

**SUPERIOR COURT OF CALIFORNIA
COUNTY OF SACRAMENTO**

JUDGE:	HON. JUDY HOLZER HERSHER	DEPT. NO:	45
		CLERK:	D. AHEE
<p>ENGINE MANUFACTURERS ASSOCIATION, Petitioner,</p> <p>VS.</p> <p>CALIFORNIA AIR RESOURCES BOARD, and DOES 1 through 100, Respondent.</p> <hr style="width: 50%; margin-left: 0;"/> <p>CATERPILLAR INC., CUMMINS INC., MACK TRUCKS, INC., and VOLVO POWERTRAIN CORPORATION, Plaintiffs,</p> <p>VS.</p> <p>CALIFORNIA AIR RESOURCES BOARD, Defendant.</p>		<p>Consolidated Cases: 05CS00386 and 05AS01133</p>	
Nature of Proceedings:		<p>PETITION FOR WRIT OF MANDATE AND COMPLAINT FOR DECLARATORY AND INJUNCTIVE RELIEF; AND FIRST AMENDED COMPLAINT FOR DECLARATORY AND INJUNCTIVE RELIEF</p> <p>CONSOLIDATED RULING ON SUBMITTED MATTERS</p>	

I.
Introduction

This case presents a novel issue. It arises out of a growing trend by administrative agencies to exact greater regulatory authority over certain industries through enforcement actions rather than by traditional rulemaking. The short-hand reference to this strategy is

"regulation by litigation."¹ The issue in the instant case is as follows: Where an administrative agency enters into a settlement agreement with all or nearly all of the regulated entities in an industry, and through the settlement obtains substantive regulatory-type provisions that the agency could not have adopted by traditional rulemaking, may the agency thereafter lawfully promulgate a regulation that is in conflict with the essential terms of the settlement agreements? The Court concludes that it may not.

While the issue may appear simple, the analysis required by the breadth of issues and legal theories at play requires extensive discussion. When all is said and done, however, the plaintiffs in these consolidated actions are entitled to the relief they seek, namely, a judicial declaration that the challenged regulations are unlawful, unconstitutional, and invalid; a permanent injunction enjoining the enforcement of the regulations; and a peremptory writ of mandate compelling the regulations to be set aside.

II.

Summary of the Court's Ruling

This case concerns the California Air Resources Board's ("ARB's") authority to adopt the "Chip Reflash Regulation" codified at California Code of Regulations, title 13, section 2011, with corresponding amendments to California Code of Regulations, title 13, sections 2190.1, 2181, 2184, 2185, 2186, 2192, and 2194.

The Chip Reflash Regulation is directed at heavy-duty diesel engines (the "Low NOx Rebuild Engines") identified in various settlement agreements entered into between the manufacturers of those engines and the ARB to settle allegations that the manufacturers used illegal fuel-injection timing strategies (or "defeat devices") to adversely effect the engines' emission control system for Nitrogen Oxides ("NOx").

Under the settlement agreements, the manufacturers were required to develop software upgrades ("Low NOx Rebuild Kits") specific to their particular engines. These "Kits" were then required to be installed in the engine control module at the time the engines were rebuilt in order to remove the alleged "defeat devices." The anticipated result was lower in-use emissions of NOx.

A few years after the California settlement agreements (hereinafter the "Settlement Agreements") were executed, ARB apparently became dissatisfied with the pace at which the Low NOx Rebuild Kits were being installed. As a result, ARB adopted the Chip Reflash Regulation. The Chip Reflash Regulation requires the owners and operators of the Low NOx Rebuild Engines to have the Low NOx Rebuild Kits installed by specified regulatory deadlines, rather than at the time of engine rebuild. It also

¹ The Court credits the article "Choosing How to Regulate," by Andrew P. Morriss, Bruce Yandle, and Andrew Dorchak, (29 Harv. Envtl. L. Rev. 179 (2005)), for the concept of "regulation-by-litigation." Although the article discusses the regulation of heavy-duty diesel vehicles by the EPA, the article is not evidence and the Court did not rely on the article for any factual (or legal) findings in these consolidated proceedings.

requires Manufacturers, through their authorized dealers, distributors, repair facilities, and rebuild facilities, to provide and install the Kits free of charge at any time to any "person" upon request. Under the Regulation, owners of engines using their original fuel-injection timing software after the implementation dates can be cited for violating title 13 and subjected to a civil penalty. The petitioners and plaintiffs in these consolidated cases challenge the ARB's authority to adopt the Chip Reflash Regulation.

The petitioner in Case No. 05CS00386 (entitled *Engine Manufacturers Association v. California Air Resources Board*) is the Engine Manufacturers Association ("Petitioner" or "EMA"). EMA's petition alleges that the adoption of the Chip Reflash Regulation is an *ultra vires* act that exceeds ARB's regulatory authority under the California Health and Safety Code and breaches ARB's covenants under the Settlement Agreements. EMA seeks a declaratory judgment that the Chip Reflash Regulation is unlawful, invalid and beyond the scope of ARB's authority; a permanent injunction enjoining ARB from enforcing the Regulation; and a writ of mandate directing ARB to cease enforcement of the Regulation and/or directing ARB to set it aside. EMA also requests an award of attorneys' fees under C.C.P. § 1021.5.

The plaintiffs (the "Plaintiffs") in Case No. 05AS01133 (entitled *Caterpillar, Inc., et al. v. California Air Resources Board*) are four of the seven Manufacturers that entered into the Settlement Agreements with ARB.² The gravamen of Plaintiffs' complaint is that ARB's Chip Reflash Regulation is unconstitutional or otherwise invalid because it (i) breaches the terms of the Settlement Agreements; (ii) unconstitutionally impairs the Manufacturers' rights under the Settlement Agreements; (iii) amounts to an illegal "recall;" and (iv) is preempted by federal law because it conflicts with the federal consent decrees. Plaintiffs seek a judicial declaration that the Chip Reflash Regulation is inconsistent with the Settlement Agreements and that the Regulation is unconstitutional and/or invalid; and a preliminary and permanent injunction enjoining ARB from unilaterally abrogating the Settlement Agreements.

After consideration of the administrative record, the points and authorities submitted by the parties, arguments of counsel, and all other matters presented to this Court, the Court has determined that ARB does not have the statutory authority to adopt the Chip Reflash Regulation. EMA's petition for a writ of mandate directing ARB to set aside the Chip Reflash Regulation should therefore be GRANTED.

After considering the evidence and argument offered at trial, the Court also has determined that the Chip Reflash Regulation unconstitutionally impairs the obligations of the Settlement Agreements in violation of the Contract Clause, and constitutes an illegal involuntary recall, and should be declared invalid and enjoined on these bases as well.

² Renault, Navistar, and Detroit Diesel are the other Manufacturers. Detroit Diesel was exempted from the provisions of the Chip Reflash Regulation. (13 C.C.R. § 2011(e)(2).)

II.
Ruling on EMA's Petition for Writ of Mandate

A. Background Facts and Law for Ruling on Petition

1. The Federal and State Statutory Landscape

The federal program for the control of motor vehicle emissions is the product of the Clean Air Act. The Clean Air Act was enacted, among other reasons, "to protect and enhance the quality of the Nation's air resources so as to promote the public health and welfare and the productive capacity of its population." (42 U.S.C. § 7401(b).) In keeping with this purpose, section 7521 of the Act authorizes the Administrator of the EPA to establish emission standards for any class or classes of new motor vehicles or new motor vehicle engines (42 U.S.C. § 7521(a)), and procedures for testing compliance with such standards. (42 U.S.C. § 7525(d).)

Before a manufacturer can introduce a new motor vehicle or engine into commerce, it first must obtain from the EPA a "certificate of conformity" indicating compliance with the requirements of the Act and applicable emission limits and standards. (42 U.S.C. §§ 7522(a)(1), 7524.) Manufacturers demonstrate compliance with applicable emission limits by testing representative (prototype) engines using the EPA's Federal Test Procedure for Heavy Duty Engines ("FTP"). The FTP is a twenty minute test cycle that measures emissions in the laboratory under a variety of testing conditions. An application for a certificate of conformity must be accompanied by data showing that the representative test engine complies with the Act's emission limits. If the Administrator finds that the engine will comply with emissions standards over the vehicle's full useful life, the Administrator issues a certificate of conformity to cover the class of engines represented by the prototype. (42 U.S.C. § 7525(a)(3)(A).)

To ensure that an engine's emission control system will operate in real world driving conditions in the same manner that it does on the FTP, the Clean Air Act prohibits the use of "defeat devices." (42 U.S.C. § 7522(a)(3)(B); 40 CFR 86.094-16.) A defeat device is an "auxiliary emission control device" ("AECD") that reduces the effectiveness of the engine's emission control system under conditions which may reasonably be expected to be encountered in normal vehicle operation and use, unless: (1) such conditions are substantially included in the FTP; (2) the need for the AECD is justified in terms of protecting the vehicle against damage or accident; or (3) the AECD does not go beyond the requirements of engine starting. (40 CFR 86.094-2.) A manufacturer's application for a certificate of conformity is required to include a description of any AECD in or on any engine covered by the application. (40 CFR 86.094-21.) EPA uses the manufacturers' disclosure of AECDs in the application to screen for "defeat devices."

California is the only state authorized under the federal Clean Air Act to adopt standards and test procedures for new motor vehicles and new motor vehicle engines that

are separate from the standards and test procedures promulgated by the EPA. (42 U.S.C. 7543(b).)

In California, the ARB is charged with coordinating efforts to attain and maintain ambient air quality standards, to conduct research into the causes of and solution to air pollution, and to otherwise address air quality problems caused by motor vehicles. (Health & Safety Code § 39003.) Acting under its statutory authority, the ARB has established a program for controlling vehicular emissions in California. As part of this emissions control program, ARB has adopted emissions standards and test procedures for virtually all classes and categories of new motor vehicles and new motor vehicle engines that are sold, offered for sale, introduced or delivered for introduction into commerce in California.

California's emissions control program parallels the federal program in many respects.³ For example, although the terminology used by California is slightly different,⁴ all new motor vehicles and engines introduced into commerce in California must be certified as meeting California's own rigorous emission limits and standards. (Health & Safety Code §§ 43101, 43104.) California uses the same two-step certification testing procedure used by the EPA, whereby prototypes from each model year of a particular class of vehicles are tested prior to sale, and then re-tested for emissions compliance after the vehicles have been sold to the public. (*See, e.g.*, 13 CCR §§ 2061, 2100-2110, 2136-2140; *see also* 13 CCR § 1956.8.) If vehicles are found or "determined" to be not in compliance with the standards, both the EPA and ARB have the authority to require manufacturers to remedy the non-conformity (i.e., recall the vehicles) at the manufacturers' expense. (*See* Health & Saf. Code §§ 43009.5, 43105; 13 CCR §§ 2122-2135; *see also* 42 U.S.C. § 7525(b), (d); 42 U.S.C. § 7541(a), (b), (c); *United States v. Chrysler Corp.* (D.C. Cir. 1979) 591 F.2d 958, 961.)

While California is the only state authorized to adopt its own standards and test procedures for new motor vehicles and engines, all states, including California, apparently remain free to adopt emission control standards applicable to "non new" motor vehicles and engines, as well as the right to adopt a variety of "in use" regulations, consistent with their unique authorizing legislation. (42 U.S.C. § 7543(d); *Allway Taxi Inc. v. City of New York* (S.D.N.Y. 1972) 340 F.Supp. 1120, 1124, *aff'd*, (2d Cir. 1972) 468 F.2d 624; *Engine Manufacturers Ass'n v. U.S. Environmental Protection Agency* (D.C. Cir. 1996) 319 U.S. App. D.C. 12, 17-19.)

³ As a result, all new motor vehicles manufactured for sale in the United States can be classified as either "federal cars" -- which must be certified to meet federal vehicle emission standards as set by the EPA -- or as "California cars" -- which must be certified to meet California's own stringent standards. (*See Motor Vehicle Mfrs. Ass'n of the United States v. New York State Dept. of Environmental Conservation* (2d Cir. 1994) 17 F.3d 521, 526-527.)

⁴ The EPA issues certificates of conformity for heavy-duty diesel engines and vehicles pursuant to section 7525 of the Clean Air Act. The ARB issues Executive Orders relating to certification of heavy-duty diesel engines in California pursuant to California Health and Safety Code sections 43100, 43102.

2. The Enforcement Actions

In mid-1998, the EPA filed civil actions against seven manufacturers of heavy-duty diesel engines, namely Caterpillar, Cummins, Mack Trucks, Volvo, Renault, Navistar, and Detroit Diesel (the "Manufacturers"), alleging violations of the Clean Air Act. According to the EPA complaint, the Manufacturers had employed computer-based strategies to adjust the timing of fuel injection in certain 1993 to 1998 model year heavy-duty diesel engines, so as to meet NOx emission limits during standardized laboratory testing, but to "turn off" the NOx emission controls during "steady state operating conditions" (i.e., conditions more typically encountered in highway driving). The EPA further alleged that these computer-based strategies were illegal "defeat devices" causing "in-use" NOx emissions to be significantly higher than certified for the engines. (*See, e.g.,* AR 1-15.)

The ARB joined in the EPA's enforcement efforts, alleging that by installing the defeat devices on engines sold or intended for sale in California, the Manufacturers had violated California Health and Safety Code sections 43102, 43105, 43106, 43151, 43152, 43153, and 43205.5, California Vehicle Code section 27156, and Title 13, California Code of Regulations, section 1956.8. (*See, e.g.,* AR 114.) ARB further alleged that the engines did not conform to applicable California emission regulations; that the non-conforming engines were subject to corrective action; and that the Manufacturers were liable for penalties under Health & Safety Code sections 43016, 43105, 43154, 43211, 43212.

The Manufacturers denied all allegations of wrongdoing, contending that their engines fully complied with applicable NOx emission limits; that they did not employ defeat devices; that the Manufacturers had fully and adequately disclosed the engines' emission control systems to the EPA and ARB; and that each of the subject engines was covered by a California-issued Executive Order or an EPA-issued certificate of conformity.

3. The Settlement Agreements

After intensive settlement negotiations, the parties reached a settlement. The Manufacturers first entered into settlement agreements with EPA, which were adopted as consent decrees in the United States District Court for the District of Columbia. Thereafter, the Manufacturers negotiated the unique terms of the California Settlement Agreements, which were executed after adoption of the consent decrees. (AR 110-475; 476-1418.) The California settlement agreements mirror most, but not all, of the provisions in settlements made with the United States Environmental Protection Agency ("EPA") and approved as consent decrees in federal court.

The California Settlement Agreements provide that "[r]ather than expend valuable resources in litigating ARB's allegations related to violations of or civil penalties under California law as described above, the ARB and [Manufacturers] voluntarily agree to

resolve this matter as to California issues by means of this Settlement Agreement." (AR 114.⁵)

The Settlement Agreements do not include any factual or legal finding that any of the engines violated ARB or EPA emissions requirements. (*See, e.g.*, AR 115.) The Settlement Agreements expressly provide that the "Settlement Agreement shall not constitute an admission of any party with respect to the matters addressed herein." (AR 114.) The Settlement Agreements also do not recall the engines or void the compliance certificates issued for such engines.

Importantly, the Settlement Agreements resolve all civil liability of the Manufacturers for the alleged violations of California law. Paragraph 161 of the Settlement Agreements provides, in relevant part:

"Satisfaction of all the obligations and requirements of this Settlement Agreement constitutes full settlement of and shall resolve all civil liability of [Manufacturer] for the violations of California law alleged in Section IV of such Agreement, and for any civil violations that could hereafter be alleged by the ARB under California law based on: (i) the use of the injection-timing strategies described in Section IV of this Settlement Agreement on Pre-Settlement Engines; and (ii) the use of electronic engine control strategies on HDDEs in accordance with Appendix B-1, B-2, and B-4 and this Settlement Agreement. . . . With respect to [the Low NOx Rebuild Engines], the ARB shall not base a determination that any class or category of [Low NOx Rebuild Engine] does not conform to Title 13 of the California Code of Regulations or a determination to suspend or revoke an Executive Order on the basis that the engine contains one or more of the injection-timing strategies [described in the Settlement Agreement] if all other requirements applicable to that engine found in this Settlement Agreement and the regulations are met." (*See, e.g.*, AR 142.)

As consideration for the release, the Manufacturers agreed to take "corrective action" to minimize emissions reduction losses and offset past emissions. The Manufacturers agreed (i) to accelerate implementation of more stringent emission standards and supplementary testing protocols in addition to the then-applicable California Test Procedures (i.e., the EURO III, the NTE Limit, the TNTE Limit, the Smoke Limit, and the NMHC Limit); (ii) not to employ the alleged "defeat devices" in engines and to provide for emissions and compliance monitoring during the term of the Settlement Agreements through supplemental test requirements, auditing procedures, in-use testing of engines, and reporting requirements; and (iii) to implement a Low NOx Rebuild Program to reduce NOx emissions from existing MHDDE and HHDDE engines. The Manufacturers also agreed to pay substantial amounts of monies to the State and to undertake environmental projects designed to reduce NOx in the environment from

⁵ Because the terms of the Settlement Agreements are, for all relevant purposes, identical, for ease of reference, the Court will cite to only one of the Agreements: the Agreement between ARB and Caterpillar.

mobile sources. (AR 115, 117, 1616.)

The heart of the controversy in the instant litigation is the "Low NOx Rebuild Program," described in Section IX of the Agreements. The program is aimed at reducing NOx emissions from the "Low NOx Rebuild Engines" by making certain software changes to the engines through the installation of "Low NOx Rebuild Kits." (*See, e.g.*, AR 124 *et seq.*) The "Low NOx Rebuild Kits," which were required to be developed under the terms of the Settlement Agreements, modify the truck engines so that they meet the new EURO III and NTE emission limits that are specified in paragraph 65 of the Settlement Agreements. (*See, e.g.*, AR 125.) In essence, EPA and ARB concluded that, rather than proceeding with a full-blown enforcement action to recall the disputed engines, they instead would require, as part of the Settlement Agreements, that the Low NOx Rebuild Kits be installed at the time of "Engine Rebuild." This, they concluded, would minimize the out-of-service time to truck owners and trucking companies, offset changes in fuel economy, and achieve a higher compliance rate. (AR 1610.)

Paragraph 69 of the Settlement Agreements provides that beginning on the date that such Kits are available, the Manufacturers "shall sell and use, and authorize the sale and use of, only Low NOx Rebuild Kits for any Low NOx Rebuild Engine in that family in the case of any *Engine Rebuild* for: (a) any HHDDE that has accumulated mileage greater than 290,000 miles, or any MHDDE that has accumulated mileage greater than 185,000 miles or (b) any HHDDE or MHDDE that has accumulated less than the applicable mileage specified in Paragraph 69(a) where the service event includes replacement or reconditioning of more than one Major Cylinder Component in all of the engine's cylinders." (*See, e.g.*, AR 126 [emphasis added].) "Engine Rebuild" is a defined term in the Settlement Agreements and means an activity occurring over one or more maintenance or repair events involving (a) disassembly of the engine, including removal of the cylinder heads; and (b) the replacement or reconditioning of more than one Major Cylinder Component in more than half the cylinders. (*See, e.g.*, AR 112; *see also* AR 1618.) ARB has admitted that nothing in the Settlement Agreements requires engine rebuilds at any specific mileage intervals or that they be performed at all. The decision of when and where to perform an engine rebuild remains an economic decision on the part of the vehicle owner. (AR 1618.)

Paragraph 71 of the Settlement Agreements reads:

"[Manufacturer] shall install, and shall only authorize its authorized dealers, distributors, repair facilities, and rebuild facilities to install, only Low NOx Rebuild Kits as required under Paragraph 64 at no added cost to the owner above the amount the owner would otherwise pay to have the engine rebuilt or repaired. In addition, subject to the provisions of Paragraph 72, [Manufacturer] shall make available, either directly or through its affiliated distribution networks, at no added cost, the appropriate Low NOx Rebuild Kit to any non-affiliated engine rebuilder or person who requests it. For the purposes of this Section, 'at no added cost' shall mean:

- (a) if a Low NOx Rebuild Kit contains parts normally replaced at engine rebuild, [Manufacturer] shall not charge more than the then-current price for the original part; and
- (b) if a Low NOx Rebuild Kit requires a part not normally replaced during rebuild, then such part shall be included without charge. [Manufacturer] shall make arrangements to reimburse its authorized dealers, distributors, repair facilities, and rebuild facilities, so that the ultimate purchaser of a Low NOx Rebuild Kit will not be charged for any required reprogramming through its authorized dealers, distributors, repair facilities, and rebuild facilities, including any computer connection fees." (*See, e.g., AR 126.*)

Paragraph 72 provides that, notwithstanding the provisions in paragraph 71, each Manufacturer, and its authorized dealers, distributors, repair facilities, and rebuild facilities, "may impose an additional fee for engine control software that includes both the low NOx reprogramming and other software enhancements for purposes unrelated to reducing NOx emissions, provided that: (a) the customer is given the option of obtaining the Low NOx Rebuild reprogramming alone at no cost; and (b) the customer chooses the option that includes such other software enhancements." (*Id.*)

The Agreements required each Manufacturer to develop a "Low NOx Rebuild Plan" that included a list of that Manufacturer's authorized dealers, distributors, repair facilities, and rebuild facilities that will install the Low NOx Rebuild Kits; a description of the procedure to be followed by "non-affiliated engine rebuild facilities or persons to obtain Low NOx Rebuild Kits;" and a description of the method by which the Manufacturer will ensure an adequate supply of Kits will be available to meet "engine rebuild facilities' demand." (*See, e.g., AR 126-127.*)

Pursuant to paragraph 79, Manufacturers are required to copy ARB on all written communications directed to "engine rebuilders and other persons who install Low NOx Rebuild Kits under the Low NOx Rebuild Plan." (*Id.*) Manufacturers also are required to maintain and turn over upon request, a list of the names and addresses of all "engine rebuilders who were provided Low NOx Rebuild Kits and the number of kits provided." (*See, e.g., AR 127.*)

The Agreements state that they do not modify, change, or limit in any way the rights and obligations of the parties under Title 13, California Code of Regulations or the California Health and Safety Code with respect to the control of emissions from HDDEs. (*See, e.g., AR 120.*) In addition, the Agreements provide that (i) the Agreements pertain to only to those matters expressly specified in the Agreements; (ii) nothing in the Agreements relieves the Manufacturers of their obligation to comply with applicable federal, State, and local laws and regulations; and that (iii) the Agreements do not release liability of any person or entity for any criminal claims or for any civil claims other than those referred to in Paragraph 161. (*See, e.g., AR 140.*)

Paragraph 162 of the Agreements pertains to third parties. It provides that the Settlement Agreements do not limit, enlarge or affect the rights of any party as against any third parties and that nothing in the Settlement Agreements shall be construed to create any rights in, or grant any cause of action to, any person not a party to such Agreements. (*See, e.g.*, AR 143.)

Paragraph 164 of the Settlement Agreements provides that the parties may agree to modify the Settlement Agreement from time to time, but only by a written instrument executed by all the parties. (*See, e.g.*, AR 143.) The Agreements also contain a dispute resolution process, which the parties to the Agreements are required to use. The process is invoked by written notice of one party to the other. (*See, e.g.*, AR 142.) After notice, the dispute resolution process requires an informal negotiation period, followed by a right to mediation. (*Id.*) In the event that the parties are unable to reach agreement during the informal negotiation period or the mediation, either party has a right to file an appropriate request for relief with the state court with jurisdiction over the matter. (*Id.*)

Paragraph 168A of the Settlement Agreements is an integration clause and acknowledges there are no representations, agreements, or understandings relating to the settlement other than those expressly contained in the Settlement Agreement itself. (*See, e.g.*, AR 144.)

Finally, pursuant to paragraph 169 of the Settlement Agreements, each party represented and warranted that it had full power and authority to enter into the Settlement Agreement and to make the representations and agreements on its own behalf and to bind and obligate itself to fully discharge each and every one of such representations and agreements. (*See, e.g.*, AR 144.)

4. The Challenged Chip Reflash Regulation and ARB's Statement of Reasons for its Adoption

ARB's rationale for the adoption of the Chip Reflash Regulation, and its history, are contained in the initial and subsequent Statement of Reasons accompanying the regulations. (AR 1600.) These "statements" are important to this Court's analysis, both for understanding ARB's analysis at the time of adoption, and because they are relevant to the subsequent evidence and arguments presented in the consolidated civil action between the parties.

ARB contends in its Initial Statement of Reasons that at the time the Settlement Agreements were negotiated, ARB expected the engine rebuilds of Low NOx Rebuild Engines would occur at around 300,000 to 400,000 miles of service. (AR 1610, 1618; *see also* AR 1419 [indicating normal engine rebuilds typically occur at around 200,000 to 300,000 miles of service].) If this expectation were accurate, ARB contends, most of the Low NOx Rebuild Engines would have been rebuilt -- with the Low NOx Rebuild Kit -- by the end of 2003. However, as of late 2003 ARB determined that only about four to ten percent of the applicable engines had the Low NOx Rebuild Kit installed. (AR 1618; *see also* AR 1419.) ARB concluded that the Low NOx Rebuild Program was not achieving

its expected emission reduction benefits. As a result, ARB initiated proceedings to adopt a regulation (the "Chip Reflash Regulation") that would require owners and operators of the Low NOx Rebuild Engines to have the Low NOx Rebuild Kits installed by specified deadlines in 2004 (later extended to 2005 and 2006). (AR 1419-20, 1446-53, 1600-89; *see also* ARB Answer ¶¶ 22, 23.)

The ARB suggested four reasons why it believed there had not been more software installations. First, ARB asserted that the Low NOx Rebuild Engines appeared to be lasting longer than ARB expected. ARB had expected engine rebuilds to occur at around 300,000 to 400,000 miles of service, but the "increased durability" of diesel engines enabled many of the engines to run 750,000 to 1,000,000 miles before needing a rebuild.⁶ (AR 1610.) Second, ARB suggested that some of the engines subject to the Consent Decree/Settlement Agreement rebuild requirements might be traveling fewer miles than expected. (*Id.*) Third, ARB suggested the poor economy might have contributed to vehicle owners delaying engine rebuilds. (*Id.*) Finally, ARB suggested that the software upgrade installations might not be occurring at the time of rebuild.⁷ (*Id.*)

Because ARB staff concluded the software was not being installed as expected under the Settlement Agreements, they believed they were justified in recommending regulations to require installation. In short, ARB staff concluded there was "no reason to wait until rebuilds are performed" and recommended that the ARB adopt a rule requiring owners and operators of the Low NOx Rebuild Engines to upgrade their engine's electronic control module with the software developed as part of the Low NOx Rebuild Program. (AR 1600, 1604, 1611.)

ARB estimated the Chip Reflash Regulation would affect about 100,000 California-registered vehicles and about 300,000 to 400,000 out-of-state vehicles. In support of their position, ARB staff also estimated that the software upgrade would take only about 15 to 30 minutes to install on an engine's ECM, plus whatever time might be required for driving to/from, and waiting at, the dealer or distributor. ARB estimated the average time out-of-service would be two hours -- equivalent to about \$100 per vehicle. (AR 1609, 1629.)⁸ ARB estimated that the only cost to the vehicle owner should be the time that the vehicle is out-of-service.⁹ (AR 1609.) The proposed penalty for not

⁶ As discussed more fully below, the evidence at trial showed that ARB could not reasonably have expected engine rebuilds to occur at 300,000 to 400,000 miles of service because the materials on which ARB claims it relied pertained to pre-1993 engines that were not "electronically-controlled" like the Low NOx Rebuild Engines. In addition, the evidence at trial showed that ARB knew or should have known that the Low NOx Rebuild Engines would travel 750,000 to 1,000,000 miles before rebuild. Its own library contained studies with this information.

⁷ ARB never provided any evidence at trial, or even alleged, that the Manufacturers were not complying with the terms of the Settlement Agreements or that the Low NOx Rebuild Kits were not being installed at the time of Engine Rebuild in accordance with the Settlement Agreements.

⁸ These assumptions were also challenged at the time of trial. The manufacturers provided persuasive evidence that the downtime was significantly greater than estimated, as was the economic impact on individual truck drivers and fleets with trucks involved in interstate commerce.

⁹ In the event engine manufacturers refuse to reimburse their dealers/distributors, ARB estimated costs to the vehicle owner/operator may include one-half to one hour of labor. (AR 1629.) ARB also recognized

installing the low NOx software as required under the regulation would be \$300 if the software were installed within 45 days of issuance of a citation, and an additional \$500 if the software were not installed within such 45-day period. (AR 1600, 1608.)

ARB further concluded that the low NOx software "should be provided and installed free of charge to vehicle owners and operators," because "ARB staff believes the applicable consent decrees and Settlement Agreements require manufacturers to supply the Low NOx software at no added cost whenever it is requested."¹⁰ (AR 1608; *see also* AR 1605.)

ARB's staff estimated that the emission benefits from the proposed regulation would be "significant" -- 30 to 40 tons per day in 2005 from California-registered vehicles, and 6-9 tons per day from out-of-state registered vehicles.¹¹ Because ARB staff assumed there would be no labor charges to the vehicle owner for the installation of the software, (AR 1609, 1627), the Initial Statement of Reasons concluded that the proposed regulation would be cost effective, at less than \$100 per ton of NOx reduced. (AR 1601, 1609.)¹²

The Initial Statement of Reasons identified alternatives to the proposed regulation, including not going forward with the regulatory proposal, implementing a voluntary software upgrades program, and requiring low NOx software to be developed for all 1993-1998 model year engines, rather than just the 1993-1998 model year engines covered by the Settlement Agreements. All of these alternatives were rejected as more burdensome and less effective than the proposed regulation affecting only those manufacturers which were a party to the Settlement Agreements. (AR 1623-24.) Notwithstanding that the Manufacturers under the Settlement Agreements would be "affected" by the regulation, ARB estimated that the regulation -- at least as it was originally proposed -- would not increase costs to the Manufacturers beyond what was required under the Settlement Agreements. (AR 1630.)

At its March 25, 2004 meeting, the ARB approved the Chip Reflash Regulation, citing as statutory authority Health and Safety Code sections 39002, 39003, 39600, 39601, 43000, 43013, 43018, and 43701(b), but directed its Executive Officer to withhold the filing of the regulation until after ARB had the opportunity to evaluate the success of a proposed voluntary program it suggested to the Manufacturers (the "Voluntary Program"). (AR 1881-82, 1919.) ARB ultimately determined that the

that there may be potential costs associated with ECM failure. According to ARB, the cost to replace a failed ECM can be \$1,500 or more. ARB declined to apportion financial responsibility for any failed ECMs, finding this to be an issue between the customer and dealer/distributor performing the service. (AR 1620.)

¹⁰ The Initial Statement of Reasons notes that some engine manufacturers are not "installing" the software free of charge unless it is installed in conjunction with an engine rebuild. ARB stated that it would be "pressing" the engine manufacturers to "meet their obligations so that the vehicle operators and owners incur no costs." (AR 1608.)

¹¹ These figures were grossly overestimated, as established at trial and discussed hereafter.

¹² Again, this figure was challenged and refuted at trial. The tonnage dropped from 30-40 tons per day, to 14.3 tons per day, to approximately 8 tons per day.

Voluntary Program was not achieving its goals and directed its Executive Officer to proceed with filing the Chip Reflash Regulation with the Office of Administrative Law. (AR 2316.) Before doing so, the ARB approved some modifications to the Regulation. (*See* AR 2410 *et seq.*) In particular, and in addition to modifying the penalties and the implementation dates for the Regulation, the ARB added language regarding who must pay for the costs to install the software upgrade.¹³ As initially proposed, the Chip Reflash Regulation did not contain any language regarding the Manufacturer's obligations to reimburse their authorized dealers, distributors, repair facilities, and rebuild facilities for costs to install the Low NOx Rebuild Kits on Low NOx Rebuild Engines at times other than engine rebuild. (AR 1636, 1889-91.) The final Chip Reflash Regulation, in contrast, mandates that Manufacturers reimburse their authorized dealers, distributors, repair facilities, and rebuild facilities for the costs to install the Low NOx Rebuild Kits "at the reimbursement cost level" described in the Settlement Agreements when any person so requests, and at any time they so request. (*See* 13 CCR § 2011.)

In its final form, the Chip Reflash Regulation provides that on and after the applicable implementation dates specified, a vehicle with a Low NOx Rebuild Engine must not operate on highways within the State of California without a Low NOx Rebuild Kit installed. (13 CCR § 2011(c)(1).) It further provides that the Manufacturer's authorized dealers, distributors, repair facilities, and rebuild facilities must (i) provide a Low NOx Rebuild Kit, at no added cost, to the owner or driver of a vehicle with a Low NOx Rebuild Engine, and to any non-affiliated rebuilder or other person who requests it; and (ii) install the Low NOx Rebuild Kit within a reasonable amount of time. (13 CCR § 2011(c)(2).) Any authorized dealers, distributors, repair facilities, and rebuild facilities refusing to install a Low NOx Rebuild Kit, or failing to install a Kit within a reasonable amount of time after being requested to do so, are subject to a civil penalty of \$500 per incident. (13 CCR § 2011(c)(7).) Manufacturers must reimburse their authorized dealers, distributors, repair facilities, and rebuild facilities for their costs to install the Low NOx Rebuild Kits "at the reimbursement cost level paid under the Consent Decrees and Settlement Agreements." (13 CCR § 2011(c)(3).) Moreover, the Regulation in its final form provides that the owner of a vehicle that operates a Low NOx Rebuild Engine without a Low NOx Rebuild Kit installed after the implementation dates can be cited and fined for violating the Regulation. (13 CCR § 2011(c)(6).)

5. EMA's Petition for Writ of Mandate

Petitioner EMA, a not-for-profit trade association representing the leading manufacturers of internal combustion engines used in most medium-duty and heavy-duty motor vehicles, filed its Complaint for Declaratory and Injunctive Relief and Petition for Writ of Mandate (the "EMA Petition" or "EMA Complaint") on March 24, 2005.

¹³ The final Regulation also exempts Detroit Diesel, and the owners, authorized dealers, authorized distributors, and authorized repair and rebuild facilities for these engines, from the requirements of the regulation because ARB determined Detroit Diesel was meeting its targets under the Voluntary Program. (13 CCR § 2011(e).) Whether Detroit Diesel was actually meeting its targets was disputed at trial. (*See, e.g.*, 8/10/06 R.T., at pp. 373-376.)

Count One of EMA's Petition alleges that ARB's authority to adopt and impose motor vehicle engine emission-control regulatory requirements on original engine manufacturers is limited to new motor vehicle engines that are still in the custody and control of engine manufacturers; that the Chip Reflash Regulation imposes emissions-related regulatory requirements on original engine manufacturers with respect to motor vehicle engines that already have been sold into commerce and placed into service; and, accordingly, ARB exceeded its regulatory authority in adopting and enforcing the Chip Reflash Regulation.

Count Two also challenges ARB's authority to adopt the Chip Reflash Regulation, but on a different basis. It alleges that the principal objective of the Chip Reflash Regulation is to mandate the retrofit of Low NOx Rebuild Kits on Low NOx Rebuild Engines at a pace faster than agreed to under the Settlement Agreements. Count Two alleges that ARB does not have the authority to require the installation of the Low NOx Rebuild Kits on the Low NOx Rebuild Engines and, even if it does, ARB does not have the authority to require the installation of the Kits in a manner inconsistent with the terms of the Settlement Agreements. EMA therefore petitions the Court for a writ of mandate directing ARB to set aside the Chip Reflash Regulation.

In addition to the two mandamus actions, EMA's Complaint asks for a judicial declaration that the Chip Reflash Regulation is unlawful, invalid and beyond the scope of ARB's statutory authority, and a permanent injunction enjoining ARB and its agents, employees, and representatives from implementing and attempting to enforce any provisions of the Chip Reflash Regulation.

B. Discussion With Respect to EMA's Petition and Declaratory and Injunctive Relief Requests

1. Does ARB Have the Authority to Adopt the Chip Reflash Regulation in the Absence of the Settlement Agreements?

Before considering the potential impact of the Settlement Agreements on ARB's authority to adopt the Chip Reflash Regulation, the Court first considers ARB's authority to adopt the Chip Reflash Regulation in the absence of the Settlement Agreements. In other words, the Court considers whether ARB would have authority to adopt the Chip Reflash Regulation assuming *arguendo* that the Settlement Agreements did not exist. This is necessary for two reasons.

First, while a settlement agreement may allow an agency to impose sanctions that the agency would otherwise lack the power to impose (Gov. Code § 11415.60), a settlement agreement cannot expand an agency's rulemaking authority. The limits of an agency's rulemaking authority are defined by its enabling statutes, not by contract. (*Morris v. Williams* (1967) 67 Cal.2d 733, 748-749 ["Administrative regulations that alter or amend the statute or enlarge or impair its scope are void."])

Second, there is always a risk that a settlement agreement will be breached, terminated, expire, or otherwise become unenforceable.¹⁴ Thus, in analyzing the Regulation for purposes of this count of the petition, the Court is not concerned with the terms of the Settlement Agreement; the Court is only concerned with the requirements of the Regulation. Those regulatory requirements must be judged independent of the terms of the Settlement Agreements.

In general, when a court inquires into the validity of a quasi-legislative administrative regulation, the scope of review is restricted. (*Cal. Assn. of Psychology Providers v. Rank* (1990) 51 Cal.3d 1, 11.) If the court is satisfied that the regulation is (1) within the scope of the authority conferred by the statute and (2) reasonably necessary to effectuate the purposes of the statute, judicial review is at an end. (*Yamaha Corp. v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 10-11.) The court's review necessarily is confined to the question whether the agency's actions were arbitrary, capricious, or entirely lacking in evidentiary support, or whether the agency failed to follow the procedures and give the notices required by law. (*Cal. Assn. of Psychology Providers, supra*, at p.11.)

When, however, a regulation is challenged as inconsistent with the terms or intent of the authorizing statute, the standard of review is different. The court, not the agency, has "final responsibility for the interpretation of the law" under which the regulation was issued. (*Yamaha, supra*, at p.11 fn.4.) If the court determines that a challenged administrative regulation was not authorized by, or is inconsistent with, acts of the Legislature, that administrative action is void. (*Cal. Assn. of Psychology Providers, supra*, at p.11; *see also* Gov. Code §§ 11350, 11342.1, 11342.2.) Therefore, a court does not completely defer to an agency's view when deciding whether a regulation lies within the scope of the authority delegated by the Legislature. (*Yamaha, supra*, at p.11 fn.4.) The California Supreme Court has referred to the standard of review for challenges to the fundamental legitimacy of a quasi-legislative regulation as being one of "respectful nondeference." (*Id.*)

This standard of review requires a careful analysis of what the challenged regulation requires. In this case, the Chip Reflash Regulation (1) prohibits the use of the Low NOx Rebuild Engines on highways within the State of California after specified dates unless the engines have the Low NOx Rebuild Kits installed; (2) requires "owners" to have the Kits installed; (3) requires authorized dealers, distributors, repair facilities, and rebuild facilities, to "provide" a Low NOx Rebuild Kit at "no added cost" to any person who requests it; (4) requires authorized dealers, distributors, repair facilities, and rebuild facilities, to "install the Low NOx Rebuild Kit within a reasonable amount of time" after such request; and (5) requires the Manufacturers to reimburse authorized dealers, distributors, repair facilities, and rebuild facilities for their costs to install the Low NOx Rebuild Kits on Low NOx Rebuild Engines "at the reimbursement cost level

¹⁴ For example, if the Settlement Agreements were invalidated for violating the reserved powers doctrine, the Chip Reflash Regulation still would exist and still would require authorized dealers and distributors to "provide" the Low NOx Rebuild Kit "upon request and at no added cost."

paid under the Consent Decrees and Settlement Agreements." (13 C.C.R. § 2011(b)(4), (b)(5), (c)(1)-(3), (c)(6)-(7), (d).)

As described above, EMA challenges not only ARB's authority to require owners to install the Low NOx Rebuild Kits, but also ARB's authority to require authorized dealers, distributors, repair facilities, and rebuild facilities to provide and install the Kits, and ARB's authority to require manufacturers to reimburse the costs of installation.

ARB asserts that it has statutory authority to adopt each provision of the Chip Reflash Regulation. Specifically, ARB contends that it has statutory authority to adopt the Chip Reflash Regulation pursuant to its power to reduce diesel emissions under Health and Safety Code sections 43700, 43018, and 43013; its power to regulate used motor vehicle engines under Health and Safety Code section 43701; its power to require manufacturers to take corrective actions in respect to vehicles already sold under Health and Safety Code sections 43009.5 and 43105; and its "general rulemaking authority" under Health and Safety Code sections 39000-39003, 39500, 39600-39602.

The Court concludes ARB does not have the statutory authority to require original engine manufacturers to develop, provide, or install such kits, or to require the manufacturers to reimburse the costs for others to develop, provide or install such kits absent a recall and its procedural safeguards. Thus, the Chip Reflash Regulation -- which requires manufacturers to provide the Low NOx Rebuild Kits, requires manufacturers' authorized dealers to install such kits, and requires manufacturers to pay for the costs of installation -- exceeds ARB's statutory authority and must be set aside. The Court's conclusion is discussed in more detail below.

a. ARB's Authority To Require Owners To Install The Low NOx Rebuild Kits.

EMA contends that Health and Safety Code section 43600 bars ARB from requiring the installation of such kits on used motor vehicles. Section 43600 provides:

"The state board shall adopt and implement emission standards for used motor vehicles for the control of emissions therefrom, which standards the state board has found to be necessary and technologically feasible to carry out the purposes of this division; however, the installation of certified devices on used motor vehicles shall not be mandated except by statute. Such standards may be applicable to motor vehicle engines, rather than to motor vehicles." (Health & Saf. Code § 43600 [emphasis added].)

EMA contends that the Low NOx Rebuild Kits are "certified devices" within the meaning of the statute. On this point, the Court agrees with EMA.

Health and Safety Code section 39040 defines a "motor vehicle pollution control device" to include not only equipment designed for installation on a motor vehicle for the purpose of reducing air pollution emitted from the vehicle, but also "a system or engine

modification on a motor vehicle which causes a reduction in air contaminants emitted from the vehicle." (Health & Saf. Code § 39040; *see also* Health & Saf. Code § 39013 [defining air contaminants].) In addition, Health and Safety Code section 39019 provides that a "certified device" means "a motor vehicle pollution control device with a certification, and includes a motor vehicle pollution control device previously accredited or approved by the state board or by the Motor Vehicle Pollution Control Board." (Health & Saf. Code § 39019.) "Certification," in turn, is defined to mean "a finding by the state board that a motor vehicle, motor vehicle engine, or motor vehicle pollution control device has satisfied the criteria adopted by the state board for the control of specified air contaminants from vehicular sources." (Health & Saf. Code § 39018.) The implication is that even if ARB has not issued an official written "certification" for a motor vehicle pollution control device, this does not mean that the device is not certified. Rather, any finding that a device has been approved by ARB will suffice to render it a "certified device."¹⁵ Under the circumstances, it seems clear that the Low NO_x Rebuild Kits are certified devices within the meaning of Health and Safety Code section 43600.

This conclusion, however, is not fatal to the instant Regulation. Section 43600 does not state that installation of certified devices on used motor vehicles is prohibited in all instances; rather, it states that installation "shall not be mandated except by statute." (Health & Saf. Code § 43600 [emphasis added].) Thus, section 43600 is not a bar if the installation of the Low NO_x Rebuild Kits is authorized by statute.

Section 43701 applies to used motor vehicles and provides that the ARB, in consultation with the State Energy Resources Conservation and Development Commission, and for the purpose of reducing gaseous and smoke emissions to the greatest extent feasible, "shall . . . adopt regulations that require that heavy-duty diesel motor vehicles subject to subdivision (a) to utilize emission control equipment and alternative fuels." (Health & Saf. Code § 43701(b).) The Court reads this language to mean that, at least with respect to heavy-duty diesel motor vehicles, the ARB is authorized to adopt regulations requiring heavy-duty diesel motor vehicles to use "emission control equipment."

The Court interprets the phrase "emission control equipment" as including "certified motor vehicle pollution control devices." This conclusion is supported by the purposes of Division 26 of the Health and Safety Code. Throughout Division 26, the Legislature has expressed its collective opinion that the control and elimination of emissions from motor vehicles, and particularly emissions from diesel-powered vehicles, is of prime importance for the protection and preservation of the public health and well being. (*See* Health & Saf. Code §§ 43000(b), 43700(d).) The Legislature also has found and declared that despite the significant reductions in vehicle emissions which have been achieved in California, continued growth in population and vehicle miles traveled throughout California have the potential not only to prevent attainment of the state

¹⁵ The Court also notes that if the software upgrade were not a "certified" device, the ARB would be wholly without power to require that it be installed. This conclusion derives not only from the language of Health & Saf. Code § 43644, which prohibits installation of uncertified devices, but also from the language of Health & Saf. Code § 43600.

standards, but in some cases, to result in worsening of air quality. The Legislature has found and declared that the attainment and maintenance of the state air quality standards "will necessitate the achievement of substantial reductions in new vehicle emissions and substantial improvements in the durability of vehicle emissions systems." (*Id.*) As a result, the Legislature found and declared that ARB "should take immediate action to implement both short- and long-range programs of across-the-board reductions in vehicle emissions and smoke." (*Id.*) Further, in order to attain the state and federal standards as expeditiously and equitably as possible, the Legislature has found and declared "it is necessary for the authority of the state board to be clarified and expanded with respect to the control of motor vehicles and motor vehicle fuels." (*Id.*)

It is therefore reasonable to conclude -- as has ARB -- that the Legislature intended to expand ARB's authority to include the power to mandate the installation of emission control devices in respect to heavy-duty diesel-powered vehicles. (*See, e.g.*, Health & Saf. Code § 43701(b) [authorizing ARB to require heavy-duty motor vehicles to utilize "emission control equipment"].)

The Court rejects EMA's argument that section 43701(b) was intended to apply only to fleets of vehicles subject to the smoke inspection program. Subdivision (b) indicates that it applies to all heavy-duty motor vehicles subject to subdivision (a). Although the ARB's regulations may or may not be limited to fleets of vehicles subject to the smoke inspection program, subdivision (a) is not so limited and applies to all heavy-duty diesel motor vehicles. Subdivision (b), therefore, likewise applies to all such vehicles.

The Court also rejects the argument that subdivision (b) does not apply because ARB did not consult with the State Energy Resources Conservation and Development Commission. The Court interprets this requirement as directory, not mandatory. (*In re Richard S.* (1991) 54 Cal.3d 857, 865-866.) ARB's failure to comply does not render the instant Regulation invalid.

Further, the Court rejects EMA's argument that subdivision (b) does not apply because ARB never adopted emissions standards and procedures for the "qualification" of the Low NOx Rebuild Kits in accordance with subdivision (c). That subdivision simply has no application in a case such as this where the "equipment" required to be installed -- and the only "equipment" authorized to be installed -- was designed by the original engine manufacturers and approved by the ARB.

The Court finally rejects EMA's argument that the instant Regulation amounts to "significant modification" of the engines that can only be required at a regularly scheduled major maintenance or overhaul. (See section 43701(b).) While the proposed modification of the engine may be "significant" from an engineering or environmental standpoint, the Legislature's concern in requiring that "significant modifications" only be done at a regularly scheduled major maintenance or overhaul of the vehicle's engine was with time, namely, the amount of time that an engine would be out of service. Based solely on the evidence in the administrative record, the Court is not persuaded that

installation of the Low NO_x Rebuild Kits constitutes a "significant modification" within the meaning of the statute.¹⁶

For these reasons, the Court concludes that, in the absence of the Settlement Agreements, ARB would have the authority under Health and Safety Code section 43701(b) to adopt a regulation requiring owners of heavy-duty diesel motor vehicle engines to install software upgrade kits. However, this assumes that the software kits already existed and were otherwise generally available. That is not the case before the court.

b. ARB's Authority To Require Manufacturers Or Their Authorized Dealers And Distributors To Provide And Install The Low NO_x Rebuild Kits.

The Court concludes that ARB does *not* have the legal authority to require manufacturers and their authorized dealers, distributors, repair facilities, and rebuild facilities to provide and install software upgrade kits "at no cost."

There is nothing in the Health and Safety Code that authorizes ARB to require manufacturers, either directly or through their authorized dealers, distributors, repair facilities, and rebuild facilities, to provide vehicle owners with proprietary engine software upgrades "at no cost." ARB's authority simply does not extend this far.

Further, while the Court does not foreclose the possibility that ARB might be able to require repair and rebuild facilities to install emission control equipment under appropriate circumstances, the Court discerns no reasonable basis for limiting such rule only to manufacturer-authorized repair and rebuild facilities. This requirement is not reasonably necessary to effectuate the implicit purpose of ensuring that emission control equipment will be timely installed. Rather, it is intended to shift the burden of installing the emission control equipment to the manufacturers. And, even if ARB had the authority to require authorized dealers, distributors, repair facilities, and rebuild facilities to install the Low NO_x Rebuild Kits, the Court concludes ARB lacks the authority to require manufacturers to reimburse the costs to install such Kits, i.e., provide the kits and install them at no added cost.

The Court's conclusion is based, in large part, upon by Health and Safety Code section 43105. That section provides:

"No new motor vehicle, new motor vehicle engine, or motor vehicle with a new motor vehicle engine required pursuant to this part to meet the emission standards established pursuant to Section 43101 shall be sold to the ultimate purchaser, offered or delivered for sale to the ultimate purchaser, or registered in this state if the manufacturer has violated

¹⁶ Again, the evidence at trial with respect to the amount of time a truck might be out of service as a result of the regulation was significantly greater than that estimated by ARB, particularly when the factor of interstate trucking was considered.

emission standards or test procedures and has failed to take corrective action, which may include recall of vehicles or engines, specified by the state board in accordance with regulations of the state board." (Health & Saf. Code § 43105.)

In addition, it provides:

"If a manufacturer contests the necessity for, or the scope of, a recall of vehicles or engines ordered pursuant to this section and so advises the state board, the state board shall not require such recall unless it first affords the manufacturer the opportunity, at a public hearing, to present evidence in support of the manufacturer's objections. If a vehicle or engine is recalled pursuant to this section, the manufacturer shall make all necessary corrections specified by the state board without charge to the registered owner of the vehicle or vehicle with such engine or, at the manufacturer's election, reimburse the registered owner for the cost of making such necessary corrections." (Health & Saf. Code § 43105; *see also* Health & Saf. Code § 43009.5.)

Section 43105 prohibits manufacturers from selling new motor vehicle engines that fail to meet the applicable emission standards and test procedures. If a manufacturer violates the emission standards or test procedures, the ARB may invoke its enforcement authority under section 43105 to initiate a recall and require the manufacturer to make all necessary corrections at the manufacturer's expense. However, if a manufacturer contests the need for a recall, the ARB may not require the recall unless it first affords the manufacturer the opportunity, at a public hearing, to present evidence in support of the manufacturer's objections.

A regulation requiring manufacturers to pay the costs to develop, deliver, and install a remedial software upgrade in used motor vehicle engines would appear to have the same purpose and effect as a recall under section 43105 -- namely, to "correct vehicles in the possession or control of consumers" at the manufacturers' expense (13 CCR § 1900(b)(19)), but it would deprive manufacturers of their statutory right to contest the recall at a public hearing. (Health & Saf. Code §§ 43105, 43009.5; *see also* 13 CCR § 2109.) ARB cannot be allowed to accomplish indirectly what it cannot do directly. Yet this is essentially what the Chip Reflash Regulation would accomplish by requiring owners to "correct" their engines' injection-timing with a remedial software upgrade installed at the manufacturers' expense.¹⁷ The Court necessarily concludes that such a regulation exceeds ARB's statutory authority.

¹⁷ The Court realizes that the Regulation only requires manufacturers to reimburse "at the cost level paid under the Consent Decrees and Settlement Agreements." However, the intent of this language was to ensure the Kits would be installed "at no added cost" to the owners. Moreover, what is being evaluated here is not the amount that manufacturers are required to pay, but whether they can be statutorily required to pay any amount.

This brings the Court back to the initial question presented in this section: does ARB have the authority to adopt the Chip Reflash Regulation? The Court concludes that it does not. While ARB has the statutory authority to adopt a regulation requiring owners to install Low NOx Rebuild Kits, assuming such Kits were available, ARB does not have the statutory authority to require manufacturers and their authorized dealers, distributors, repair and rebuild facilities to make Low NOx Rebuild Kits available or to bear all the burdens and costs of having Low NOx Rebuild Kits installed absent the statutory and procedural due process requirements of a recall.

In making the above determination, the Court recognizes ARB's argument that the Chip Reflash Regulation "imposes no obligations on the Engine Manufacturers beyond that agreed to in the Settlement Agreements." (Opposition to Petition, p. 25.) However, as discussed above, the limits of an agency's rulemaking authority are defined by its enabling statutes, not by contract; a settlement agreement cannot expand an agency's rulemaking authority.

2. Does ARB Have the Authority to Promulgate a Regulation that Materially Breaches the Terms of the Settlement Agreements?

Having considered the ability of ARB to promulgate the regulation in the absence of the California Settlement Agreements, the Court now turns to the impact of the agreements on ARB's ability to adopt the Regulation. The EMA Petition alleges -- albeit somewhat vaguely -- that ARB does not have authority to promulgate a regulation that materially breaches the terms of a binding settlement agreement. (See EMA Petition, ¶ 55.) This is the same issue presented in the consolidated action entitled *Caterpillar, Inc., et al. v. California Air Resources Board*. The only difference between the two actions, and the Court's consideration of the same in making its rulings, is that the EMA Petition must be decided on the evidence in the administrative record, whereas the *Caterpillar* complaint was determined on the evidence presented at trial, which included references to the administrative record and other evidence. To avoid duplication, the Court has consolidated its discussion of EMA's allegations regarding the Settlement Agreements into the portion of this ruling discussing the Caterpillar allegations. As described in more detail below, the Court concludes that the Chip Reflash Regulation materially breaches the terms of the Settlement Agreements. Breach alone is insufficient to invalidate the regulations. In this circumstance, however, the rules rise to the level of an unconstitutional impairment of contract and an illegal involuntary recall. As a result, the Court grants moving parties' request for a declaratory judgment that the Regulation is invalid and for a permanent injunction against its implementation.

III. Ruling on Caterpillar Complaint

A. Factual Background of the Caterpillar Action

The Court, sitting as the trier of fact, heard evidence and arguments over several days. It now makes the following findings of fact for purposes of its ruling on the Caterpillar Complaint.¹⁸

Beginning in late 1997, the Manufacturers, EPA, and ARB were engaged in a regulatory dispute over whether the injection-timing strategies used on the Low NOx Rebuild Engines violated federal and California emissions requirements. At issue was whether the fuel injection timing software "defeated" the engine's emission controls by increasing NOx emissions in steady-state (long haul) driving modes relative to the transient (stop and go) urban driving modes to which the emissions tests were geared. Manufacturers disputed the EPA and ARB allegations that the injection timing software violated emissions laws. Manufacturers believed, and still believe, that their engine designs fully complied with applicable statutes and regulations, and that EPA knew of, and approved, the disputed engine controls.

The parties engaged in ten months of negotiations, with the EPA taking the lead on behalf of the two governments. ARB, for the most part, monitored the negotiation sessions and did not become actively involved until it becomes time to draft various unique California provisions. Both sides in the negotiations recognized that they faced litigation risks absent settlement.

On or about October 22, 1998, each Manufacturer executed a consent decree with the EPA. The consent decrees were lodged with the United States District Court for the District of Columbia the day they were executed. After the consent decrees were executed, each Manufacturer separately executed a Settlement Agreement with ARB. The Settlement Agreements were later twice amended in writing by agreement of the parties, although the amendments did not change any of the contract provisions at issue in this litigation.

On November 3, 1998, the United States published notices of its proposed consent decrees in the Federal Register and invited the public to submit comments. Kathleen Walsh, General Counsel of ARB at the time, reviewed the public comments to the consent decrees to determine how issues raised by the public might affect the Settlements. After reviewing the comments, Ms. Walsh did not suggest any changes to either the consent decrees or the Settlements. After reviewing the public comments, the United States filed a motion with the United States District Court for the District of Columbia to enter the consent decrees. The supporting memorandum summarized the bases for entry and responded to the public comments. Before the consent decrees were entered, Ms. Walsh reviewed the supporting memorandum. She did not inform the United States that ARB disagreed with anything stated in the memorandum.

¹⁸ Other findings of fact that are relevant to specific issues appear elsewhere in the decision.

Following its review of the proposed consent decrees, the public comments, and the United States' motion and supporting memorandum, the United States District Court for the District of Columbia approved and entered the consent decrees. (Trial Exhibit 307.) The requirements of the Settlement Agreements were triggered when the consent decrees were entered by the United States District Court. (Settlement Agreements, ¶¶ 2, 165.)

Through the mechanism of the Settlement Agreements the Manufacturers agreed to (1) pay substantial penalties to the State of California; (2) reduce emissions from certain engines and meet specified emission levels in accordance with a schedule set forth in the Settlements by modifying current injection-timing strategies, implementing a Low NOx Rebuild Program for Low NOx Rebuild Engines, and implementing new technology; (3) replace, on future production, the alleged defeat devices and provide for emissions and compliance monitoring through supplementary test requirements, auditing procedures, in-use testing, and reporting requirements; (4) reduce ambient levels of air pollutants by accelerating implementation of more stringent on-road HDDE and Nonroad CI Engine emission standards and other emission reduction programs; and (5) perform certain California Offset Projects, described in the Settlements. (Settlement Agreements, at ¶ 8A.)¹⁹ The parties stipulated at trial that ARB is not challenging Manufacturers' performance under the Settlement Agreements.

In 2003, ARB proposed the Chip Reflash Regulation to amend Title 13 of the California Code of Regulations. It required owners and operators of Low NOx Rebuild Engines to have Low NOx Rebuild Kits installed, not at the time of Engine Rebuild as required in the Settlement Agreements, but in accordance with a set of mandatory deadlines. The Chip Reflash Regulation targeted only the engines (i.e., the "Low NOx Rebuild Engines") described in the Settlement Agreements. The ARB adopted the Chip Reflash Regulation at its meeting on March 2, 2004. However, the Board also approved a voluntary program to promote the reflash and directed its Executive Officer to withhold filing the adopted Chip Reflash Regulation until the Board's December 2004 meeting so the Board could evaluate the efficacy of the voluntary program.

At its December 9, 2004 meeting, the Board decided it was not satisfied with the pace of the Low NOx Rebuild Kit installation under the voluntary program or the terms of the Settlement Agreements. As a result, the Board authorized the filing of the Chip Reflash Regulation with the Office of Administrative Law, which approved the Regulation on March 21, 2005.

¹⁹ Specifically, the Manufacturers paid approximately \$17 million to the California Air Pollution Control Fund. Caterpillar also paid \$8,247,015 in non-conformance penalties to the California Air Pollution Control Fund. Additionally, certain Manufacturers agreed to pay for supplemental environmental projects unique to California. Caterpillar expended \$9,300,000; Mack expended \$2,214,014; Volvo expended \$1,200,000; and Cummins expended \$2,090,525, and an additional \$4,533,162, subject to ARB approval. Under the Settlements, Manufacturers also accelerated emissions reductions for both on-highway and non-road engines, implemented additional testing requirements and related standards, and eliminated the disputed injection timing strategies.

The Plaintiffs in Consolidated Case No. 05AS01133 (entitled *Caterpillar, Inc., et al. v. California Air Resources Board*) are four of the seven Manufacturers of heavy-duty diesel engines that entered into the Consent Decrees/Settlement Agreements with EPA and ARB. The Plaintiffs filed their original Complaint for Declaratory and Injunctive Relief on March 23, 2005, and a First Amended Complaint on September 5, 2005 (as amended, the "Caterpillar Complaint").

The gravamen of the Caterpillar Complaint is that ARB, in adopting the Chip Reflash Regulation, breached the terms of the various "Settlement Agreements" entered into by ARB and the Manufacturers to settle the allegations made in EPA's enforcement action. The Caterpillar Complaint contains five claims for relief, each seeking declaratory and/or injunctive relief.²⁰

The First Claim for Relief alleges that the Chip Reflash Regulation is contrary to paragraph 161 of the Settlement Agreements and seeks a judicial declaration that paragraph 161 bars ARB from "determining" that the engines identified in the Settlement Agreements (the "Low NOx Rebuild Engines") do not conform to Title 13 of the California Code on the basis of their injection timing strategies.

The Second Claim for Relief alleges that the Chip Reflash Regulation is contrary to paragraph 69 of the Settlement Agreements and seeks a judicial declaration that paragraph 69 bars ARB from mandating installation of the "Low NOx Rebuild Kits" before the time of engine rebuild.

The Third Claim for Relief alleges that the Chip Reflash Regulation is contrary to paragraph 71 of the Settlement Agreements and seeks a judicial declaration that paragraph 71 bars ARB from requiring the engine manufacturers to reimburse the cost to install the "Low NOx Rebuild Kits" at a time other than engine rebuild.

The Fourth Claim for Relief alleges that the Chip Reflash Regulation is contrary to the provision in the Settlement Agreements (paragraph 164) providing that the agreements may be modified only by a written instrument executed by both the manufacturer and ARB and seeks a judicial declaration that ARB may not unilaterally alter the terms of the Settlement Agreements.

Finally, the Fifth Claim for Relief alleges that ARB's regulatory action is unconstitutional or otherwise invalid because (i) ARB acted in conflict with the Settlement Agreements; (ii) the Chip Reflash Regulation unconstitutionally impairs the manufacturers' rights under the Settlement Agreements; (iii) the Chip Reflash Regulation is an unlawful recall; and (iv) the Chip Reflash Regulation is preempted by federal law because it conflicts with the federal Consent Decrees. The Fifth Claim for Relief seeks a

²⁰ At trial, Plaintiffs stated that if the Court is not inclined to grant the relief requested in the Caterpillar Complaint, Plaintiffs request an order canceling and/or rescinding the Settlement Agreements, with restitution of all penalties and other monies paid by Plaintiffs under the Settlement Agreements. Having reached the conclusion that Plaintiffs are entitled to the relief requested in the Caterpillar Complaint, the Court denies the alternative remedy requested by Plaintiffs.

judicial declaration that ARB's Chip Reflash Regulation is unconstitutional, void and invalid, and also seeks a preliminary and permanent injunction enjoining ARB from unilaterally abrogating the Settlement Agreements.

B. Discussion

To adjudicate Plaintiffs' claims for relief, the following issues must be addressed:

- (1) What do the relevant terms of the Settlement Agreements mean?
- (2) Do the Settlement Agreements violate the Reserved Powers Doctrine?
- (3) Does the Chip Reflash Regulation breach the Settlement Agreements?
- (4) If the Chip Reflash Regulation breaches the Settlement Agreements, are the breaches sufficient to enjoin and/or invalidate the Regulation?

Defendant ARB's answer to the Complaint also raised, as an affirmative defense, that the equitable relief sought by Plaintiffs is barred because ARB entered into the Settlement Agreements based on a mistake of fact. Defendant withdrew this affirmative defense before closing at trial.

1. What Do the Relevant Terms in the Settlement Agreements Mean?

a. Rules Governing the Interpretation of Contracts

The laws with respect to contract interpretation have been restated many times. The basic rule of contract interpretation is to give effect to the parties' mutual intent at the time of contracting. To determine the parties' mutual intent, the Court looks first to the words used in the agreement. (Civ. Code § 1639.) The words of a contract are to be understood in their ordinary and popular sense, rather than according to any strict legal meaning, unless the parties used the words in a technical sense or gave them a special meaning by usage. (Civ. Code § 1644.) In addition, the meaning of the words used must be determined from a reading of the entire contract, so as to give effect to every part, if possible, with each clause helping to interpret the other. (Civ. Code § 1641.) Repugnancy in a contract must be reconciled, if possible, by such an interpretation as will give some effect to the repugnant clauses, subordinate to the general intent and purpose of the whole contract. (Civ. Code §§ 1652, 1653.) Similarly, an interpretation that gives a reasonable, lawful, and effective meaning to all the terms is preferred to an interpretation that leaves a part unreasonable, unlawful or of no effect. (Civ. Code § 1643.)

Where the language of a contract is clear and does not involve an absurdity, it will be followed. (Civ. Code § 1638.) Thus, a court may interpret a contract without recourse to extrinsic evidence if the contract terms are unambiguous. On the other hand, where the meanings of words used in a contract are disputed, resort to extrinsic evidence may be required. (See *Morey v. Vannucci* (1998) 64 Cal.App.4th 904, 912; *Wolf v. Superior Court* (2004) 114 Cal.App.4th 1343, 1350; Civ. Code § 1647; Civ. Proc. Code § 1860.) A trial court must provisionally receive any proffered competent extrinsic evidence that is

relevant to show whether the contract is reasonably susceptible of a particular meaning. (*Wolf, supra*, at p. 1350.) It is reversible error for a trial court to refuse to consider competent extrinsic evidence on the basis of the trial court's own conclusion that the language of the contract appears to be clear and unambiguous on its face. (*Id.* at p. 1351.) Even if a contract appears unambiguous on its face, a latent ambiguity may be exposed which reveals more than one possible meaning to which the language of the contract is reasonably susceptible. (*Id.*)

Thus, where the meaning of a contract is disputed, the interpretation of the contract involves a two-step process. First, the court must provisionally receive (without actually admitting) all relevant²¹ extrinsic evidence concerning the parties' intentions to determine whether the language is "reasonably susceptible" to the interpretation urged by the party. If in light of the extrinsic evidence the court decides the language is "reasonably susceptible" to the interpretation urged, the extrinsic evidence is then admitted to aid in the second step, which is interpreting the contract. (*Id.*) Extrinsic evidence is thus admissible to interpret the language of a written instrument, as long as such evidence is not used to give the instrument a meaning to which it is not reasonably susceptible.

The Court's determination of whether an ambiguity exists in a contract is a question of law. Where no extrinsic evidence has been introduced, or where the extrinsic evidence is not in conflict, the Court's interpretation of the contract also is a question of law. However, where the interpretation of contractual language turns on a question of the credibility of conflicting extrinsic evidence, the Court's resolution of that conflict is a question of fact. (*Id.*)

b. The Unmistakability Doctrine

ARB argues that the Court's interpretation of the Settlement Agreements also should be guided by another canon of construction, namely, the "unmistakability doctrine." The unmistakability doctrine provides that surrenders of sovereign authority must appear in unmistakable terms.

It has been stated that the unmistakability doctrine is "as easily summarized as it is poorly delineated, the latter owing to a welter of conflicting opinions, no less than four of which are in *Winstar* [*United States v. Winstar* (1996) 518 U.S. 839] itself." (*Cuyahoga Metro. Hous. Auth. v. United States* (2003) 57 Fed. Cl. 751, 763.) In *Cuyahoga*, the court stated that the "most unmistakable thing about the 'unmistakability doctrine' is the sheer number of unresolved questions it engenders." (*Id.*) Nevertheless, it appears that *Cuyahoga* establishes a relatively straightforward test for determining when the doctrine does not apply. (*Id.* at p. 777.)

²¹ Undisclosed intentions of a contracting party are irrelevant under the objective theory of contracts. (*Founding Members of the Newport Beach Country Club* (2003) 109 Cal.App.4th 944, 960; *Shaw v. Regents of the Univ. of Cal.* (1997) 58 Cal.App.4th 44, 55.)

The unmistakability doctrine is closely related to the "sovereign acts doctrine." (*Cuyahoga, supra*, at p. 771-74 [citing *General Dynamics Corp. v. United States* (2000) 47 Fed. Cl. 514; *Grass Valley Terrace v. United States* (2002) 51 Fed. Cl. 436].) The sovereign acts doctrine is a defense which provides that when the United States is sued as a contractor, it is not liable for obstructing performance of the contract resulting from its "public and general" acts as a sovereign. (*Winstar, supra*, at p. 892.) Both doctrines hinge on whether challenged legislation constitutes an exercise of "sovereign power." (*Cuyahoga, supra*, at p. 771-74 [citing *General Dynamics Corp. v. United States* (2000) 47 Fed. Cl. 514; *Grass Valley Terrace v. United States* (2002) 51 Fed. Cl. 436].)

With respect to the sovereign acts doctrine, the United States Supreme Court has rejected the notion that the government may abrogate its contractual commitments so long as the object of the legislation is "regulatory" in nature. A plurality of the United States Supreme Court expressed doubt that a workable line can be drawn between the Government's regulatory and nonregulatory capacities. (*Id.* at p. 894.) According to the plurality, the Government's "regulatory" and "nonregulatory" capacities are so commonly "fused" in the modern regulatory state that trying to make such a distinction would raise "enormous analytical difficulties." (*Id.* at pp. 886, 894-895.) Further, allowing the Government to avoid contractual liability merely by passing a nominal "regulatory" statute would "flout the general principle that, 'when the United States enters into contract relations, its rights and duties therein are governed generally by the law applicable to contracts between private individuals.'" (*Id.* at p. 895.)

Rather than trying to distinguish whether the Government's act is "regulatory" or "non-regulatory," the plurality in *Winstar* instead focused on whether the act is "public and general." The Court ruled that the "public and general" criterion usually is met where the impact of the Government's act upon public contracts is merely incidental to the accomplishment of a broader governmental objective. (*Id.* at p. 898 [noting that the generality requirement almost always is met where the Government action bears upon the Government's contract as it bears upon all similar contracts between citizens].) The greater the Government's self interest, however, the more likely the defense will be unavailable. (*Id.* [citing *Sun Oil Co. v. United States* (1978) 215 Cl. Ct. 716, 768 (rejecting sovereign acts defense where actions were "directed principally and primarily at plaintiff's contractual right); *Resolution Trust Corp. v. Federal Savings and Loan Ins. Corp.* (10th Cir. 1994) 25 F.3d 1493, 1501 (stating that the limits of the defense are defined by the extent to which the government's failure to perform is the result of legislation "targeting" a class of contracts to which it is a party); *South Louisiana Grain Services, Inv. v. United States* (1982) 1 Cl. Ct. 281, 287 (rejecting defense where Government's actions were "directed specifically at plaintiff's alleged contract performance")]; see also *Coast-to-Coast Financial Corp. v. United States* (2000) 45 Fed. Cl. 796 [stating that for an act of Congress to qualify as an exercise of sovereign power, it cannot have been designed merely to eliminate an obligation that arose under one of the Government's contractual relationships]; *Doe v. Pataki* (S.D.N.Y. 2006) 427 F.Supp.2d 398 [distinguishing cases involving pure contracts from those involving consent decrees or settlement agreements].)

The plurality in *Winstar* framed the test as follows: "[A] governmental act will not be public and general if it has the substantial [purpose or] effect of releasing the Government from its contractual obligations" (*Winstar, supra*, at p. 899 [rejecting a similar test focusing on the "predominant" purpose or effect of the Government's act because it would be too difficult to apply]; *see also Cuyahoga, supra*, at p. 780.) In sum, the sovereign acts defense will not be available when an enactment targets for elimination the "essential bargain of the contract at issue," or the "very right that [the] sovereign explicitly granted by contract." (*Winstar, supra*, at pp. 917 (Breyer, J.), 924 (Scalia, J.); *see also Cuyahoga, supra*, at p. 773.)

The Supreme Court's opinion in *Winstar* has important implications for the unmistakability doctrine asserted by ARB. If a particular legislative act (here, the Chip Reflash Regulation) is not a "sovereign act" for purposes of the sovereign acts doctrine, then it also is not a "sovereign act" for purposes of the unmistakability doctrine. (*Id.* at p. 774.) In *Winstar*, the Supreme Court's plurality opinion concluded that enactments protected by the sovereign powers doctrines must serve broad societal purposes and not be directed at the abrogation of particular contracts. The same inquiry is relevant to determining whether the unmistakability doctrine applies. (*Cuyahoga, supra*, at p. 776.)

Thus, an inquiry into the purpose and effect of the challenged legislation is relevant to determining whether the Government can take advantage of the unmistakability doctrine in a particular case. (*Cuyahoga, supra*, at p. 773.) Such an inquiry is relevant to determine whether the alleged breach of contract is merely the incidental effect of a sovereign act designed to promote the public good, or instead a deliberate attempt by the Government to "target" its own contract rights. Where a substantial purpose or effect of the Government's action is to release the Government from its own contractual obligations, the unmistakability doctrine -- like the sovereign acts doctrine -- will be unavailable. (*Winstar, supra*, at p. 898; *see also Cuyahoga, supra*, at p. 776 [the government should not be presumed to have retained the power to target undesirable provisions of particular contracts]; *Coast-to-Coast Financial, supra*, at p. 804 [for an act to qualify as an exercise of sovereign power, it cannot have been designed merely to eliminate an obligation arising under one of the Government's contractual relationships]; *Associated Oregon Veterans v. Dept. of Veterans Affairs* (Ore. 1985) 300 Ore. 441, 450 [finding state agency does not possess "reserved" or "sovereign" power to modify contracts to which it is a party whenever, in the opinion of its responsible officials, such modification will further the interests of the citizenry].)

In this case, a substantial part of the impact of the ARB's Chip Reflash Regulation falls on ARB's Settlement Agreements with the Manufacturers. Indeed, the Chip Reflash Regulation is based on the Settlement Agreements and applies only to those engines that are subject to the Low NOx Rebuild Program described in the Settlement Agreements. Although the ultimate effect of the Regulation may be to lower motor vehicle emissions of NOx, the means chosen to achieve this reduction was to adopt a Regulation targeting the Low NOx Rebuild Engines that were the subject of the ARB's Settlement Agreements -- and only those engines. Under the circumstances, the Court is not persuaded that the unmistakability doctrine should apply.

Further, even if the unmistakability presumption applies, for the reasons discussed below, the Court finds that, to the extent the parties agreed to a surrender of sovereign powers, such surrender was made in unmistakable terms.

c. What Is The Meaning Of Paragraphs 161, 69, And 71 Of The Settlement Agreements?

Having identified the relevant rules of contract interpretation, the Court now applies those rules to the disputed provisions of the Settlement Agreements, namely, paragraphs 69, 71, and 161.

i. Paragraph 161

Paragraph 161 states, in relevant part, that "the ARB shall not base a determination that any class or category of [the Low NOx Rebuild Engines] does not conform to Title 13 of the California Code of Regulations or a determination to suspend or revoke an Executive Order on the basis that the engine contains one or more of the injection-timing strategies [described in the Settlement Agreement] if all other requirements applicable to that engine found in this Settlement Agreement and the regulations are met." (*See Settlement Agreements*, at ¶ 161.) The parties disagree as to the proper interpretation of this paragraph.

Both parties appear to agree -- and the Court finds unambiguous -- that paragraph 161 was not intended to preclude all rulemaking in respect to the Low NOx Rebuild Engines on any basis.²² To the contrary, the Settlement Agreements explicitly state that ARB was not relinquishing such authority. (*See Settlement Agreements*, at ¶¶ 30, 146, 168A.) Paragraph 161, by its terms, precludes ARB only from making a determination that the Low NOx Rebuild Engines do not conform to Title 13 of the California Code of Regulations "on the basis that the engine contains one or more of the injection-timing strategies." (*Settlement Agreements*, at ¶ 161 [emphasis added].) If this language were intended to preclude ARB from determining that the Low NOx Rebuild Engines do not conform to Title 13 on *any* basis, then the reference to the injection-timing strategies would be superfluous. Such an interpretation is disfavored. Accordingly, the Court concludes that paragraph 161 does not preclude ARB from enacting a rule based on a determination that such engines do not conform to Title 13 for reasons *other than* the injection-timing strategies. The language in paragraph 161 is not reasonably susceptible to such an expansive interpretation.

The issue in this case, however, is whether paragraph 161 precludes future rulemaking where such rulemaking *is* based on a determination that the engines contain the disputed injection-timing strategies.

²² If there were such language, the provision could render the entire contract void under the reserved powers doctrine, as discussed below.

Plaintiffs contend that paragraph 161 "unambiguously" settled the regulatory status of all Low NOx Rebuild Engines, including engines that had already been sold and delivered into the hands of truck owners. According to Plaintiffs, the purpose of the "determination" language was to ensure that the engines could continue to be operated anywhere in California until the time of engine rebuild without being found in violation of Title 13. Thus, Plaintiffs contend that the "determination" clause "runs with the engines," and precludes ARB from promulgating regulations prohibiting the use of such engines by anyone based on their injection-timing strategies.

Defendant ARB, in contrast, contends that paragraph 161 "unambiguously" settled only the Manufacturers' liability for the claims described in the EPA's enforcement action regarding the allegedly non-conforming engines. Defendant contends that the Settlement Agreements do not in any way limit ARB's rulemaking power over the engines or ARB's powers vis-à-vis truck owners.

Was the "determination" language in paragraph 161 intended to apply only to "enforcement" actions against the Manufacturers, or was it intended to apply to any action -- including rulemaking -- that is based on a determination that the disputed injection-timing strategies do not conform to the requirements of Title 13? If it is the former, ARB arguably remains free under the Settlement Agreements to adopt a rule based on a finding that the injection-timing strategies do not conform to Title 13, so long as the rule does not impact the release of liability of the Manufacturers. In contrast, if it is the latter, then the Settlement Agreements would bar any rule that is based in any way on a determination that the disputed injection-timing strategies do not conform to the requirements of Title 13, arguably including any rule which aims to correct the engines by removing or replacing the disputed injection-timing strategies.

After having provisionally received and considered all relevant extrinsic evidence, the Court concludes that the language in paragraph 161 is unambiguous on its face and that the "determination" clause was intended to "run with the engines" and prevent ARB from taking any action, including rulemaking, prohibiting the use of such engines based on their injection-timing strategies. The Court reaches this conclusion based on the plain language of the agreement.

Paragraph 161 provides that ARB "shall not base a determination that any class or category of [Low NOx Rebuild Engine] does not conform to Title 13 of the California Code of Regulations . . . on the basis that the engine contains one or more of the injection-timing strategies . . . if all other requirements applicable to that engine found in this Settlement Agreement and the regulations are met." The word "determination" is not defined in the Settlements and there is no indication that the term was to have any meaning other than its plain, ordinary meaning. The plain, ordinary meaning of a "determination" is a "decision" or "pronouncement." Black's Law Dictionary specifically defines a determination as the "decision of a court or administrative agency." (Black's Law Dictionary [6th ed. 1990].) A "decision," in turn, may refer both to judicial acts as well as to those that are non-adjudicative. (*Id.*) Indeed, there can be no dispute that regulatory bodies make both quasi-adjudicative and quasi-legislative "determinations."

(See, e.g., *Sierra Club v. San Joaquin Local Agency Formation Com.* (1999) 21 Cal.4th 489, 495 [finding a LAFCO "determination" is quasi-legislative]; *Western States Petroleum Assn. v. Superior Court* (1995) 9 Cal.4th 559, 568-69 [finding court generally should not consider evidence outside the administrative record in reviewing a "quasi-legislative administrative decision"]; *Woods v. Superior Court of Butte County* (1981) 28 Cal.3d 668, 677 [distinguishing cases involving "quasi-legislative determinations"]; *Engelmann v. State Bd. of Education* (1991) 2 Cal.App.4th 47, 56 [finding rules for the evaluation of textbooks are "quasi-legislative determinations"]; *Patterson v. Central Coast Regional Com.* (1976) 58 Cal.App.3d 833, 840 [finding the distinction between quasi-adjudicative and quasi-legislative determinations is sometimes difficult to draw].) Moreover, even if the regulation itself is not a "determination," the regulation still may be based on a "determination." (See *20th Century Ins. Co. v. Garamendi* (1994) 8 Cal.4th 216, 273 [noting the term "determination" is always implicated in regulations].)

Paragraph 161 does not limit the type of "determination" it covers. It does not distinguish between enforcement actions and regulatory actions. It does not restrict the meaning of "determination" in any way. In addition, the "determination" language is specifically directed to the engines, without even mentioning the Manufacturers. This is persuasive evidence that paragraph 161 was intended to bar "determinations" with respect to all Low NOx Rebuild Engines, including those in the hands of the truck owners. Thus, on its face, the plain meaning of paragraph 161 bars any decision or pronouncement by ARB that the Low NOx Rebuild Engines do not conform to title 13 based on their use of the disputed injection timing strategies.

Further, the Recitals to the Settlement Agreements provide that the objective of the Agreements is to memorialize the resolution of the disputed claims. (Settlement Agreements, at ¶ 8A.) The principal "disputed claim" was that the Manufacturers had illegally installed "on engines intended for sale in California certain computer-based fuel-injection timing strategies" that "have an adverse effect on the engine's emissions control system for NOx." (Settlement Agreements, at ¶ 5.) As a result, ARB alleged that the engines were not covered by a valid Executive Order or EPA-issued Certificate of Conformity. (*Id.*) The Settlement Agreements require the Manufacturers, among other things, to take corrective action to modify the existing electronic injection-timing strategies used on the Low NOx Rebuild Engines so as to reduce their emissions. (Settlement Agreements, at ¶¶ 8A, 64, 68.) Thus, it is clear the Settlement Agreements did not just concern the Manufacturers' liability for allegedly violating the Clean Air Act, as ARB alleges. ARB's allegations and the Settlement Agreements also concerned the regulatory status of the engines themselves. This further supports the Court's conclusion that the "determination" clause was intended to settle the regulatory status of the Low NOx Rebuild Engines.

In contrast, the language of paragraph 161 does not support ARB's proposed interpretation. If the Court were to accept ARB's interpretation -- that paragraph 161 was intended merely to limit enforcement actions against the Manufacturers -- it would render the "determination" language in paragraph 161 superfluous, because the first sentence of paragraph 161 unambiguously releases the Manufacturers from "all civil liability . . . for

the violations of California law" alleged by the EPA and ARB, and "for any civil violations that could hereafter be alleged" based on the use of the injection-timing strategies. (Settlement Agreements, at ¶ 161.) As described above, a contract must be interpreted so as to give effect to every part, if possible, with each clause helping to interpret the others. (Civ. Code § 1641.) Thus, the only reasonable interpretation of paragraph 161 is that it was intended not only to release the Manufacturers for all civil liability based on their use of the injection-timing strategies, but also to bar ARB from determining that the engines do not conform to title 13 based on such injection-timing strategies.

ARB incorrectly suggests that the Court cannot apply the plain language of this release because the parties agreed in paragraph 162 that the Settlement Agreements do not create any rights in, or grant any cause of action to, third parties. (Settlement Agreements, at ¶ 162.) ARB's argument must fail because it ignores an important distinction between intended third party beneficiaries and incidental third party beneficiaries. The fact that parties may have agreed there will be no "third party beneficiaries" -- i.e., that third persons shall not have any rights to performance under the contract -- does not mean that the contract cannot result in a benefit to third persons. To the contrary, performance of a contract often will benefit third persons who are not themselves entitled to demand enforcement of the contract. (*See Hess v. Ford Motor Co.* (2002) 27 Cal.4th 516, 524 [fact that literal interpretation of contractual language will result in benefit to third party is not sufficient to entitle that party to demand performance]; *Neverkovec v. Fredericks* (1999) 74 Cal.App.4th 337, 348 [the circumstance that a literal contract interpretation would result in a benefit to the third party is not enough to entitle that party to demand enforcement of the contract].) For example, the Settlement Agreements negotiated by ARB in this case purportedly benefited millions of residents of the State of California, even though the general public was not named as a "third party beneficiary" and even though the general public does not have any right to demand performance under the Agreements. Plaintiffs could not successfully argue that ARB is precluded from enforcing any terms of the Agreements that benefit the public merely because the Agreements are not enforceable by the public. Likewise, Manufacturers are not precluded from enforcing terms of the Agreements that benefit truck owners merely because the Agreements are not enforceable by the truck owners.

Neither is the scope of paragraph 161 limited by the language in paragraph 146. Paragraph 146 does not, as ARB contends, limit the releases in paragraph 161 to "civil claims" only and not regulatory actions. Rather, paragraph 146 clarifies that, to the extent paragraph 161 releases certain civil claims, the Settlement Agreements shall release only those civil claims referred to and no others. The language does not abrogate the otherwise plain meaning and scope of paragraph 161 to incorporate the regulatory status of the engines.

Although it is not necessary to resort to extrinsic evidence, the Court finds that the extrinsic evidence supports the Court's reading of paragraph 161. Having considered the

evidence and argument offered at trial, the Court makes the following findings of fact in this regard in support of its conclusions:

At the time of the negotiations, the Low NOx Rebuild Engines were already in the hands of the truck owners.

Because of California's specific and unique regulatory structure, the parties understood that ARB's authority to "correct" the Low NOx Rebuild Engines in the hands of the truck owners differed from the EPA's authority. Thus, although the California Settlement Agreements were modeled on the federal consent decrees negotiated primarily by the Manufacturers and EPA, certain provisions of the Settlement Agreements, including the release provision in paragraph 161, were specifically negotiated between ARB and the Manufacturers.

In September 1998, during the settlement negotiations, the Environmental Law Foundation sued Manufacturers seeking to force the Manufacturers to remedy the disputed emission control systems with systems that would ensure compliance with applicable air quality standards. That lawsuit, and the risk of similar litigation, became the specific subjects of negotiation with ARB. The Manufacturers told ARB that they wanted to limit rulemaking under title 13 with respect to the engines' injection-timing strategies. By addressing the regulatory status of the Low NOx Rebuild Engines in the Settlement Agreements, the Manufacturers sought to minimize this type of litigation exposure.

The evidence shows Manufacturers sought the broadest possible language for whatever action ARB might try to take under title 13 against the Low NOx Rebuild Engines. Although the Manufacturers asked for a "shield" against such litigation, ARB refused to give the Manufacturers a shield against litigation. ARB did, however, give Manufacturers the negotiated "determination" language.

The evidence shows that the Manufacturers intended the release of the Low NOx Rebuild Engines to apply to the engines already in the hands of the truck owners. Indeed, minimizing the impact on truck owners was a critical driving force in the Manufacturers' negotiations of the Settlement Agreements, and this was expressed by Manufacturers to ARB during the course of the settlement negotiations.²³ As part of the negotiations of paragraph 161, Manufacturers specifically expressed that the purpose of paragraph 161 was to, among other things, prevent ARB from determining, in a regulation or any other proceeding, non-conformance with title 13 on the basis that an engine contains one or more of the injection timing strategies described in the Settlement Agreements. ARB noted that this provision was "huge" to Manufacturers.

In contrast, ARB did not verbally express its desire to retain the right to regulate the Low NOx Rebuild Engines in the hands of the truck owners with respect to the

²³ ARB also sought to minimize the impact the Settlement Agreements would have on truck owners. (8/9/06 R.T., at pp. 206-215; 8/10/06 R.T., at pp. 475-477, 479-483; 8/11/06 R.T., at pp. 544, 569-570; Trial Exhibit 32, at p. 7 [AR 1610].)

disputed injection-timing strategies. Nor did ARB establish at trial that "determination" was intended to have a special meaning in the context of the Settlement Agreements or this case. While the term "determination" appears in the release language agreed upon in the federal consent decrees, the "determination" language in paragraph 161 of the Settlement Agreements is different -- and broader -- than its federal counterparts because it does not limit the scope of prohibited determinations to those made "under" specific statutes or regulations. (*Cf.* Trial Exhibit 305 [federal consent decrees], at ¶¶ 138-140, *with* Settlement Agreements, at ¶ 161.) Whereas paragraphs 138 and 140 of the federal consent decrees reference determinations made "under" specific provisions of the federal Clean Air Act, the determination language in paragraph 161 is not so limited. (*Id.*) This suggests that the "determination" language of paragraph 161 was intended to apply to *any* determination of non-conformity, and not just those determinations made under a specific statute or regulation.

In short, the evidence shows that the Manufacturers were concerned about the regulatory status of the Low NOx Rebuild Engines in the hands of truck owners; that it was important to Manufacturers that the Settlement Agreements resolve the regulatory status of those engines; and that Manufacturers specifically expressed this purpose during the negotiations of paragraph 161. While the Manufacturers always expected that ARB might promulgate regulations in respect to the Low NOx Rebuild Engines, the evidence shows that the Manufacturers specifically sought to prevent ARB from promulgating regulations based on the disputed injection timing strategies discussed in the Settlement Agreements. Thus, the objective evidence of intent is consistent with what is expressed in the plain language of the Agreements.

ii. Paragraph 69.

The Court next considers the meaning of paragraph 69. Paragraph 69 states, in relevant part, that "[b]eginning on the date a Low NOx Rebuild Kit is available for any engine family under Paragraph 68, [Manufacturer] shall sell and use and authorize the sale and use of, only Low NOx Rebuild Kits for any Low NOx Rebuild Engine in that family in the case of any Engine Rebuild for: (a) any HHDDE that has accumulated mileage greater than 290,000 miles, or any MHDDE that has accumulated mileage greater than 185,000 miles or (b) any HHDDE or MHDDE that has accumulated less than the applicable mileage specified in Paragraph 69(a) where the service event includes replacement or reconditioning of more than one Major Cylinder Component in all of the engine's cylinders." (Settlement Agreements, at ¶ 69.)

The parties have stipulated that paragraph 69 requires Manufacturers to sell and use, and authorize the sale and use of, only Low NOx Rebuild Kits when an Engine Rebuild is performed. (Trial Exhibit 405, at ¶ 7.) A "Low NOx Rebuild Kit" is "the software and/or minor hardware included by [Manufacturer] in a rebuild kit offered for sale in California for purposes of complying with" the Low NOx Rebuild Program described in Section IX.B of the Settlement Agreements. (Settlement Agreements, at ¶ 2.) "Engine Rebuild" is unambiguously defined in the Settlements to mean "an activity occurring over one or more maintenance or repair events involving: (a) disassembly of

the engine, including removal of the cylinder heads; and (b) the replacement or reconditioning of more than one Major Cylinder Component in more than half the cylinders." (Settlement Agreements, at ¶ 2.)

Plaintiffs contend that paragraph 69 contains the only mandatory trigger for installation of the Low NO_x Rebuild Kits and, when read in conjunction with paragraph 161, it makes clear that reflashing can be required only at the time of rebuild.

Defendant ARB contends that paragraph 69 is clear on its face: it requires manufacturers to provide and authorize the installation of no kits other than Low NO_x Rebuild Kits when an Engine Rebuild is performed. Defendant further contends paragraph 69 does not prohibit, expressly or impliedly, the ARB from adopting a regulation requiring truck owners to install reflash kits on trucks operated in California.

The Court has determined that the language of paragraph 69 is ambiguous because the language is reasonably susceptible to both interpretations. Extrinsic evidence is thus admissible to interpret the language of paragraph 69. Having considered the evidence and argument offered at trial, the Court finds that the extrinsic evidence shows that Plaintiffs' interpretation is correct.

The Court makes the following findings of fact:

The parameters of the Low NO_x Rebuild Program, including the timing of when reflash would occur, were the subject of negotiations. During negotiations, Manufacturers sought a provision that Low NO_x Rebuild Kits would be required to be installed only at the time of engine rebuild – a major service event. The purpose of this was to minimize the burden on truck owners and service facilities. There were specific discussions among EPA, ARB and Manufacturers about the effects of the settlements on truck owners, and Manufacturers expressed to the ARB and EPA their concerns about the effects of the agreements on the owners of trucks that were already sold to consumers. The parties specifically negotiated when reflashing of engines would occur and ultimately settled on the time of "Engine Rebuild." The parties considered and rejected the approach of requiring installation of Low NO_x Rebuild Kits before the time of engine rebuild. In its memorandum in support of the consent decrees, the United States summarized the basis for rejecting rebuild at the time of first service, explaining that "at rebuild, the truck or engine is already down for a significant period and reprogramming the computer will contribute little in the way of added downtime." The United States noted that the consent decrees and settlements "appropriately balance the need for prompt compliance and redress to the environment, with the interest of the truck manufacturers and owners in having reliable, affordable trucks." (Trial Exhibit 49, at pp. 6-7, 46.)

In promulgating the Chip Reflash Regulation at issue in this case, ARB again acknowledged that when it entered the settlement agreements it "seemed more reasonable to require the installation of Low NO_x rebuild kits at the time of engine rebuild," because "[d]uring the consent decree/ settlement agreement negotiations, the U.S. EPA and the ARB expected that installing the low NO_x rebuild kits at the time of engine rebuild

would minimize the amount of time a vehicle is out-of-service, would offset any changes in fuel economy, and would achieve a higher compliance rate.” (Trial Exhibit 32, at p. 7 [AR 1610].)

The parties' course of performance provides additional objective evidence that the parties tied installation of the Low NOx Rebuild Kits to the time of Engine Rebuild due to concerns about the effect the Low NOx Rebuild Program would have on truck owners. EPA informed Heavy Duty Engine Rebuilders in a letter “[t]he Low NOx Rebuild will occur at the time of engine rebuild to minimize the burden on vehicle owners and service facilities.” (Trial Exhibit 94, at p. 2; 8/14/06 R.T., at pp. 728-729.) ARB received a copy of this letter. (Trial Exhibit 119, at p. 1.)

Nothing in the Settlement Agreements requires, or authorizes the ARB to require, the Low NOx Rebuild Kits to be installed before Engine Rebuild.

The above evidence and findings show that the parties agreed that the Low NOx Rebuild Kits would be installed at the time of Engine Rebuild. It can be reasonably inferred from the evidence that the parties also intended that the Low NOx Rebuild Kits would not be required to be installed before Engine Rebuild. Thus, the Court concludes that paragraph 69 contains the only mandatory trigger for installation of the Low NOx Rebuild Kits and, when read in conjunction with paragraph 161, paragraph 69 makes clear that the parties intended reflashing to be required only at the time of Engine Rebuild.

iii. Paragraph 71

The Court next considers paragraph 71. Paragraph 71 states that “[e]ach [Manufacturer] shall install, and shall only authorize its authorized dealers, distributors, repair facilities, and rebuild facilities to install, only Low NOx Rebuild Kits as required under Paragraph 64 at no added cost to the owner above the amount the owner would otherwise pay to have the engine rebuilt or repaired. In addition, subject to the provisions of Paragraph 72, [Manufacturer] shall make available, either directly or through its affiliated distribution networks, at no added cost, the appropriate Low NOx Rebuild Kit to any non-affiliated engine rebuilder or person who requests it. For the purposes of this Section, 'at no added cost' shall mean: (a) if a Low NOx Rebuild Kit contains parts normally replaced at engine rebuild, [Manufacturer] shall not charge more than the then-current price for the original part; and (b) if a Low NOx Rebuild Kit requires a part not normally replaced during rebuild, then such part shall be included without charge. [Manufacturer] shall make arrangements to reimburse its authorized dealers, distributors, repair facilities, and rebuild facilities, so that the ultimate purchaser of a Low NOx Rebuild Kit will not be charged for any required reprogramming through its authorized dealers, distributors, repair facilities, and rebuild facilities, including any computer connection fees.” (Settlement Agreements, at ¶ 71.)

Plaintiffs contend that the first sentence in paragraph 71 requires Manufacturers and their authorized dealers, distributors, repair facilities, and rebuild facilities, to install

the Low NOx Rebuild Kits at the time of Engine Rebuild, at no added cost to the owner above the amount the owner would otherwise pay to have the engine rebuilt or repaired. Plaintiffs contend the second sentence of paragraph 71 does not cover installation of Kits or payment for the costs of installation, and does not apply to authorized dealers, distributors, repair facilities, and rebuild facilities. According to Plaintiffs, the second sentence requires Manufacturers to make the Kits available, "at no added cost," either directly or through affiliated distribution networks, to any non-affiliated engine rebuilder who requests it. Plaintiffs contend that, under the Settlements, Manufacturers are only required to pay for installation of the Kits if the installation is performed by Manufacturers or their authorized dealers, distributors, repair facilities, and rebuild facilities, at the time of Engine Rebuild.

Defendant ARB disagrees and contends that paragraph 71 means manufacturers are required to provide and install the kits free of charge at any time to any "person" upon request.

The Court has determined that paragraph 71 is unambiguous and that Manufacturers do not have any obligation to install, and/or reimburse the costs to install, the Low NOx Rebuild Kits when installation is requested at a time other than Engine Rebuild. As discussed above, the Court already has determined that paragraph 69 makes clear that the parties intended reflashing to be required only at the time of Engine Rebuild. Paragraph 71 tracks paragraph 69 and requires Manufacturers' authorized dealers, distributors, and repair and rebuild facilities to install Low NOx Rebuild Kits, as required under the Settlement Agreements, "at no added cost to the owner above the amount the owner would otherwise pay to have the engine rebuilt or repaired."²⁴ (Settlement Agreements, at ¶ 71.) This language clearly contemplates that installation will occur at the time of Engine Rebuild. And it is the only language in the Settlement Agreements that pertains to installation of the Kits. The remainder of paragraph 71 does not address installation; rather, it describes Manufacturers' obligation to make the Kits "available" to non-affiliated engine rebuilders. On their face, the Settlement Agreements require authorized dealers, distributors, repair and rebuild facilities to install the Low NOx Rebuild Kits only at the time of Engine Rebuild, and require Manufacturers to pay for such installation only when it is performed through their authorized dealers, distributors, repair and rebuild facilities. Thus, Manufacturers do not have any obligation to install, and/or reimburse the costs to install, the Low NOx Rebuild Kits when installation is requested at a time other than Engine Rebuild.

On the other hand, the Court has determined that the language of paragraph 71 is ambiguous as to whether the term "person" means any person or only those persons who

²⁴ ARB makes much of the fact that the definition of "at no added cost" states the "ultimate purchaser of a Low NOx Rebuild Kit will not be charged for any required reprogramming through its authorized dealers, distributors, repair facilities, and rebuild facilities." (Settlement Agreements, at ¶ 71.) However, this is largely beside the point. The issue is not whether the ultimate purchaser will be charged for reprogramming performed through authorized dealers; the issue is whether authorized dealers are required to install the Kits at a time other than Engine Rebuild. The Court concludes that they are not. Since the Settlement Agreements do not require such installations to be performed outside Engine Rebuild, they also do not require such installations to be reimbursed outside Engine Rebuild.

are individual rebuilders. Extrinsic evidence is thus admissible to aid in the interpretation of this term. Having considered the evidence and argument offered at trial, the Court finds that the extrinsic evidence shows that Plaintiffs' interpretation that "person" refers to individual engine rebuilders and not just any person is correct.

The Court makes the following findings of fact:

The term "person" was intended to allow individuals who perform their own rebuilds to obtain the Low NOx Rebuild Kits. It was not intended to allow any "person" anywhere in the world to obtain such Kits.

There are a number of paragraphs in the Settlement Agreements that, when read together, indicate that person is not any just individual, but those who are called upon to install Low NOx Rebuild Kits under the Low NOx Rebuild Plan. First, paragraph 71 itself uses the term "person" only in the context of discussing how "non-affiliated engine rebuilders" may obtain the "Low NOx Rebuild Kits." The Kits, in turn, are required to be installed at the time of "Engine Rebuild," and are required to be made available "at no added cost" above the amount the owner would otherwise pay for parts normally replaced during an engine rebuild. (Settlement Agreements, at ¶ 71.)

Second, it is noteworthy that paragraph 74 requires Manufacturers to take reasonable steps to inform their authorized dealers, distributors, repair facilities, and rebuild facilities about the requirements of the Low NOx Rebuild Program, but does not require any similar notification to be sent to owners or any other persons. (Settlement Agreements, at ¶ 74.)

Third, paragraph 75 requires Manufacturers to provide ARB with (i) a list of all authorized dealers, distributors, repair facilities, and rebuild facilities which will install the Low NOx Rebuild Kits; (ii) a description of the procedure to be followed by "non-affiliated engine rebuild facilities or persons" to obtain Low NOx Rebuild Kits; and (iii) a description of the system Manufacturers will use to ensure an adequate number of Low NOx Rebuild Kits will be available "to be installed by affiliated and non-affiliated engine rebuild facilities" The fact that the parties felt it sufficient to ensure an adequate number of Kits would be available to "non-affiliated engine rebuild facilities," without mentioning "other persons," strongly suggests that the parties did not see a material distinction between "persons" and "rebuild facilities." This implies that the term "persons" refers to persons who are to install the Low NOx Rebuild Kits. (Settlement Agreements, at ¶ 75.)

Fourth, paragraphs 76, 77, and 81 also suggest that the term "engine rebuilders" was intended to include the term "persons." Paragraph 76 requires Manufacturers to provide their authorized dealers, distributors, repair facilities or rebuilders with a description of the procedures which "non-affiliated engine rebuilders should follow to obtain appropriate Low NOx Rebuild Kits." Paragraph 77 requires Manufacturers to, among other things, provide a label to any "non-affiliated engine rebuilders who install one of its Low NOx Rebuild Kits" with instructions on how to complete and affix the

label to the engine to indicate when and by whom the Kit was installed on the engine. Paragraph 81 requires Manufacturers to maintain a list of the names and addresses of all "engine rebuilders" who were provided Low NOx Rebuild Kits and the number of kits provided to them. The absence of any reference to "persons" in paragraphs 76, 77, and 80, suggests the term "engine rebuilders" was intended to encompass such "persons." (Settlement Agreements, at ¶¶ 76, 77, 80.)

Fifth, and most importantly, paragraph 79 explicitly links "engine rebuilders" and "persons." Paragraph 79 requires Manufacturers to send ARB copies of any written communications about the Low NOx Rebuild Plan that Manufacturers send to "engine rebuilders and other persons who are to install Low NOx Rebuild Kits under the Low NOx Rebuild Plan." Thus, in paragraph 79 the parties specifically used the term "persons" to mean "persons who are to install Low NOx Rebuild Kits." (Settlement Agreements, at ¶ 79.)

Furthermore, the extrinsic evidence shows that during the negotiations of the Settlement Agreements, the parties openly discussed how rebuilds are performed and that paragraph 71 was intended to ensure Kits would be available to non-affiliated engine rebuilders and individuals who perform their own rebuilds. (8/9/06 R.T., at pp. 206-208.)

The memorandum in support of the consent decrees also supports this interpretation of paragraph 71. That memorandum discusses a concern that the Low NOx Rebuild Program might unfairly disadvantage "independent rebuilders," meaning rebuilders who are not "authorized dealers, distributors, repair facilities or rebuilders." (Trial Exhibit 49, at p. 63.) The concern was that the reimbursement scheme under the consent decrees would have the effect of forcing all rebuilding work to the Manufacturers' dealers. The memorandum indicates that the consent decrees reduced this risk by (i) requiring the Manufacturers to make the Kits available to independent engine rebuilders; (ii) allowing independent rebuilders to have the necessary reprogramming performed at no charge by authorized dealers, distributors, repair facilities or rebuild facilities; and (iii) requiring Manufacturers to reimburse their authorized dealers, distributors, repair facilities or rebuild facilities for all costs associated with the necessary reprogramming. The memorandum notes that Manufacturers would not agree "to reimburse independent rebuilders" for the costs to install the Kits because they do not have a formal relationship with them. However, because independent rebuilders could accomplish the necessary reprogramming by taking the engine or computer to an authorized facility, the memorandum concluded that independent rebuilders would not necessarily have to incur any reprogramming expenses. (Trial Exhibit 49, at pp. 63-70.) This memorandum clearly assumes that the Kits will be made available only to "rebuilders," independent or otherwise, and that Manufacturers will be required to pay for installation of such Kits only when the installation is performed by authorized dealers, distributors, repair facilities, and rebuild facilities in connection with an engine rebuild.

Finally, the extrinsic evidence shows that the Low NOx Rebuild Kits are "proprietary" software. (Trial Exhibit 49, at p. 77.) It is difficult to believe that, in

negotiating the Settlement Agreements, the Manufacturers willingly agreed to provide proprietary software to any "person" in the world who requests it.

In sum, the Court concludes that the term "person" in paragraph 71 has a specialized meaning and means those persons who are individual engine rebuilders. Thus, while a truck owner might voluntarily choose to install a Low NOx Rebuild Kit prior to Engine Rebuild, the Settlement Agreements do not obligate Manufacturers to make the Low NOx Rebuild Kits available to the truck owner. The Settlement Agreements merely obligate the Manufacturers to make their proprietary software available to "engine rebuilders."

After an engine rebuilder obtains a Low NOx Rebuild Kit, the engine rebuilder is free to install the Kit at any time. However, the Settlement Agreements do not require Manufacturers to install the Kits, or to pay for installation of the Kits, except when the installation is performed by an authorized dealer, distributor, repair or rebuild facility, at the time of Engine Rebuild. Manufacturers are not required to provide and install the kits free of charge at any time to any "person" upon request.

2. Are The Settlement Agreements Void For Violating The Reserved Powers Doctrine?

The Court next considers whether the Settlement Agreements are void for violating the reserved powers doctrine. Whereas the sovereign acts doctrine described above is concerned with the purpose or effect of a subsequent legislative act on a contract's enforceability, the reserved powers doctrine concerns the ability of the government to enter into an agreement that limits the Government's power to act in the future. The reserved powers doctrine holds that a state government is without power to agree to contract away "an essential attribute of its sovereignty." (*United States v. Winstar* (1996) 518 U.S. 839, 888; *Hermosa Beach Stop Oil Coalition v. City of Hermosa Beach* (2001) 86 Cal.App.4th 534; see also *Butchers' Union Slaughter-House & Live-Stock Landing Co. v. Crescent City Live-Stock Landing & Slaughter Co.* (1884) 111 U.S. 746, 751; *United States Trust Co. v. New Jersey* (1977) 431 U.S. 1, 23-24; *Stone v. Mississippi* (1979) 101 U.S. 814, 818, 820; *Avco Community Developers, Inc. v. South Coast Regional Com.* (1967) 17 Cal.3d 785, 800; *Delucchi v. County of Santa Cruz* (1986) 179 Cal.App.3d 814, 823.) A contract that violates the reserved powers doctrine is void *ab initio*. (See *United States Trust Co. v. New Jersey* (1977) 431 U.S. 1, 23.)

ARB initially argued that the Settlement Agreements are void for violating the reserved powers doctrine. However, ARB later retreated from its earlier contention that the Settlement Agreements are wholly void and unenforceable, and now contends that only those portions of the Agreements construed as a surrender of ARB's ability to require owners and operators to reflash their engines -- namely paragraph 161 -- must be declared void as contrary to the reserved powers doctrine. The Court does not agree.

Paragraph 161 of the Settlement Agreements is a vitally important component of the Settlement Agreements -- likely the only component of the Agreements of any

concern to the Manufacturers -- and the Court finds that such Agreements cannot be given any effect if Paragraph 161 is found to be invalid. Indeed, as the Recitals to the Settlement Agreements make clear, the very purpose of the Settlement Agreements was to memorialize the settlement of ARB's allegations regarding the injecting timing used in the specified engines. (Settlement Agreements, at ¶¶ 3-9.) The settlement of these allegations, at least from the Manufacturers' perspective, is contained almost entirely, if not entirely, within Paragraph 161 of the Agreement (entitled "Satisfaction, Release, and Discharge"). If Paragraph 161 of the Agreement were to be severed from the Agreements and declared void, the Manufacturers would receive virtually no benefit from having entered into the Agreements. Accordingly, the Court is convinced that the Settlement Agreements must stand or fall with Paragraph 161.

The test for deciding whether a government contract is void under the reserved powers doctrine is whether the disputed contract amounts to a "surrender," "abnegation," "divestment," "abridging," or "bargaining away" of a government entity's control of its sovereign police power. (*108 Holdings, Ltd. v. City of Rohnert Park* (2006) 136 Cal.App.4th 186, 195.) The inquiry turns on whether the crucial element of control has been lost. (*Id.*)

The *108 Holdings, Ltd.* court held that the City of Rohnert Park did not unlawfully surrender its police power by entering into a settlement agreement and stipulated judgment to resolve litigation concerning its general plan. Pursuant to the settlement, the City agreed to bind itself to interpret and apply its general plan and certain policies in the manner specified in the stipulated judgment. The plaintiff then filed an action alleging that the adoption of the settlement agreement was an *ultra vires* act because the City is prohibited from surrendering or impairing its delegated power. The court rejected the argument that the City's agreement in the stipulated judgment to interpret its general plan in a particular fashion amounts to an improper surrender of its police power. (*Id.* at p. 195.)

The *108 Holdings, Ltd.* court distinguished the holding in *County Mobilehome Positive Action Com., Inc. v. County of San Diego* (1998) 62 Cal.App.4th 727. In *County Mobilehome*, a county had imposed a 15-year moratorium on the enactment of rent control legislation for any mobile home park owners who entered into an accord with the county. (*County Mobilehome, supra*, at pp. 730, 731-32, 736.) The court in *County Mobilehome* concluded that the accord amounted to an unlawful surrender of the county's police power to regulate rents with respect to those owners who had entered into the accord. (*Id.* at pp. 739-41.) In *108 Holdings, Ltd.*, in contrast, the court concluded that the stipulated judgment did not limit the City's ability to alter or amend its general plan should future events so require. Unlike the accord at issue in *County Mobilehome*, the settlement agreement and stipulated judgment at issue in *108 Holdings, Ltd.* did not restrict the City's power to legislate in the future.

The court in *108 Holdings, Ltd.* relied in part on the holding in *Santa Margarita Area Residents Together v. San Luis Obispo County Bd. of Supervisors* (2000) 84 Cal.App.4th 221. In *Santa Margarita*, the court upheld a county's right to use a

development agreement to impose a five-year freeze on a property's zoning. The court in *Santa Margarita* held that the zoning freeze in the development agreement was not a surrender or abnegation of the county's police power. To the contrary, the court found that such an agreement is "more accurately described as a legitimate exercise of governmental police power in the public interest than as a surrender of police power to a special interest." (*Santa Margarita, supra*, at p. 233.)

Under the circumstances, this Court is convinced that the compromise embodied in the Settlement Agreements does not amount to a "surrender" or "abnegation" of ARB's police power. The scope of the reserved powers doctrine is not so broad as to prohibit a state agency from agreeing to settle an enforcement dispute, nor to exact thereunder additional regulatory requirements in the public interest that it otherwise would not have the statutory authority to obtain. Rather, this Court concludes that an agency legally may agree in a settlement that during the term of the agreement it will not bring a future enforcement or regulatory action based on the same misconduct that was alleged in the settled enforcement action. Such an agreement is "more accurately described as a legitimate exercise of governmental police power in the public interest than as a surrender of police power to a special interest." (*Santa Margarita, supra*, at p. 233; *see also* 8/15/06 R.T., at p. 840; Trial Exhibit 49, at pp. 6, 36, 79, 97-99.) To conclude otherwise would be inconsistent with the State's policies of encouraging compromises and certainty of contract without infringing upon the essential attributes of the State's power. (*Rich Vision Centers, Inc. v. Bd. of Med. Examiners* (1983) 144 Cal.App.3d 110; *Utility Consumers Action Network v. Public Util. Comm'n* (2004) 120 Cal.App.4th 644; *In re Pacific Gas & Elec. Co.* (2004) 304 B.R. 395, 407; Gov. Code § 11415.60; *see also* Cal. Ops. Atty. Gen. No. 00-510 (2000 Cal. Ag. Lexis 54.) The Settlement Agreements are not void for violating the reserved powers doctrine.

3. Does The Chip Reflash Regulation Breach The Settlement Agreements?

Having delineated the terms of the Settlement Agreements and determined that the Settlement Agreements are not void *ab initio* for violating the reserved powers doctrine, the Court next considers whether the Chip Reflash Regulation breaches the Settlement Agreements. The Court concludes that the Chip Reflash Regulation breaches the terms of paragraphs 161, 69, 71, and 164.

a. Breach of Paragraph 161 -- Prohibited Determinations

As discussed above, ARB agreed in paragraph 161 not to "base a determination that any class or category of the Pre-Settlement or Interim Engine does not conform to Title 13 of the California Code of Regulations . . . on the basis that the engine contains one or more of the [disputed] injection timing strategies" (Settlement Agreements, at ¶ 161.) This language was intended to settle the regulatory status of the engines and to bar ARB from taking any action, including rulemaking, prohibiting the use of such engines based on their injection-timing strategies.

The Chip Reflash Regulation amended Title 13 of the California Code of Regulations to provide that on and after dates fixed by ARB, vehicles propelled by a Low NOx Rebuild Engine must not operate on highways within the State of California without a Low NOx Rebuild Kit installed. It is undisputed that the purpose of the Low NOx Rebuild Kits is to alter the disputed injection-timing strategies of the Low NOx Rebuild Engines so that they meet the emission limits specified under the Low NOx Rebuild Program. It also is undisputed that the Chip Reflash Regulation targets the "Low NOx Rebuild Engines" described in the Settlement Agreements, and that the only engines subject to the Chip Reflash Regulations are the Low NOx Rebuild Engines with the disputed injection-timing strategies described in the Settlement Agreements. Thus, the Chip Reflash Regulation mandates a change to the injection-timing strategies used on the Low NOx Rebuild Engines described in the Settlement Agreements.

After the dates fixed by ARB in its rule, the Low NOx Rebuild Engines are prohibited to operate on California Highways if the engines still contain the disputed injection-timing strategies at issue in the Settlement Agreements. Owners of vehicles that continue to operate their vehicles after the applicable implementation dates without a Low NOx Rebuild Kit installed are subject to citation for violating Title 13 of the California Code of Regulations. In sum, the Chip Reflash Regulation determines that a Low NOx Rebuild Engine that continues to use its original injection-timing software on California highways, after the date the rule requires a reflash be performed, does not conform to title 13 of the California Code of Regulations.

At the time of trial, ARB had issued 673 citations. Each citation represents a determination that the engine subject to the citation does not conform to title 13 by reason of the engine's injection-timing software. The "determination" bar set forth in paragraph 161 of the Settlement Agreements covers each of these engines. Therefore, in adopting the Chip Reflash Regulation, and in issuing citations for violating the Chip Reflash Regulation, ARB has made a determination that the Low NOx Rebuild Engines do not conform to title 13 of the California Code of Regulations on the basis that the Engines contain one or more of the injection-timing strategies described in the Settlement Agreements. This is prohibited by paragraph 161 of the Settlement Agreements. The Court therefore determines that the Chip Reflash Regulation breaches paragraph 161 of the Settlement Agreements.

b. Breach of Paragraph 69 -- Requiring Kits to be Installed Before Engine Rebuild

The Court has determined that the Chip Reflash Regulation also breaches paragraph 69 of the Settlement Agreements because the rule requires installation of the Low NOx Rebuild Kits on a schedule fixed by ARB rather than at the time of Engine Rebuild, as agreed to by the parties in the Settlement Agreements. ARB's rule accelerates the implementation of the Low NOx Rebuild Program, contrary to the agreement of the parties. (*See* Settlement Agreements, at ¶ 82 [providing that the Low NOx Rebuild Program will run for ten years, through 2009 and that installation of the Kits will continue even after that time]; *see also* 8/9/06 R.T., at pp. 193-194.)

c. Breach of Paragraph 71 -- Requiring Manufacturers To Pay For Installation At Times Other Than Engine Rebuild

The Court has determined that the Chip Reflash Regulation also breaches paragraph 71 of the Settlement Agreements because it requires Kits to be installed outside of Engine Rebuild. In addition, the Chip Reflash Regulation breaches paragraph 71 of the Settlement Agreements because it requires Manufacturers to reimburse their authorized dealers, distributors, repair facilities, or rebuild facilities for their costs to install the Kits outside of Engine Rebuild. The rule requires Manufacturers (through their authorized dealers) to install the Kits, and pay for installation of the Kits, under circumstances where the Settlements only require that Kits be made "available."

d. Breach of Paragraph 164 -- Modifying the Settlement Agreements

The Court finds paragraph 164 of the Settlement Agreements also was breached because the Chip Reflash Regulation unilaterally modified the terms of the Settlement Agreements within the meaning of paragraph 164.

4. Should the regulations be enjoined and/or declared invalid?

Having concluded that the Chip Reflash Regulation breaches the terms of the Settlement Agreements, the Court next considers whether the breaches justify enjoining and/or invalidating the Regulation. Plaintiffs put forth several legal theories upon which they base their request to enjoin and/or invalidate the Regulation. The Court rejects several, but finds two are valid and support the requested relief.

Specifically, Plaintiffs contend the Chip Reflash Regulation should be enjoined and/or invalidated because (i) ARB lacks authority to unilaterally modify the terms of the Settlement Agreements; (ii) the rule constitutes an illegal involuntary recall; (iii) the Chip Reflash Regulation materially breaches the Settlement Agreements; (iv) the rule unconstitutionally impairs the Settlement Agreements in violation of the Contract Clause;²⁵ and (v) the rule is preempted by the federal consent decrees.

Plaintiffs have failed to establish that the Chip Reflash Regulation should be invalidated because it materially breaches the Settlement Agreements. While the Court agrees with Plaintiffs that ARB's breach of the Settlement Agreements is material,

²⁵ The Contract Clause, in turn, will require the Court to determine (1) whether a valid contractual relationship exists; (2) whether such contractual relationship has been substantially impaired; and, if so, (3) whether the substantial impairment is nevertheless constitutional because it is "reasonable and necessary" to serve a significant and legitimate public purpose. (*See United States Trust Co. v. New Jersey* (1977) 431 U.S. 1; *Energy Reserves Group, Inc. v. Kansas Power & Light Co.* (1983) 459 U.S. 400; *see also Hermosa Beach Stop Oil Coalition v. City of Hermosa Beach* (2001) 86 Cal.App.4th 534.) The questions whether there is a contractual relationship and whether the contractual relationship is impaired are mixed questions of fact and law. (*Board of Administration v. Wilson* (1997) 52 Cal.App.4th 1109, 1129) The ultimate question whether a law constitutes an unconstitutional impairment of an agreement is a question of law. (*Hermosa Beach, supra*, at p. 549.)

Plaintiffs have not cited any authority to suggest that mere breach of contract is grounds to invalidate a duly adopted regulation, except if the breach rises to the level of an unconstitutional impairment of contract (discussed below). In the absence of an unconstitutional impairment of contract, a material breach of contract may excuse future performance and give rise to an action for breach of contract, but it would not be grounds to invalidate the regulation.²⁶

For similar reasons, the Court is not persuaded the Chip Reflash Regulation can be invalidated because it is inconsistent with paragraph 164's prohibition of unilateral modifications of contract. A breach of paragraph 164 is simply another instance of breach.

Neither is the Court persuaded that the Chip Reflash Regulation should be invalidated because it is preempted by the federal consent decrees. Plaintiffs failed to meet their burden of showing that the Regulation is "preempted" by the federal consent decrees, even though the Regulation conflicts with the federal consent decrees by requiring out-of-state trucks driven into California to have Rebuild Kits installed in accordance with ARB's expedited schedule.

However, the Court is persuaded that the Chip Reflash Regulation should be declared invalid and enjoined because the rule unconstitutionally impairs the Settlement Agreements and constitutes an illegal involuntary recall.

a. The Chip Reflash Regulation Unconstitutionally Impairs The Settlement Agreements In Violation Of The Contract Clauses.

The Contract Clauses of the United States Constitution and the California Constitution provide "No State shall . . . pass any . . . Law impairing the Obligation of Contracts."²⁷ (U.S.Const., art. 1, § 10; Cal. Const. art. 1, § 9.) To state a claim under the Contract Clause, a plaintiff must allege a contractual relationship exists, which the state, through its legislative authority, has impaired. The process of determining whether a state law substantially impairs contractual obligations consists of a four-part inquiry: (1) is there a valid contract relating to the matter that is the subject of the statute; (2) does the law effect a change that impairs the contract, and is the impairment substantial; and, if so, is the substantial impairment nevertheless constitutional because it is (3) a "reasonable and necessary" means (4) to achieve a significant and legitimate public purpose. (*See United States Trust Co. v. New Jersey* (1977) 431 U.S. 1; *Energy Reserves Group, Inc. v. Kansas Power & Light Co.* (1983) 459 U.S. 400; *see also Hermosa Beach Stop Oil*

²⁶ In general, the State is liable for a breach of contract in the same manner as a private party. Any breach, total or partial, that causes a measurable injury, gives the injured party a right to damages as compensation. If the breach is material, the breach will also give the injured party the right to refuse further performance on his own part and give him the election of certain remedies, including cancellation (termination) or rescission. In this case, terminating the agreements or excusing further performance may render the Chip Reflash Regulation essentially meaningless, but it does not mean ARB lacked authority to *adopt* the Regulation in the first instance.

²⁷ For simplicity, the Court sometimes refers to the federal and state Contract Clauses collectively as the "Contract Clause."

Coalition v. City of Hermosa Beach (2001) 86 Cal.App.4th 534.²⁸) The questions of whether there is a contractual relationship and whether there is an impairment are mixed questions of fact and law. (*Board of Administration v. Wilson* (1997) 52 Cal.App.4th 1109, 1129.) The ultimate question whether a law constitutes an unconstitutional impairment of an agreement is a question of law. (*Hermosa Beach, supra*, at p. 549.)

The initial inquiry under the Contract Clause is whether a contractual relationship between Plaintiffs and ARB exists. Plaintiffs have claimed the existence of a contractual relationship by virtue of the Settlement Agreements and both parties seem to agree that a contract existed. This is consistent with prevailing California law holding that a settlement agreement is in the nature of a contract and is therefore governed by the same legal principles applicable to contracts generally. (*Folsom v. Butte County Assn. of Governments* (1982) 32 Cal.3d 668, 677; *In re Marriage of Hasso* (1991) 229 Cal.App.3d 1174, 1180; *Roe v. California* (2001) 94 Cal.App.4th 64, 72-73; see also *20th Century Ins. Co., supra*, at p. 1270; *Homestead Ins. Co. v. Casden Co.* (C.D. Cal. 2004) 2004 U.S. Dist. Lexis 27823; *Price v. Penn. Prop. & Cas. Ins. Guaranty Ass'n* (E.D. Pa. 2001) 158 F.Supp.2d 547.)

ARB called into question the existence of a contract when it claimed that the Settlement Agreements run afoul of the reserved powers doctrine. However, for the reasons described above, the Court has determined that the Settlement Agreements do not violate the reserved powers doctrine and are therefore not invalid.

The second step is to ask whether the law has operated as a substantial impairment of the contractual relationship. (*Energy Reserves Group, Inc. v. Kansas Power & Light Co.* (1983) 459 U.S. 400, 411.) Total destruction of the contractual relationship is not necessary for a finding of substantial impairment. (*Id.*) Among the factors to be considered in assessing the severity of the impairment are whether the parties have relied on the preexisting contract right and the extent to which the legislation violates their reasonable expectations. Whether the legislation is in a previously regulated area should also be considered. (*In re Marriage of Carpenter* (1986) 188 Cal.App.3d 604, 611.) An impairment of a public contract is substantial if it deprives a private party of an important right, thwarts performance of an essential term, defeats the expectations of the parties, or alters a financial term. (*So. Cal. Gas Co. v. City of Santa Ana* (C.D. Cal. 2002) 202 F.Supp.2d 1129, 1132-1133.)

The Court concludes that the Chip Reflash Regulation operates as a substantial impairment of the parties' contractual relationship. The rule strikes at the heart of the one provision in the Settlement Agreements that is critically important to Manufacturers -- namely, paragraph 161. In particular, the rule thwarts Manufacturers' expectations that trucks with Low NOx Rebuild Engines would not be recalled and could lawfully be driven in California until the time of Engine Rebuild. In addition, the rule defeats

²⁸ California courts do not differentiate between the federal and state contract clauses in their analysis, and their opinions rely heavily on United States Supreme Court cases. (*Hermosa Beach Stop Oil Coalition, supra*, at p. 559 fn. 15; *20th Century Ins. Co. v. Superior Court* (2001) 90 Cal.App.4th 1247, 1269 fn. 24.)

Manufacturers' expectations that reflash would be tied to Engine Rebuild so that truck owners would not bear the downtime costs of installation of the Low NOx Rebuild Kits. Further, the rule defeats Manufacturers' expectations that the reflash program would be implemented over a ten year period, ending in 2009. Finally, the rule defeats Manufacturers' expectations that Manufacturers would not be required to install the Rebuild Kits, or pay the costs to install the Kits, except when the installation is performed at the time of Engine Rebuild.

The third step in the Contract Clause analysis, if the state law constitutes a substantial impairment, is to ask if there is a significant and legitimate public purpose behind the regulation, such as the remedying of broad and general social or economic problems. (*Energy Reserves Group, supra*, at p. 411; *California Teachers Assn. v. Cory* (1984) 155 Cal.App.3d 494, 511.) This requirement serves to guarantee that the State is exercising its police power, rather than imposing a burden on, or providing a benefit to, special interests. (*Energy Reserves Group, supra*, at p. 411.)

In *Allied Structural Steel Co. v. Spannaus*, the United States Supreme Court held that if the Contract Clause is to retain any meaning at all, it must be understood to impose some limits upon the power of a State to abridge existing contractual relationships, even in the exercise of otherwise legitimate police power. (*Allied Structural Steel Co. v. Spannaus* (1978) 438 U.S. 234, 242; *see also Home Bldg. & Loan Assn. v. Blaisdell* (1934) 290 U.S. 398, 439 ["The reserved power cannot be construed so as to destroy the (contract clause)].) In *Allied Structural Steel*, the Court found that the police power has limits when its exercise effects substantial modifications of private contracts. (*Allied Structural Steel, supra*, at p. 244.) Thus, despite the customary deference courts give to state laws directed to social and economic problems, "legislation adjusting the rights and responsibilities of contracting parties must be upon reasonable conditions and of a character appropriate to the public purpose justifying its adoption." (*Id.*)

Courts have struck down legislation that did not have a significant and legitimate public purpose. For example, in *Allied Structural Steel*, the Supreme Court struck down a Minnesota pension law because it found that the state had not acted to meet an important general social problem when it adopted a pension law that appeared to single out a small group of specific employers. (*Allied Structural Steel, supra*, at pp. 248-249; *see also Associated Oregon Veterans v. Department of Veterans' Affairs* (Ore. 1985) 300 Ore. 441, 449 [stating state agency does not possess "reserved" or "inherent" power to modify contracts to which it is a party whenever, in the opinion of its responsible officials, such modification will further the interests of the citizenry].)

In this case, the Court concludes that the Chip Reflash Regulation does not have a significant and legitimate public purpose. The evidence in this case shows that the purpose of the Chip Reflash Regulation was to speed up the pace of the reflashes required under the Low NOx Rebuild Program described in the Settlement Agreements. In other words, the purpose of the Regulation is to target, and modify, the essential bargain of the contracts, and the limited number of parties who were parties to those contracts. As described above, this is not a significant and legitimate public purpose.

At trial, ARB disingenuously argued that the purpose of the Regulation is to reduce emissions of NOx. It is true that the Chip Reflash Regulation likely would have the effect of reducing NOx emissions, by speeding up the pace at which Low NOx Rebuild Kits are required to be installed. However, ARB's argument completely ignores the targeted nature of the Regulation. The Chip Reflash Regulation was not a regulation aimed at reducing the NOx emissions of all trucks, or even all heavy-duty diesel trucks, operating on California highways. Rather, the only engines subject to the Chip Reflash Regulations are the specific Low NOx Rebuild Engines described in the Settlement Agreements, and then not even all of them.

The evidence shows that the Chip Reflash Regulation targeted the Low NOx Rebuild Engines because they contain the disputed injection-timing strategies, which, ARB contends, allows the engines to emit more NOx than is legally allowed. In other words, even though ARB had agreed to settle, without any admissions of liability, its allegations that the Low NOx Rebuild Engines contained illegal "defeat devices," ARB nevertheless continued to assert that the engines contained illegal defeat devices and promulgated the Regulation to have this "defect" corrected. The ARB's May 30, 2002 letter to owners and operators of the Low NOx Rebuild Engines amply demonstrates this. Under the heading "Your 1993-1998 Model Year Diesel Engine May Have a Software Problem," ARB wrote:

"Most truck engines built from 1993 through 1998 contained software that allows considerably more oxides of nitrogen (NOx) to be emitted than is legally allowed. NOx emissions cause smog pollution. These 1993 through 1998 model year engines need to be reprogrammed to reduce the amount of NOx that is emitted." (Trial Exhibit 28, at p. 1 [AR 305]; 8/10/06 R.T., at p. 356-357.)

Similarly, at its December 9, 2004, public meeting, the Board's Executive Officer characterized the Chip Reflash Regulation initiative as "an enforcement action to accomplish the goals of the previous settlement." (Trial Exhibit 76, at p. 161 [emphasis added].) Under the circumstances, it is disingenuous for ARB to contend that the only purpose of the Regulation was to reduce NOx emissions. A substantial purpose of the Regulation was to "accomplish the goals of the previous settlement" by speeding up the pace at which Low NOx Rebuild Kits are required to be installed under the Settlement Agreements.

Moreover, even if the Court were to accept ARB's assertion that the purpose of the Chip Reflash Regulation was to reduce emissions of NOx, the record at trial is not persuasive that the potential reduction in NOx emissions from this Regulation will have beneficial health impacts.

It is undisputed that California meets (i.e., is in attainment of) the applicable ambient air quality standards for nitrogen dioxide. (8/16/06 R.T., at p. 1156.) National

ambient air quality standards are the standards requisite to protect the public health. (*See* 42 U.S.C. § 7409(b).)

ARB contends, however, that there is a legitimate public need to reduce NOx because NOx reacts with hydrocarbons in the atmosphere to form secondary particulate matter, including ozone, which, in turn, contributes to respiratory disease, lung damage, cancer, and premature death. California does not meet the applicable ambient air quality standards for ozone. Thus, protecting the public health and safety by reducing secondary particulate matter/ozone would appear to be a legitimate public purpose.

There is no credible evidence in the record before the Board, or adduced at trial before this Court, establishing how much, if any, secondary particulate matter would be reduced by the Chip Reflash Regulation, or that secondary particulate matter would be reduced at all.

In the course of this litigation, ARB conceded that the rule's expected impact on NOx emissions had been vastly overstated. In enacting the rule, ARB claimed that the Regulation would reduce NOx emissions by 30 to 40 tons per day. However, ARB admitted at trial that the rule will reduce NOx emissions by only 8.3 tons per day -- much less than the 30 to 40 tons claimed by the Board in enacting the Regulation.²⁹ The apparent reasons for the large discrepancy are that the Board's initial estimate (i) assumed the rule would include the Low NOx Rebuild Engines manufactured by Detroit Diesel, which engines ultimately were exempted from the Regulation; (ii) did not take into account the emissions benefits that would occur anyway under the Settlements; and (iii) assumed that all reflashes required by the rule would be completed by the end of 2005, even though the rule did not require this.

Further, even if there were credible evidence showing that the rule will reduce NOx emissions by 14.3 tons or 8.3 tons per day, ARB failed to present any reliable evidence that this will reduce secondary particulate matter in the ambient air across the State. Before enacting the rule, ARB never determined how, if at all, the alleged reduction of 8.3 or 14.3 tons of NOx each day would affect the levels of particulate matter in the ambient air across the state. At trial, ARB presented the opinion of Richard Bode. However, there is no evidence that Bode, or anyone else, ever modeled the effect that reducing NOx emissions by 8.3 tons (or 14.3 tons) per day would have on the levels of particulate matter in the ambient air across the state. To the contrary, ARB admitted at trial that the conversion of NOx to particulate matter is a complicated and poorly understood process. In light of this concession, ARB's decision to apply a conversion rate of .81 microgram per cube NOx to particulate matter appears to be little more than a guess.

Finally, even if ARB could establish a reliable basis for the conversion rate it applied, there does not appear to be any study linking the expected reduction in particulate matter to beneficial health impacts. Bode opined, based on the Lloyd and

²⁹ ARB argued alternatively at trial that the correct figure was 14.3 tons, and then 8.3 tons. Both figures were refuted by Plaintiffs.

Cackette study, that the Chip Reflash Regulation will avoid "8 premature deaths, 190 asthma attacks, 1600 lost work days, and 8400 minor restricted activity days" each year. But Bode's work was created for this litigation, was not based on his own data, and was never peer reviewed. All that Bode did was to "scale" the potential health impacts from the amount of NOx supposedly at issue here (5223 tons per year) to the health impacts reported in a 2001 study of diesel emissions published by Alan Lloyd and Thomas Cackette. The Lloyd and Cackette study assumed that the total concentration of NOx in the State of California at the time of the study was 598,965 tons. Therefore, Bode simply multiplied the total number of premature deaths, asthma attacks, lost work days, and restricted activity days reported in the Lloyd and Cackette study by the fraction of 5223 over 598,965. The principal flaw with this approach is that the Lloyd and Cackette study merely purported to assess the adverse health impacts from diesel emissions, not the adverse health impacts of NOx. ARB never established that the adverse health impacts reported in the Lloyd and Cackette study could be attributed to NOx -- ARB merely assumed this. As a result, ARB never established that there is any basis to "scale" the reported health impacts from the Lloyd and Cackette study to the amount of NOx supposedly at issue here. Thus, ARB never established that the rule will have any discernable, beneficial effect on human health. The only reliable evidence was to the contrary -- that any changes would not be discernable. Plaintiffs' expert, Barbara Beck, testified that Bode's data and analysis are flawed and his conclusions are unreliable. The Court finds Beck's opinion, and qualifications, credible and persuasive.

In sum, the Court finds there was no reliable basis for Bode to opine on the effect, if any, that reducing NOx emissions by 14.3 tons per day will have on the levels of particulate matter in the State, or on the effect, if any, that reducing the levels of particulate matter will have on the public's health. Thus, even if ARB's belated expert opinion evidence is relevant, the Court finds that it is not supported by any reliable data and should carry little to no weight.³⁰

Finally, even if reducing NOx emissions serves a legitimate public purpose, the Court finds that where, as here, the means chosen to achieve that purpose is a narrow regulation with the sole aim of modifying the essential terms of a Settlement Agreement to which the Government is a party, the regulation does not have a significant and legitimate public purpose.

The fourth step in the Contract Clause analysis, if a significant and legitimate public purpose has been identified, is to determine whether the adjustment of "the rights and responsibilities of contracting parties [is based] upon reasonable conditions and [is] of a character appropriate to the public purpose justifying [the legislation's] adoption." (*Energy Reserves Group, Inc. v. Kansas Power & Light Co.* (1983) 459 U.S. 400, 411.) A substantial impairment may nevertheless be constitutional where it is "reasonable and necessary" to serve an important public purpose. (*United States Trust Co. v. New Jersey* (1977) 431 U.S. 1, 25.) The state has the burden of establishing that the legislation is

³⁰ Bode's opinion was first presented to the Court in opposition to a motion for a temporary restraining order or preliminary injunction. Had the Court known then what it now knows, it likely would have issued the preliminary injunction.

both reasonable and necessary to an important public purpose. (*So. Cal. Gas Co. v. City of Santa Ana* (C.D. Cal. 2002) 202 F.Supp.2d 1129, 1137.)

Higher courts have distinguished between impairments of a State's own financial obligations through the exercise of its taxing or spending powers, on the one hand, and the abridgement of rights in a public contract as a result of the State's exercise of its police powers, on the other hand. If the legislation at issue falls within the ambit of traditional police powers, the Supreme Court has held that a court's inquiry into the purpose or reasonableness of the legislation is more limited. (*Hermosa Beach Stop Oil Coalition v. City of Hermosa Beach* (2001) 86 Cal.App.4th 534, 560.)

Appellate courts have also distinguished between laws affecting the contractual relationships of private parties and laws affecting obligations of the state itself. (*Id.*) A higher level of scrutiny is required to assess abrogation of government obligations than in the case of legislative interference with the contract of private parties. (*University of Haw. Prof'l Assembly v. Cayetano* (9th Cir. 1999) 183 F.3d 1096, 1107; *see also Energy Reserves Group, supra*, at p. 412 [holding that complete deference to a legislative assessment of reasonableness and necessity is not appropriate when the State is a party to the contract because the State's self-interest is at stake].) Accordingly, courts are "less deferential to a state's judgment of reasonableness and necessity when a state's legislation is self-serving and impairs the obligations of its own contracts." (*Cayetano, supra*, at p. 1107; *see also West Indian Co. v. Government of Virgin Islands* (1988) 844 F.2d 1007, 1021 [stating that although the court's inquiry may be circumscribed where the inherent police power of the State is at issue, there are limits to this circumscription]; *Allied Structural Steel, supra*, at p. 244 [same].)

In this case, the Chip Reflash Regulation is closer to an exercise of the State's police powers than it is an exercise of its taxing or spending powers, arguably requiring greater deference to the State's judgment of reasonableness and necessity. On the other hand, the Chip Reflash Regulation is self-serving and impairs the State's own contractual obligations, arguably requiring less deference to the State's judgment of reasonableness and necessity. Because the severity of the impairment also increases the level of scrutiny to which the legislation is subjected, (*Energy Reserves Group, supra*, at p. 411), and because the Court finds that the impairment of the Settlement Agreements is severe, the Court does not give complete deference to the ARB's assessment of reasonableness and necessity.

In this case, even if reducing NOx emissions is deemed a significant and legitimate public purpose, the Court finds the Chip Reflash Regulation would be unconstitutional because it was not a "reasonable" and "necessary" means to achieve that purpose. To determine reasonableness, a court looks at the extent of the impairment as well as the public purpose to be served. (*Cayetano, supra*, at p. 1107.) An impairment will not be considered reasonable and necessary if there is "an evident and more moderate course" of action that would serve the public purpose equally well. (*Cayetano, supra*, at p. 1107; *So. Cal. Gas Co., supra*, at p. 1137.) The Contract Clause limits the

ability of a State, or a subdivision of a State, to abridge its contractual obligations without first pursuing other alternatives. (*Id.*)

In the administrative record for its rule, ARB asserted that the Regulation was necessary because the Low NOx Rebuild Kits were not being installed at the rate it expected they would be. ARB asserted that the primary reason for this was that ARB had expected engine rebuilds to occur at around 300,000 to 400,000 miles of service, when, in fact, the increased durability of engines has enabled many of the engines to run 750,000 to 1,000,000 miles before needing a rebuild. At its December 11, 2003, Board hearing concerning the rule, the Board's Executive Officer responded to Board member concerns that ARB was "walking away from a mutual agreement" by stating ARB did not get what it expected because the "record of the agreement stipulated that the assumptions upon which it was premised were rebuild at 350 thousand miles." (Trial Exhibit 74, at p. 73; 8/10/06 R.T., at pp. 378-379.) Later in the same public Board hearing, ARB's Executive Officer responded to a question from the Chairman of ARB by stating that the mileage to rebuild assumptions "aren't assumptions people were carrying around in their heads. These were written down as part of the formal federal publications of the settlement agreement. The assumptions were clearly stated. The anticipated emission benefits and the time frames were stated. So, if, in fact, the engine manufacturers had a different point of view, they never expressed it." (Trial Exhibit 74, at pp. 106-107; 8/10/06 R.T., at p. 380.) ARB staff also told the Board that the Settlement Agreements provided engines would be rebuilt at 300,000 to 350,000 miles.

All of the above statements were false. (8/10/06 R.T., at pp. 377-379, 378-381.) The ARB was relying upon data provided for pre-1990 engines, all but one of which were not electronically controlled. ARB was told during the negotiations that the subject engines would be rebuilt between 750,000 and 1,000,000 miles, and information on the reasonable expectation of the life of the engine before rebuild was readily available to ARB in its own library and in documents it reviewed. The prevailing information at the time of the Settlements was that the subject engines would travel 750,000 to 1,000,000 miles before rebuild. ARB was apparently referencing mechanical engine information that predated the engines at issue when it talked about 350,000 miles to rebuild.

For the reasons discussed above, the Regulation also is not necessary to achieve the purported purpose of reducing NOx emissions, especially where, as here, the State had several available alternatives to the reflash rule, including amendment of the Settlement Agreements.

Ms. Witherspoon, the Executive Officer of ARB, informed the Board at a public meeting that there are multiple ways of achieving the objectives of the Low NOx Rebuild rule and that the regulation is just one of these ways. (8/10/06 R.T. at pp. 375-376; Trial Exhibit 74, at p. 65.) Ms. Witherspoon stated that other possibilities included amendment of the settlement agreements and she told the Board that ARB had been in discussions with Manufacturers regarding amendments to the settlements. This was not true. At trial, ARB did not present any evidence that it had considered any actual amendment to the Settlement Agreements as an alternative to the rule. (*See, e.g.*, 8/10/06 R.T., at p. 376.)

ARB made no attempt to amend the Settlements, even though the Settlements specifically set forth procedures for negotiation of such amendments.

Another available alternative was financial incentives to truck owners to retrofit their engines before rebuild. ARB administers one such specific program, the Carl Moyer program, which provides incentives to retrofit engines and equipment to reduce NOx emissions. Seventeen million dollars of penalties paid by Manufacturers under the Settlements were allocated by the California legislature to fund the California Air Pollution Control Fund. Thus, incentive money was available as a direct result of the Settlement Agreements.

There was also testimony at trial that prior incentive programs had been successful and the evidence indicated that the Chairman of ARB was willing to consider government incentives as an alternative to a mandatory rule. Yet the ARB staff never presented financial incentives as an alternative to the Board. ARB staff instead made a policy decision not to expend state funds on such an incentive program, opting instead to establish the regulatory mandates in conflict with the Settlement Agreements in lieu of monetary incentives otherwise made available under the Settlement Agreements.

Ironically, as a result of the reflash rule, then existing incentive programs in Sacramento and elsewhere that were specifically designed to incentivize the installation of reflash kits ended once the regulations were adopted. In one such program, an allocation of more than \$500,000 that was earmarked to incentivize installation of Low NOx Rebuild Kits was eliminated when ARB's rule was finalized.

In sum, ARB had several available alternatives that ARB could have pursued that would have served its purposes as well, or better, than the Chip Reflash Regulation.

For all of the reasons discussed above, the Court concludes that the Chip Reflash Regulation substantially impairs the contractual obligations of the Settlement Agreements and that the substantial impairment is not reasonable and necessary to achieve a significant and legitimate public purpose. Accordingly, the Chip Reflash Regulation is an unconstitutional impairment of contract in violation of the Contract Clauses.

b. The Chip Reflash Regulation Is An Illegal Involuntary Recall.

The Court concludes that the Chip Reflash Regulation also is an illegal involuntary recall. As discussed above, ARB does not have the statutory authority to order an involuntary recall without complying with the due process protections built into the recall process. ARB gave up its right to a recall in the Settlement Agreements. The Chip Reflash Regulation is a *de facto* recall in that it requires owners to have their engines "corrected" at Manufacturers' expense.

c. Manufacturers Also Are Entitled To The Requested Injunctive Relief.

As described above, the Court is persuaded that the Chip Reflash Regulation should be declared invalid because the rule unconstitutionally impairs the Settlement Agreements and constitutes an illegal involuntary recall. However, even if Plaintiffs were not entitled to the requested judicial declarations, the Court would find that the Chip Reflash Regulation nevertheless should be enjoined.

Plaintiffs assert that the Court should enjoin the Chip Reflash Regulation, rather than terminate the Settlement Agreements, because Plaintiffs do not have an adequate remedy at law for breach of contract. Specifically, Plaintiffs contend that they cannot be made whole for the lost benefit of their bargain with ARB because, among other reasons, (i) the Settlements have changed the way Manufacturers are regulated and do business, subjecting them to new testing procedures and requirements; (ii) Manufacturers have already performed the majority of their obligations under the Settlements; (iii) ARB's rule has already forced truck owners to have corrective action performed before rebuild; and (iv) ARB's strategy in the rulemaking has damaged Manufacturers' reputation and impaired Manufacturers' good will in a way that cannot be measured. Thus, Plaintiffs would rather invalidate or enjoin the Chip Reflash Regulation than terminate the Settlement Agreements. Plaintiffs prefer that all parties simply be held to their obligations under the Settlements. (*See* Plaintiffs' Memorandum Re Remedies, at p. 1.)

The Court agrees that Plaintiffs do not have an adequate remedy at law for ARB's breaches of contract. Not only would the Chip Reflash Regulation likely serve as a defense to prevent or materially limit Plaintiffs' ability to recover damages from ARB, but even if damages were recoverable, the Court is persuaded that damages would not afford an adequate remedy at law. Plaintiffs will be irreparably injured if ARB is not enjoined from unilaterally altering the terms of its Settlement Agreements with the Manufacturers. Thus, in addition to the requested judicial declarations, Plaintiffs are entitled to entry of the injunctive relief sought in the Caterpillar Complaint.

IV. CONCLUSION

Regulations adopted by a public agency come to this Court with a presumption of regularity and the Court will not declare a regulation invalid without having first performed a measured and careful legal analysis.

In this case, the presumption of regularity was undermined by ARB's evolving explanation of what the Chip Reflash Regulation does and why it was adopted. For example, at the time the rule was first enacted, the ARB referred to the rule as an "enforcement action" to accomplish the goals of the previous settlement. (Trial Exhibit 76, at p. 161.) ARB stated the rule was necessary because the "increased durability" of diesel engines meant that engine rebuilds were occurring later than ARB had expected, allowing the engines to continue to emit "excess" levels of NOx. ARB stated that the purpose of the rule was to achieve the emission benefits it had expected under the Low NOx Rebuild Program. This focus was repeated in a May 30, 2003, letter to truck owners and operators, informing them that their engines have a "software problem" that allows

considerably more NOx to be emitted than is legally allowed. Further, at the beginning of this litigation, ARB plainly alleged that "[t]he Chip Reflash Regulations are necessary because of a devious strategy employed by seven heavy-duty diesel manufacturers" to "secretly program[]" their heavy-duty diesel engines to emit excess NOx. (Opposition to Petition for Writ of Mandate, p. 4.)

Over the course of the litigation, however, ARB's trial counsel took the position that the Chip Reflash Regulation had virtually nothing to do with the Settlement Agreements, and that the Regulation was not in any way based on a finding that the Low NOx Rebuild Engines violated existing law. ARB specifically denied that the Reflash Regulation was an enforcement action to reduce "excess" emissions. Instead, ARB argued that the Reflash Regulation was adopted for the sole purpose of providing "new emission reductions," namely the Board's finding that it would reduce NOx emissions by 30 to 40 tons per day. ARB alleged that the findings supporting the Reflash Regulation are that NOx is a grave threat to human health and that the Chip Reflash Regulation protects the public health and safety by reducing NOx emissions. ARB also took the position that it had entered into the Settlement Agreements based on a fundamental mistake of fact as to when the engines would be rebuilt, and that Plaintiffs were aware of this mistake but failed to bring it to the attention of ARB.

By the conclusion of trial, ARB's position had taken another turn. It no longer claimed it entered into the Agreements based on a "mistake;" it conceded that the threats to public health are ozone and particulate matter, not NOx; and it admitted that the Chip Reflash Regulation is expected to reduce NOx emissions by at most only 14.3 tons per day, and not the 30 to 40 tons claimed by the Board. At trial, ARB asserted that the Low NOx Rebuild Engines cause "excess emissions" because they contain "defeat devices," but continued to deny that the Reflash Regulation was an "enforcement action" or in any way based on a determination that the engines do not conform to title 13.

The Court finds ARB's arguments inconsistent and lacking credibility. Its evidence is not persuasive in the face of the overwhelming facts produced by Plaintiffs. Accordingly, and for all of the reasons described above, the Court finds that judgment should be issued in favor of Petitioner EMA and Plaintiff Manufacturers and against Respondent and Defendant ARB.

[continued on following page]

Petitioner/Plaintiffs are directed jointly to prepare a formal order, attaching the Court's ruling herein as an Exhibit, and a judgment and peremptory writ of mandate consistent with this ruling; submit each of them to opposing counsel for approval as to form; and thereafter submit them to the Court for signature and entry of judgment in accordance with Rule of Court 391. Petitioner and Plaintiffs shall be entitled to recover their costs upon appropriate application. The Court reserves jurisdiction to consider any motions for an award of attorney fees.

IT IS SO ORDERED.

Dated: October __, 2006

Judge Judy Holzer Hersher