1937) 10 Cal.2d 307, 331.) Section 1037 expressly provides that the Conservator's duties, powers, and authority are not limited to those enumerated.

The Conservator's broad discretion in administering a conserved company extends to his adoption of a rehabilitation plan. Indeed, the Conservator's plan must be approved absent an affirmative showing that its terms constitute an abuse of discretion, either because they are unsupported by a rational basis or are arbitrary and improperly discriminatory. (See *In re Executive Life Ins. Co. v. Aurora National Life Assurance Co.* (1995) 32 Cal.App.4th 344, 358 (*Executive Life*) [the conservator's actions in rehabilitating a conserved insurer are reviewed for abuse of discretion]; see also *Carpenter v. Pacific Mut.*, *supra*, 10 Cal.2d at p. 329 ["The only restriction on the exercise of this . . . power is that the state's action shall be reasonably related to the public interest and shall not be arbitrary or improperly discriminatory."].)

PRINCIPAL PROVISIONS OF THE PLAN

This Court's Conservation Order authorizes the Conservator to "assist CIC in addressing their Form A deficiencies with the goal of obtaining Form A approval and settlement of disputes with CDI." (Conservation Order, ¶ 6.) The Conservator's Plan is designed to do just that—complete CIC's exit from the state on terms that protect the Company, policyholders, and the public.

This Plan has been structured around an Assumption Reinsurance and Administration Agreement (Reinsurance Agreement) under which an admitted insurer authorized to write workers' compensation insurance in California will assume CIC's in-force California policies and reinsure the liabilities under expired CIC California policies. CIC will then be permitted to merge with its out-of-state affiliate, CIC II, and will surrender its certificate of authority to write insurance in California without diminishing the rights of policyholders. Prior to the transfer of policies to the reinsurer, policyholders with RPA claims will be offered an opportunity to settle their claims and the litigation arising out of those claims on terms that align with the rights of a person who was induced to sign an illegal contract and wishes to elect its remedies. Specifically, policyholders will be permitted to either (i) renounce the contract and, having received the benefit of insurance coverage, to pay the reasonable value of that coverage and get back whatever excess it has paid, (ii) affirm the contract and pay the amount due under the guaranteed-cost CIC policy, or (iii) affirm the contract and pay the amount due under the RPA. If a CIC affiliate plans to bring an action against a policyholder to enforce the RPA, the underlying guaranteed-cost policy, or a promissory note, that policyholder will have the opportunity to file a notice of claim and opt in to the three-option process. And if a policyholder has a claim regarding the RPA that was not time-barred as of the date of the Conservation Order, that policyholder is given an opportunity to assert its claim and avail itself of the same opportunity to settle that claim under the three options. This solution is a fair and equitable process for resolving the respective rights of CIC and its policyholders in relation to the SolutionOne and EquityComp programs. (Holloway Dec., ¶ 27.) The Conservator believes this process will resolve a substantial portion of CIC's outstanding policies and policy liabilities before the Reinsurance Agreement goes into effect.

The Plan provides for the Conservator to assess whether there is a market for a non-affiliated insurer to acquire the CIC portfolio of policies. If such a market exists, the Conservator will conduct a selection process to identify an insurer to assume the policies and negotiate the terms of transfer. The Conservator understands that a CIC affiliate, Continental Indemnity Company (Continental), which is authorized to write workers' compensation insurance in California, may be prepared to assume the policies as the reinsurer. (Holloway Dec., ¶ 24.) However, in light of the Conservator's concern about CIC's management, affiliates, and the incentives created by the EquityComp program to overpay and over reserve policyholder claims (see Muzzarelli Dec., ¶ 29), he is reluctant to permit an affiliate of CIC to take over the policies. If the Conservator finds sale of the policy portfolio to Continental to be in the best interests of policyholders, creditors, shareholders, and the public, or if there are no non-affiliated bidders, Continental would become the reinsurer, but will be required to utilize an unaffiliated third-party administrator (TPA) selected by the Conservator to administer the claims.

DISCUSSION

I. The Transfer of CIC's California Business Is Within the Conservator's Powers and Necessary to Protect Policyholders Upon CIC's Redomestication.

Reinsurance agreements, such as the one the Conservator proposes, are a common tool in the insurance industry when a carrier wishes to remove policies and transfers them to a different insurance company. Indeed, the Code explicitly contemplates the Conservator reinsuring the business of a conserved company. (§ 1043; see also § 1071.5 ["every insurer which . . . is required to withdraw as an insurer, from this State shall, prior to such withdrawal, discharge its liabilities to residents of this State . . . [and] shall cause the primary liabilities under such policies to be reinsured and assumed by another admitted insurer."].) As stated in the Conservation Application, CIC's attempt to merge with New Mexico-based CIC II without consent would have had the effect of forfeiting by operation of law its Certificate of Authority to transact the business of insurance in California. (Conservation Application, ¶ 11.) The Conservator has determined it is in the best interest of CIC, its policyholders, and the public to allow CIC to complete its merger with CIC II on terms that would complete CIC's forfeiture of its California certificate of authority. (Holloway Dec., ¶ 22.) The Conservator has further determined that a reinsurance agreement is the proper vehicle for implementing this task. (Holloway Dec., ¶¶ 22-24.) The Reinsurance Agreement provides for another admitted insurer to assume CIC's book of California business, avoiding harm to the policyholders and their employees. (Holloway Dec., ¶ 22.)

Following a typical reinsurance process related to a conservation, the Conservator will issue a Solicitation of Expressions of Interest, inviting qualified insurers to express their interest in submitting a bid to acquire the in-force California policies and the liabilities incurred under expired California policies. The Solicitation will verify the characteristics of the policies and adequacy of reserves, and provide other data a prospective reinsurer would want to know. (Plan, § 2.2(a)(1).) Exhibit A to the Plan sets out the form of this Reinsurance Agreement. Expressions of Interest are to indicate the financial terms under which the bidder would agree to assume the portfolio. (*Id.*, § 2.2(a)(2).) The Conservator will retain a qualified actuary to provide an actuarial opinion attesting to the accuracy of the information provided. (*Id.*, § 2.2(a)(2).) The Conservator will then evaluate the expressions of interest, potentially negotiate terms, and use his discretion to select the reinsurer, taking into consideration the interests of policyholders, creditors, and shareholders, consistent with the public interest. (*Id.*, § 2.2(a)(4).) The selection will require Court approval. (*Id.*, § 2.2(a)(7).)

For various reasons, there may not be any qualified unaffiliated insurer applicants,[10] and the Conservator will consider any expression of interest from a CIC affiliate. During the Conservation, CIC has indicated that its own affiliate, Continental, operated by Steven Menzies as President/CEO and Jeffrey Silver as Secretary with both individuals serving as Directors (RJN, Ex. 7), is prepared to assume the portfolio of policies. The Conservator would allow this, but because of the history of CIC's prior management's sale of an illegal RPA, multiple attempts to evade regulatory authority, and the closing of the illegal acquisition of CIC and certain affiliates from Berkshire by Menzies, the Conservator has determined that it cannot protect California policyholders by simply shifting existing policies from CIC to another company with a different name run by the same officers. (Holloway Dec.,

[10] Applicant insurers would need to know whether the reserves are adequate, whether the existing reinsurance is reliable, what the future prospects are for the policies, associated liabilities, and other characteristics of the policies. These concerns may be exacerbated if applicant insurers lack confidence in the reliability of CIC's financial statements or management.

¶ 24; see also RJN, Ex. 4, pp. 2-3 [explaining CIC's violations of the stipulated cease and desist order].) Further, the Conservator understands that Continental itself has no claim-handling employees, instead, like CIC, Continental would rely on another affiliate, AUI, to adjust and pay claims and set reserves, but AUI was a core part of CIC's illegal RPA scheme. (*Shasta Linen*, pp. 49-50.) The Conservator, therefore, would require that if the successful applicant is an affiliate of CIC, it must contract for claims administration with an independent third-party administrator appointed by the Conservator. (Plan, §§ 2.2(a)(3), 2.2(a)(5).) With these assurances, the Conservator believes that the Plan will adequately protect policyholders and the public while taking into consideration the interests of CIC's shareholder. (Holloway Dec., ¶ 24.)

The prospective reinsurer will assume the liabilities of the policies, which should be accurately reflected in the reserves on CIC's statutory financial statements. Those reserves, by definition, represent the expected values of future liabilities. (See Muzzarelli Dec., ¶ 19.) In return, the reinsurer will receive all future premiums on active policies plus the unearned premium reserves.[11] The prospective reinsurer will also be assigned the rights of CIC under third-party reinsurance agreements maintained by CIC that cover the liabilities of CIC to be reinsured and assumed by the reinsurer under the Reinsurance Agreement. The assumption of the policies and associated rights and liabilities may be sufficient to induce an eligible buyer to acquire the CIC portfolio of policies. Or, if a purchaser expects competition from other prospective buyers, it may offer additional consideration to acquire the policies. Conversely, if the applicant insurer believes the portfolio is overpriced (e.g., if it believes the reserves are inadequate or the premium rates are too low), it may require an additional payment to assume the portfolio. Either way, if the successful applicant offers additional consideration, it would go to CIC; and if the winning applicant requires additional funds, those funds would come from CIC. Because the portfolio is to be offered and sold in a competitive open market with net proceeds of the sale going to CIC, the terms under which the sale takes place will represent the fair market value of the portfolio.

[11] "Unearned premium reserves" represent premiums the insurer has received, typically for the full term of the policy, that are attributable to the portion of the premium attributable to future coverage and hence is "unearned." (See Muzzarelli Dec., ¶ 18.)

II. Settling Claims Related to the RPA Is Within the Conservator's Authority and Will Provide CIC and Policyholder Claimants a Reasonable Opportunity to Resolve Their Respective Rights Under the RPA on Terms Fair to Them, to the Estate, and to the Public.

When Menzies illegally sought to merge CIC with CIC II and then consummated his transaction with Berkshire Hathaway before obtaining the Commissioner's approval of his Form A, he robbed the Commissioner of an opportunity to evaluate whether the acquisition would be fair and reasonable to policyholders. Had CIC instead abided by the Form A process, the Commissioner would likely have been able to implement policyholder protections relating to the substantial liability raised by the RPA-related litigation. But because CIC evaded that regulatory process and attempted to flee the state, and because CIC's management has not inspired confidence during the conservation, the Conservator has determined that he must exercise discretion afforded to him under the Code and resolve these issues during this conservation. In short, allowing the conservation to conclude without rehabilitating the company and its relationship to its policyholders—one of the very problems threatening California's approval of the purchase from Berkshire in the first place—would not be consistent with the Conservator's duty to act to protect the interests of policyholders, other beneficiaries, and the public. (See *Altus Finance*, *supra*, 36 Cal.4th 1284 at p. 1302; *Golden Eagle*, *supra*, 201 Cal.App.4th at p. 146; *Caminetti v. Guaranty Union Life Ins. Co.* (1942) 52 Cal.App.2d 330, 336-37.)

Accordingly, as part of his Plan, the Conservator has developed a process that provides CIC and California policyholders a reasonable opportunity to resolve their respective rights under the SolutionOne and EquityComp programs, including the associated RPAs, on terms fair to them, to CIC, and to the public. The process provides a judiciously expedient way to determine and enforce the rights and obligations of CIC and its policyholders. The resolution will mirror the outcomes to which the litigants would be entitled in civil litigation, with less cost and delay than is typical in litigation—costs and delays that have become a regular feature and apparent strategy of CIC's insurance business. (Lichtenegger Dec., ¶¶ 18-19, 37, 40-44, 47, 61.) As described below, policyholders are entitled to the remedies available to someone who has been forced to sign an illegal contract: to waive the illegality and affirm the contract or, at the person's option, to reject the illegal contract and pay the amount that fairly compensates the other party for the services it provided, in this case insurance coverage. The process by which that resolution is achieved is laid out in Section 2.6 of the Plan and is incorporated in

Schedule 2.6, which is explained below, after reviewing the legal and factual basis for this resolution.

A. The Conservator Has Authority Under the Insurance Code to Settle Claims By and Against the Conserved Entity.

The Conservator has concluded that it is not only appropriate but necessary to provide a means to resolve RPA-related litigation prior to ending the Conservation (Holloway Dec., ¶¶ 27-28), an exercise of discretion that fits squarely within the authority granted to him by the Code. *Executive Life* considered the Commissioner's authority under section 1037, subdivision (c), to settle disputes over priority of claims against an insolvent estate. (32 Cal.App.4th at p. 374.) The court concluded that because section 1037 divulged a "legislative expression of policy favoring resolution of claims by settlement" (*id.*, pp. 374-375), the Conservator was vested with authority to engage in these settlements if "reasonably related to the public interest in rehabilitating the insurer" and not "arbitrary or improperly discriminatory" (*id.*, p. 376).

Not only did *Executive Life* find broad authority to settle disputed claims where necessary to vindicate the public interest, but the court suggested that settlement was even more important in the rehabilitation context, because even "more than probate, rehabilitation of insolvent insurers is a matter particularly affected with the public interest. Of necessity, if required to satisfy the public interest, the Commissioner possesses considerable discretion in settling claims." (*Id*., p. 475.) In fact, the Court noted that this discretion extended to settlement of some claims "which would not be justified in the absence of other parallel settlements might be justifiable if a global settlement including other claims is reached, or if the particular settlement materially contributes to an appropriate near global settlement which benefits the estate." (*Id*., pp. 475-476.)

That is precisely what is before the Conservator here. CIC and its affiliates use "scorched earth" tactics to attempt to wear down these small- and medium-sized businesses with drawn-out litigation that often involves parallel proceedings in California and Nebraska, excessive pretrial motions and discovery, settlement agreements that they reach only to then contend are ambiguous and refuse to comply with, numerous writs and appeals and, ultimately, refusal to pay judgments. (Lichtenegger Dec., ¶¶ 7, 34, 36, 37, 39, 43.) In order to rehabilitate CIC, the Conservator must not only ensure that sufficient funds are reserved to satisfy any judgments that may arise out of the litigation (a process that was bypassed by Menzies when he attempted to circumvent the Form A process), but also address that fact that CIC and its affiliates have leveraged their size and resources in concerted efforts to grind down individual policyholders by using excessive litigation and repeatedly litigating the legality of the RPA, which the Commissioner has already declared illegal. (Holloway Dec., ¶¶ 27-28.)

B. Given that CIC, AUI, AUCRA Operate as a Single Entity, It Is Fair and Appropriate That All Claims By or Against Them Related to the RPAs be Resolved.

The Conservator's Plan contemplates that CIC, AUI, and AUCRA will be required to enter settlements at the option of policyholder claimants. As discussed above, Commissioner has found that CIC, AUI, and AUCRA were so intertwined that they should be considered a single entity. (*Shasta Linen*, p. 49; see also *Nielsen Contracting, supra*, 22 Cal.App.5th at pp. 1113-1116 [record on appeal supported conclusion that affiliated entities should be considered together because they were so enmeshed and intertwined]; *Luxor Cabs, supra*, 30 Cal.App.5th at pp. 985-986 [same].) Similarly, the Plan treats these entities as a joint enterprise with shared identities of interest for purposes of settling suits and claims related to the RPA. Doing so falls squarely within the Conservator's authority and this Court's jurisdiction, both of which reach non-conserved entities that share an identity of interest with the conserved estate. (*Garamendi v. Executive Life Ins. Co.* (1993) 17 Cal.App.4th 504, 523)

In *Garamendi v. Executive Life*, the court upheld the assertion of in rem jurisdiction over the assets of a non-conserved entity because "an identity of interest" existed between the entity and the insolvent insurance company. (17 Cal.App.4th at p. 508). The court held that "when an 'identity of interest' exists between an insolvent insurance company and a partnership in which the insurance company has a substantial ownership interest, a trial court overseeing the company's insolvency may validly exercise in rem jurisdiction over such partnership's assets where reasonably necessary to promote the insolvent company's rehabilitation." (*Id.*)

Here, CIC's operations largely depend on a system of intertwined agreements between itself and its parent and affiliates. There is substantial overlap between CIC and its affiliated companies' boards of directors and they also share common addresses, registered agents, and executives. (Holloway Decl., ¶¶ 11-12.) For example, CIC, AUCRA, AUI, and other related entities all have the same mailing address, registered agent, and principal office in California. (*Ibid.*) These companies also share management—with Menzies as President or CEO and Silver as Secretary. Menzies and Silver are also directors of CIC and AUCRA and, according to the Nebraska Secretary of State's website, the sole directors of AUI, Applied Risk Services (ARS) and NACC. (*Ibid*.)

As discussed above, attempting to resolve the RPA-related litigation is an appropriate and necessary part of the rehabilitation of CIC. Given that CIC, AUCRA, and AUI share an identity of interests, are parties to the EquityComp and SolutionOne programs, and are parties to the multiplicity of suits involving the RPA,[12] resolving suits involving these CIC-affiliated entities as part of the effort to rehabilitate CIC falls within the authority of the Conservator and the jurisdiction of this Court.

C. CIC and Its Affiliates Face Liability Under California Statutes and Contract Law.

1. CIC Faces Liability to Policyholders Under Contract Law.

CIC faces legal exposure from policyholders seeking to invalidate part or all of the EquityComp insurance product *and* policyholders seeking to enforce the profit-sharing provisions of the RPA. Because the RPA is based on unfiled rates in violation of Insurance Code sections 11735 and 11658, the RPA is unlawful and void. (*Shasta Linen*, pp. 67-68; Code Civ. Proc., §§ 1598, 1608.) But that is not the end of the matter; the Commissioner's finding of illegality does not preclude policyholders from seeking, in court or in arbitration, refunds of premium paid in excess of that required by the Guaranteed-Cost Policy. (Civ. Code, § 1599 [permitting severance of illegal portions of an otherwise valid contract]; *Marathon Entertainment, Inc. v. Blasi* (2008) 42 Cal.4th 974, 998 ["Inevitably, no verbal formulation can precisely capture the full contours of the range of cases in which severability properly should be applied, or rejected."].) Indeed, in *Shasta Linen*, the Commissioner concluded that there was no compelling reason to enforce the RPA *against* a policyholder—an outcome that would have favored CIC—because in that case it would "not be equitable to allow the party who created the illegality to enforce the illegal contract." (*Shasta Linen*, p. 68.)

[12] As a joint enterprise, these entities are also jointly and severally liable. (See *Gopal v. Kaiser Foundation Health Plan, Inc.* (2016) 248 Cal.App.4th 425, 431 ["Under California law, if [several business] entities are a single enterprise, they are each liable for all of the acts and omissions of the other components of the enterprise"]; *Toho-Towa Co., Ltd. v. Morgan Creek Productions, Inc.* (2013) 217 Cal.App.4th 1096, 1108 ["'single-business-enterprise' theory is an equitable doctrine applied to reflect partnership-type liability principles when corporations integrate their resources and operations to achieve a common business purpose"].)

The Conservator cannot ignore the likelihood of policyholders' success in seeking to enforce aspects of the EquityComp program under cases recognizing that even illegal contracts should be enforced "to avoid unjust enrichment to a defendant and a disproportionately harsh penalty upon the plaintiff." (*Kyablue v. Watkins* (2012) 210 Cal.App.4th 1288, 1293; *Tri-Q, Inc. v. Sta-Hi Corp.* (1965) 63 Cal.2d 199, 219 [explaining courts will enforce illegal agreements to "prevent the guilty party from reaping the benefit of his wrongful conduct, or to protect the public from the future consequences of an illegal contract"].) Consider, for example, a policyholder whose injury-preventing investments and low losses would have entitled it to a sizeable return of premium under the RPA—more than it would have been entitled to had the Guaranteed-Cost Policy been the operative agreement. In such a circumstance, the protective purpose of the Code provisions requiring filing and approval would be well-served by allowing employers to enforce aspects of the EquityComp program, notwithstanding the illegality of the RPA. (See *Lewis & Queen v. N. M. Ball Sons* (1957) 48 Cal.2d 141, 153.)

2. CIC Faces Significant Liability Under the Unfair Competition Law.

CIC also faces liability stemming from California's Unfair Competition Law (UCL, Bus. & Prof. Code, § 17200 et seq.). The UCL protects consumers and competitors from unfair competition, defined broadly to include "any unlawful, unfair or fraudulent business act or practice." (*Cel-Tech Communications, Inc. v. Los Angeles Cellular Telephone Co*. (1999) 20 Cal.4th 163, 181 [noting that, because the statute is written in the disjunctive, "it establishes three varieties of unfair competition—acts or practices which are unlawful, or unfair, or fraudulent."].) Under the UCL, insurers may be liable to private plaintiffs for conduct that violates laws other than the Unfair Insurance Practices Act (UIPA, § 790 et seq.). (*Zhang v. Superior Court* (2013) 57 Cal.4th 364, 368.) In the Conservator's opinion, CIC faces significant liability to policyholders on all three of the grounds for relief under the UCL.

a. Illegal Acts and Practices

"By proscribing 'any unlawful' business practice, [the UCL] 'borrows' violations of other laws and treats them as unlawful practices' that the [UCL] makes independently actionable." (*Hale v. Sharp Healthcare* (2010) 183 Cal.App.4th 1373, 1382–1383, quoting *Cel-Tech Communications*, *supra*, 20 Cal.4th at p. 180.) In *Shasta Linen*, the Commissioner found that CIC violated section 11658 by failing to file and secure approval of EquityComp and the RPA, and violated section 11735 by failing to file the RPA rates. (*Shasta Linen*, pp. 62, 64; see also Cal. Code Regs., tit. 10, §§ 2218, 2268 [requiring filing of forms and rates and prohibiting use of forms and rates that have not been filed and approved by the Commissioner].) Policyholders have a strong argument that using the unfiled RPA and charging its unfiled rates are "unlawful" business practices.

Courts have agreed with the Commissioner that the RPA was a collateral agreement that should have been filed with regulators for approval prior to use. (See, e.g., *Jackpot Harvesting, supra*, 33 Cal.App.5th at p. 736 ["We conclude that the Request to Bind is such a collateral agreement, triggering section 11658 and Regulations section 2268's regulatory approval requirement."]; *Luxor Cabs, supra*, 30 Cal.App.5th at p. 986; *Nielsen Contracting, supra*, 22 Cal.App.5th at p. 1118; see also *Minnieland Private Day School, Inc. v. Applied Underwriters Captive Risk Assurance Company, Inc., supra*, 913 F.3d 409, 423 [holding that the RPA is an insurance contract subject to Virginia's insurance regulations].) By selling the RPA policy, CIC violated California law, a violation that is "independently actionable" (*Hale*, *supra*, 183 Cal.App.4th at p. 1383) under the "unlawful" prong of the UCL.

b. Unfair Acts and Practices

Policyholders also have a strong argument that selling and utilizing the RPA constituted an "unfair" business practice. California courts apply various tests of unfairness. Some find that "[a]n act or practice is unfair if the consumer injury is substantial, is not outweighed by any countervailing benefits to consumers or to competition, and is not an injury the consumers themselves could reasonably have avoided." (E.g., *Daugherty v. American Honda Motor Co., Inc.* (2006) 144 Cal.App.4th 824, 839). Other cases find that an unfair business practice occurs when the practice "offends an established public policy or when the practice is immoral, unethical, oppressive, unscrupulous or substantially injurious to consumers. (E.g., *Smith v. State Farm Mutual Automobile Ins. Co.* (2001) 93 Cal.App.4th 700, 719.) Still others have found an unfair practice when it violates a "public policy that is 'tethered' to specific constitutional, statutory, or regulatory provisions.'" (*Scripps Clinic v. Superior Court* (2003) 108 Cal.App.4th 917, 940.) The Conservator cannot ignore the likelihood of a court concluding that CIC has engaged in unfair practices regardless of the test used.

CIC's routine practice of keeping policyholders' plans open far past their three-year term—to avoid having to refund policyholders their excess payments owed under the RPA—is a paradigmatic oppressive and "unfair" practice. CIC marketed EquityComp as a novel "program [that] can provide *immediate* cash flow benefits and financial reward *unlike other plans that require waiting for cumbersome retrospective or uncertain dividend calculations that can run for years beyond policy expiration*." (Lichtenegger Dec., ¶ 32, Ex. F, p. 2, emphasis added.) Only *after* a customer was bound into the EquityComp program, however, would they receive the RPA itself,[13] which clarified that a policyholder would have to wait an additional three years after expiration of the RPA—at minimum—to receive a refund of excess premium and fees. (*Shasta Linen*, p. 34.) And while the RPA was to be active only for three years, it provided that the parties' obligations extinguished "only where the Company no longer has any potential or actual liability to the issuing insurers with respect to the Policies reinsured by AUCRA," the CIC affiliate. (*Id.*, p. 31, quoting the RPA.) Thus, the employers were obligated to continue depositing collateral until the RPA was terminated—a date to be determined by AUCRA at its "sole discretion." (*Id.*, pp. 31-32; Lichtenegger Dec., ¶ 16.)

Even if CIC routinely returned overpayments to its policyholders following the end of that three-year period once all claims were closed—which, to be clear, it did not (Lichtenegger Dec., ¶¶ 17, 57)—utilizing a program under which Affiliates retained the discretion to retain excess premium and fees beyond what was promised by the deceptive inducements of their marketing materials would itself constitute an unfair, if not also a fraudulent, business practice. But CIC used the RPA's "sole discretion" provision to drag out for *years* the process of returning to policyholders the amounts they were owed. (*Id.*, ¶¶ 17, 33.) In some cases, CIC would keep one claim open regardless of the incurred amount (*id.*, ¶¶ 56-58); in others, it refused to respond to inquiries even after all claims had closed and three years had passed (*id.*, ¶ 18). The RPA contained no provision allowing acceleration of this process, and the affiliate was entitled to hold the policyholder's funds for up to seven years after expiration of the policy, during which time it could invest those funds and reap the benefits. (*Shasta Linen*, p. 35; Lichtenegger Dec., ¶¶ 17-19, 34, 37, 52 [detailing cases in which clients had to wait to receive return of excess funds].) A policyholder anxious to recover its excess funds was, in effect, left with no recourse aside from litigation, unless it was willing to settle with CIC for amounts far below

[13] The Commissioner also found that the Request to Bind contained a dispute-resolution provision that differed from that of the CIC guaranteed-cost policy. (*Id.*, pp. 27-28.)

what it was owed under the RPA. (Lichtenegger Dec., ¶¶ 52, 54.)

Indeed, in the *Shasta Linen* case the ALJ twice ordered AUI to provide the number of participants who had received profit-sharing distribution but it refused to comply, leading the Commissioner to infer that AUCRA had never made any profit-sharing distributions. (*Id.*, p. 35.) This conduct also reveals bad-faith practices that "may qualify as any of the three statutory forms of unfair competition." (*Zhang, supra*, 57 Cal.4th at p. 380, citing *State Farm Fire & Casualty Co. v. Superior Court* (1996) 45 Cal.App.4th 1093, 1107.)

Utilizing unfiled workers' compensation rates is also an "unfair" practice for purposes of the UCL. This practice clearly contravenes the policy behind section 11735's filing and public inspection requirement because ensuring broad access to filed rate information allows employers to find coverage at the best competitive rates. (§§ 11735, subd. (b); 11742, subd. (a).) When rate information is transparent, policyholders are able to compare coverage and reduce their costs, and insurers are less likely to gain a monopolistic advantage. The transparency-enforcing mechanisms also help protect the state's workforce by ensuring benefits are available to those injured or sickened over the course of employment. (*Arriaga v. County of Alameda* (1995) 9 Cal.4th 1055, 1065.) The filing requirements ensure the Commissioner has the rate information necessary to determine that insurers charge amounts that are not discriminatory, not monopolistic, adequate to cover their losses and expenses, and do not threaten the solvency. (§ 11737.) Withholding the RPA rate information also prevented the Commissioner from exercising oversight duties. Furthermore, section 11742, subdivision (a), establishes a mandatory online rate comparison guide to "help employers find the required coverage at the best competitive rates." Using unfiled rates and supplementary rate information to modify filed rates and information frustrates the purpose of this comparison guide. Indeed, the "sole purpose of [CIC's] EquityComp program and arrangements with AUCRA was to circumvent the necessary regulatory checks-and-balances needed in a comprehensive state workers' compensation system to protect insurers, employers, and injured workers and assure financial accountability, fairness, and non-discriminatory treatment of insureds." (*Shasta Linen*, p. 61.)[14]

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[14] In fact, AUI acknowledged that one of the challenges of its non-linear retrospective rating

c. Fraudulent Practices

CIC and its affiliates also face liability under the UCL's bar on "fraudulent" practices. "The fraud prong of the UCL is unlike common law fraud or deception. A violation can be shown even if no one was actually deceived [or] relied upon the fraudulent practice . . . . Instead, it is only necessary to show that members of the public are likely to be deceived." (*Schnall v. Hertz Corp.* (2000) 78 Cal.App.4th 1144, 1167, internal quotation marks, citations, and alteration omitted; *see also People ex rel. Harris v. Aguayo* (2017) 11 Cal.App.5th 1150, 1160.) "Under the UCL, it is necessary only to show that the plaintiff was likely to be deceived, and suffered economic injury as a result of the deception." (*Zhang, supra*, 57 Cal.4th at p. 380, citing *Kwikset Corp. v. Superior Court* (2011) 51 Cal.4th 310, 322.)[15]

In *Shasta Linen*, the Commissioner found that the "Program Summary & Scenario" prepared by AUI and distributed to brokers for marketing the EquityComp program was misleading and misrepresented the amounts a prospective policyholder could expect to pay. (*Shasta Linen*, p. 27.) These practices, among others, constitute fraudulent practices under the UCL.

3. The Allegations of Breaches of the Covenant of Good Faith and Fair Dealing.

The Conservator is aware of serious complaints that would amount to violations of the implied covenant of good faith and fair dealing. "There is an implied covenant of good faith and fair dealing in every contract that neither party will do anything which will injure the right of the other to receive benefits of the agreement." (*Comunale v. Traders & General Ins. Co.* (1958) 50 Cal.2d 654, 658, internal citation omitted.) The duty is especially strong in insurance contracts, such that a breach of the duty may support punitive damages in a tort action. "'[W]e have emphasized the "special relationship"

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program is that "the structure must be approved by the respective insurance departments regulating the sale of insurance." (*Shasta Linen*, p. 23.) As it happens, many jurisdictions restrict the sale of loss sensitive programs to employers whose annual premiums exceed $500,000. (*Id.*, p. 15.) AUI's solution was to offer a "reinsurance based approach to providing non-linear retrospective rating plans" that, in AUI's scheme, would not be called "insurance" and did not have to be filed. (*Ibid*.)

[15] Even if demonstrating actual reliance were necessary, it is clear that employers relied to their detriment on the enforceability of the RPA, evidenced by their decision to pay premiums under a policy they believed to be enforceable while being unaware the RPA was unlawful.

between insurer and insured, characterized by elements of public interest, adhesion, and fiduciary responsibility.'" (*Gomez v. Volkswagen of America, Inc.* (1985) 169 Cal.App.3d 921, 927, quoting *Egan v. Mutual of Omaha Ins. Co.* (1979) 24 Cal.3d 809, 820.)

Particularly apt are the allegations that (1) CIC and its affiliates refused to settle open claims, even when the policyholder wanted to accept an employee's offer to do so, to prevent closing the RPA and distributing funds in policyholders' accounts (Lichtenegger Dec., ¶¶ 56-58); (2) CIC knew for over a year that an employee to whom it was making payments for lost wages was actually still engaged in similar work, for another company (*id.*., ¶¶ 59-60); and (3) CIC failed to pursue subrogation efforts to minimize the financial impact on its policyholder (*id.*, ¶ 62). Such conduct by a workers' compensation insurer in administering a retrospective program is a recognized breach of the covenant of good faith and fair dealing. (E.g., *California Lettuce Growers v. Union Sugar Co.* (1955) 45 Cal.2d 474, 484; *Courtesy Ambulance Service v. Superior Court* (1992) 8 Cal.App.4th 1504 [overreserving may give rise to tort action for breach of covenant of good faith, exposing insurer to punitive damages].)[16]

D. Policyholders Are Entitled to Elect Their Remedy, Including Ratification or Repudiation of the Policy and Restitution.

Policyholders under an illegal insurance contract are entitled to choose whether to pursue remedies for breach of the insurance contract, tortious breach of the covenant of good faith and fair dealing, fraud, violation of the UCL, or other cause of action.

With respect to the UCL, restitution is explicitly authorized. (Bus. & Prof. Code, § 17203 ["The court may make such orders or judgments, … as may be necessary to restore to any person in interest any money or property, real or personal, which may have been acquired by means of such unfair competition."].) The cases emphasize that "the equitable remedies of the UCL are subject to the broad discretion of the trial court." (*Zhang v. Superior Court*, *supra*, 57 Cal.4th at p. 371.) That may require a complete "return of money or other property obtained through an improper means to the person from whom the property was taken." (*Clark v. Superior Court* (2010) 50 Cal.4th 605, 613-614.) Moreover, "restitution is broad enough to allow a plaintiff to recover money or property in which he or she has a

[16] To be clear, claimants accepting an offer under Schedule 2.6 would give up their right to seek punitive damages.

vested interest.” (*Korea Supply Co. v. Lockheed Martin Corp.* (2003) 29 Cal.4th 1134, 1148.) And restitution can include disgorgement of profits. (*Ibid*. [“Under the UCL, an individual may recover profits unfairly obtained to the extent that these profits represent monies given to the defendant or benefits in which the plaintiff has an ownership interest.”].) In the UCL context, courts generally calculate “restitution” based on the difference between the total dollar figure paid by a plaintiff and the value of what the plaintiff received from the defendant. (*In re Vioxx Class Cases* (2009) 180 Cal.App.4th 116, 131 [“The difference between what the plaintiff paid and the value of what the plaintiff received is a proper measure of restitution.”]; *Cortez v. Purolator Air Filtration Products Co.* (2000) 23 Cal.4th 163, 174 [describing “the return of the excess of what the plaintiff gave the defendant over the value of what the plaintiff received” as “an element of restitution”].)

Applying these principles to the claims of policyholders, three alternative forms of relief are apparent. First, the policyholder may choose to renounce the illegal RPA and accept liability for premiums under the CIC Guaranteed-Cost Policy. Second, the policyholder may choose to renounce the policy and RPA in their entirety and pay the value of the coverage received. Third, the policyholder may choose to ratify the RPA and accept its liability under that agreement.

E. Schedule 2.6 Provides Policyholders a Reasonably Prompt, Efficient, and Economical Means to Resolve the RPA Litigation on Terms to Which They Are Legally Entitled.

The foregoing principles are implemented in the Plan in its Section 2.6 and its incorporated Schedule 2.6. The policyholder is offered the opportunity to resolve its claims, and the opposing claims of CIC, by selecting from three options: Under **Option 1**, the policyholder pays the premium on the CIC Guaranteed-Cost Policy. This corresponds to a contracting party’s right to elect to enforce the contract with the illegal provisions (the RPA) cancelled. Under **Option 2**, the policyholder rejects the contract in its entirety and pays CIC the reasonable value of the coverage it was afforded, measured by the cost of a commercially available retrospective rating policy. Under **Option 3**, the policyholder waives the illegality of the RPA and pays CIC under the terms of the RPA. Alternatively, the policyholder may choose to opt out of all three options, in which case it and the reinsurer will be at liberty to pursue litigation after conclusion of the conservation. The Conservator believes this is a fair and equitable process that reflects the rights of the respective parties (Holloway Dec., ¶ 27) and that a substantial majority of the policyholders in currently pending litigation will likely choose an option.

Covered policyholders. The options will be available to three groups of policyholders: (1) those engaged in RPA litigation at the time of the Conservation Order; (2) those against whom CIC believes it has claims for payments and whom CIC will identify in a Schedule of Subsequent Litigation, with CIC permanently barred from suing any not listed; and (3) those who believe they have a claim arising out of the RPA but are not currently parties to litigation, who will receive notice of the opportunity and will be given a window in which to submit their claims to the Conservator. (Sched. 2.6, art. I, ¶¶ 5, 19, 23, 24, 32, art. VII.) Policyholders in all three groups will be given the opportunity to resolve the dispute through Schedule 2.6 and the three options.

Calculation of the offers. Department Senior Actuary Giovanni Muzzarelli describes in his declaration how the offers are calculated. As he explains, Schedule 2.6 provides for calculation of an Option 1 Restitution Amount, an Option 2 Restitution Amount, and an Option 3 Restitution Amount. In each case, the restitution amount is the amount the policyholder paid CIC minus the amounts it owes under that option. The restitution amount may be positive or negative. If it is positive, the policyholder paid CIC more than it owes under the option, so CIC must pay that amount, with interest, if that option is chosen. If it is negative, the policyholder paid less than it owes under that option, so the policyholder must pay that amount to CIC, with interest. (Muzzarelli Dec., ¶¶ 31-33.)

The *Option 1 Restitution Amount* is straightforward: It is simply the amount paid to CIC and its affiliates minus the amount owed under the CIC Guaranteed-Cost Policy. (*Id.*, ¶¶ 31, 33, 39.)

The *Option 2 Restitution Amount* is more complex because Option 2 is based on the cost of a commercially available retrospective policy. Under such policies, the premium is determined by the ultimate losses under the policy, which include both paid losses and amounts set aside in reserves on open claims and claims not yet reported. Schedule 2.6 prescribes how the losses are calculated from CIC's data. However, because the propriety and accuracy of claims payments and reserves may be disputed, those quantities are subject to review if challenged by a policyholder. Schedule 2.6 uses the California Retrospective Rating Plan (Cal Retro) filed by the Workers' Compensation Insurance Rating Bureau as the commercially available retrospective policy whose pricing is the standard under Option 2. The Option 2 Restitution Amount is the amount the policyholder paid minus the premium that would have been charged under the Cal Retro plan. (*Id.*, ¶¶ 31, 40-44, 47-53.)

The *Option 3 Restitution Amount* is the amount paid to CIC minus the amount due under the RPA. Because the RPA is a retrospective policy, the amount due is determined by the losses under the policy. Because some policyholders dispute those losses, they may be challenged and reviewed. (*Id.*, ¶¶ 31, 45-46, 47-53.) Schedule 2.6 details how the terms of the RPA are to be implemented.

Procedure. The process begins with the Conservator appointing an Independent Consultant, whose first task is to translate the formulas in Schedule 2.6 into a template, first circulated in draft and then finalized after any comments are received and considered. (Sched. 2.6, art. VI.) CIC then submits to the Independent Consultant a data file for each eligible policyholder (Claimant), from which the Independent Consultant submits to the Conservator a written Settlement Offer that the Conservator tenders to the Claimant, who has 30 days to make an election of one of the offers or decline all of the offers. (*Id.*, ¶ VI(6).) Alternatively, the Claimant may request review of the paid losses or reserves by the Independent Consultant (*id.*, art. VII), which extends the time to respond to the Settlement Offer. (*Id.*, ¶ VI(6).) If the review results in a change in the losses, the Independent Consultant recalculates the Settlement Offer, from which the Claimant makes its election. (*Id.*, ¶ VII(4).)

Schedule 2.6 has been carefully designed to reflect the respective rights of CIC and policyholders under the principal theories of recovery to which policyholders would be entitled in litigation, and to deliver the outcome more fairly, quickly, and economically than continued litigation.

III. Approval of the Plan Will Facilitate Closure of the Conservation.

At the conclusion of the tasks enumerated in the Plan, including selection of the assumption reinsurer, transfer of the CIC policies to the reinsurer, and completion of the Schedule 2.6 process, the Conservator expects to apply to the Court to close the conservation, permitting CIC to merge into CIC II and surrender its certificate of authority, its policyholders and the public having been protected.

CONCLUSION

The Plan appropriately balances the interests of insureds, shareholders, and the public and resolves the problems created by the RPA and CIC's implementation of it. The Plan is well within the Conservator's discretion and, accordingly, the Conservator asks that the Court approve the Plan.

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Respectfully submitted,

STRUMWASSER & WOOCHER LLP
Michael J. Strumwasser
Dale K. Larson
Caroline Chiappetti
Julia Michel

ORRICK, HERRINGTON & SUTCLIFFE LLP
Cynthia J. Larsen
Justin Giovannettone

By ______________________________
Michael J. Strumwasser

Attorneys for Applicant Insurance Commissioner of the State of California and Conservator for California Insurance Company