RECENT DEVELOPMENTS IN INSURANCE REGULATION

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I. Overview

Insurance regulatory developments in 2009 will be dominated by responses to the financial market meltdown in the fall of 2008. In that connection, some of the insurance regulatory trends in 2008 and the immediately preceding years may be reevaluated. Other developments may be reinforced.

Recent years have seen efforts to streamline state insurance regulation, evidenced by rate and form filing reforms in a number of states and legislation to facilitate the use of captives. At the same time, consumer protection efforts have generated increased regulation of producer compensation and financial product suitability legislation. The wild card for 2009 is whether the federal government will play an increased role in insurance regulation.

II. Recent Developments Regarding the McCarran-Ferguson Act

The McCarran-Ferguson Act[1] was passed in 1945 in response to the U.S. Supreme Court's decision in *United States v. South-Eastern Underwriters' Ass'n*,[2] which held that insurance companies engage in interstate commerce

1. 15 U.S.C. §§ 1011–1015 (2008).
2. 322 U.S. 533 (1944). Before the *South-Eastern Underwriters'* decision, the issuing of an insurance policy was not thought to be a transaction in commerce subject to federal regulation under the Commerce Clause. *See* 15 U.S.C. § 1011 (2008) (declaring that the continued

and, therefore, are subject to the Sherman Act.[3] McCarran-Ferguson provides a limited exemption to the insurance industry from the federal antitrust laws.[4] The Act exempts from scrutiny under federal antitrust law conduct that: (1) is part of the "business of insurance"; (2) is regulated by state law; and (3) does not constitute "boycott, coercion, or intimidation."[5] The Act confers the federal commerce power on the states to enact laws that "relate to" the regulation of the "business of insurance" and restricts federal authority to "invalidate, impair, or supersede" state law, unless federal law does so explicitly.[6]

A. *The "Business of Insurance" Requirement*

The limited McCarran-Ferguson Act exemption from federal antitrust law applies only to activities that constitute the "business of insurance."[7] Initially, the Supreme Court adopted a "rather expansive interpretation of 'business of insurance,' addressing the issue in terms of 'issuance of policies,' 'contracts,' and payment of insurance claims."[8] Subsequently, in *Union Labor Life Insurance Co. v. Pireno*, the Supreme Court clarified its interpretation of the "business of insurance" by establishing three criteria to test whether a particular practice falls within the McCarran-Ferguson exemption: (1) whether the practice has the effect of transferring or spreading a policyholder's risk, (2) whether the practice is an integral part of the policy relationship between the insurer and the insured, and (3) whether the practice is limited to entities within the insurance industry.[9] Although none of these factors is necessarily determinative alone, courts have found that "affirmative responses to these criteria indicate that the practice *is* the

regulation and taxation by the states of the business of insurance is in the public interest and that silence on the part of Congress should not be construed to impose a barrier to the regulation or taxation of that business by the states). *See South-Eastern Underwriters'*, 322 U.S. at 534; *see also* Union Labor Life Ins. Co. v. Pireno, 458 U.S. 119, 135–36 (1982); Life Partners, Inc. v. Morrison, 484 F.3d 284, 293 (4th Cir. 2007).

3. *See Pireno*, 458 U.S. at 135; Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. 205, 217 (1979).

4. 15 U.S.C. §§ 1011–1015.

5. *Id.* §§ 1012–1013.

6. *See id.* § 1012.

7. *See* 15 U.S.C. § 1012(b); *see also* Arroyo-Melecio v. Puerto Rican Am. Ins. Co., 398 F.3d 56, 66 n.6 (1st Cir. 2005) ("In fact, the term 'business of insurance' is used twice in 15 U.S.C. § 1012(b). The first clause commits laws enacted . . . 'for the purpose of regulating the business of insurance' to the States, while the second clause exempts only 'the business of insurance' itself from the antitrust laws." (internal citations omitted)).

8. *In re* Ins. Brokerage Antitrust Litig., No. 04-5184, 2006 WL 2850607, at *7 (D.N.J. Oct. 3, 2006) (citing Prudential Ins. Co. v. Benjamin, 328 U.S. 408 (1946)).

9. 458 U.S. 119, 129 (1982).

'business of insurance.'"[10] Courts' determinations whether a particular practice falls within the "business of insurance" criteria—and, therefore, is within the limited antitrust exemption—are inherently driven by both the facts of the case and the context of the litigation. This propensity is well illustrated by two decisions from 2005 and 2006 addressing the "business of insurance" question.

In *Arroyo-Melecio v. Puerto Rican American Insurance Co.*, the First Circuit addressed a challenge to a joint underwriting association (JUA) created to provide auto coverage to motorists unable to obtain coverage in the market.[11] Plaintiffs alleged that private insurers and the JUA agreed to monopolize the market for low-cost compulsory auto insurance and boycotted and coerced at least one broker in order to maintain that monopoly.[12] The First Circuit concluded that the alleged horizontal agreements among insurers to fix prices and issue policies fell within the "business of insurance."[13] The alleged potential effects on pricing if the insurers did not use brokers and agents also fell within the "business of insurance" exemption.[14] The court dismissed all claims against the JUA, with the exception of alleged coercion targeted at a broker, as discussed below.[15]

In a different context, the federal court of the District of New Jersey held that alleged practices of "bid-rigging"[16] and "steering"[17] by commercial lines insurers and brokers fell outside the McCarran-Ferguson exemption.[18] In *In re Insurance Brokerage Antitrust Litigation*, the court concluded that the practices failed the first prong of the *Pireno* test because "bid-rigging" and "steering" did not transfer or spread a policyholder's risk.[19]

10. Genord v. Blue Cross & Blue Shield, 440 F.3d 802, 806 (6th Cir. 2006) (citing *Pireno*, 458 U.S. at 129); *see also In re Ins. Brokerage Antitrust Litig.*, 2006 WL 2850607, at *7 (quoting Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. 205, 252 (1979)); *see also* Life Partners, Inc. v. Morrison, 484 F.3d 284, 294 (4th Cir. 2007) (stating the "business of insurance" generally refers to "marketing, selling, entering into, managing, servicing, and performing of insurance contracts").

11. 398 F.3d at 60.

12. *Id.*

13. *Id.* at 67.

14. *Id.* at 68.

15. *Id.* at 60.

16. *In re* Ins. Brokerage Antitrust Litig., No. 04-5184, 2006 WL 2850607, at *9 (D.N.J. Oct. 3, 2006) ("Bid-rigging is an agreement to manipulate bids for insurance contracts pursuant to which the Brokers solicit collusive, noncompetitive or inflated quotes from the insurers in order to ensure the placement or renewal of insurance policies with certain insurers.").

17. *Id.* ("[S]teering consists of implicit and explicit agreements to allocate premium volume to certain preferred insurers for the purpose of increasing the amount of contingent commissions paid to the brokers.").

18. *Id.* at *10.

19. *Id.* at *9.

The court found that the practices were too remotely related to risk allocation, and the "business of insurance" exemption requires more than a mere impact on premiums.[20] The court also held that the practices were directly between the broker and carrier and not "an integral part of the policy relationship between the insurer and insured."[21] The alleged bid-rigging and steering arrangements constituted "independent agreements between entities operating within the insurance industry, but outside the sphere of the insurer/insured relationship."[22] As a result, the McCarran-Ferguson exemption did not apply.[23]

B. *The State Regulation Requirement*

The McCarran-Ferguson Act exempts the business of insurance from federal antitrust law only to the extent that it is "regulated by State law."[24] A state regulatory scheme will be deemed sufficient if the regulator has jurisdiction over insurers' practices generally and has the authority either to approve or prohibit their activities.[25] Furthermore, the state regulation test is met if the state has established a pervasive insurance regulatory scheme.[26] All fifty states and the District of Columbia comprehensively regulate the insurance industry, and all have established rules related to premiums, commissions, and the relationships among insurers, brokers, and the insured.

The Fourth and Fifth Circuits recently addressed the state regulation requirement in different contexts and found the requisite degree of state regulation. In *Life Partners, Inc. v. Morrison*, the Fourth Circuit in 2007 held that the Virginia Viatical Settlements Act, which regulates viatical settlements with insured residents of Virginia, regulates the "business of insurance."[27] Thus, the court held that the Act was saved from the dormant Commerce Clause. In *Life Partners*, "Jane Doe," a terminally ill resident of Virginia, sold her life insurance policy to Life Partners, Inc. at a deep discount.[28] Following the transaction, Jane Doe sought to increase the sale price of her policy by invoking the minimum-pricing provisions of the Virginia Viatical Settlements Act. Defendant moved to enjoin enforcement of the Viatical Settlements Act, contending that it violated the dormant

20. *Id.*
21. *Id.*
22. *Id.*
23. *Id.* at *10.
24. 15 U.S.C. § 1012. *See, e.g.*, FTC v. Nat'l Cas. Co., 357 U.S. 560 (1958).
25. William M. Hannay & William A. Montgomery, Insurance Antitrust and Unfair Trade Practices Law 219 (2004) (citing *Nat'l Cas. Co.*, 357 U.S. 560).
26. *Id.*
27. 484 F.3d 284, 296–97 (4th Cir. 2007).
28. *Id.* at 286.

Commerce Clause. The court concluded that the sale of life insurance policies by terminally ill patients directly and substantially affects the business of insurance and that "the Virginia Viatical Settlements Act 'relates to' such business and was enacted 'for the purpose of regulating' such business."[29] The court reasoned that the subject of every viatical settlement is an insurance policy.[30] Furthermore, a viatical settlement changes the parties' obligations and benefits, and also creates a new arrangement among the insurer, insured, and the insured's assignee. The court held that the Virginia Viatical Settlements Act directly regulated the conduct and relationships of those new arrangements that were comprised of persons traditionally engaged in the business of insurance.[31] Thus, the court concluded that the Virginia law was not preempted by the Commerce Clause and found it constitutional.[32]

Similarly, in *American Bankers Insurance Co. of Florida v. Inman*, the Fifth Circuit held that Mississippi Code § 83-11-109, which prohibited the arbitration of disputes regarding uninsured/underinsured motorists, regulated the "business of insurance."[33] The court denied the plaintiff's motion to compel arbitration pursuant to the Federal Arbitration Act (FAA), finding that state law preempted the FAA.[34] The court explained that the purpose behind the Mississippi statute was to "protect those injured by uninsured and underinsured motorists."[35] The court reasoned that the state law had the effect of transferring or spreading a policyholder's risk, and the law was an "integral part of the insurer-insured relationship because it controls how disputes regarding uninsured/underinsured motorist coverage will be resolved."[36]

C. *"Boycott, Coercion, or Intimidation"*

15 U.S.C. § 1013(b) carves out a specific exception to the "business of insurance" exemption from federal antitrust liability. It provides that "[n]othing

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29. *Id.* at 287.
30. *Id.* at 295.
31. *Id.* at 298.
32. *Id.* at 291; *see also* Nat'l Viatical, Inc. v. Oxendine, No. 1:05-CV-3059-TWT, 2006 WL 1071839 (N.D. Ga. Apr. 20, 2006) (holding the Georgia Life Settlements Act regulated core aspects of the business of insurance, including the relationship between the insurer and insured, the type of policy that could be issued, its reliability, its interpretation, and its enforcement, and dismissing plaintiffs' Commerce Clause challenge).
33. 436 F.3d 490, 492 (5th Cir. 2006); *see, e.g.*, Patterson v. Nexion Health, Inc., No. 2-06-CV-443, 2007 WL 2021326 (E.D. Tex. July 9, 2007) (holding Chapter 74 of the Texas Civil Practice and Remedies Code was enacted for the purpose of regulating the business of insurance as a "comprehensive effort to regulate medical malpractice liability insurance premiums," and the state law requirements, rather than the FAA, applied to the case pursuant to McCarran-Ferguson).
34. 9 U.S.C. §§ 1–16 (2008).
35. *Inman*, 436 F.3d at 494.
36. *Id.*

contained in [the McCarran-Ferguson Act] shall render the said Sherman Act inapplicable to any agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation."[37] A boycott need not be an absolute refusal to deal on any terms but may be "conditional, offering the target the incentive of renewed dealing if and when he mends his ways."[38] However, under a McCarran-Ferguson analysis, it is important to "distinguish between a conditional boycott and a concerted agreement to seek particular terms in a particular transaction."[39] The Supreme Court has held that parties to a concerted agreement are not engaging in a boycott because "they are not coercing anyone, at least in the usual sense of the word."[40] Thus, a "boycott" under McCarran-Ferguson must involve an agreement by two or more persons to compel another person to accept terms on one transaction by concertedly refusing to deal with that person on other, unrelated transactions.[41] Two pertinent cases applying the "boycott, coercion, or intimidation" exception to the McCarran-Ferguson exemption are discussed below.

In *Arroyo-Melecio* (discussed above), the plaintiffs claimed in part that the "private insurers acting in concert coerced brokers to refrain from selling compulsory insurance through private companies."[42] In an attempt to avoid the McCarran-Ferguson exemption, the plaintiffs asserted that an alleged agreement that the private insurers would not compete with the JUA and threats to a broker constituted boycott and coercion. Although the court held that an agreement among private insurers and between the insurers and the JUA to refuse to provide compulsory low-risk insurance to consumers was not a boycott, the court found that alleged coercion against a brokerage firm could state a claim of boycott.[43] The court reversed the dismissal of the plaintiffs' claims of coercion directed at a broker.[44]

Similarly, in *Total Benefits Planning Agency, Inc. v. Anthem Blue Cross & Blue Shield*, the plaintiffs alleged violations of the Sherman Act, Clayton Act, and various state laws against defendant insurance companies and unnamed co-conspirators.[45] The plaintiffs claimed that the defendants and their co-conspirators defamed and libeled them to third parties such as

37. 15 U.S.C. § 1013(b) (2008).
38. *See* Hartford Fire Ins. Co. v. California, 509 U.S. 764, 801 (1993).
39. *Id.*; *see also* Arroyo-Melecio v. Puerto Rican Am. Ins. Co., 398 F.3d 56, 70 (1st Cir. 2005).
40. *Hartford Fire Ins. Co.*, 509 U.S. at 801–02.
41. *See id.* at 802–03.
42. *Arroyo-Melecio*, 398 F.3d at 64.
43. *Id.* at 69.
44. *Id.* at 71.
45. No. 1:05cv519, 2006 WL 2612996, at *1 (S.D. Ohio Sept. 8, 2006).

insurance agencies, businesses, and consumers; coerced and threatened certain insurance agents; coerced and threatened the plaintiffs; "blacklisted" the plaintiffs within the insurance industry; and "otherwise organized a boycott of the plaintiffs."[46] Defendants argued that plaintiffs failed to satisfy the pleading requirements for an antitrust claim, and alternatively argued that plaintiffs' claim was exempt under the McCarran-Ferguson Act.[47] After concluding that plaintiffs sufficiently alleged a *prima facie* case under the Sherman Act, the court found that plaintiffs' antitrust claim was not exempted by McCarran-Ferguson.[48] The court reasoned that because plaintiffs sufficiently stated a claim under the Sherman Act based on defendants' group boycott of plaintiffs and defendants' alleged refusal to deal with plaintiffs in an unrelated transaction, the plaintiffs' antitrust claim was not barred.[49]

D. *Reverse Preemption of Federal Law*

Under McCarran-Ferguson, a state law "reverse preempts" federal law if "(1) the federal statute does not specifically relate to the 'business of insurance;' (2) the state law was enacted for the 'purpose of regulating the business of insurance;' and (3) the federal statute operates to 'invalidate, impair, or supersede' the state law."[50] However, "when federal law does not directly conflict with state regulation, and when application of the federal law would not frustrate any declared state policy or interfere with a State's administrative regime, the McCarran-Ferguson Act does not preclude its application."[51] Case law in recent years has applied this subsection of McCarran-Ferguson to a wide variety of state and federal laws.

1. Federal Removal Statutes

In *Hudson v. Supreme Enterprises, Inc.*, the plaintiffs sought to prevent removal of their claims to federal court under the federal removal statutes.[52] Plaintiffs contended that Ohio law set forth a comprehensive statutory

46. *Id.*
47. *Id.* at *2.
48. *Id.* at *3.
49. *Id.* at *4.
50. Am. Bankers Ins. Co. of Florida v. Inman, 436 F.3d 490, 493 (5th Cir. 2006); *see also* 15 U.S.C. § 1012(b) (2008); Genord v. Blue Cross & Blue Shield, 440 F.3d 802, 805 (6th Cir. 2006).
51. Humana, Inc. v. Forsyth, 525 U.S. 299, 310 (1999) (holding Racketeer Influenced and Corrupt Organizations Act would not impair Nevada's Unfair Insurance Practices Act because it would not frustrate any declared state policy).
52. No. 2:06-cv-795, 2007 WL 2323380, at *3 (S.D. Ohio Aug. 9, 2007) (addressing 28 U.S.C. §§ 1332, 1441).

scheme for the dissolution of insolvent Ohio insurers and explicitly granted the Franklin County Court of Common Pleas exclusive jurisdiction over the proceedings.[53] In response, the defendants argued that federal courts have the authority to entertain diversity actions, even those involving the liquidation of insurers.[54] The court concluded that the federal removal statutes do not "specifically relate to the business of insurance."[55] Further, the court determined that the relevant Ohio statute was enacted to regulate the business of insurance because the statute was designed to protect policyholders.[56] The court held that the application of the federal removal statutes would directly interfere with the state's administrative regime, and the McCarran-Ferguson Act precluded application of the federal laws.[57]

2. RICO

In 2008 the Southern District of Iowa considered whether the Racketeer Influenced and Corrupt Organizations Act (RICO)[58] interfered with Iowa insurance regulation.[59] In *Bendzak v. Midland National Life Insurance Co.*, plaintiff, a senior citizen who purchased deferred annuity policies from defendant, filed a class action alleging defendant violated RICO, engaged in common law civil conspiracy under Iowa and other states' laws, and was unjustly enriched through the wrongful collection of premiums, penalties, and surrender charges.[60] Defendant contended that the adjudication of plaintiff's claim in federal court would improperly interfere with state regulation of insurance.[61] Relying on the Supreme Court's reasoning in *Humana, Inc. v. Forsyth*, which held that RICO's private right of action and treble damages provision complemented the Nevada statutory scheme,[62] the court held that the plaintiff's RICO claim did not interfere with Iowa's regulatory scheme.[63] Because the defendant failed to assert that allowing plaintiff's RICO claim to proceed would interfere with a state regulatory scheme in some way that the claim in *Humana* did not, McCarran-Ferguson was not grounds for dismissal.[64]

53. *Id.*
54. *Id.*
55. *Id.* at *4.
56. *Id.* at *6.
57. *Id.* at *7.
58. 18 U.S.C. §§ 1961–1968 (2008).
59. Bendzak v. Midland Nat'l Life Ins. Co., 440 F. Supp. 2d 970 (S.D. Iowa 2006).
60. *Id.* at 974.
61. *Id.* at 975.
62. *See* 525 U.S. 299, 303 (1999).
63. *Bendzak*, 440 F. Supp. 2d at 976.
64. *Id.*

3. Fair Housing Act

Several district courts have applied the McCarran-Ferguson exemption in the context of the Fair Housing Act (FHA).[65] For example, in *Saunders v. Farmers Insurance Exchange*, the Western District of Missouri granted defendant's motion to dismiss plaintiffs' price discrimination claims under the FHA on the grounds that the claims were barred by McCarran-Ferguson.[66] The court found that the Missouri Insurance Rating Law prohibited insurers from setting "excessive, inadequate, or unfairly discriminatory" rates and grants the director of Insurance exclusive power to enforce the state's regulation of insurance rates.[67] In contrast, the FHA and civil rights laws provided different remedies, such as punitive damages, and were enforced through private lawsuits.[68] The court held that allowing the plaintiffs to proceed with their FHA and civil rights claims "would clearly frustrate [the ability of] Missouri's Administrative regime to regulate the insurance industry."[69]

Similarly, in *McKenzie v. Southern Farm Bureau Casualty Insurance Co*., the plaintiff filed a class action seeking redress under the FHA for an alleged scheme of racial discrimination.[70] The plaintiff asserted that the defendant used credit information and "credit scoring" to screen applicants and set premiums for its insurance policies that "resulted in a disparate impact on minorities."[71] The Northern District of Mississippi held that the plaintiff's claim was "untenable" because Mississippi had enacted a regulation authorizing the activity about which she complained.[72] The court reasoned that the plaintiff's FHA claim would "impair" State law within the meaning of McCarran-Ferguson and barred plaintiff's claim.[73]

4. False Claims Act

The Western District of Oklahoma recently held that the False Claims Act (FCA)[74] would frustrate the Oklahoma Property and Casualty Insurance Guaranty Association Act (Guaranty Act) and barred the plaintiff's claim.[75] In that case, plaintiff was injured in an automobile accident and

65. 42 U.S.C. § 3601 (2008).
66. 515 F. Supp. 2d 1009, 1012 (W.D. Mo. 2007).
67. *Id*. at 1019.
68. *Id*. at 1020.
69. *Id*. at 1019–20.
70. No. 3:06CV013-B-A, 2007 WL 2012214, at *1 (N.D. Miss. July 6, 2007).
71. *Id*.
72. *Id*. at *3.
73. *Id*.
74. 31 U.S.C. §§ 3729–3733 (2008).
75. United States *ex rel*. Vaughn v. Okla. Prop. & Cas. Ins. Guar. Ass'n, No. CIV-04-1278-M, 2006 WL 2372962, at *2 (W.D. Okla. Aug. 15, 2006) (citing Oklahoma Property and Casualty Insurance Guarantee Association Act, Okla. Stat. tit. 36, §§ 2001–2043 (1991)).

filed a lawsuit against the alleged tortfeasor. Subsequently, the alleged tortfeasor's insurer was declared insolvent, and the Oklahoma Property and Casualty Insurance Guaranty Association (Guaranty Association) assumed the defense. Plaintiff then filed suit alleging that the Guaranty Association's conduct in connection with the claim (and other claims) violated the FCA.[76] The court held that the application of the FCA would frustrate the purpose of the Guaranty Act.[77] The court reasoned that the application and imposition of "civil penalties, treble damages, and attorney fees under the FCA would frustrate the Guaranty Act's purpose to provide a mechanism for the payment of covered claims, avoid excessive delay in payment, and avoid financial loss to claimants or policyholders."[78] Furthermore, the court concluded that application of the FCA would invalidate and impair the immunity provision of the Guaranty Act.[79]

5. Federal Arbitration Act

In contrast to the cases discussed above holding that federal statutes improperly impinged on state insurance laws, the federal court of the District of Nevada recently held that the Federal Arbitration Act[80] did not "invalidate, impair, or supersede" the Nevada state law at issue.[81] Plaintiff alleged that he held a credit card with defendant MBNA, which sent him advertisements for "valuable insurance protection that would discharge his indebtedness to MBNA should he become disabled, unemployed or die."[82] Plaintiff claimed that he purchased credit insurance through the insurer defendants and monthly premiums were charged to his credit card. Thereafter, plaintiff allegedly became disabled, but the insurer defendants ceased paying on plaintiff's account before the debt was completely discharged. Plaintiff brought suit and the defendants moved to compel arbitration pursuant to an arbitration clause in the credit card agreement. The court rejected plaintiff's claim that the insurance he purchased should be considered health insurance pursuant to Nevada law and held that he was not entitled to opt out of the binding arbitration.[83] Because the state insurance law governing arbitration clauses in health insurance policies did not apply to plaintiff's credit disability insurance, the

76. *Id*. at *1.
77. *Id*.
78. *Id*. at *2.
79. *Id*.
80. 9 U.S.C. § 1 (1947).
81. Coleman v. Assurant, Inc., 508 F. Supp. 2d 862, 867 (D. Nev. 2007).
82. *Id*. at 865.
83. *Id*.

court held that enforcing the FAA did not invalidate, impair, or supersede Nevada state law.[84]

6. International Arbitration

Several courts have held that McCarran-Ferguson does not provide exemption from international arbitration agreements. For example, in *Goshawk Dedicated Ltd. v. Portsmouth Settlement Co. I, Inc.*, plaintiff, a British underwriter, brought an action against defendant, a Georgia-based investment company, seeking a court order compelling arbitration.[85] Plaintiff had insured defendant against losses related to defendant's investment in the secondary life insurance market pursuant to a contingent cost insurance policy.[86] This insurance policy contained an arbitration clause.[87] After concluding a valid arbitration clause existed, the court held that the Convention on the Recognition of Foreign Arbitral Awards (Convention) superseded the McCarran-Ferguson Act and thus required arbitration.[88] The court reasoned that the Convention, as incorporated into federal law, "is intended to encourage the recognition and enforcement of commercial arbitration agreements in international contracts and to unify the standards by which agreements to arbitrate are observed and arbitral awards are enforced . . . ."[89] The court concluded that the Convention must be enforced according to its terms over all prior inconsistent laws, including the McCarran-Ferguson Act.[90]

III. PRODUCER LICENSING

In December of 2004, the National Association of Insurance Commissioners (NAIC) convened an executive task force in response to the New York authorities' heightened scrutiny of producer compensation. The NAIC

84. *Id.* at 867; *see also* Midwest Employers Cas. Co. v. Legion Ins. Co., No. 4:07CV870, 2007 WL 3352339, at *5 (E.D. Mo. Nov. 7, 2007) (holding state insurance law did not preempt the FAA because the ultimate issue was a standard contract dispute not involving the state's regulation of insurance and allowing it to proceed would not impair the state's insurance regulatory scheme and McCarran-Ferguson did not apply).

85. 466 F. Supp. 2d 1293, 1296 (N.D. Ga. 2006).

86. *Id.* at 1296–97.

87. *Id.* at 1297.

88. *Id.* at 1301.

89. *Id.* at 1304.

90. *Id. See also* Murphy Oil USA, Inc. v. SR Int'l Bus. Ins. Co., No. 07-CV-1071, 2007 WL 2752366 (W.D. Ark. Sept. 20, 2007) (holding the New York Convention, "a treaty entered into by the United States directing district courts to recognize and enforce arbitration agreements between international merchants," supersedes McCarran-Ferguson because the Convention prevails over previously enacted inconsistent rules of law, legislative history of McCarran-Ferguson indicates that it is limited to domestic commerce, and international comity is a fundamental principle deserving substantial deference).

charged the group with creating revisions to the NAIC's Producer Licensing Model Act (PLMA) that would effectively regulate potential conflicts of interest inherent to the insurance market. The resulting amendments in § 18 of the PLMA (Section 18) contain several key producer compensation disclosure requirements.[91]

Section 18 at subsection A(1) provides that producers who receive compensation from insureds or otherwise represent insureds—generally referred to as "brokers"—may not receive any compensation from an insurer or other third party for the placement of insurance unless, prior to the client's purchase, the producer (a) has obtained the client's "documented acknowledgement" of such compensation and (b) discloses the amount of compensation that will be received.[92]

Section 18 at subsection A(2) provides that producers who have been appointed by an insurer and do not receive compensation from the client—generally referred to as "agents"—will not be subject to subsection A(1)'s disclosure requirements so long as the producer, prior to the client's purchase of insurance, discloses to the client that (1) the producer will receive compensation from an insurer in connection with the placement or (2) the producer represents the insurer and the producer may provide services to the client for the insurer.[93]

Since the promulgation of Section 18, several states have responded by enacting the amended PLMA either in whole or in part: Arkansas,[94] Connecticut,[95] Georgia,[96] Texas,[97] and Rhode Island.[98] Georgia and Texas do not require that a producer make any disclosures when the producer's sole compensation is derived from the insurer.

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91. Producer Licensing Model Act § 18 (2005).

92. *Id.* § 18A(1)(a)–(b).

93. *Id.* § 18A(2)(c)(i)–(ii).

94. *See* Ark. Code Ann. § 23-64-520 (2008). *See also* Arkansas Ins. Dept., Bull. No. 5-2005, Producer Compensation Disclosures (2005), *available at* http://www.insurance.arkansas.gov/Legal%20Dataservices/Bulletins/2005/5.pdf (describing the State's reaction to the latest PLMA amendments).

95. Conn. Gen. Stat. § 38a-707a (2008).

96. Ga. Code Ann. § 33-23-46 (2008). Subsection 33-23-46(b)(1) provides that a producer or producer's affiliate cannot receive compensation from both a customer and an insurer or other third party for the initial placement of insurance without both (A) obtaining the customer's acknowledgment of such compensation as well as (B) disclosing the amount of compensation to be received. *Id.*

97. Tex. Ins. Code Ann. § 4005.004 (Vernon 2007). Section 4005.004 provides that an agent or agent's affiliate cannot receive compensation from both a customer and an insurer or other third party for the placement or renewal of an insurance product, an application fee, or an inspection fee without (1) obtaining the customer's acknowledgment of such compensation as well as (2) providing a description of the "method and factors utilized" for calculating the compensation. *Id.*

98. R.I. Gen. Laws § 27-2.4-15.1 (2005). Subsection 27-2.4-15.1(a) provides that a producer or producer's affiliate cannot receive compensation from both a customer and an insurer

Oregon has adopted the substance of Section 18 by regulation.[99] The regulation does not specify whether a producer who receives compensation solely from an insurer must make any disclosures to the client. Insurance regulators in New Jersey,[100] Washington,[101] and Wisconsin[102] have addressed producer compensation disclosure in bulletins.

In 2008, the New York Insurance Department issued an opinion letter on whether producers must disclose to their clients the fixed commission earned on the policies that the producers place.[103] The letter states that, as a general matter, producers are not required to disclose to clients that the producers have received fixed commissions for the placement of insurance.

The NAIC's heightened scrutiny of compensation disclosure requirements is not limited to the amendments to the PLMA. In June of 2007, the NAIC also adopted amendments to the Viatical Settlements Model Act (VSMA).[104] Among other revisions, the VSMA now contains enhanced disclosure requirements for viatical settlement brokers and providers.[105] Specifically, brokers must disclose to sellers all offers, counteroffers, acceptances, and rejections in connection with a proposed settlement contract.[106]

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or other third party for the initial placement of insurance without (1) obtaining the customer's acknowledgment of such compensation as well as (2) providing a description of the "method and factors utilized" for calculating the compensation. *Id*. In 2006, the Rhode Island Department of Business Regulation issued a bulletin clarifying the statute's requirements. R.I. Dep't of Bus. Reg., Bull. No. 2006-2, Producer Compensation Disclosure (2006), *available at* http://www.dbr.state.ri.us/documents/news/insurance/InsuranceBulletin2006-2.pdf. Specifically, producers who receive compensation solely from the insurer still must inform the insured of the compensation, including any contingent commissions. *Id*.

99. Or. Admin. R. 836-071-0260(1)(a)–(c) (2009). This provision states that a producer or producer's affiliate cannot receive compensation from both a customer and an insurer or other third party for the initial placement of insurance without (a) obtaining the customer's acknowledgment of such compensation, (b) providing the amount of compensation to be received, and (c) disclosing the nature of the work that will be performed on the client's behalf. *Id*.

100. New Jersey Dep't of Banking and Ins. Legislative and Regulatory Affairs, Bull. No. 04-20, Producer Conduct Requirements (2004), *available at* http://newjersey.gov/dobi/bulletins/blt04_20.pdf.

101. Washington Office of Ins. Comm'r, Bull. No. 06-04, Property and Casualty Broker Compensation Disclosure (2006), *available at* http://www.insurance.wa.gov/oicfiles/techadvisories/T06-04.pdf (citing Wash. Rev. Code Ann. § 48.17.270 (2008)).

102. Wisconsin Office of the Comm'r of Ins., Disclosure Required by § 628.32 Wis. Stat. (2005), *available at* http://oci.wi.gov/bulletin/0205discl.htm (citing Wis. Stat. Ann. § 628.32 (2007)).

103. N.Y. Ins. Dep't, Office of General Counsel, Opinion (Jan. 30, 2008), *available at* http://www.ins.state.ny.us/ogco2008/rg080110.htm.

104. Viatical Settlements Model Act (VSMA) No. 697 (2007); s*ee generally* http://www.naic.org/Releases/2007_docs/viatical_settlements_model.htm.

105. Project History Report, Viatical Settlements Model Act (No. 697) (July 9, 2008) (on file with author).

106. VSMA § 8(C)(2).

Brokers also must disclose any affiliations or contractual arrangements with any person who makes an offer in connection with the contract.[107] Whenever any portion of the broker's compensation is derived from the proposed contract offer, the broker must disclose the total amount of the offer and the percentage of the offer that is comprised by the broker's compensation.[108] Brokers must clearly disclose to viators that the broker represents exclusively the viator, and not the viatical settlement provider.[109] The broker must also disclose its fiduciary duty to the viator.[110] In addition, viatical settlement providers must disclose to viators any affiliations or contractual arrangements between the provider and the settlement purchaser.[111]

IV. FINANCIAL PRODUCTS SUITABILITY

Questionable sales of annuities and other financial or investment products, especially to senior citizens, have been an ongoing concern of both insurance and securities regulators for some time. Historically, regulators have been concerned that consumers may be encouraged to purchase annuities that are not appropriate given their individual financial situations. Recently, both insurance and securities regulators have significantly enhanced the legal standards that the issuers of these products and the persons who sell them must meet before making a recommendation to a consumer. In general, these suitability laws require salespersons to obtain relevant financial and personal information from consumers and base any product recommendations on that information.

Variable annuities and variable life insurance contracts are subject to dual regulation by both securities and insurance regulators.[112] Due to their investment risks, variable annuities and variable life insurance contracts are considered securities and must be registered under the Securities Act of 1933.[113] Persons selling these products must have the appropriate securities license as well as an insurance license. Both variable annuities and variable life insurance contracts are issued by insurance companies and the issuance and sale of these products are, in addition, regulated by state insurance

107. *Id.* § 8(C)(3).
108. *Id.* § 8(C)(5).
109. *Id.* § 8(A)(2).
110. *Id.*
111. *Id.* § 8(B)(3).
112. Variable annuities are insurance contracts with investment features. Three basic features of a typical variable annuity are (1) tax-deferred treatment of earnings, (2) a death benefit, and (3) annuity payout options that can provide income for life. *See* National Association of Securities Dealers, Notice to Members 99-35 (May 1999), *available at* http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p004395.pdf.
113. *Id.*

departments. Fixed annuities lack the investment features of variable annuities and are regulated under state insurance laws but not under securities laws.

The suitability laws enacted by state insurance regulators generally apply to sales of both fixed and variable annuity products, whereas rules promulgated by the Financial Industry Regulatory Authority (FINRA) apply to variable annuities and other securities.[114] The insurance laws of some states also include suitability requirements for sales of long-term care insurance.

In the purchase, sale, or exchange of an annuity or a variable life insurance product, the suitability obligations of the issuing company and the producer or broker will vary depending upon the type of product and the state in which the transaction occurs. Not all states have adopted suitability requirements and the state laws that do exist are not identical. In some jurisdictions, there are no suitability requirements in the state insurance code for any products, but the securities regulations apply to sales of variable annuities. In states that have enacted insurance code suitability laws, issuers and producers must comply with two sets of requirements for sales of variable annuities that may not be consistent.

States have begun enacting laws that contain suitability requirements for the sale and replacement of long-term care insurance. Long-term care insurance provides coverage for medical, diagnostic, maintenance, and personal care services, including nursing home services, generally with a benefit period of at least a year.

A. *Securities Rules*

Securities regulators had a "suitability" requirement for recommendations for the purchase, sale, or exchange of securities in 1939.[115] NASD Rule 2310(a), the current formulation of the seventy-year-old suitability requirement, requires a member to have reasonable grounds for believing that a recommendation is suitable for a customer given the customer's other security holdings and financial situation and needs. The rule requires the member to make reasonable efforts to obtain information about the customer's financial status, tax status, investment objectives, and other information that is used or considered to be reasonable by the member.

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114. FINRA was created in 2007 through a consolidation of the National Association of Securities Dealers (NASD) and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange (NYSE). *See* http://www.finra.org/AboutFINRA/index.htm. FINRA is in the process of consolidating NASD rules and certain NYSE rules that FINRA incorporated. *Id*.

115. The precursor to NASD Rule 2310 was Article III, § 2 of the NASD Rules of Fair Practice. *See* NASD Notice to Members 96-86 (Dec. 1996), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p004697.pdf.

In a 1996 Notice to Members, the NASD reminded members that Rule 2310 applies to the recommendation of any security, including variable life insurance contracts and variable annuity contracts.[116] In that notice, the NASD also indicated that other securities rules may be implicated in suitability concerns. For example, the replacement of a customer's variable annuity contract would be prohibited when the new product does not improve the customer's existing position but does generate a new sales commission. Such conduct would be prohibited under the NASD Conduct Rule that requires members and registered representatives to deal fairly with customers. That rule also prohibits excessive activity in a customer's account, also known as "churning" or "overtrading."[117]

NASD Rule 2821 became effective in 2008 and it applies only to deferred variable annuities and their subaccount allocations.[118] Rule 2821 is entitled "Members' Responsibilities Regarding Deferred Variable Annuities" and was intended to supplement, not replace, other rules on suitability. Rule 2821 imposes additional duties on member firms and persons associated with members who make recommendations for the purchase or exchange of deferred variable annuities. In addition to being required to have a reasonable basis for believing the transaction is suitable, the member also must have a reasonable basis to believe that the customer would benefit from the features of a deferred variable annuity (e.g., tax-deferred growth, annuitization, death, or living benefit). The rule imposes a duty to request specific information from customers and certain disclosures are required. These requirements apply not just to the purchase or exchange of the annuity but also to the initial subaccount allocations.

Rule 2821 also requires the member to have "a reasonable basis to believe" that the "customer has been informed" of the various features of a deferred variable annuity including the surrender period and charge; potential tax penalty if the annuity is sold or redeemed prior to the customer reaching age 59½; mortality and expense fees; investment advisory fees; potential charges for and features of riders; the insurance and investment components of deferred variable annuities; and market risk.[119] When the exchange of a deferred variable annuity is contemplated, the member

116. *Id.*
117. *Id.*
118. NASD, Rule 2821 (2008). The effective dates of paragraphs (c) and (d) of Rule 2821 were delayed pending approval of a change to Rule 2821 proposed by FINRA. *See* Self-Regulatory Organizations: Financial Industry Regulatory Authority, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Delay the Effective Date of Certain FINRA Rule Changes Approved in SR-NASD-2004-183, 73 Fed. Reg. 26,176 (May 8, 2008) (publishing SR-FINRA-2008-015).
119. NASD, Rule 2821(b)(1)(A).

also must consider whether the customer would incur a surrender charge, would lose existing benefits, would be subject to increased fees, has had another annuity exchanged within the past thirty-six months, and would benefit from product enhancements and improvements.[120] Finally, Rule 2821 also contains requirements for the timely handling of funds, review of the suitability by a registered principal, the establishment of additional supervisory procedures, surveillance or oversight procedures, and training.[121]

Inherent in all broker-dealer relationships with customers is a fundamental responsibility of fair dealing. The NASD advised that recommending the purchase of a securities product in amounts exceeding the customer's financial ability to meet such commitment is a violation of the member's responsibility of fair dealing.[122] Excessive trading activity, trading in mutual fund shares, and recommending speculative low-priced securities also may violate this duty of fair dealing. The NASD has specifically stated that the practice of a registered representative replacing a customer's existing variable contract with a new variable contract that does not improve the customer's current position, but is merely designed to generate a new sales commission, is prohibited.

B. *Development of Suitability Standards for Insurance Products*

Most insurance regulators were slower to identify a need for suitability laws than securities regulators. In 2000, the National Association of Insurance Commissioners (NAIC) issued a white paper, *Suitability of Sales of Life Insurance and Annuities*.[123] In that paper, the NAIC described the applicable securities laws and enforcement activities and reported the results of a 1997 survey conducted by the NAIC. The survey revealed that, in 1997, only three state insurance departments reported they had suitability standards in place for annuity sales. One had standards only for variable life insurance. Twenty-two states recommended that a model law should be developed and seven states reported there was no need for a law. The NAIC noted that, at the time the white paper was prepared, only six states had suitability standards for individual life and annuity products and that four additional states had some limited standards. Since the white paper was issued, the NAIC has adopted two versions of a model regulation for suitability and over forty states now have suitability laws.

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120. NASD, Rule 2821(b)(1)(B).

121. NASD, Rule 2821(c)–(e).

122. *See* NASD, Conduct Rules, IM-2310-2, Fair Dealing with Customers, *available at* http://sec.gov/pdf/nasd1/2000ser.pdf.

123. National Association of Insurance Commissioners, *Suitability of Sales of Life Insurance and Annuities* (White Paper) (2000).

In 2003 the NAIC adopted a model regulation that applied to the sales of annuities to senior citizens, the Senior Protection in Annuity Transactions Model Regulation.[124] Shortly afterwards, in 2006, the NAIC amended the model regulation to apply to all sales of annuities and it became known as the Suitability in Annuity Transactions Model Regulation. By mid-2008, approximately forty states had adopted one model or the other; a few had other suitability laws; and several others had legislation or new regulations pending. Also in 2008, the NAIC formed a Suitability of Annuity Sales Working Group to continue addressing suitability issues.[125]

In 2008, the U.S. Congress showed interest in the issue of suitability and the sale of investment products to seniors and the Senior Investor Protection Act of 2008[126] was introduced in the Senate. Although the primary focus of the bill is on the use of potentially deceptive professional designations and credentials in sales to seniors, the bill states that many state laws and enforcement measures with respect to suitability standards in selling financial products to seniors are "inadequate."

1. NAIC Model Regulations

The NAIC's Suitability in Annuity Transactions Model Regulation (NAIC Model) is essentially identical to the Senior Protection in Annuity Transactions Model Act except that the former applies to sales to persons younger than 65 years of age.[127] It applies to recommendations made by insurance producers and, if no insurance producer is involved, it applies to recommendations made by an insurer. Like Rule 2310, the NAIC Model applies to recommendations for the purchase or exchange of an annuity. Unlike Rule 2310, however, the NAIC Model does not apply to sales of variable life insurance contracts.

The NAIC Model exempts sales of certain kinds of annuities, including direct response sales when there is no recommendation, contracts used to fund pension or welfare benefit plans, 401(k) and similar plans, government or church welfare benefit or deferred compensation plans, nonqualified deferred compensation arrangements established by employers,

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124. Press Release, National Association of Insurance Commissioners, NAIC Committee Expands Suitability Standards (Mar. 6, 2006), *available at* http://www.naic.org/Releases/2006_docs/suitability_standards.htm.

125. Press Release, Wisconsin Office of the Commissioner of Insurance, National Working Group Modeled After Wisconsin Annuity Committee (May 6, 2008), *available at* http://www.insurancenewsnet.com/article.asp?n=1&neID=20080507810.3_7b4c0006dbb548e9.

126. Senior Investor Protection Act of 2008, S. 2794, 110th Cong. (2008).

127. *Compare* NAIC SUITABILITY IN ANNUITY TRANSACTIONS MODEL ACT *with* NAIC SENIOR PROTECTION IN ANNUITY TRANSACTIONS MODEL ACT.

structured settlements in personal injury cases, and annuities used to fund formal prepaid funeral contracts.[128]

The NAIC Model suitability standard for recommendations is similar to that in Rule 2310. Under the NAIC Model, the producer, or if there is no producer then the insurer, must have "reasonable grounds for believing that the recommendation is suitable for the consumer on the basis of the facts disclosed by the consumer as to his or her investments and other insurance products and as to his or her financial situation and needs." The standard under the NAIC Model differs slightly in that a recommendation must be reasonable "under all the circumstances actually known" by the producer or insurer at the time the recommendation is made. Like Rule 2310, the NAIC Model requires an insurance producer to make reasonable efforts to obtain information about the consumer's financial status, tax status, and investment objective, as well as other information that is used or considered reasonable by the producer. Unlike Rule 2310, however, the NAIC Model does not impose any obligation on the producer or insurer if the consumer refuses to provide relevant information, does not follow a recommendation, or provides incomplete or inaccurate information.[129]

Under the NAIC Model, insurers are not directly responsible for the suitability of recommendations when an insurance producer is involved in a transaction, but insurers are required to have a "system to supervise recommendations that is reasonably designed to achieve compliance" with the regulation.[130] There are some similarities between Rule 3010's supervision requirements and the system of supervision required under the NAIC Model. However, again, the duties are significantly less extensive and rigorous under the NAIC Model than under the securities rules.

Because the persons who sell variable annuities are required to be licensed to sell securities as well as insurance, all sales of variable annuities are subject to the more stringent and detailed requirements of Rule 2821. Given the detailed requirements in Rule 2821, and the rigorous supervisory requirements of Rules 3010 and 2821, it is likely that securities regulators will find it easier and will have more grounds for taking disciplinary actions for unsuitable variable annuity sales than insurance regulators will under the NAIC Model.

2. State Suitability Regulation

At least thirty-two states have enacted laws or regulations that mirror the NAIC Model or the original model regulation that applied only to sales to

128. NAIC, Suitability in Annuity Transactions Model Regulation § 4.
129. *Id.* § 6(C).
130. *Id.* § 6(D).

senior citizens.[131] A few states have other laws that generally require a suitable recommendation.[132]

At least three states adopted the essential provisions of the NAIC Model and added a safe harbor when there is compliance with suitability requirements of the NASD rules.[133] Those provisions state that compliance with NASD rules on suitability for recommendations of variable annuities satisfies the requirements for variable annuities under the state regulation. The practical effect of this provision may be essentially to incorporate Rule 2821's requirements for recommendations of variable annuities into state law.

A few states have either enacted their own consumer protection laws regarding the suitability of annuities or have not enacted a specific suitability law. Some states specifically require insurers, agents, and brokers to comply with Rule 2310; others deem the insurer, agent, or broker to be in compliance with the state suitability mandate if they comply with the federal requirements.

California has a regulation that requires brokers and agents who sell variable products (variable life insurance and variable annuity contracts) to have reasonable grounds for believing the recommended contract is suitable for the particular customer.[134] The regulation specifies that a prospective

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131. Ala. Admin. Code r. 482-1-137-.01–.10 (2007); Alaska Admin. Code tit. 3, §§ 26.770–.789 (2007); Ariz. Admin. Code §§ 20-1243–20-1243.06 (2006); 3 Colo. Code Regs. § 702-4-1-11 (2006); Conn. Agencies Regs. § 38a-432a-5 (2005); Ga. Comp. R. & Regs. 120-2-94.06 (2006); Haw. Rev. Stat. § 431:10D-621 (2008); Idaho Code Ann. § 41-1940 (2008); Idaho Admin. Code r. 18.01.09.004–.025 (amended 2008); Ill. Admin. Code tit. 50, §§ 3120.10–.70 (2008); Ind. Code §§ 27-4-9-2–27-4-9-6 (amended 2008); 760 Ind. Admin. Code 1-72-1–1-72-6 (2006); Iowa Code § 507B.4B (2007); Iowa Admin. Code r. 191-15.68(507B)–.73(507B) (2008); Kan. Admin. Regs. § 40-2-14a (2005); 806 Ky. Admin. Regs. 12:120 (2008); La. Admin. Code tit. 37 §§ 117.01–.17 (2008); 02-031 Me. Code R. §§ 1–10 (2007); Md. Code Regs. 31.09.12.01–.08 (2008); 211 Mass. Code Regs. 96.01–.10 (2006); Mich. Admin. Code r. 500.4151–.4165 (2006); Mo. Code Regs. Ann. tit. 20, § 700-1.146 (2008); Mont. Code Ann. § 33-20-802 (2007); Neb. Rev. Stat. §§ 44-8101–44-8107 (2007); N.C. Gen. Stat. Ann. §§ 58-60-155–58-60-180 (West 2008); N.D. Cent. Code § 26.1-24.2 (2007); N.D. Admin. Code 45-02-02-14(2); Ohio Admin. Code 3901:6-13 (2007); Okla. Admin. Code § 365:25-17-7 (2006); 02-030-012 R.I. Code R. § (Weil 2006); Tenn. Comp. R. & Regs. 0780-1-86-.01–.09 (2008); Tex. Ins. Code Ann. §§ 1115.001–.102 (Vernon 2007); Utah Admin. Code r. 590-230-1–590-230-9 (2004); 14 Va. Admin. Code §§ 5-45-10–5-45-50 (2007); W. Va. Code R. §§ 114-11B-1–114-11B-7 (2008); Wis. Stat. § 628.347 (2009).

132. *See* 054-00-082 Ark. Code R. §§ 1–9 (Weil 2004); Conn. Agencies Regs. § 38a-32a-5 (2005); 18-1200-1214 Del. Code Regs. § (Weil 2008); Fla. Stat. Ann. § 627.4554 (2004).

133. Conn. Agencies Regs. § 38a-432a-5 (2008); Iowa Admin. Code r. 191-15.71 (2008); W. Va. Code R. § 114-11B-5 (2009).

134. Cal. Code Regs. tit. 10, § 2534.44 (West 2009); *see also* Cal. Ins. Bulletin 87-3 at 8 (amended Nov. 1, 1992), *available at* http://www.insurance.ca.gov/0250-insurers/0300-insurers/0200-bulletins/bulletin-notices-commiss-opinion/upload/Bulletin_87_3.pdf.

purchaser of a variable annuity for retirement purposes holds the viewpoints and expectations of a "reasonably prudent investor."

Minnesota has a general suitability law that applies to all life insurance, accident and health, long-term care, annuity, and Medicare Supplement product sales.[135] The general standard is similar to the NAIC Model in that the producer must make reasonable inquiries about the customer's situation and must have reasonable grounds for believing that the recommended product is suitable for the customer. The suitability of a recommendation is determined by the "totality of the particular customer's circumstances."[136]

Missouri amended its regulation in 2008. The regulation applies to variable annuities and variable life insurance products but it does not apply to fixed annuities.[137] While somewhat similar to the NAIC Model, the Missouri law requires a producer to make reasonable efforts to obtain more information than suggested by the NAIC Model, including information about the customer's investment time horizon, liquid net worth, and current and anticipated needs for liquidity. The Missouri law also incorporates provisions similar to Rule 2821, including a requirement that certain disclosures about the features of deferred annuity products, including surrender charges and potential tax penalties, be disclosed. Also like Rule 2821, the Missouri law provides that for a transaction to be suitable, there must be a reasonable basis for believing that the customer would benefit from the product and that any underlying subaccount allocations are suitable at the time of purchase. Missouri's suitability law contains a specific section applicable to indexed annuities, which imposes duties and obligations similar to those required for sales and exchanges of deferred variable annuities.

Oregon has a concise regulation that simply contains the essential suitability standard contained in the NAIC Model.[138] The Oregon law does not contain a requirement for insurers to maintain a system of supervision. It purports to apply equally to insurers and producers and it applies to life insurance policies as well as annuities.

New Hampshire has a regulation pertaining to life insurance solicitations that simply states that "reasonable inquiry shall be made by insurers and/or their agents to determine the suitability of any sale to a prospective buyer's insurance and annuity needs and means."[139] The insurance department issued a bulletin in 2007 that explains that "reasonable inquiry"

135. Minn. Stat. § 60K.46(4) (2007).
136. *Id.*
137. Mo. Code Regs. Ann. tit. 20, § 700-1.146 (2008).
138. Or. Admin. R. 836-080-0090 (2008).
139. N.H. Code Admin. R. Ann. Ins. 301.06 (2009).

means that producers must provide insurers with sufficient documentation to establish that a proper suitability inquiry was made.[140] The bulletin clarifies that insurers must have a system for monitoring producers and are prohibited from issuing an annuity or life insurance product unless the insurer receives documentation from the producer that is sufficient to establish there was a proper suitability inquiry.

V. DEVELOPMENTS IN STATE RATE AND FORM FILING REGULATION

State insurance regulators are responding to growing complaints from both insurers and some groups of insureds that state insurance regulation is too fragmented and too slow. The NAIC has sponsored a portfolio of initiatives to revitalize state insurance regulation. The Interstate Insurance Product Regulation Compact (IIPRC) addresses uniformity and redundancy concerns in the product approval filing process by aiming to improve speed-to-market conditions for life insurance, annuity, disability income, and long-term care products through the use of one regulatory body to review new insurance products.[141] The ability to secure approval from a single source for the sale of insurance products in multiple states translates into a more efficient and uniform product approval process than the traditionally fragmented multistate product review system. In June 2008, South Carolina and Louisiana became the thirty-second and thirty-third states, respectively, to join the IIPRC.

Twelve states and the District of Columbia now mandate electronic filing via the System for Electronic Rates and Form Filing (SERFF), but all fifty states and U.S. territories accept e-filing as a method for streamlining and accelerating the process.[142]

A number of states have adopted "speed to market" or competitive rating systems that streamline rate and form regulation and more fully embrace free-market principles. Under flex-rating, insurers may increase or decrease a rate within a "flex band" or range determined by statute or a regulator, without obtaining prior approval from the state insurance commissioner.

In 2003, Louisiana transitioned from prior approval of personal line rates to a ten percent flex-rating band. In June 2007, the state's Insurance Rating Commission was abolished and replaced with a "file and use"

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140. N.H. Ins. Dep't, Bull. INS07-047-AB (May 4, 2007), *available at* http://www.nh.gov/insurance/media/bulletins/lah.htm.

141. NAIC Model Interstate Insurance Product Regulation Compact, *available at* http://www.insurancecompact.org/documents/topics_compact_model.pdf.

142. National Association of Insurance Commissioners, *About SERFF*, *available at* http://www.serff.org/about.htm.

system that allowed insurers to immediately implement new rates.[143] South Carolina quickly followed suit, adopting several elements of a flex-rating system for its personal lines. South Carolina also now follows a "file and use" system, allowing insurers to assume that forms requiring approval but not yet having received or been denied such approval after thirty days are acceptable.[144]

By October 2007, eleven states had adopted flex-band rating systems for property-casualty products to replace the rigid system of price controls.[145] In May 2008, Georgia enacted a flex-rating system for auto insurance lines.[146] Kansas lawmakers recently passed Senate Bill 560, a flex-rating bill that allows insurers to increase property/casualty rates by as much as twelve percent without prior regulatory approval.[147] The bill was based on the NCOIL Flex-Rating Model Act but allows insurers to decrease rates by *any* amount rather than establishing a rate decrease floor.

Between 1995 and 2001 when the state's flex-rating law expired, New York operated under a flex-rating system. New York revived flex-rating with the enactment of A-11693/S-8624, which allows New York auto insurers to adjust rates twice annually by a total of five percent without prior regulatory approval from the New York superintendent of insurance.[148]

Even Massachusetts, where the insurance commissioner has established auto insurance rates for many years, instituted a "managed competition" model for auto insurance in April 2008.[149]

VI. CAPTIVE INSURER REGULATION

Since 2007, thirteen states and the District of Columbia have passed legislation pertaining to the regulation of captive insurance. Of these, five states (Connecticut, Louisiana, Michigan, Missouri, and Nebraska) have signed into law their states' first captive insurance legislation. Meanwhile, nine established states of domicile passed measures to offer captives greater flexibility. Delaware, the District of Columbia, Utah, and Vermont

143. Insurance Information Institute, Inc., *Issues Updates: Rate Regulation Modernization*, July 2008, http://netgoldex.com/media/hottopics/insurance/ratereg/index.htm.

144. S.C. Stat. 38-61-20(B) (2008).

145. John Bykowski, President/CEO, Nat'l Ass'n Mut. Ins. Co., *Testimony Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Financial Services Committee* (Oct. 3, 2007), *available at* http://74.125.47.132/search?q=cache:LR3c2pJpbEcJ:www.house.gov/apps/list/hearing/financialsvcs_dem/htbykowski100307.pdf+John+Bykowski+subcommittee+%22Capital+Markets%22&hl=en&ct=clnk&cd=1&gl=us.

146. S.B. 276, 2008 Reg. Sess. (Ga. 2008).

147. S.B. 560, 2008 Reg. Sess. (Kan. 2008).

148. Assemb. 11693, S. 8624 (N.Y. 2008).

149. Insurance Information Institute, *supra* note 143.

provided for the establishment of special-purpose financial captives to enable captives to facilitate risk securitization transactions in order to access additional sources of capital. Other state bills have included measures that permit branch captives to transact business in a state (Arizona), allow captives to form as limited liability corporations (Hawaii), reduce minimal capital requirements for captives (Montana), enlarge the scope of an insolvency pool to handle captives (Georgia), and expand the type of coverage a captive can transact (South Carolina).

A. *Arizona*

Since 2007, Arizona has passed two bills amending Arizona Revised Statutes, Title 20, Chapter 4, Article 14, governing the state's captive insurance program. House Bill 2294 allows branch or out-of-state captive insurers to transact insurance business.[150] To obtain licensure, branch captives must maintain their principal place of business in Arizona. Other changes in House Bill 2294 include authorizing pure captive insurers to incorporate as limited liability corporations; allowing captive insurers to transact commercial motor vehicle insurance policies; and decreasing, from $1 million to $500,000, the minimum unimpaired paid-in capital and surplus required of a protected cell captive to maintain licensure.

The second set of amendments to Arizona's captive insurer law, House Bill 2081, authorizes captives to offer employment practices liability risk coverage and authorizes branch captives to provide the same line of coverage that is statutorily permissible for pure captives.[151] House Bill 2081 also eliminates the requirement that at least one of the three organizing subscribers of a reciprocal insurer be a resident of Arizona.

B. *Connecticut*

Connecticut's captive insurance legislation, Senate Bill 281, effective January 1, 2009, is modeled on the captive regulation in Vermont, the largest U.S. captive domicile.[152] Senate Bill 281 permits captives licensed and domiciled in Connecticut to transact life insurance, annuity, health insurance, and commercial risk insurance business. In addition, captives can reinsure a parent's or affiliated company's qualified self-insured workers' compensation plan (unless prohibited by federal law) and accept or cede reinsurance according to certain specifications. However, Connecticut captives are prohibited from providing personal lines insurance such as private passenger motor vehicle or homeowner's insurance.

150. H.B. 2294, 48th Leg., 1st Sess. (Ariz. 2007).
151. H.B. 2081, 48th Leg., 2d Sess. (Ariz. 2007).
152. S.B. 281, 2008 Leg., 1st Sess. (Conn. 2008).

C. *Delaware*

House Bill 214,[153] which amended Title 18, Chapter 69 of the Delaware Code pertaining to captive insurance companies, establishes special-purpose financial captives (SPFCs). Insurance risks and associated premiums may be transferred to an SPFC, which has the authority to fund its obligations through capital market transactions. Such securitization typically involves commercial insurance companies using SPFCs to borrow funds from capital market investors to satisfy regulations pertaining to the establishment of reserves for insurance claims. House Bill 214 sets requirements for the treatment of certain assets involved in the insurance securitization transactions of SPFCs for accounting and regulatory purposes.

D. *District of Columbia*

Two changes to captive insurance laws of the District of Columbia enacted in 2006 became effective in 2007. The Captive Insurance Company Amendment Act of 2006 provides for the formation and regulation of protected cell captive insurers.[154] The District of Columbia also enacted legislation authorizing SPFCs. The Special Purpose Financial Captive Authorization Amendment of 2006[155] authorizes the utilization of SPFCs to facilitate securitization transactions.

E. *Georgia*

Effective January 1, 2008, Georgia association and industrial insured captive insurance companies issuing workers' compensation policies may join, contribute, and receive benefits from the Insurers' Insolvency Pool.[156]

F. *Hawaii*

Hawaii is the second-largest captive domicile in the country. House Bill 272,[157] enacted in 2007, allows Hawaiian captive insurance companies to form as limited liability companies (LLCs) and clarifies that LLCs may be parents or owners of Hawaiian captives. In addition, the legislation modifies minimum capital and surplus requirements and provides greater investment flexibility for pure captives, subject to oversight by the insurance commissioner. Finally, House Bill 272 also removes previous requirements that two of three of the organizing subscribers of a reciprocal insurer and at least one member of a captive's board of directors be residents of the state.

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153. H.B. 214, 144th Gen. Ass., 1st Sess. (Del. 2007).
154. Leg. B. 16-0286, 2006 Leg. (D.C. 2006).
155. Leg. B. 16-0285, 2006 Leg. (D.C. 2006).
156. Ga. Code Ann. § 33-41-20.1 (2008).
157. H.B. 272, 2007 Leg., Reg. Sess. (Haw. 2007).

G. *Louisiana*

On June 21, 2008, Louisiana became the newest state captive insurance domicile when Senate Bill 150[158] was signed into law. The bill prohibits captives from directly providing life insurance or annuities, health insurance, title insurance, credit insurance, or personal lines coverages. In addition, captives cannot directly insure workers' compensation or employers' liability coverage except in connection with a self-funded insurance program prescribed in the bill. Furthermore, the bill prohibits a captive from providing reinsurance on risks ceded by any other insurer without approval from the insurance commissioner.

Effective January 1, 2009, Senate Bill 150 requires that a Louisiana captive be incorporated as a stock insurer and maintain its principal place of business in Louisiana.[159] Captives must maintain unimpaired paid-in capital and surplus of at least $1 million in the form of cash, cash equivalents, or bonds or evidences of indebtedness.

H. *Michigan*

In March 2008, Senate Bill 1061 was signed into law creating Michigan's first captive insurance legislation.[160] Senate Bill 1061 adds Chapters 46 (Captive Insurance Companies), 47 (Special Purpose Financial Captives), and 48 (Protected Cell Insurance Companies) to the state's Insurance Code, allowing for the formation of captive insurers and authorizing both captive and domestic insurers to establish protected cells. Michigan captives are authorized to transact any insurance authorized by the Code except workers' compensation, personal automobile, and homeowner's insurance.

Michigan SPFCs can only insure or reinsure those risks insured or reinsured by a counterparty, such as the SPFC's parent or affiliated company or an approved nonaffiliated company.[161] SPFCs can also establish protected cells in order to isolate and identify the assets and liabilities attributable to risks ceded to it by a counterparty, as well as those arising from related insurance securitization. The chapter permits SPFCs to issue securities and provides for its rehabilitation, conservation, or liquidation.

Chapter 48 allows protected cell companies to establish protected cells upon the commissioner's approval of a plan of operation.[162] Such companies

158. S.B. 150, 2008 Leg., Reg. Sess. (La. 2008).
159. *Id.*
160. S.B. 1061, 94th Leg., Reg. Sess. (Mich. 2008). Michigan also enacted Senate Bill 1062, which amends the Michigan Business Tax Act to exempt insurance companies from the 1.25% business tax on gross direct premiums written on property or risk located or residing within the state. S.B. 1062, 94th Leg., Reg. Sess. (Mich. 2008).
161. S.B. 1061.
162. *Id.*

must keep the assets and liabilities of its protected cell separate from those pertaining to its general account and other protected cells. The chapter also limits creditors' access to protected cell assets and provides that those assets cannot be charged with liabilities arising from any other business of the company. Protected cell companies are required to engage in insurance securitization in order to bolster the exposures of its protected cell but do not have to contribute to a guaranty fund.

I. *Missouri*

In July 2007, Senate Bill 215[163] was signed into law and allows for the formation of captive insurance companies in Missouri. Under the new law, a captive can provide insurance and annuity contracts to its parent, affiliated, or controlled unaffiliated companies; reinsure workers' compensation of its parent and affiliated companies; and accept or cede reinsurance. However, a captive cannot provide personal lines coverage.

Additionally, Senate Bill 215 provides for the creation and operation of special-purpose life reinsurance captives (SPLRCs) as a "means of facilitating financing of life insurance reserves, annuity reserves, or accident and health reserves and reinsuring the embedded value of insurance business."[164] SPLRCs may enter into swap agreements, as well as contracts with ceding companies under certain conditions. Like other forms of captives, SPLRCs must maintain minimum surplus requirements. The bill also establishes additional regulations for SPLRCs pertaining to the issuance of securities and the valuing of assets.

J. *Montana*

As a result of the 2007 enactment of Senate Bill 161,[165] Montana now allows pure and branch captives to insure group health plans and health insurance and pure captives to insure "controlled unaffiliated business entities," defined as those entities "not part of the parent's corporate system that have an existing contractual relationship with the parent or its affiliated company." Senate Bill 161 also reduces the minimum capital requirements for captives and protected cell captives.

K. *Nebraska*

As part of Legislative Bill 117[166] signed into law on May 30, 2007, the Captive Insurers Act authorizes a company to create a domestic captive insur-

163. Mo. Comm. on Small Bus., Ins., and Indus. Relations, S.B. 215, 94th Leg., Reg. Sess. (Mo. 2007).
164. *Id.*
165. S.B. 161, 60th Leg., Reg. Sess (Mont. 2007).
166. L.B. 117, 100th Leg., 1st Sess. (Neb. 2007).

ance entity to provide insurance and reinsurance to the parent company, an affiliated entity, or both. Captives may only transact in property, credit property, glass, burglary and theft, boiler and machinery, liability, and marine insurance. In addition, Legislative Bill 117 allows for the creation of SPFCs, limited to providing insurance or reinsurance for a parent or affiliated domestic life insurer. The measure grants these captives the authority to issue securities and enter into contracts, asset management agreements, or other transactions.

L. *South Carolina*

In June 2007, two pieces of legislation were signed into law amending Title 38, Chapter 90, of the Code of Laws of South Carolina, pertaining to captive insurance companies. As part of House Bill 3820, otherwise known as the "Omnibus Coastal Property Insurance Reform Act of 2007," Article 5 was added to Chapter 90 to enact the South Carolina Coastal Captive Insurance Company Act of 2007.[167] This legislation allows for the creation of captives specifically formed to provide wind and storm surge property insurance coverage.[168] Senate Bill 589[169] amends § 110 of Chapter 90, with respect to credit for reinsurance by captives.

M. *Utah*

As part of House Bill 55[170] signed into law on March 18, 2008, the Special Purpose Financial Captive Insurance Company Act authorizes the organization and operation of SPFCs in Utah to facilitate risk securitization transactions and other risk financing structures. The measure restricts an SPFC's insurance operations to reinsurance of a licensed ceding insurer. Sponsored captive insurers may become SPFCs that conduct reinsurance through protected cells.

Additionally, House Bill 55 amends portions of the state's Captive Insurance Companies Act in order to maintain Utah's competitiveness in relation to other state captive domiciles.[171] In particular, the bill allows industrial insured captives to insure the risks of a controlled unaffiliated business of an industrial insured and its affiliates and permits captives to incorporate as limited liability companies.

167. H.B. 3820 § 16, 117th Leg., 1st Sess. (S.C. 2007).
168. *Id.*
169. S.B. 589, 117th Leg., 1st Sess. (S.C. 2007).
170. H.B. 55, 58th Leg., Gen. Sess. (Utah 2008).
171. *Id.*

N. *Vermont*

Vermont is the leading captive domicile state. Vermont's Senate Bill 91,[172] signed into law on May 25, 2007, authorizes the organization and operation of SPFCs and grants SPFCs the authority to facilitate securitization of insurance risks. Under Senate Bill 91, sponsored captives may be licensed as SPFCs and may conduct reinsurance and securitization transactions through protected cells with respect to various ceding insurers. Additionally, Senate Bill 91 makes changes to existing state law, allowing industrial insured captives to insure the controlled affiliate business of an industrial insured or its affiliates and permitting all captives to form as manager-managed limited liability companies.

The following year, Senate Bill 284,[173] effective July 1, 2008, was signed into law to facilitate the merger of captives into existing companies. The bill also clarifies the process by which SPFCs can merge and redefines the terms under which the Insurance Commissioner can supervise their activities in order to ensure their solvency.

172. S.B. 91, 2007–2008 Leg. (Vt. 2007).
173. S.B. 284, 2007–2008 Leg. (Vt. 2008).