

# INSURANCE REGULATION IN THE UNITED STATES: REGULATORY FEDERALISM AND THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

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## I. INTRODUCTION

The states regulate insurance in the United States. The history of insurance regulation, however, has been marked by federal-state tensions and accommodations, and, after more than a century of state dominance, by periodic proposals for federal intervention.<sup>1</sup> Recent proposals to integrate financial services industries<sup>2</sup>—banking, securities, and insurance—have prompted yet another round of debate over the appropriate structure of insurance regulation and the relative merits of federal versus state regulation. Key federal legislators, current state legislators and regulators, and the insurance industry have expressed a commitment to functional regulation of each of the affected industries, as well as the maintenance of the current state regulatory structure in insurance. Public debate, however, seems to be occurring—to the extent it occurs at all<sup>3</sup>—on a superficial level with no real account of or inquiry into the ways in which states

1. See, e.g., Federal Insurance Solvency Act, H.R. 1290, 103d Cong. (1993); H.R. 4900, 102d Cong. (1992) (introduced by Rep. John D. Dingell).

2. The Financial Services Act of 1998, H.R. 10, 105th Cong. (1998), the latest in a series of congressional attempts to modernize the nation's banking and financial services laws, was passed in the House of Representatives on May 13, 1998, by one vote. The House intended for the Act to promote affiliations among commercial banks, securities firms, insurance companies, and other commercial enterprises, thereby enhancing efficiency in the financial services industry and increasing the competitiveness of American providers in the international market. Specifically, the Act would permit securities firms, insurance companies, and financial firms to own or affiliate with a commercial bank by removing restrictions contained in the Glass-Steagall Act of 1933, ch. 89, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C. (1994)), and the Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841-1850 (1994). An April 1998 vote on the Act was postponed when the House Republican leadership realized they could not muster the necessary votes, but the Travelers/Citicorp merger spurred further consideration of the Act. See Mark A. Hoffman, *Megadeal Could Influence Bill; H.R. 10 Would Remove Walls Between Banking, Commerce*, BUS. INS., Apr. 13, 1998, at 26. The Act similarly failed in the 104th Congress. See Dan Lonkevich, *Slim Chance Seen for 94 Financial Services Reform*, NAT'L UNDERWRITER (Prop. & Casualty/Risk & Benefits Mgmt. ed.), May 12, 1997, at 4. The bill has been reintroduced as the Financial Services Act of 1999, H.R. 10, 106th Cong. (1999), and is currently pending before the Committee on Banking and Financial Services. See 145 CONG. REC. D261, D263 (daily ed. Mar. 11, 1999).

With regard to insurance regulation, the Act contemplates continued state-level regulation of insurance, but creates a self-regulating organization, the National Association of Registered Agents and Brokers, charged with establishing uniform licensing requirements for insurance agents and brokers operating on a multistate level. The provisions would take effect three years after the Act's enactment if a majority of the states fail to enact uniform licensing and reciprocity laws and regulations governing the licensure of nonresident entities or individuals. See H.R. 10, §§ 321-23 (1999).

3. The dearth of public debate is not surprising. Insurance regulatory issues are typically complex and generally do not generate public interest. See KENNETH J. MEIER, *THE POLITICAL ECONOMY OF REGULATION: THE CASE OF INSURANCE* 17 (1988) (noting that "[i]nsurance regulation is a widely ignored segment of political economy").

actually accomplish regulation of the industry. This Article attempts to fill that gap.

An initial premise, which will be briefly explained here but not discussed further, is that regulation of the insurance industry is necessary.<sup>4</sup> As the United States Supreme Court has long recognized, insurance is business coupled with a public interest.<sup>5</sup> Consumers invest substantial sums in insurance coverage in advance, but the value of the insurance lies in the future performance of the various contingent obligations. Because the interests protected are so important—including an individual's future ability to provide for dependents in case of death or injury, to retire, to obtain necessary medical treatment, to replace damaged or destroyed property—regulation of the industry furthers public welfare. Related reasons for insurance regulation center on the complexity of insurance and consumers' inability to obtain and understand information about insurance. Consumers are ill-equipped to assess a company's future solvency, to compare the coverage of various policies, or to evaluate a company's claims service. Theoretically, government regulation of insurance eliminates these problems. Regulation can ensure solvency and the insurer's ability to pay claims in the future, standardize policy coverage, require minimum coverage, and require fair claims processing.

An equally important justification for insurance regulation is the prevention of excessive and potentially destructive competition. Because an insurance company's real costs are not known until an insurance policy matures and all claims are paid, the insurance business tends toward extreme competition in pricing. If the insurer's insolvency results, the consequences for the insured and their beneficiaries may be devastating.

A second premise, supported in detail in this Article, is that some level of centralization and uniformity of insurance regulation is essential. Insurance is an increasingly international and interdependent industry. American insurers are consolidating into large national and international businesses. Increasing numbers of non-U.S. insurers are entering the U.S. market, and the reinsurance network on which the national market depends is worldwide. The ability of individual states to monitor this increasingly complex and global enterprise is questionable at best. The history of insurance regulation bears out this point: despite the persistence of the state regulatory system, its history demonstrates an increasing trend toward centralization, uniformity, and cooperation. The National Association of

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4. *But see* BANKS MCDOWELL, DEREGULATION AND COMPETITION IN THE INSURANCE INDUSTRY (1989) (advocating deregulation of the insurance industry); D. Joseph Olson, *It's Time to Rethink Insurance Regulation*, NAT'L UNDERWRITER (Life & Health/Fin. Servs. ed.), June 10, 1996, at 47 (same).

5. *See, e.g.,* German Alliance Ins. Co. v. Lewis, 233 U.S. 389, 411-15 (1914).

Insurance Commissioners (NAIC), a voluntary association of state insurance commissioners, has played an essential role in the process of centralization, expanding upon its initial advisory and model law drafting functions until it resembled a federal agency in many ways.

This Article attempts three basic tasks: (1) to examine the current system of insurance regulation and to identify problems in insurance regulation; (2) to understand why these problems exist; and (3) to suggest ways in which these problems may be resolved. Part II argues that the nature of the insurance business and the role of the NAIC in the system of state insurance regulation demonstrate the necessity of centralization and uniformity in insurance regulation. Part III reinforces that conclusion by tracing the NAIC's pivotal role in the development of insurance regulation over the past century, examining the NAIC's institutional structures and purposes, and focusing on recent regulatory failures and the NAIC's response. Part IV analyzes the reasons for continued state dominance of state insurance regulation in the face of acknowledged regulatory problems, and state-level efforts to resolve those problems through centralization and uniformity.

Part V proposes alternative reforms to the regulatory system, each of which presumes continued preferences for state-level regulation.<sup>6</sup> Although recent Supreme Court decisions have reinvigorated federalism as a constitutional principle, indicating that the federal government lacks constitutional authority to direct the states to act,<sup>7</sup> Congress could indirectly accomplish significant reform of existing, state regulatory standards through other measures including conditional funding<sup>8</sup> or conditional preemption.<sup>9</sup> Alternatively, the states could implement joint reforms through one or more interstate compacts dealing with such national issues. More limited reforms could be accomplished by individual states. Part V also addresses the role of the NAIC under various possible reforms.

The development of appropriate regulatory frameworks for a newly integrated financial services industry must be grounded in an understanding of the present system. The recent history of state insurance regulation indicates that the commitment to continued state regulation of insurance, especially in the context of financial services integration, must be reexamined. This Article concludes that such a commitment to state regulation is only rational if state regulation,

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6. Congress could assert its constitutional power over insurance under the Commerce Clause by repealing the McCarran-Ferguson Act, 15 U.S.C. §§ 1011-15 (1994).

7. See *Printz v. United States*, 521 U.S. 898, 931-35 (1997) (finding the Brady Handgun Violence Protection Act provisions requiring state law enforcement officers to administer portions of the federal act invalid as incursions on state sovereignty).

8. See *New York v. United States*, 505 U.S. 144, 167 (1992); see also *Printz*, 521 U.S. at 936 (O'Connor, J., concurring).

9. See, e.g., *New York*, 505 U.S. at 167-68.

and the role of the NAIC in state regulation, is substantially reconfigured.

## II. STATE REGULATION OF INSURANCE

### A. *State Insurance Departments and Commissioners*

Insurance is unique among financial services in that it is regulated by the states. Largely due to the efforts of the NAIC, the content of insurance regulation evidences strong similarities from state to state. The goals of insurance regulation articulated by most states include fair pricing of insurance, protecting insurance company solvency, preventing unfair practices by insurance companies, and ensuring availability of insurance coverage.<sup>10</sup> For example, all states have the power to approve insurance rates; to periodically conduct financial examinations of insurers; to license companies, agents, and brokers; and to monitor and regulate claims handling.<sup>11</sup>

Each state has a department within the executive branch to regulate insurance. The head of the department is usually called the commissioner or director of insurance. A handful of states elect their insurance commissioner.<sup>12</sup> In the remaining states, the insurance commissioner is appointed by the governor and serves at the governor's pleasure.<sup>13</sup> The insurance department typically has broad, legislatively delegated powers to enforce state insurance laws, promulgate rules and regulations, and conduct hearings to resolve disputed matters. In practice, this power is exercised sparingly, partly because state insurance departments are often significantly underfunded and partly because of political preferences for less regulation.

### B. *The National Association of Insurance Commissioners*

The NAIC is a voluntary association of the insurance commissioners from each of the fifty states, the District of Columbia, and the U.S. territories.<sup>14</sup> Shortly after the 1868 Supreme Court decision in

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10. See generally ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW 22 (2d ed. 1996); Spencer L. Kimball, *The Purpose of Insurance Regulation: A Preliminary Inquiry in the Theory of Insurance Law*, 45 MINN. L. REV. 471 (1961).

11. See, e.g., NAIC MODEL LAWS, REGULATIONS, AND GUIDELINES §§ IV-775-1, IV-780-1 (Property & Casualty Model Rating Law); *id.* § II-390-1 (Model Law on Examinations); *id.* § II-320-1 (Organization and Ownership of New Insurance Companies); *id.* § I-210-1 (Agents & Brokers Licensing Model Act); *id.* § IV-880-1 (Unfair Trade Practices Act); *id.* § IV-900-1 (Unfair Claims Settlement Practices Act).

12. California, Delaware, Florida, Kansas, Louisiana, Mississippi, Montana, North Carolina, North Dakota, Oklahoma, and Washington. See, e.g., DEL. CONST. art. III, § 21; N.C. CONST., art. III, § 7; WASH. REV. CODE § 48.02.010 (1988).

13. See, e.g., COLO. CONST. art. IV, § 23; IOWA CODE ANN. § 505.2 (1997); N.H. REV. STAT. ANN. § 400-A:6 (1992).

14. Insurance supervisory officials in Canada and the Republic of the Philippines are honorary members. See NATIONAL ALLIANCE OF AMERICAN INSURERS, NAIC IN

*Paul v. Virginia*,<sup>15</sup> which established state supremacy over insurance, state regulators formed the NAIC to further what they viewed as necessary uniformity in insurance regulation.<sup>16</sup> The history of the NAIC, from its beginning in 1871 to the present, illuminates the tension between state-level regulation and an acknowledged need for uniformity.<sup>17</sup> The NAIC's central role in the United States system of insurance regulation demonstrates that, for the most part, the states' regulatory apparatus has been unable to function appropriately as individual units because of the complex national and international nature of the insurance industry.

### 1. *Paul v. Virginia: Insurance Is Subject to State Regulation*

Organized regulation of the insurance industry by the states began in the mid-1800s. Faced with the need to supervise a burgeoning industry, several state legislatures created independent administrative agencies to supervise insurance within their borders.<sup>18</sup> As insurance operations extended across state lines, the industry sought federal regulation to avoid burdensome multiple state regulations,<sup>19</sup> preferring what it presumed would be weak federal regulation to sometimes aggressive state oversight.<sup>20</sup>

Hoping to supplant state authority, several New York-based insurance companies hired Samuel Paul to represent them as an agent in Virginia but refused to deposit the licensing bond required by Virginia law.<sup>21</sup> Paul was consequently denied a license to sell insurance.<sup>22</sup> He sold policies, nonetheless, and was convicted of violating

TRANSITION: A DISCUSSION PAPER ON ISSUES FACING THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 1 (1982) [hereinafter NAIC IN TRANSITION].

15. 75 U.S. (8 Wall.) 168 (1868).

16. See NAIC IN TRANSITION, *supra* note 14, at 13 (noting that the NAIC grew out of an 1871 meeting of insurance officials from 30 states).

17. Many capable scholars and historians have documented the history of insurance regulation, and this Article relies on many of them. See generally JOHN G. DAY, DEP'T OF TRANSP., ECONOMIC REGULATION OF INSURANCE IN THE UNITED STATES (1970); SPENCER L. KIMBALL, INSURANCE AND PUBLIC POLICY (1960); KENNETH J. MEIER, THE POLITICAL ECONOMY OF REGULATION: THE CASE OF INSURANCE 49-87 (1988). However, none have adequately chronicled the often central role of the NAIC.

18. New Hampshire was the first of these, establishing the New Hampshire Board of Insurance Commissioners in 1851. A number of other states quickly followed suit. See DAY, *supra* note 17, at 9-10.

19. For discussions of the industry's early efforts to secure federal regulation, see Peter R. Nehemkis, Jr., *Paul v. Virginia: The Need for Re-examination*, 27 GEO. L.J. 519 (1939); Michael D. Rose, *State Regulation of Property and Casualty Insurance Rates*, 28 OHIO ST. L.J. 669 (1967).

20. See Spencer L. Kimball & Ronald N. Boyce, *The Adequacy of State Insurance Rate Regulation: The McCarran-Ferguson Act in Historical Perspective*, 56 MICH. L. REV. 545, 553 (1958).

21. See *Paul v. Virginia*, 75 U.S. (8 Wall.) 169, 169 (1868).

22. See *id.*

the Virginia statute.<sup>23</sup> The Virginia Supreme Court affirmed the conviction, and insurance companies, led by the National Board of Fire Underwriters, used the case to challenge state regulation of insurance in the U.S. Supreme Court.<sup>24</sup> Paul argued that Virginia's laws violated the Privileges and Immunities Clause by requiring additional security for foreign insurers and that the power to regulate insurance resided in the federal government under the Commerce Clause.<sup>25</sup> The Supreme Court held that the insurers were not protected as "citizens" within the meaning of the Privileges and Immunities Clause and that "[i]ssuing a policy of insurance was not a transaction of commerce."<sup>26</sup> Thus, the Supreme Court's decision placed the burden of insurance regulation squarely on the states, to the industry's disappointment. Further efforts also proved unsuccessful: the Supreme Court maintained its position that insurance was not subject to federal oversight,<sup>27</sup> and attempts to amend the Constitution to permit the federal government to regulate insurance failed.<sup>28</sup>

The industry was not alone in its early preference for federal regulation of insurance. Early state regulators believed that the national nature of the insurance business and considerations of efficiency supported federal regulation. Elizur Wright, known as the "Father of Insurance Regulation,"<sup>29</sup> opined that "insurance, being of widespread interest, should be secure against the adverse operation of local causes—that simplicity required a national bureau, and that a state could probably not protect itself as well with reference to insurance of other states as it could be protected by the federal government."<sup>30</sup>

Other state regulators also considered the challenges of regulation by individual states daunting. In 1871 the New York superintendent of insurance, George W. Miller, asked the insurance commissioners in each of the thirty-six states to attend a meeting to discuss insurance regulation.<sup>31</sup> Representatives of nineteen states attended, marking the beginning of what was then known as the National In-

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23. *See id.*

24. *See id.* at 169-70.

25. *See id.* at 177.

26. *Id.* at 183.

27. *See* New York Life Ins. Co. v. Deer Lodge County, 231 U.S. 495, 510 (1913) (citing *Paul* for the proposition that "contracts of insurance are not commerce at all"); *see also* DAY, *supra* note 17, at 15-17 (noting the precedential value of *Paul*).

28. *See* DAY, *supra* note 17, at 16 n.48 (citing S.J. Res. 58, 64th Cong. (1915); S.J. Res. 103, 63d Cong. (1914); H.R.J. Res. 194, 63d Cong. (1914)).

29. Wright earned this title for his efforts to institute regulation in Massachusetts and for his service as the state's commissioner. *See id.* at 52.

30. *Id.*

31. *See id.*

insurance Convention.<sup>32</sup> A contemporary account of the meeting emphasized the need for uniformity in protective regulation:

In a session “remarkable for its harmony,” the commissioners are now “fully prepared to go before their various legislative committees with recommendations for a system of insurance law which shall be the same in all states—not reciprocal, but identical; not retaliatory, but uniform. That repeated consultation and future concert of action will eventuate in the removal of discriminating and oppressive statutes which now disgrace our codes, and that the companies and the public will both be largely benefited, we have no manner of doubt.”<sup>33</sup>

Thirty states attended the next meeting that same year.<sup>34</sup>

## 2. *The Development of State Regulation*

For three-quarters of a century after the Supreme Court decision in *Paul*, state authority over insurance regulation was unquestioned. By the 1940s, state regulation was fairly comprehensive,<sup>35</sup> with the exception of rate regulation. Most states had adopted some form of rate regulation, but its scope and enforcement varied widely.<sup>36</sup> For practical purposes, “insurance rate making was as yet largely uncontrolled in the United States.”<sup>37</sup>

In Missouri, however, the situation was different. Missouri’s superintendent of insurance resisted rate increases and was sued by 139 insurance companies in 137 lawsuits brought to enjoin the prevention of rate increases.<sup>38</sup> The court granted a temporary injunction permitting the increase but required that the difference between the old and new rates be deposited in the court until final disposition.<sup>39</sup> Negotiations took place for several years, and in the late 1930s, the Missouri Superintendent of Insurance, Emmett O’Malley, a member of the Kansas City political machine, negotiated a settlement with the industry in exchange for substantial payoffs from 134 fire insurance companies.<sup>40</sup> The insurers would receive higher future rates and eighty percent of the fund; the state would retain twenty percent.<sup>41</sup>

32. *See id.*

33. NAIC, 1995 NAIC ANNUAL REPORT 1 (1996) (quoting BALTIMORE UNDERWRITER, June 1871).

34. *See DAY, supra note 17*, at 52-53.

35. The states were typically authorized to obtain information from the insurance companies; to monitor reserve levels, asset valuation, and investments; and to oversee policy forms and trade practices. *See KIMBALL, supra note 17*, at 121-28.

36. *See Kimball & Boyce, supra note 20*, at 552.

37. *Id.*

38. *See Franklin H. Elmore, Jr., How Insurance Became Commerce, in READINGS IN PROPERTY AND CASUALTY INSURANCE 497, 500-01 (H. Wayne Snider ed., 1959).*

39. *See id.*

40. *See id.*

41. *See id.*

The Missouri attorney general, Roy McKittrick, filed suit against the companies contributing to the bribe, charging them with conspiracy to defraud the state and the policyholders and later with conspiracy to fix prices and limit competition.<sup>42</sup> Because the conspiracy involved out-of-state insurers acting through multistate rate-making bureaus, McKittrick took the matter to the U.S. Department of Justice.<sup>43</sup>

In late 1942, a grand jury indicted South-Eastern Underwriters Association (SEUA),<sup>44</sup> its officers, and the 198-member companies for violations of the Sherman Act, charging conspiracy to fix rates and the monopolization of trade in fire insurance.<sup>45</sup> The district court, relying on *Paul*, dismissed the indictment.<sup>46</sup> In 1944 the Supreme Court in *United States v. South-Eastern Underwriters Ass'n*<sup>47</sup> reversed its earlier decision in *Paul* and in a four-to-three decision held that insurance is interstate commerce subject to federal regulation under the Commerce Clause.<sup>48</sup>

The decision was viewed as an assault on state regulatory and tax authority over the insurance industry,<sup>49</sup> and the NAIC's response was swift.<sup>50</sup> The NAIC proposed a bill that was introduced with revisions by Senators Pat McCarran (D-Nev.) and Warren Ferguson (R-Mich.), and signed into law by President Franklin Roosevelt on March 9, 1945.<sup>51</sup> The McCarran-Ferguson Act declares that the business of insurance will be subject to state law:

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42. See *id.* at 502.

43. See *id.*

44. SEUA is a cooperative rating bureau composed of stock fire insurance companies in six southeastern states.

45. See Elmore, *supra* note 38, at 510.

46. See *United States v. South-Eastern Underwriters Ass'n*, 51 F. Supp. 712, 715 (N.D. Ga. 1943).

47. 322 U.S. 533 (1944).

48. See *id.* at 552-53.

49. As the Supreme Court noted almost fifty years later, "This result [in *South-Eastern Underwriters*], naturally, was widely perceived as a threat to state power to tax and regulate the insurance industry." *United States Dep't of Treasury v. Fabe*, 508 U.S. 491, 499-500 (1993). Justice Jackson's dissenting opinion in *South-Eastern Underwriters* suggested that the majority decision rendered state taxes on insurance companies unconstitutional. See *South-Eastern Underwriters*, 322 U.S. at 590 (Jackson, J., dissenting). Some insurance companies immediately filed suits challenging state premium taxes, while others paid premium taxes under protest. See Linda M. Lent, *McCarran-Ferguson in Perspective*, 48 INS. COUNS. J. 411, 412 (1981).

50. The industry acted even before the decision in *South-Eastern Underwriters* by backing the Walter-Hancock bill, which was introduced in 1943 to appease the stock fire insurance companies. See H.R. 3270, 78th Cong. (1943). It proposed exempting the insurance industry from the Sherman and Clayton Antitrust Acts. See *id.*; see also 90 CONG. REC. 6565, 8054 (1943) (recording that although both the Senate and the House originally passed the bill, the Senate reconsidered the bill and did not enact it). After its defeat, the NAIC proposed a bill that passed both houses in modified form. See McCarran-Ferguson Act, ch. 20, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011-15 (1994)); see also MEIER, *supra* note 3, at 68-69.

51. See McCarran-Ferguson Act, ch. 20, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011-15 (1994)); see also MEIER, *supra* note 3, at 69. Despite some variations be-

Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.<sup>52</sup>

Under the Act, federal law supersedes state insurance regulation only if it specifically relates to “the business of insurance.”<sup>53</sup> If, however, the states do not regulate the business of insurance, the Sherman and Clayton Acts, as well the Federal Trade Commission Act, still apply.<sup>54</sup>

Again, the NAIC responded quickly. In cooperation with the All-Industry Committee, a group of industry representatives organized by the NAIC, the NAIC drafted model laws to demonstrate that the states were regulating insurance and to preclude federal intervention.<sup>55</sup> By the early 1950s, most of the states had enacted these laws.<sup>56</sup>

### C. NAIC Goals and Functions

This history demonstrates the inconsistent dual commitment to uniformity of regulation and preservation of state regulation. The NAIC’s constitution also reflects this tension. The NAIC’s current constitution, adopted in 1980, articulates the basic goals of insurance regulation—to ensure the solvency of insurers and to protect policyholders—but includes a commitment to the preservation of state regulation and not, incidentally, to the preservation of the NAIC. The constitution provides:

The objective of this body is to serve the public by assisting the several State insurance supervisory officials, individually and collectively, in achieving the following fundamental insurance regulatory objectives:

- (1) Maintenance and improvement of state regulation of insurance in a responsive and efficient manner;
- (2) Reliability of the insurance institution as to financial solidity and guaranty against loss;

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tween the House and Senate versions, final legislation followed the NAIC’s proposal almost exactly. See 1945 NAIC PROCEEDINGS 157-60; see also Lent, *supra* note 49, at 412.

52. 15 U.S.C § 1011 (1994).

53. *Id.* § 1012(b). Congress retains substantial Commerce Clause authority over insurance companies under this formulation.

54. See *id.* § 1012(b).

55. One of the first model laws drafted in response to McCarran-Ferguson was “An Act Relating to Unfair Methods of Competition and Unfair and Deceptive Acts and Practices in the Business of Insurance.” See 1946 NAIC PROCEEDINGS 132-34, 142-48. Generally, derivations of the model law now are known in the states as the Unfair Trade Practices Act. See, e.g., PA. STAT. ANN., tit. 73 §§ 201-207 (West 1993 & Supp. 1997); LA. REV. STAT. ANN. §§ 51:1401-1419 (West 1987 & Supp. 1995); FLA. STAT. §§ 501.201-.213 (1997).

56. See JERRY, *supra* note 10, at 22-23.

(3) Fair, just and equitable treatment of policyholders and claimants.<sup>57</sup>

Prior to the adoption of its new constitution in 1980, the NAIC's stated objectives more clearly indicated its conflicting commitments to both centralized regulation and the preservation of regulation by the states. For more than a century, between its inception in 1871 until the adoption of the 1980 NAIC constitution, the NAIC stated its purposes in this way:

The object of this association shall be to promote uniformity in legislation affecting insurance; to encourage uniformity in departmental rulings under the insurance laws of the several states; to disseminate information of value to insurance supervisory officials in the performance of their duties; to establish ways and means of fully protecting the interest of insurance policyholders of the various states, territories and insular possessions of the United States; and to preserve to the several states the regulation of the business of insurance.<sup>58</sup>

Elsewhere, the NAIC stated a goal of creating a "national" regulatory system.<sup>59</sup>

The tension among the NAIC's various organizational goals is evident: the goal of uniform, nationalized regulation is facially inconsistent with the preservation of autonomous regulation by the states. To preserve state regulation, the NAIC has increasingly assumed a national role, centralizing many basic regulatory functions and operating as a quasi-federal agency by attempting to enforce national standards.

The growth of the NAIC illustrates the states' increasing reliance on the NAIC to regulate what has become a national industry. In 1987 the NAIC's staff numbered about seventy and its budget was approximately \$5.9 million.<sup>60</sup> Its staff currently numbers at least

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57. NAIC CONST. art. II (1980), *reprinted quarterly in* NAIC PROCEEDINGS, at iv; *see also* NAIC IN TRANSITION, *supra* note 14, at 13-14 (summarizing the historical development of NAIC objectives leading up to the adoption of the new constitution in 1980).

58. NAIC IN TRANSITION, *supra* note 14, at 13; *see also* WOODWARD & FONDILLER, INC., NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS: OBJECTIVES, OPERATIONS, AND ORGANIZATIONS 53 (1966) (reporting to the NAIC Subcommittee to Study Reorganization and Public Information Matters and recording the same statement as the NAIC statement of purpose prior to the adoption of its new constitution in 1980).

59. *See Regulation of Ins. Cos. and the Role of the Nat'l Ass'n of Ins. Comm'rs: Hearings Before the Subcomm. on Policy Research and Ins. of the House Comm. on Banking, Fin., and Urban Affairs*, 102d Cong. 122 (1991) (statement of Richard L. Fogel, Assistant Comptroller General, General Accounting Office). The General Accounting Office concluded, however, that the NAIC would fail to reach that goal because it lacked enforcement capability. *See id.*

60. *See id.* app. I.

300,<sup>61</sup> and its budget exceeds \$40 million.<sup>62</sup> Its complex organizational structure demonstrates the breadth and diversity of its tasks. As of April 1998, the NAIC had more than 115 different committees, subcommittees, task forces, and working groups.<sup>63</sup> Its headquarters are located in Kansas City, Missouri,<sup>64</sup> with a specialized office for uniform securities valuation in New York,<sup>65</sup> and an office in Washington, D.C., to deal with legislative and policy issues.<sup>66</sup>

The tasks performed by the NAIC also illustrate the increasing nationalization of insurance regulation. In addition to performing basic regulatory functions itself, the NAIC supports, coordinates, and, on some occasions, even directs state regulators.<sup>67</sup> The NAIC performs centralized duties that mirror those of federal regulators in other industries, including the prescription of standard forms for insurance company annual financial statements,<sup>68</sup> the coordination of

61. As of 1994, the NAIC had a staff of 290 and a budget of \$35 million. See Mark L. Schussel, *Legislators to Ponder Legality of NAIC Program*, BEST'S REV. (Prop./Cas. ed.), Sept. 1994, at 10.

62. See NAIC, 1997 NAIC ANNUAL REPORT 27 (1998). The NAIC's proposed 1998 budget was \$40.55 million. See NAIC: *Proposed Budget Adds New Projects*, BUS. INS., Oct. 6, 1997, at 67.

63. For exhaustive lists of the NAIC committees, subcommittees, tasks forces, and working groups, see NAIC, *1999 Committee List* (visited Mar. 19, 1999) <<http://www.naic.org/1committee/documents/cmtelist.pdf>>.

64. The office is known as the Support and Services Office (SSO).

65. The NAIC's Securities Valuation Office (SVO) values securities held by insurance companies on a uniform basis to facilitate state monitoring of the financial condition of insurers.

66. Through its Washington Counsel Office, the NAIC tracks federal proposals and congressional bills that may affect state regulators, provides state insurance departments with periodic status reports, and formulates policy positions on various issues. See NAIC, *Washington Counsel* (visited Mar. 19, 1999) <<http://www.naic.org/geninfo/about/about12.htm>>.

67. Many commentators conclude that the NAIC performs and does not merely support regulatory functions. For example, the House Committee on Energy and Commerce concluded in a 1994 report that the NAIC's expanded efforts in the early 1990s, including financial analysis, enforcement information, and accreditation functions, changed its role from advisor to "regulatory participant." STAFF OF HOUSE SUBCOMM. ON OVERSIGHT AND INVESTIGATIONS OF THE COMM. ON ENERGY AND COMMERCE, 103D CONG., 2D SESS., WISHFUL THINKING: A WORLDVIEW OF SOLVENCY REGULATION 10 (Comm. Print 1994) [hereinafter WISHFUL THINKING]. A recent *Wall Street Journal* article examining the influence of the industry in insurance regulation stated that "many insurers believed that national regulation was creeping up on them in the unlikely form of the National Association of Insurance Commissioners . . . [which was] armed with its own computer resources and a talented staff that was increasingly tackling consumer-oriented issues." Scot J. Paltrow, *The Converted: How Insurance Firms Beat Back an Effort for Stricter Controls*, WALL ST. J., Feb. 5, 1998, at A1; see also Charles E. Schmidt, Jr., *Under Fire: The NAIC Struggles to Redefine Itself*, BEST'S REV. (Prop./Cas. ed.), June 1, 1995, at 39. New York Superintendent of Insurance Edward J. Muhl commented, "It [the NAIC] has moved from strictly a support function to one that has taken on some regulatory responsibility." *Id.* Similarly, acting Michigan Insurance Commissioner Patrick M. McQueen, referred to the NAIC's "quasi-regulatory role." *Id.* at 35.

68. See NAIC, *The NAIC: A Tradition of Consumer Protection* (visited Mar. 19, 1999) <<http://www.naic.org/geninfo/about/about01.htm>>.

regional financial examinations of insurance companies;<sup>69</sup> the creation and maintenance of an extensive system of national databases to facilitate state monitoring of insurers and insurance agents;<sup>70</sup> the rating of non-U.S. insurers for the states;<sup>71</sup> the periodic review and accreditation of state insurance departments;<sup>72</sup> the drafting of model laws and regulations, many of which have been adopted by state legislatures;<sup>73</sup> the valuation of insurance company invest-

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69. See NAIC, *Accreditation Program: Baseline Standards for Solvency Regulation* (visited Mar. 19, 1999) <<http://www.naic.org/geninfo/about/about08.htm>>.

70. The NAIC maintains a sophisticated insurance financial database for the use of state regulators in monitoring insurance company solvency. Among the systems supported by the NAIC are the Financial Analysis Solvency Tracking System (FAST), the Insurance Company Information System (ICIS), the State Data Network (SDN), and the CD Insurance and Financial Analysis Working Group (FAWG). See Robert W. Klein, *Insurance Regulation in Transition: Structural Change and Regulatory Response in the Insurance Industry* (visited Mar. 19, 1999) <<http://www.naic.org/geninfo/about/regutra3.htm>> (providing information about FAST and FAWG). In addition, the NAIC houses, as a separate business unit, the System for Electronic Rate and Form Filings (SERFF), an electronic rate and form filing system. See NAIC, *Welcome to SERFF* (visited Mar. 19, 1999) <<http://www.serff.org>>. NAIC databases also collect and publish market conduct information. The Insurance Regulatory Information Network (IRIN) was incorporated in October 1996 and operates as a nonprofit affiliate of the NAIC. See NAIC, 1997 NAIC ANNUAL REPORT 11 (1998). IRIN is funded by industry pledges (\$3.1 million for 1997), and its purpose is the development and implementation of the Producer Database (PDB), an electronic database containing information relating to insurance producers, and the Producer Information Network (PIN), an electronic communication network that links state regulators with insurance companies and agents, and permits electronic transmission of licensing, appointment, and termination applications. See *id.* PDB will provide information from state regulatory licensing databases, including producers' names, aliases, dates of birth, addresses, current license information, regulatory actions shown in the NAIC's Regulatory Information Retrieval System (RIRS), information from the National Association of Securities Dealers (NASD), and automatic notice of disciplinary actions and loss of resident licenses. RIRS contains the names of individuals and companies that have been involved in disciplinary or regulatory actions. See NAIC, *Market Information Systems* (visited Mar. 19, 1999) <<http://www.naic.org/geninfo/about/about04b.htm>>. State regulators check RIRS when individuals or companies apply to do business in their state to screen applicants and ensure that violators do not move to new states. The Special Activities Database (SAD) facilitates exchange of information on charges against firms and individuals, investigations by insurance departments or other government investigations, and other unauthorized activities. The Complaints Database System (CDS) consists of complaint data from the NAIC's membership. The Examination Tracking System (ETS) is a central source of insurance company financial examination and market conduct information. See *id.*

71. See NAIC, *International Insurers Department* (visited Jan. 29, 1999) <<http://www.naic.org/geninfo/about/about13.htm>>. The NAIC's International Insurers Department (IID) tracks non-U.S. insurers who want to do business in the United States in the surplus lines or excess lines markets. IID maintains a list of international insurers who meet its standards (minimum capital and surplus requirements, establishment of a trust fund for U.S. policyholders, and filing of annual financial statements). In 14 states, appearance on the IID list is the only way alien insurers can be eligible to write surplus and excess lines. In 21 states, it is only one means by which alien insurers may establish eligibility, while other states simply use it as a criterion in determining eligibility. The IID also acts as the NAIC's liaison with international insurance regulatory bodies. See *id.*

72. See *infra* notes 122-24 and accompanying text.

73. See generally NAIC, NAIC MODEL LAWS, REGULATIONS, AND GUIDELINES (1997). The four volume loose-leaf set contains the numerous NAIC models, brief legislative histories, and information concerning state adoptions.

ments;<sup>74</sup> training of state insurance regulators; the preparation of statistical reports for state regulators; the assistance to state regulators with technical financial analysis; and the assistance to U.S. officials negotiating international trade agreements that concern insurance issues.<sup>75</sup>

In the midst of this expansion of its activities, staff, and funding, the NAIC has suffered something of an identity crisis. In 1995 the NAIC officially defined itself as a private trade organization.<sup>76</sup> Around the same time, Robert M. Willis, District of Columbia insurance commissioner, described the NAIC as a “trade organization” and distinguished his role as a public official from his role as a member of the NAIC.<sup>77</sup> Similarly, in a 1994 opinion, U.S. District Judge Peter Leisure stated that the NAIC was not a government body but “a private trade association composed of government regulators from different states.”<sup>78</sup>

None of these self-definitions squared with the NAIC’s active and central role in the processes of state insurance regulation. In 1995, at the urging of some NAIC members, and in particular James Schacht, acting Illinois insurance commissioner, an NAIC working group prepared a written report discussing the NAIC’s status. The group split over whether the NAIC was “a group of public officials imbued with the public trust” or “an instrumentality of the states.”<sup>79</sup> The membership of the NAIC ultimately concluded that it had characteristics of both.<sup>80</sup> Schacht stated, “At least we know we are not a trade organization.”<sup>81</sup>

Regardless of the NAIC’s difficulties defining itself, it is clear that the NAIC is a private rather than a governmental entity. This status carries two important implications: first, the NAIC has no power to compel the states or the industry, and second, the NAIC is a com-

74. See NAIC, *The NAIC Story* (visited Mar. 19, 1999) <[http://www.naic.org/products/publicat/naic.htm#naic\\_story](http://www.naic.org/products/publicat/naic.htm#naic_story)>.

75. See NAIC, *Continuing Education for Regulators* (visited Mar. 19, 1999) <<http://www.naic.org/geninfo/about/about07.htm>>; NAIC, *Research Division & Library* (visited Mar. 19, 1999) <<http://www.naic.org/geninfo/about/about06.htm>>; NAIC, *Financial Services: Financial Services Aids State Examiners* (visited Mar. 19, 1999) <<http://www.naic.org/geninfo/about/about09.htm>>.

76. In a 1995 joint meeting of the NAIC and NCOIL, NAIC general counsel Susan Martin stated that the NAIC was as a private trade organization. See L.H. Otis, *Just What Is the NAIC? Legal Status Up for Grabs*, NAT’L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), May 22, 1995, at 1; *Oversight of Public Funds Pits Lawmakers, NAIC*, NAT’L UNDERWRITER (Life & Health/Fin. Servs. ed.), Apr. 10, 1995, at 8.

77. *NAIC Adopts Open Meeting Parameters*, INS. REGULATOR, Sept. 26, 1994, at 8.

78. *Preferred Physicians Mut. Risk Retention Group v. Cuomo*, 865 F. Supp. 1057, 1072 (S.D.N.Y. 1994), *vacated*, *Preferred Physicians Mut. Risk Retention Group v. Pataki*, 85 F.3d. 913 (2d. Cir. 1996).

79. L.H. Otis, *NAIC Votes to Open Highest Level Meetings*, NAT’L UNDERWRITER (Life & Health/Fin. Servs. ed.), June 12, 1995, at 3.

80. See *id.*

81. *Id.*

pletely self-governing entity, neither accountable to voters nor subject to government oversight. Thus, although the NAIC has assumed a central and national role in insurance regulation, acting in many ways as a federal agency, it cannot sanction regulators or insurers, and it is not subject to various mechanisms designed to ensure fair and open regulatory policy making and processes, including the Administrative Procedure Act of 1966,<sup>82</sup> the Federal Advisory Committee Act,<sup>83</sup> the Freedom of Information Act (FOIA),<sup>84</sup> the Government in the Sunshine Act,<sup>85</sup> the Paperwork Reduction Act of 1980,<sup>86</sup> or the state law analogues.

As a result, the NAIC is closely identified with the insurance industry. Capture of regulatory agencies by the regulated industry is a much-described and much-discussed phenomenon.<sup>87</sup> However, the problem of capture as it exists in other regulatory contexts is minimal when compared to the problem in the insurance industry. The industry directly funds the NAIC. Each year the NAIC assesses insurance companies a fee, based on premium volume, to file information in its centralized databases. In recent years, database fees account for approximately half of the NAIC's revenues.<sup>88</sup> In contrast, state assessments account for less than five percent of revenues.<sup>89</sup> As a result, members of the industry view the NAIC as part of the in-

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82. Pub. L. No. 89-554, 80 Stat. 381 (codified as amended in scattered sections of 5 U.S.C. (1994)).

83. 5 U.S.C. app. II, §§ 1-15 (1994 & Supp. III 1997).

84. 5 U.S.C. § 552 (1994 & Supp. II 1996).

85. *Id.* § 552(b).

86. 44 U.S.C. §§ 3501-20 (1994 & Supp. I 1995).

87. See, e.g., William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861 (1995) (analyzing the state of securities regulation, applying capture theory analysis, and exploring corporate law reforms for encouraging shareholder initiative); Matthew L. Spitzer, *Antitrust Federalism and Rational Choice Political Economy: A Critique of Capture Theory*, 61 S. CAL. L. REV. 1293 (1988) (critiquing the use of capture theory as applied to the state action doctrine); John Shepard Wiley, Jr., *A Capture Theory of Antitrust Federalism*, 99 HARV. L. REV. 713 (1986) (arguing that the threat of capture erodes confidence in regulation and proposing a more efficient application of federal antitrust law).

88. Consumer groups have recently warned state governors of the threats to state regulation that accompany industry funding of the NAIC. Ralph Nader, Mary Griffin of the Consumers Union, J. Robert Hunter of the Consumer Federation of America, and E. Mierzwinski of the U.S. Public Interest Groups wrote the governors to warn that "[d]ue to the overwhelming and pervasive influence of the insurance industry in the activities of the NAIC, consumers and the public are not being served in the current system of state regulation." *Consumer Groups Warn Governors of "Breakdown of Regulation,"* FED. & STATE INS. WEEK, Mar. 9, 1998, at 1.

89. In 1995 the NAIC's total revenues were \$38,371,170. Database fees generated \$17,349,275, and \$1,282,186 came from state assessments. See NAIC, 1995 NAIC ANNUAL REPORT 16 (1996). In 1996 database fees of \$17,902,826 again accounted for almost half of the NAIC's total revenues of \$38,641,556; state assessments totaled \$1,356,171. See NAIC, 1996 NAIC ANNUAL REPORT 24 (1997). Database fees in 1997 totaled \$19,308,058 and state assessments only \$1,423,292 of the NAIC's total revenues of \$42,977,235. See NAIC, 1997 NAIC ANNUAL REPORT 27 (1998).

dustry<sup>90</sup> and accountable to the industry. Furthermore, much of the NAIC's work often appears to be in direct response to the industry.<sup>91</sup>

### III. THE NAIC'S ROLE IN CONTINUING STATE REGULATION: INSOLVENCIES AND THE ACCREDITATION CONTROVERSY

The NAIC has made continued state regulation possible by attempting to nationalize aspects of insurance regulation in response to threats of federal intervention. The *South-Eastern Underwriters Ass'n* crisis<sup>92</sup> exemplifies a recurring pattern of regulatory behavior: a crisis precipitates threatened federal intervention, and in response to such threats, the NAIC, working with the industry, proposes, but only partially accomplishes, a program of centralized reform.

The NAIC's attempts to accomplish regulatory reform through accreditation of state insurance departments is a notable recent example. Following large scale insurer insolvencies in the 1980s and threatened federal regulation of the insurance industry, the NAIC instituted a new accreditation program for state insurance departments. By requiring minimum regulatory standards and procedures

90. Spencer L. Kimball, writing in the late 1960s, observed:

The insurance regulator is conceived by far too many insurance executives, and too often he conceives himself, as a part of the industry, existing to serve the industry. Indeed, I have heard life insurance men express the notion that it would be useful to have a national regulator to "represent" the industry in the executive branch of the national government. Nothing unsavory was intended—whatever else one may say about the insurance business, it is a business run by honorable men. However, the notion that a regulator should "represent" the industry is a subtly corrupted point of view.

Spencer Kimball, *The Case for State Regulation of Insurance*, in INSURANCE, GOVERNMENT, AND SOCIAL POLICY: STUDIES IN INSURANCE REGULATION 411, 432 (Spencer L. Kimball & Herbert S. Denerberg eds., 1969).

Although the notion that a regulator should represent the industry may be a "subtly corrupted" perspective, it is also a troubling common one. See *id.* Banks McDowell states in a recent book that "[o]rganizations of insurance commissioners . . . can also serve as spokespersons for the industry, to either the public or the legislature, without appearing as clearly self-interested as official industry representatives would." BANKS MCDOWELL, *THE CRISIS IN INSURANCE REGULATION* 586 (1994); see also Sara Marley, *Insurers, Legislators Criticize NAIC's Practices*, BUS. INS., May 30, 1994, at 3 ("We can do a better job locally for companies than someone in Washington." (quoting Texas Rep. David Counts)).

Members of the industry also view the NAIC as part of the industry and answerable to the industry. Eric Gustafson, a member of the NAIC industry liaison group recently created by the NAIC to give members of the industry an opportunity to participate in high level policy discussions, representing his employer, the Blake Agency, and the Independent Insurance Agents of America, commented recently that the industry "never had a problem getting our issues addressed by the NAIC . . . I view regulators as part of the industry. I don't view it as a separate entity." L.H. Otis, *NAIC Considers Reengineering Proposals*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), Mar. 31, 1997, at 5. Roy Woodall, an ALCI attorney, views the industry as the NAIC's "foremost constituency." *New NAIC Panel Raises Questions of Influence*, BEST'S INS. NEWS, Feb. 24, 1997, available in 1997 WL 7077380.

91. See *infra* text accompanying notes 301-21.

92. See *supra* Part II.B.2.

as a condition of accreditation, the NAIC attempted to improve state regulation and avoid federal regulation.

The NAIC's attempted reforms were not adequate to address the problems of inadequate and ineffective state solvency regulation for two reasons. First, the NAIC is a voluntary organization of state insurance commissioners and has no power to force state reform. Second, the NAIC, as a private, nongovernmental entity funded largely by the insurance industry, is highly susceptible to industry influence. The industry, through various means, circumscribed the NAIC's ability to accomplish significant reform, limiting the scope of solvency regulation and preventing essential market conduct regulation.<sup>93</sup>

The NAIC's second goal of evading federal takeover was realized, but not through the NAIC's efforts. Rather, Democrat would-be reformers lost power with the 1994 Republican victories in Congress, and concerns over states' rights and deregulation eliminated any possibility of federalized insurance regulation.<sup>94</sup>

Ironically, the NAIC's failures to achieve centralized regulatory control are also its successes. Excessive centralization of regulatory standards and functions undercuts state regulatory dominance. Despite its efforts to accomplish centralization, the NAIC is ultimately an organization controlled and limited by the states and by the industry. The NAIC has maintained a delicate balance by proposing various reforms toward centralization, but it only partially accomplishing them. Thus, the NAIC achieves sufficient uniformity to head off threats of federal control without unduly sacrificing state regulatory primacy. In the early days of insurance regulation, the NAIC's standardizing role substituted for the national government. In the recent past, states have preserved their regulatory dominance by ceding some measure of autonomy to the NAIC—a collection of state officials—in lieu of the federal government. When the threat of federal intervention recedes, the states tend to reclaim their authority.

#### A. *Congressional Criticism of the State Regulation of Insurance*

The controversies surrounding the spate of insurer insolvencies in the 1980s mirror the pattern of controversy and promises of reform

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93. Market conduct refers to sales and claims practices. The focus of much insurance regulation, and the bulk of the NAIC's efforts, has been financial regulation. This Article argues that market conduct regulation is a necessary part of ensuring solvency.

94. Representative John D. Dingell (D-Mich.), the foremost proponent of federal regulation of insurance, lost the influential chairmanship of the House Committee on Energy and Commerce. See Thomas J. Bliley, Jr., *A Folksy Legislator with Power Over Industries*, N.Y. TIMES, Dec. 20, 1994, at D1. Senator Howard Metzenbaum (D-Ohio), who championed federal insurance regulation in the Senate, did not seek reelection in 1994. See Stephanie Nall, *EU Ruling Against TAA Could Boost Anti-Conference Bill, Supporters Say*, J. COM., Jan. 13, 1994, at A8.

that surrounded *South-Eastern Underwriters* and McCarran-Ferguson and illustrate the substantial problems with state insurance regulation and the NAIC's role. In the late 1980s, a series of large property and casualty insurer failures<sup>95</sup> prompted congressional criticism of state regulation of insurance and congressional proposals for federal takeover of insurance regulation. Thereafter, the U.S. General Accounting Office (GAO) produced a series of investigative reports,<sup>96</sup> and the House Energy and Commerce Committee's Subcommittee on Oversight and Investigations conducted numerous hearings.<sup>97</sup> These efforts are illustrated in a sharply critical report entitled *Failed Promises: Insurance Company Insolvencies*.<sup>98</sup> According to the report, both insurance companies and regulators were to blame for insolvencies:

[The] many similarities and common elements among the insolvent companies . . . included rapid expansion, overreliance on managing general agents, extensive and complex reinsurance arrangements, excessive underpricing, reserve problems, false reports, reckless management, gross incompetence, fraudulent activity, greed, and self-dealing. There were also similar failures of state regulators and independent audit firms to identify and correct such problems before they got out of control.<sup>99</sup>

Congress criticized many specific state regulatory practices. State solvency regulators relied on annual financial statements filed by insurers and periodic field examinations. Most states did not require independent verification of annual statements,<sup>100</sup> field examinations

95. The Mission Insurance Company, Integrity Insurance Company, Transit Casualty Company, and Anglo-American Insurance Company. For a description of the crisis, see TAX POLICY WORKING GROUP, U.S. DEP'T OF JUSTICE, REPORT OF TAX POLICY WORKING GROUP ON THE CAUSES, EXTENT, AND POLICY IMPLICATIONS OF THE CURRENT CRISIS IN INSURANCE AVAILABILITY AND AFFORDABILITY (1986), and George L. Priest, *The Current Insurance Crisis and Modern Tax Law*, 76 YALE L.J. 1521 (1987). For additional discussion, see Kyle D. Lague, *Toward a Tax-Based Explanation of the Liability Insurance Crisis*, 82 VA. L. REV. 895 (1996).

96. See General Accounting Office, GAO/GGD-91-92, *Insurance Regulation: State Handling of Financially Troubled Property/Casualty Insurers* (May 1991) (Report to the Chairperson, H.R. Subcomm. on Commerce, Consumer Protection, and Competitiveness, Comm. on Energy and Commerce) [hereinafter *State Handling*].

97. *Insurance Regulation: Assessment of the National Association of the Insurance Commissioners: Hearings Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce*, 101st Cong. (1991) [hereinafter *NAIC Assessment*]; General Accounting Office, GAO/GGD-89-129, *Insurance Regulation: Problems in State Monitoring of Property/Casualty Insurer Solvency* (Sept. 1989) (Report to the Chairperson, H.R. Subcomm. on Commerce, Consumer Protection, and Competitiveness, Comm. on Energy and Commerce) [hereinafter *Problems in State Monitoring*].

98. STAFF OF THE H.R. SUBCOMM. ON OVERSIGHT AND INVESTIGATIONS OF THE COMM. ON ENERGY AND COMMERCE, 101ST CONG., 2D SESS., *FAILED PROMISES: INSURANCE COMPANY INSOLVENCIES* (Comm. Print 1990) [hereinafter *FAILED PROMISES*].

99. *Id.* at 2.

100. See *State Handling*, *supra* note 96, at 27.

occurred only every three to five years,<sup>101</sup> and some states did not conduct mandatory field examinations at all.<sup>102</sup> Regulators limited the scope of examinations to the company actually licensed by the state and excluded oversight of managing general agents, holding companies, and affiliated entities.<sup>103</sup> Furthermore, most states did not require actuarial certification of loss reserves.<sup>104</sup> One-half of the states did not have actuaries participating in field examinations.<sup>105</sup> The NAIC's Insurance Regulatory Information System (IRIS), designed to assist the states in monitoring solvency, failed to eliminate these problems because it also relied on the use of unaudited annual statement information.<sup>106</sup> Time lags in getting financial information contributed to the problems. Regulators had no means of detecting financial difficulties occurring early in a calendar year until well into the next calendar year.<sup>107</sup> Many state insurance departments lacked adequate funding to conduct solvency examinations; state governments allocated only an average of 0.063% of their total budgets to regulating insurance and utilized only an average of 5.37% of premium taxes received from insurance companies to regulate insurance.<sup>108</sup>

Congressional investigators also identified state laws on insurance company licensing and initial capital requirements as seriously deficient. Capital and surplus requirements were very low, bearing no relationship to the risks underwritten by an insurance company.<sup>109</sup> Background checks of those applying for licenses were inadequate in many states and nonexistent in others.<sup>110</sup> Typically, state commissions did not verify information of applications and only checked their own records for insurance violations.<sup>111</sup> Failures to enforce regulations also contributed to insurance company insolvencies.<sup>112</sup> According to the congressional reports, state regulators generally did not punish violators of state insurance laws and regulations. They were lax in prosecuting insurance violations, "perhaps because such cases were difficult to document and prove."<sup>113</sup>

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101. See *id.* at 28.
  102. See *Problems in State Monitoring*, *supra* note 97, at 14-15.
  103. See *NAIC Assessment*, *supra* note 97, at 21-22.
  104. See *Problems in State Monitoring*, *supra* note 97, at 16-17.
  105. See *id.* at 17.
  106. See *NAIC Assessment*, *supra* note 97, at 13, 15-16; see also *Problems in State Monitoring*, *supra* note 97, at 17-19.
  107. See *Problems in State Monitoring*, *supra* note 97, at 13-14.
  108. See *id.* at 20-21.
  109. See *FAILED PROMISES*, *supra* note 98, at 57.
  110. See *id.* at 57-58.
  111. See *id.*
  112. See *id.* at 61-62.
  113. *Id.*

These efforts led to the introduction of H.R. 4900, the Federal Insurance Solvency Act of 1992,<sup>114</sup> and a similar bill, H.R. 1290, the Federal Insurance Solvency Act of 1993,<sup>115</sup> by Representative John D. Dingell (D-Mich.), former Chair of the House Committee on Energy and Commerce. The Federal Insurance Solvency Act of 1993 would have created a system of dual regulation under which the federal government would have assumed control of some regulatory functions and shared others. The Act would have established a five-member Federal Insurance Solvency Commission (FISC) appointed by the President with the advice and consent of the Senate. Its duties would have included establishment of national, preemptive solvency standards for insurers and reinsurers involved in interstate commerce.<sup>116</sup> FISC would also have monitored and regulated federally certified insurers,<sup>117</sup> including rehabilitation and liquidation of financially impaired insurers where necessary.<sup>118</sup> In addition, the Act would have created two nongovernmental, nonprofit corporations: the National Insurance Protection Corporation (NIPC) to protect policyholders in the event of a certified insurer's financial impairment or insolvency,<sup>119</sup> and the National Association of Registered Agents and Brokers (NARAB).<sup>120</sup> The states would have continued to regulate rates, policy forms, market conduct, residual markets, insurance producers, and corporate structure and organization.<sup>121</sup>

### B. NAIC Response: The Accreditation Program

In response to these federal criticisms and initiatives, the NAIC initiated its Financial Regulation Standards and Accreditation Program (FRSAP).<sup>122</sup> In June 1989 the NAIC adopted a set of financial regulation standards for state insurance departments, which identified model laws and regulations, and regulatory, personnel, and organizational processes and practices necessary for effective solvency

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114. H.R. 4900, 102d Cong. (1992).

115. H.R. 1290, 103d Cong. (1993).

116. *See id.* § 201 (recording national standards for the financial condition of insurers in interstate commerce and federal certificates of solvency for insurers); *id.* § 301 (providing for federal certificates for reinsurance).

117. *See id.* § 102(1)-(11). Insurance companies that met specified financial criteria could obtain federal certificates of solvency from FISC and be regulated under federal standards. *See id.* § 201. FISC would provide national standards for state application to uncertified insurers. *See id.* § 207.

118. *See id.* §§ 701-729.

119. *See id.* § 502.

120. *See id.* § 601.

121. *See id.* § 207.

122. *See* 1992 NAIC PROCEEDINGS I, Dec. 9-12, 1991, at 6 ("I feel that the only way we're going to succeed in staving off the federal regulation is with strong insurance departments." (quoting Ohio Insurance Commissioner Harold Duryee)).

regulation.<sup>123</sup> In June of the following year, the NAIC instituted its accreditation program with the articulated purposes of improving solvency regulation and financial examinations by individual state regulators and creating consistency of solvency regulation among the states.<sup>124</sup>

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123. See 1989 NAIC PROCEEDINGS II, June 4-8, 1989, at 33-36 (recording NAIC Policy Statement of Financial Regulation Standards). The standards were substantial. Recommendations for the laws and regulations of state insurance departments included: authority to examine companies whenever necessary, including access to the company's books and records as well as those of any affiliated company, agent, or managing general agent, and to its officers, employees, and agents; authority to require minimum levels of capital and surplus; use of the NAIC annual statement blank by all companies for the department, prepared in accordance with the NAIC's Accounting Practices and Procedures Manual; valuation of securities and other assets owned by insurance companies in accordance with the standards promulgated by the NAIC's Securities Valuation Office and the procedures promulgated by the NAIC's Financial Condition Subcommittee; prescription of the maximum net amount of risk to be retained by a property liability company for an individual risk at no more than 10% of the company's capital and surplus; requirement of a diversified investment portfolio for domestic and foreign companies; statutory prescription of assets which may be allowed in statutory financial statements; statutory prescription of minimum standards for the establishment of liabilities and reserves; required annual audits of domestic insurance companies by independent certified public accountants; required annual actuarial opinions on loss and loss adjustment expense for domestic property and casualty insurers; statutory prescription of a mechanism to ensure payment of policyholder obligations; and new NAIC model laws and regulations or substantially similar laws, including: Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to Be in Hazardous Financial Condition, Model Insurance Holding Company System Regulatory Act and accompanying model regulation, Model Law on Credit for Reinsurance, Insurers Rehabilitation, and Liquidation Model Act, NAIC model requiring domestic insurance companies to participate in the NAIC Insurance Regulatory Information System (IRIS), Model Risk Retention Act, and Business Transacted with Producer Controlled Property/Casualty Insurer Act. See *id.*

Recommended regulatory practices and procedures included: a sufficient staff of capable financial analysts; intradepartmental communication and reporting systems to ensure relevant information is received by the financial analysis staff; priority-based financial analysis procedures to ensure that potential problem companies receive prompt review utilizing IRIS or the state's own system; sufficient resources to examine all domestic insurers by a staff of various specialists and department supervisors; use of policies and procedures outlined in the NAIC's Examiners Handbook; timely scheduling of periodic examinations with priority to potential problem companies; timely submission of adverse examination reports to the commissioner for determination of appropriate regulatory action; and sharing of reports with other states. See *id.*

With regard to organizational and personnel practices, the NAIC recommendations included professional development requirements; periodic evaluation of staff; minimum education and experience requirements for professional employees, financial surveillance staff, and regulation staff; and pay structures designed to attract and retain qualified personnel. See *id.*

124. The mission statement of the FRSAP, adopted in 1995, provided:

The NAIC's Financial Regulation Standards and Accreditation Program seeks cooperation among state officials to maintain a high level of merited confidence in solvency regulation in each state. The goals to achieve this objective are as follows:

- (1) Clearly define standards for solvency regulation of multistate domestic insurers which each state utilized in regulating the business of insurance;
- (2) Assure that accreditation standards are applied consistently and fairly;

In its early stages, the process of accreditation involved inspection of a state insurance department by an accreditation team consisting of individuals knowledgeable about insurance and insurance regulation who had no association with the department under review. The inspection included review of laws and regulations, financial examination reports, and organizational and personnel policies, as well as interviews with department personnel regarding implementation of laws and regulations. The accreditation team reported its assessment of the department's compliance with the accreditation standards to the NAIC Committee on Financial Regulation Standards and Accreditation (composed of state insurance commissioners), who voted on the state's accreditation. Full certification review was to be required every five years, as well as an annual desk audit.

### 1. *Criticism of the Accreditation Process*

Although the accreditation standards addressed many of the concerns articulated by critics of state solvency regulation, such as requiring independently audited financial examinations and annual regulatory examinations, with priority to troubled companies, they fell short in the view of many. Criticisms focused on several areas: the lack of specificity in the standards, the absence of market conduct standards, deficiencies in the accreditation review process, and the inability of the NAIC to force compliance with the standards.

A basic criticism leveled against the standards was their lack of specificity. Several examples will illustrate. The NAIC standards specified sufficient resources to conduct necessary financial examinations,<sup>125</sup> but did not specify what would qualify as sufficient. In contrast, accreditation standards that were suggested by the Consumer Insurance Interest Group (CIIG) and the National Association of Professional Insurance Agents (PIA National) specified a minimum of ten percent of premium taxes for insurance department funding.<sup>126</sup>

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(3) Provide periodic review by Members of the NAIC of the accreditation process and the standards to assure that Mission is being achieved;

(4) Inform legislators and other state officials about the purpose of and need for the standards and include them in the process;

(5) Maintain an independent audit team for review of a state insurance department at a state's invitation.

NAIC, 1995 NAIC ANNUAL REPORT 12 (1996) [hereinafter 1995 MISSION STATEMENT].

125. *See id.*

126. 1989 NAIC PROCEEDINGS II, June 4-8, 1989, at 28 (recording a CIIG and PIA National report). The report cited average insurance regulatory budgets of six percent of premium taxes and concluded that "[m]ost state insurance departments cannot function adequately without spending a minimum of ten percent of premium taxes." *Id.* The Risk Insurance Management Society (RIMS) was also cited in the report as recommending funding levels of 25% of premium taxes. *See id.*

In addition to the specific recommendations highlighted in the text, the report called for the development of procedures for sharing information with other states and the NAIC; the

The NAIC's capital and surplus standard stated that departments should have the ability to require minimum levels of capital and surplus but did not specify what those minimums should be.<sup>127</sup> Similarly, standards requiring adoption of model laws allowed the states to substitute "substantially similar" laws.<sup>128</sup>

The accreditation program was also deficient in its failure to specify standards for market conduct regulation. From the outset of the NAIC's accreditation program, and even before, regulators discussed and proposed market conduct standards for accreditation. It is clear that market conduct affects an insurer's bottom line. Some years ago, A.M. Best (for many years the principal rating agency for property and liability, as well as life insurers) identified market conduct as a rating issue, recognizing that market conduct affects an insurer's financial position.<sup>129</sup> A draft NAIC White Paper, unanimously adopted for publication by the NAIC Market Conduct and Consumer Affairs Subcommittee in June 1991, articulated the belief that market conduct regulation was essential to ensure the solvency of insurance companies.<sup>130</sup> The White Paper called for extensive accreditation standards, including the adoption of fourteen NAIC model acts or comparable provisions;<sup>131</sup> substantial market conduct examination procedures; extensive consumer services; sufficient staff and resources for monitoring of policy language, forms, and rates, as well as for agent licensing and discipline; participation in the NAIC Regulatory Information Retrieval System (RIRS) and the NAIC Special Activities Database; and staffing and personnel requirements similar to

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coordination of state solvency regulation and market conduct oversight; the identification of triggers for financial and market conduct examinations; the development of complaint ratios for various lines of insurance, standards for length of insurance claims processing, written procedures for handling consumer complaints; and the maintenance and reporting of complaint data to the NAIC. The report also recommended the prohibition of state commissioners from working for insurance companies within one year after leaving the insurance department to avoid potential or perceived conflicts of interest.

127. See *id.*

128. See *id.*

129. See Larry G. Mazewski et al., *Market Conduct Emerges as Rating Issue*, BEST'S REV. (Prop./Cas. ed.), Nov. 1995, at 29.

130. See *Performance (Market Conduct) Regulation Standards and Accreditation Program of the NAIC*, reprinted in 1991 NAIC PROCEEDINGS IIA, June 9-13, 1991, at 232 (Attachment I) [hereinafter *Performance Regulation Standards*].

131. These provisions included the Unfair Trade Practices Act, Unfair Claims Settlement Practices Act, Life and Health Unfair Claims Settlement Practices Regulation, Property and Casualty Unfair Claims Settlement Practices Regulation, Agents and Brokers Licensing Act or the Single License Procedure Act, Long-Term Care Insurance Act and Regulation, Medicare Supplement and Minimum Standards Act and Regulation, Rules Governing the Advertising of Life Insurance, Rules Governing the Advertising of Medicare Supplement Insurance, Health Maintenance Organization Act, Jurisdiction to Determine Jurisdiction of Health Care Providers Act, Immunity Act, Credit Life and Credit Accident and Health Insurance Act, and Third Party Administrator Act. See *id.* at 234. Additional standards were later suggested. See 1992 NAIC PROCEEDINGS I, Dec. 9-12, 1991, at 224.

those in the Financial Regulation Standards.<sup>132</sup> None of these were adopted.

The accreditation review process was also a target of criticism. The GAO criticized the process for its lack of documentation and procedural requirements.<sup>133</sup> For example, in 1990 the accreditation teams sent to Florida and New York produced review reports consisting of only one-half page and recommended accreditation "based on this evaluation effort and the knowledge and experience of the evaluation team."<sup>134</sup> Neither report documented the team's findings or recommendations. The GAO also criticized the NAIC's accreditation of numerous states: South Carolina, alleging that it occurred primarily "on the basis of discussions with state regulatory personnel about how they intended to use the new authority and how they might have used it in the past had it been available;" Wisconsin, alleging that it had not examined certain insurers for eight to ten years and had not adopted required standards for companies in hazardous financial condition; Iowa, which had insufficient staff in 1991 to review all of the annual statements it received; Ohio, which lacked specialists to review actuarial analyses and reinsurance; and Kansas, which had no expertise in casualty actuarial or computer audits, among others.<sup>135</sup> Finally, the GAO questioned the accreditation teams' abilities to assess implementation of regulations quickly adopted for purposes of accreditation, citing the example of Florida when the Department of Insurance adopted required regulations weeks before the accreditation review through emergency rulemaking procedures.<sup>136</sup>

Perhaps the most serious deficiency noted by critics of the accreditation program was the NAIC's inability to force states to participate. The NAIC had no institutional ability to force states to seek accreditation, to monitor compliance with Financial Regulation Standards outside of the accreditation and reaccreditation process, or to impose penalties or sanctions of any sort for failure to comply. In an attempt to remedy these defects, the NAIC implemented an indirect enforcement mechanism. In 1991 it adopted as an accreditation standard a new model law, the Model Law on Examinations.<sup>137</sup>

In lieu of an examination under this Act of any foreign or alien insurer licensed in this State, the Commissioner may accept an examination report on the company as prepared by the Insurance

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132. See *Performance Regulation Standards*, *supra* note 130, at 234-35.

133. See *State Handling*, *supra* note 96, at 28-31.

134. *NAIC Assessment*, *supra* note 97, at 30.

135. L.H. Otis, *GAO Slaps NAIC on Accreditations*, NAT'L UNDERWRITER (Life & Health/Fin. Servs. ed.), Apr. 27, 1992, at 3.

136. See *NAIC Assessment*, *supra* note 97, at 31.

137. See 1991 NAIC PROCEEDINGS IA, Dec. 2-6, 1990, at 26 (Attachment II).

Department for the company's state of domicile or port-of-entry state until January 1, 1994. Thereafter, such reports may only be accepted if (1), the Insurance Department was at the time of the examination accredited under the National Association of Insurance Commissioners' Financial Regulation Standards and Accreditation Program or (2) the examination is performed under the supervision of an accredited Insurance Department or with the participation of one or more examiners who are employed by such an accredited State Insurance Department and who, after a review of the examination work papers and report, state under oath that the examination was performed in a manner consistent with the standards and procedures required by their Insurance Department.<sup>138</sup>

This sanction would work in several ways. No state could be accredited unless it enacted this model law provision or a substantially similar provision. If an accredited state accepted a zone examination that did not conform to these requirements, it could presumably lose its accreditation. The model law provision raised the alternative possibilities that insurers domiciled in unaccredited states would be subjected to additional financial examinations, with attendant expenses, by accredited states in which they did business, or that they could avoid such expenses by redomesticating to accredited states. Both possibilities provided significant incentives for a state to become accredited. Insurers would lobby their states to participate in the accreditation program; legislatures and regulators would take necessary steps to become accredited to avoid losing insurance companies—and the attendant tax revenues and employment opportunities—to other states. Testimony offered by the NAIC at hearings before the House Committee on Energy and Commerce provided:

We do not view these standards as voluntary, and the impetus for States to comply with the NAIC standards does not rest merely on the policy notion that every State ought to comply with [the] standards. Rather, the State insurance departments have devised sanctions, which are based on their legal power to impose regulations on insurers doing business in their respective States. Accredited States will impose additional regulatory requirements on companies based in non-complying States. For example, beginning in January 1994, accredited States will not accept reports of financial examination from non-accredited States.<sup>139</sup>

Critics voiced skepticism about the efficacy of the sanction. The possibilities of additional examinations for insurers or redomestication of insurers were merely theoretical; the exceptions contained in

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138. *Id.* at 28 (quoting Model Law on Examinations § 3 (1991)).

139. WISHFUL THINKING, *supra* note 67, at 99.

a subpart<sup>140</sup> were likely to be satisfied in nearly every case, since zone examinations would likely include an examiner from an accredited state.<sup>141</sup> In addition, unaccredited states scheduled examinations immediately prior to the January 1, 1994, deadline to put off possible sanctions for an additional year.<sup>142</sup> Some commentators concluded that the sanctions were merely “window-dressing,”<sup>143</sup> demonstrating only that the NAIC lacked “backbone,”<sup>144</sup> while others questioned the integrity of the accreditation program and speculated that this “loop-hole” in the standards might provoke further interest in federal regulatory oversight.<sup>145</sup>

The NAIC continued to work on the accreditation program, quickly and almost continuously instituting changes to respond to criticisms of the program and to improve the standards and the processes of accreditation. In 1991 the NAIC required, as part of the Regulatory Practices and Procedures, the enactment of a state statute allowing for sharing of confidential information and establishment of a written policy to cooperate and share all information regarding domestic companies with the NAIC and other state regulators.<sup>146</sup> The NAIC also voted to add three new models<sup>147</sup> and one

140. See Model Law on Examinations §3(C)(2), reprinted in NAIC PROCEEDINGS IA, Dec. 2-6, 1990, at 28. The exceptions permit acceptance of any examination supervised by an examiner from an accredited state or of any examination in which an examiner from an accredited state participated and stated under oath that the examination had been performed consistent with the standards and procedures required by his or her state. See *supra* text accompanying note 137.

141. Under the NAIC system of zone examinations, regulators join together with neighboring states to conduct joint examinations of large insurers. The geographic distribution of accredited states made it possible to have examiners from accredited states participating in the zone examination. See Meg Fletcher, *Accreditation Wins Support as NAIC Strives for Balance*, BUS. INS., Dec. 20, 1993, at 2; Thomas Ressler, *Concern, Skepticism Mount: Sanction Woes Hurt NAIC, Accreditation Credibility*, INS. REGULATOR, Mar. 7, 1994, at 1; *In the Fine Print—Accreditation: Sanction That Is No Sanction*, INS. REGULATOR, Feb. 28, 1994, at 1.

142. See Fletcher, *supra* note 141, at 2.

143. *Id.* (quoting former Vermont Insurance Commissioner Jeffrey Johnson).

144. Susan Harrigan, *He Just Doesn't Like Being Told What to Do; Senator Vellea Blocks Insurance Rules*, NEWSDAY, Jan. 18, 1994, at 1 (quoting Kevin Hennoy, an insurance policy analyst).

145. Robert L. Zeman, assistant vice president and assistant general counsel of the National Association of Independent Insurers, calls “borrowing” examiners a “loophole” in the accreditation standards, and lists it as “another factor that could call into question the integrity of the [accreditation] program as members of Congress and others interested in federal oversight of the insurance industry continue to look at it.” L.H. Otis, *Questions Surface About Accreditation “Loophole,”* NAT’L UNDERWRITER (Life & Health/Fin. Servs. ed.), Dec. 6, 1993, at 3.

146. See 1992 NAIC PROCEEDINGS I, Dec. 9-12, 1991, at 102 (Attachment I-B: Memorandum from FRSAC Drafting to Members of FRSAC). This change directly responded to the GAO reports and other criticisms: “While cooperation and communication between the states have overall been good, we need something included in the FRS to require it. . . . [because it] is often noted by our critics as a shortcoming in the system of state regulation. In fact, this was noted by the GAO in a report they released in September 1989.” *Id.*

147. See 1991 NAIC PROCEEDINGS I, Dec. 2-6, 1990, at 15-16, 77.

amended model to the standards,<sup>148</sup> and devised a scoring system for accreditation inspections.<sup>149</sup> In March 1993 the NAIC voted to add seven new accreditation standards;<sup>150</sup> in June it voted to add one new standard,<sup>151</sup> and later that year, it revised two standards and added two new models to standards.<sup>152</sup>

These accreditation program expansions and the NAIC's involvement in state insurance regulation prompted further criticisms from many directions. Legislators complained about the continuous adoption of new model standards and described as unrealistic the NAIC's requirement that the standards be adopted within two years.<sup>153</sup> Particularly as the sanction deadline of January 1994 approached, many voiced the opinion that the NAIC's accreditation program, particularly the NAIC's attempts to sanction unaccredited states, went too far. State legislators and regulators, the National Conference of Insurance Legislators (NCOIL),<sup>154</sup> and the insurance industry generally attacked the NAIC's newly expanded authority and operations. The states and NCOIL viewed the NAIC's expanded accreditation efforts as encroaching on state sovereignty.<sup>155</sup> The industry viewed any NAIC activities and initiatives unrelated to solvency regulation as inappropriate and criticized the NAIC for failing to seek outside input on accreditation standards.<sup>156</sup>

## 2. *State Response to Accreditation*

Several states engaged in long battles with the NAIC over the accreditation process. Vermont failed to obtain accreditation in 1995

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148. See 1991 NAIC PROCEEDINGS II, June 9-13, 1991, at 25, 52, 75, 82.

149. See 1992 NAIC PROCEEDINGS I, Dec. 9-12, 1991, at 102 (Attachment I-D: Summary of Review Team Interlineations). On Part A, Laws and Regulations, the accreditation team would score the state on each standard as "excellent," "good," "acceptable," or "unacceptable." On Part B, Regulatory Practices and Procedures, and Part C, Organizational and Personnel Practices, the team would score the state with an A1" or better on each subpart, with required totals of 24 or better for Part B and 12 or better for Part C.

150. See 1993 NAIC PROCEEDINGS I, Mar. 7-9, 1993, at 4.

151. See 1993 NAIC PROCEEDINGS I, June 20-23, 1993, at 33.

152. See *id.* at 101-02.

153. See L.H. Otis, *States Battle NAIC on Accreditation*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), Nov. 28, 1994, at 4. According to various state legislators, an average bill takes three years to pass. Texas legislators noted that the Texas Legislature met only once every two years, making passage within the NAIC's deadlines virtually impossible. See *id.*

154. The National Conference of Insurance Legislators is an association of state legislators. During this time period, it had 33 members, a limited staff, and a budget of \$500,000. See Mark L. Schussel, *Legislators to Ponder Legality of NAIC Program*, BEST'S REV. (Prop./Cas. ed.), Sept. 1994, at 10.

155. See L.H. Otis, *NAIC Accreditation Plan Draws Fire*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), Oct. 10, 1994, at 4.

156. See *id.*

due to its regulation of risk retention groups as captives.<sup>157</sup> The Vermont Captive Insurance Association and the National Risk Retention Association threatened to sue the NAIC because it did not to accredit Vermont on the grounds that the Liability Risk Retention Act of 1986<sup>158</sup> precluded the NAIC from regulating risk retention groups for solvency.<sup>159</sup> Risk retention groups are not insurance companies and were not intended by Congress to be treated as insurance companies. The Liability Risk Retention Act specifically exempts risk retention groups from state regulation. Vermont treats them as captive insurers even though there is no secure corporate entity behind them. Vermont ultimately won accreditation in September 1995,<sup>160</sup> after the NAIC capitulated and suspended the requirement that risk retention groups be treated as property-casualty insurers.<sup>161</sup>

Similar problems occurred in New York. New York was accredited in 1990, but its accreditation was suspended in 1993<sup>162</sup> when state Senator Guy Velella, Chair of the Senate Insurance Committee, blocked passage of two new required model laws by delaying their consideration by the Senate Insurance Committee.<sup>163</sup> Senator Velella complained that the NAIC accreditation process usurped state sovereignty by mandating legislative action by the states. He then introduced a bill that would have permitted New York to retaliate against any state that enforced sanctions against it in accordance with accreditation standards.<sup>164</sup> Finally, Senator Velella made veiled threats to discontinue contributions to the NAIC,<sup>165</sup> and requested a Justice

157. Captive insurers are established by a parent firm for the purpose of insuring the parent firm's exposures. Risk retention groups are group-owned insurance companies that can be structured as multi-owner captives and which insure the common liability risks of their owners.

158. 15 U.S.C. § 3901 (1994).

159. See Gavin Souter, *Risk Facility Groups Threaten to Sue NAIC over Vermont Status*, BUS. INS., Nov. 15, 1993, at 26.

160. See Rodd Zolkos, *Vermont Settles Gladly into New Role as Mature Domicile; NAIC Dispute No Longer Demands Attention*, BUS. INS., Apr. 22, 1996, at 45.

161. See Meg Fletcher, *Oversight Law's Impact Less than Anticipated*, BUS. INS., July 15, 1996, at 3.

162. See 1993 NAIC PROCEEDINGS I, Mar. 7-9, 1993, at 67. The Financial Regulations Standards and Accreditation Committee suspended New York's accreditation on March 6, 1993, as a result of its failure to enact the Managing General Agents Act and the Reinsurance Intermediary Act by the December 31, 1992, deadline. See *id.*

163. See Meg Fletcher, *New York's Accreditation Suspended*, BUS. INS., Mar. 15, 1993, at 1.

164. See N.Y.S.B. 4223 § 4 (1995); N.Y.S.B. 6648 (1993); see also Christopher Dauer, *N.Y. Mulls Retaliation for Accreditation Penalties*, NAT'L UNDERWRITER (Life & Health/Fin. Servs. ed.), Apr. 11, 1994, at 9.

165. In a letter to Governor Cuomo, Velella wrote, "I find it incongruous that New York . . . would continue to contribute to an organization that summarily and for its own purposes attempts to strip this state of its credibility." Dauer, *supra* note 164, at 9. Velella estimated that New York spent \$1 million on NAIC-related activities, and noted that New York companies spent far in excess of that amount in various fees and assessments. See *id.* In response, NAIC President David Walsh stated that the New York insurance department

Department probe of the NAIC alleging that its activities violated antitrust law.<sup>166</sup> Velella stated, "The NAIC is a private organization that has, in a collusive manner, restrained trade and commerce among the several states in the insurance industry."<sup>167</sup>

Ironically, the NAIC testified before the House Committee on Energy and Commerce in 1993 on its revocation of New York's accreditation:

It is important to note that the State of New York has an excellent department and does a superb job of protecting that State's insurance consumers. However, it is a testament to the Financial Regulation Standards and Accreditation Program that a department of such high caliber can be denied accreditation status if it does not possess the statutory tools deemed necessary for effective solvency regulation.<sup>168</sup>

This testimony is quite remarkable. Suspension of "an excellent department" that does "a superb job" directly calls into question the substance of the accreditation program and the motives of the NAIC in establishing it.

These states and others took steps to limit the NAIC's power by proposing and often enacting laws specifically designed to control the NAIC. Vermont enacted an oversight law in 1995, with an effective date of July 1, 1996.<sup>169</sup> The law permits the Vermont Legislature to oversee the NAIC and mandates NAIC reporting of its fiscal, regulatory, and other activities in an annual report.<sup>170</sup> Earlier versions of

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paid \$117,000 to the NAIC in 1993 and received approximately \$1.2 million in services, including development and maintenance of on-line databases to track solvency and market conduct, training for state regulators, valuation of insurer investments, standardized annual statement forms, and legal and financial analysis services. *See id.* at 11.

166. *See Velella Calls for Antitrust Probe of NAIC*, INS. REGULATOR, Oct. 9, 1995, at 2. According to Judge Peter Leisure, U.S. District Judge for the Southern District of New York, the NAIC is not immune from antitrust liability. *See Preferred Physicians Mut. Risk Group v. Cuomo*, 865 F. Supp. 1057, 1071 (S.D.N.Y. 1994), *vacated*, 85 F.3d 913 (2d Cir. 1996). As a private trade association composed of regulators from different states, the NAIC does not enjoy Noerr-Pennington immunity, which immunizes from antitrust liability concerted efforts to restrain or monopolize trade through lobbying government officials. *See id.* at 1072; *see also* L.H. Otis, *Judge Raises Doubts Over NAIC Immunity*, NAT'L UNDERWRITER (Life & Health/Fin. Servs. ed.), Oct. 31, 1994, at 1.

167. L.H. Otis, *N.Y. State Senator Seeks Antitrust Probe of NAIC*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), Oct. 9, 1995, at 23 (quoting Senator Velella). The Senator alleged:

By its activities, it [the NAIC] has substantially lessened competition and by its directives to state governments and insurance companies tended to create a controlled market or monopoly situation in the insurance market . . . . The NAIC's actions to establish a controlled and cohesive market are in direct violation of the Sherman Anti-trust Act and Clayton Anti-trust Act [sic].

*Id.*

168. WISFUL THINKING, *supra* note 67, at 100.

169. 1996 Vt. Acts & Resolves 83.

170. *See id.* The annual report must include a summary of the NAIC's activities; a list of each law or regulation proposed or required for accreditation, with an explanation of

the law also empowered Vermont's insurance commissioner to establish and authorize fees and assessments of its domiciliary insurers<sup>171</sup> and to impose retaliatory sanctions against states that take similar actions against Vermont for its lack of accreditation.<sup>172</sup> Under the more onerous early versions of the bill, the NAIC's failure to comply with the requirements would rescind immunities afforded by Vermont to the NAIC members and staff, subjecting them to civil liability for their actions.<sup>173</sup>

Other states, including New York,<sup>174</sup> New Jersey,<sup>175</sup> Louisiana,<sup>176</sup> and Michigan,<sup>177</sup> made similar complaints and proposed, but did not pass, similar measures. New York's bill found that the NAIC "deviated from its legitimate role" in "derogation of state sovereignty and prerogatives"<sup>178</sup> and that "the association has become less accountable to the public and has failed to act in a fundamentally fair manner."<sup>179</sup> The bill included provisions similar to those in the early Vermont proposals.<sup>180</sup> Through the efforts of state Representative John Llewellyn and state Senator Michael J. Bouchard, the Michigan Legislature adopted a bill that would cut off state funding to the NAIC if its activities threatened state sovereignty.<sup>181</sup> Florida Representative Stan Bainter also included a NAIC oversight provision in a 1995 Florida bill to ensure that "the [state insurance] department would understand that we, as the legislature, are responsible for

why the requirement is in the public interest; a fiscal report, including statements of expenditures by major programs, an audit opinion of the fiscal report, salaries and other compensation of the NAIC's officers and the five highest salaried professional and managerial staff, and projections for the next year; a description of policies and procedures utilized by the NAIC to ensure that accreditation is based only on a state's effectiveness in regulating; a description of policies and procedures utilized by the NAIC to ensure open conduct of its activities with notice and opportunities for interested parties to participate. *See id.*; *see also Commissioners Doubt OCC Assurances*, INS. REGULATOR, Apr. 1, 1996, at 1 [hereinafter *Commissioners Doubt*]; L.H. Otis, *New Vermont Law Requires Annual Reporting by NAIC*, NAT'L UNDERWRITER (Life & Health/Fin. Servs. ed.), Mar. 25, 1996, at 1.

171. *See* Fletcher, *supra* note 161, at 3.

172. *See Commissioners Doubt*, *supra* note 170, at 1.

173. *See* Otis, *supra* note 170, at 1.

174. *See* Assembly Bill No. 7475, 218th Gen. Ass., 1st Sess. (N.Y. 1995) (amending the insurance law relating to the legislative oversight of the NAIC).

175. *See* N.J.A. 857, 208th Leg. (N.J. 1995) (ordering oversight of certain NAIC activities).

176. *See* H.B. 1502, Reg. Sess. (La. 1997) (amending the insurance law to provide for legislative oversight of fines imposed by the NAIC for failure to comply with standards adopted by the NAIC and to prohibit the imposition of fees by the NAIC absent rulemaking by the commissioner of insurance).

177. *See* Linda Koco, *Michigan Senate Seeks Curbs on NAIC*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), Dec. 22, 1997, at 6.

178. Assembly Bill No. 7475, 218th Gen. Ass., 1st Sess. (N.Y. 1995).

179. *Id.*

180. *See supra* text accompanying notes 169-73.

181. *See* 1998 Mich. Pub. Acts 279. The Act adopted a House bill that was similar to an earlier bill in the Senate. *See* H.B. 5418, 89th Leg., Regular Sess. (Mich. 1998); S.B. 723, 89th Legislature, Regular Sess. (Mich. 1997); *see also* Koco, *supra* note 177, at 6.

passing legislation, not the NAIC.”<sup>182</sup> Many observers warned that the states’ battles with the NAIC over accreditation might lend credence to claims that state regulation of insurance was unworkable and could possibly trigger further federal efforts to take over insurance regulation.<sup>183</sup>

NCOIL also criticized the NAIC, approving two resolutions stemming from the accreditation program. The first called for reform of the NAIC practices and policies, removal of the sanctions from the accreditation program, and the requirement of public financial reporting by the NAIC. The second proposed the establishment of a multistate legislative commission and creation of an interstate compact to oversee the NAIC’s budget and accreditation activities.<sup>184</sup> NCOIL established a subcommittee to review the NAIC accreditation program<sup>185</sup> and enumerated several possible remedies to what NCOIL viewed as NAIC overstepping its bounds. These possible remedies included asking courts to invalidate the accreditation program, asking Congress to amend the NAIC’s charter to require open meetings, requiring NCOIL to hold public hearings on NAIC model laws, and using interstate compacts to foster state cooperation and ultimately, perhaps, to eliminate any role for the NAIC.<sup>186</sup>

Individual insurance commissioners also expressed concerns about the NAIC’s role. Patrick M. McQueen, acting Michigan insurance commissioner, stated that the NAIC had “excessive authority” over regulators, and posed the question: “Is this the commissioners’

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182. *State Survey*, INS. REGULATOR, Apr., 1, 1996, at 4.

183. See, e.g., Editorial, *Fighting over Spilled Milk*, BUS. INS., Feb. 21, 1994, at 8. We recognize Sen. Velella’s need to defend New York’s turf. On the other hand, his threats—whether they are leveled at the NAIC or states that are accredited—illustrate one of the problems inherent in state solvency regulation: Too many cooks can spoil the broth. . . . By engaging in petty disputes like the one Sen. Velella is encouraging, they are making a good case for federal regulation. Rodd Zolkos, *No Winners in NAIC, Vermont Fight; Dispute Could Open Door to Federal Regulation, Experts Warn*, BUS. INS., Aug. 29, 1994, at 83.

184. See L.H. Otis, *State Legislatures Seek NAIC Accreditation Probe*, NAT’L UNDERWRITER (Life & Health/Fin. Servs. ed.), Aug. 7, 1995, at 36; Rodd Zolkos, *NCOIL Resolutions Target NAIC Reform; Solvency Task Force Urges States to Extend NAIC Financial Oversight*, BUS. INS., Aug. 7, 1995, at 3.

185. See Mark L. Schussell, *Legislators to Ponder Legality of NAIC Program*, BEST’S REV. (Prop./Cas. ed.), Sept. 1994, at 10. The NCOIL charged the subcommittee with these tasks:

[S]tudy whether or not executive branch officials or employees have used the accreditation process to enact certain bills; whether or not accreditation has been awarded to and retained by states on a meritorious basis; whether or not the accreditation process contains adequate due process protection for all those who would be affected by its terms; whether or not the accreditation process should contain sanctions against insurers located in nonaccredited domiciles; and whether or not the NAIC has the authority to impose any sanctions on nonaccredited states . . . .

*Id.*

186. See *id.*

association or are the commissioners reporting to the association?"<sup>187</sup> D. Joseph Olsen, McQueen's successor, also questioned the NAIC's role in solvency regulation, noting that the NAIC's "boycott" of states that did not follow the NAIC's accreditation program was problematic.<sup>188</sup> Commissioner John Oxendine of Georgia, while crediting the NAIC with preserving state regulation of insurance, criticized the NAIC for its arrogance: "[T]he Georgia State Legislature and I feel strongly about sovereignty."<sup>189</sup> The Hawaii insurance commissioner, Lawrence Reiforth, stated that state legislators did not want to be "pushed around by the NAIC."<sup>190</sup>

### 3. Industry Critiques

The industry also took steps to limit the NAIC's growing power. As the NAIC's role in the regulation of insurance grew, its financial needs increased, and it assessed larger fees against insurance companies. Database fees were, and continue to be, the NAIC's most important source of revenue, accounting for approximately forty-five percent of its total revenues.<sup>191</sup> Beginning in 1992, State Farm refused to pay increased fees to support NAIC's expanded activities, paying only what had been assessed in prior years.<sup>192</sup> Many other companies similarly refused to pay their fees, complaining that fees were being used inappropriately to subsidize market conduct activities not related to solvency regulation. In February 1996, the National Association of Independent Insurers (NAII) sent a letter to its membership, calling for what apparently amounted to an industry boycott of fees payments. The letter stated that some of the trade association's members had withheld fees and urged other insurers "to exercise your own judgment on this important policy issue," and attached a list of suggested grounds for refusal to pay.<sup>193</sup> As of Novem-

187. Charles E. Schmidt, Jr., *Under Fire: The NAIC Struggles to Redefine Itself*, BEST'S REV. (Prop./Cas. ed.), June 1995, at 35.

188. *See id.*

189. *Id.* at 37.

190. *The Sanctioned 16*, BEST'S REV. (Prop./Cas. ed.), June 1994, at 33.

191. *See supra* notes 88-89 and accompanying text; *see also Big P/Cs Agree to Pay Database Fees*, INS. ACCT., Nov. 25, 1996, at 1 [hereinafter *Big P/Cs*].

192. *See* Scot Paltrow, *The Converted: How Insurance Firms Beat Back an Effort for Stricter Controls*, WALL ST. J., Feb. 5, 1998, at A1; Scot Paltrow, *Pressure Mounts to Curb Insurance Industry Guard*, L.A. TIMES, Apr. 30, 1996, at A1 [hereinafter Paltrow, *Pressure Mounts*].

193. Paltrow, *Pressure Mounts*, *supra* note 192, at A1. Michael P. Duncan, the senior vice president and general counsel of the NAII, denied that the NAII was attempting to lead a boycott of NAIC database fees. The letter was characterized as "an informational response to queries from the NAII's members," which "made it clear that it was up to companies to decide whether to pay their database fees." *Consumer Group Blasts NAII Effort to Weaken NAIC*, BEST'S INS. NEWS, Apr. 26, 1996, available in 1996 WL 15585553; *see also* Steven Brostoff, *NAII Accused of Assailing NAIC and State Regulation*, NAT'L UNDERWRITER (Life & Health/Fin. Servs. ed.), Apr. 29, 1996, at 3.

ber 1996, various companies owed the NAIC more than \$1.8 million in past-due database fees.<sup>194</sup> In late November, Allstate paid its delinquent database fees for 1995 in full. State Farm paid its 1995 fees, but not its fees for three previous years.<sup>195</sup> As of early 1998, uncollected database fees totaled \$1.35 million, including \$750,000 for 1997.<sup>196</sup>

The industry also engaged in public attacks on the NAIC. The NAI criticized the NAIC for its lack of accountability, its use of fees assessed against insurance companies for activities not related to solvency, the influence of the NAIC staff, the lack of industry input into policy decisions, and the NAIC's incursion into state sovereignty.<sup>197</sup>

#### 4. NAIC Backpedaling from Accreditation Measures

The combined force of all of this criticism accomplished the intended results. As the criticisms of the NAIC's actions by the industry and the states grew, and the threats of federal regulation receded, the pace of the accreditation effort slowed and the NAIC backpedaled on existing standards and procedures. The 1996 NAIC president's statement describing the previously touted sanctions for non-accreditation, "I am not sure the word sanction is the most appropriate term," marked the change.<sup>198</sup> Any repercussions for noncompliance with standards and procedures in an unaccredited state were no longer viewed as a sanction but simply an "effect" of not being accredited. The 1996 NAIC president, Steven Foster, further noted that the states, and not the NAIC, actually imposed these so-called effects.<sup>199</sup>

After 1993, the NAIC's programmatic actions on accreditation consisted primarily of delaying implementation of new standards and diluting the existing standards. In 1994 the NAIC revised one stan-

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194. See L.H. Otis, *Nonpayment of Insurer Data Fees Haunt NAIC*, NAT'L UNDERWRITER (Life & Health/Fin. Servs. ed.), Nov. 4, 1996, at 54. According to NAIC data, State Farm owed \$422,867; Allstate owed \$115,409; Farmers Group owed \$275,013; Blue Cross plans collectively owed \$460,100; and dozens of small credit-life and disability insurers in Arizona owed \$147,425 collectively. See *id.*

195. See *Big P/Cs*, *supra* note 191, at 1.

196. See Dan Lonkevich, *NAIC Adopts "Stable" 1998 Budget*, NAT'L UNDERWRITER (Life & Health/Fin. Servs. ed.), Jan. 5, 1998, at 35.

197. See L.H. Otis, *NAIC, NAI Engage in War of Words*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), Oct. 2, 1995, at 3.

198. Otis, *supra* note 145, at 3 (quoting Steven Foster, 1996 NAIC President); see also Editorial, *Don't Backpedal on Accreditation*, NAT'L UNDERWRITER (Life & Health/Fin. Servs. ed.), Dec. 6, 1993, at 44.

199. See Otis, *supra* note 145, at 3 ("It is not regulators [NAIC] who are thrusting models upon the New York legislature, but all other state legislatures who have agreed to accreditation as the best way to improve state regulation and avoid federal oversight." (paraphrasing Steven Foster, 1996 NAIC President)).

dard.<sup>200</sup> In 1995 it extended the deadline for implementation of eight standards,<sup>201</sup> adopted a policy designed to curtail changes and additions to the standards,<sup>202</sup> and proposed an appeals process for accreditation decisions.<sup>203</sup> In 1996 it extended the deadlines for implementation of new standards until July 1, 1997,<sup>204</sup> due to the NAIC's failure to complete review of accreditation standards.<sup>205</sup> Finally, in 1996 the NAIC subcommittee on accreditation standards eliminated six of the model laws required for accreditation because they were not relevant to solvency,<sup>206</sup> recategorized several standards as "supplemental,"<sup>207</sup> and adopted "results-oriented" accreditation standards.<sup>208</sup> Parts of these measures were vetoed by the NAIC Executive Committee, which retained four of the six standards slated for deletion.<sup>209</sup> However, the Executive Committee accepted the subcommittee's "results-oriented" approach to state accreditation standards. This approach further diluted accreditation standards, which in many instances already permitted substitution of similar provisions

200. See 1994 NAIC PROCEEDINGS II, June 12-15, 1994, at 1042.

201. See *N.Y. Lawmaker Seeks Antitrust Probe of NAIC*, BESTWIRE, Oct. 5, 1995, available in LEXIS, Ins. News Archive Library) (noting a new NAIC deadline of Jan 1, 1996).

202. The sponsor of any proposed change or addition must state, in writing:

- (1) How the change directly related to solvency and why it is needed;
- (2) Why it should be adopted by all jurisdictions;
- (3) The number of jurisdictions that have adopted it and their experience;
- (4) For laws or regulations, which provisions must be worded in substantially similar language and why;
- (5) The estimated cost for insurers to comply and the impact on state regulators;
- (6) The impact on consumer if the change is not approved.

NAIC, 1995 NAIC ANNUAL REPORT 12 (1996).

203. See *id.*

204. See *NAIC Accreditation Deadlines Extended Again*, BEST'S INS. NEWS, June 4, 1996, available in 1996 WL 15586792.

205. See *id.*

206. See *id.*

207. See *id.* Core standards were defined as "standards that are essential to the effective solvency regulation of the state's multistate domestic insurers;" supplemental standards, in contrast, "supplement or complement the state's core requirements for effective solvency regulation of multistate domestic insurers." Supplemental standards are "important tools for solvency regulation" which can help a state to "achieve a higher standard in its role as insurance regulator." 1995 NAIC PROCEEDINGS IV, Dec. 2-6, 1995, at 748 (Attachment II-A) (recording the meeting of the Financial Regulation Standards and Accreditation Subcommittee). The Subcommittee identified as supplemental the model laws relating to Guaranty Funds, Risk Retention, Producer Controlled Insurers, Managing General Agents, Reinsurance Intermediaries, Diskette Filings, and Disclosure of Material Transactions. See *id.*

208. See *id.*

209. See L.H. Otis, *Most NAIC Accreditation Standards Survive Vote*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), Mar. 24, 1997, at 1. The Executive Committee reinstated the Managing General Agents Act, the Reinsurance Intermediaries Act, the Business Transacted with Producer Controlled Property/Casualty Insurer Act, and the guaranty funds models. The Executive Committee voted to delete the Model Risk Retention Act and the Disclosure of Material Transactions Model Act. See *id.*

for required NAIC model laws. Under the new approach, both core and supplemental standards can be met with either NAIC model laws or regulations, or similar provisions (as previously required), or with an established practice or a combination of laws, regulations, or practices that achieves the objective of the standard.<sup>210</sup> One result of these diminished accreditation standards was that a number of previously unaccredited insurance departments were able to obtain accreditation.

Market conduct regulations never became a part of the accreditation requirements<sup>211</sup> despite unanimity on the Market Conduct and Consumer Affairs Subcommittee that such standards were essential.<sup>212</sup> In a 1991 discussion, the North Dakota insurance commissioner and past NAIC president, Earl Pomeroy, and Missouri's insurance director and chair of the NAIC Market Conduct and Consumer Affairs Subcommittee, Lewis Melahn, agreed that market conduct regulation is critical to effective insurance regulation. Commissioner Pomeroy, however, warned of an industry backlash if market conduct accreditation standards were promulgated.<sup>213</sup> Despite a continued push by market conduct regulators in state insurance departments, the NAIC took no action to implement market conduct accreditation standards. By 1994, NAIC President David Walsh characterized market conduct regulations as a "difficult sell," noting the difficulties of forcing state legislatures to enact additional required model laws and regulations.<sup>214</sup> The latest draft of market conduct regulations, promulgated in 1995, is significantly weaker than the 1991 draft, but even that draft has not been implemented.<sup>215</sup> In response to the NAI's 1995 criticism of the NAIC for attempting to establish a national system of market conduct regulation, the NAIC stated that it had rejected the concept of accreditation standards for

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210. See L.H. Otis, *Compromise Okayed on NAIC Accreditation Plan*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), Dec. 23, 1996, at 3; *Accreditation Vote Brings Dire Warnings*, INS. REGULATOR, Jan. 1, 1997, at 1. Outgoing NAIC President Brian Atchinson and incoming Vice President Glenn Pomeroy opposed the compromise. See *id.*

211. The 1995 Mission Statement of the Accreditation Program specifically limits the program to solvency regulation. See 1995 MISSION STATEMENT, *supra* note 124. The policy for changing or adding to the accreditation standards requires a demonstration that the change or addition is directly related to solvency. See *id.*

212. See *supra* text accompanying notes 130-32.

213. See *The Non-Financial Areas of State Regulation Crucial*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), Sept. 30, 1991, at 36.

214. See L.H. Otis, *Accrediting Market Conduct Regs Deemed a Hard "Sell,"* NAT'L UNDERWRITER (Life & Health/Fin. Servs. ed.), Aug. 1, 1994, at 1.

215. See Editorial, *Don't Downplay Market-Conduct Oversight*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), Oct. 9, 1995, at 20.

market conduct.<sup>216</sup> The NAIC promised to institute program-based budgeting in direct response to industry criticisms that database fees and industry assessments should be allocated only to solvency regulation and not to market conduct regulation.<sup>217</sup>

During the same time period, the NAIC adopted reforms in response to criticism. The NAIC opened its meetings,<sup>218</sup> many of which had previously been closed.<sup>219</sup> The NAIC also began its program of funding the attendance of consumer representatives at NAIC meetings.<sup>220</sup>

### C. *The Lessons of the Accreditation Controversy*

Several lessons can be derived from the accreditation controversy. Most importantly, the accreditation program demonstrates the needs for state regulation reform and for the centralization of at least some aspects of insurance regulation. The accreditation program was initiated with the cooperation of the states and the industry, as well as the tacit cooperation of federal legislators because they all recognized the critical deficiencies in the state regulatory system. The problems with state regulation were viewed to be serious, requiring sustained attention, and only some measure of uniformity could accomplish necessary reform.

Second, as the review of the NAIC's accreditation program illustrates, these problems have not been fully addressed by the program. The required model laws and procedures are susceptible to criticism based on their content,<sup>221</sup> and even where they afford state regulators additional authority, funding inadequacies, which were not addressed by the accreditation program, may preclude effective use of that authority. Average state insurance department funding is approximately six percent of premium taxes.<sup>222</sup> The CIIG suggests ex-

216. However, market conduct activities accounted for approximately 20% of the NAIC's expenses in 1995. See *NAIC Issues Counterattack to NAII*, INS. REGULATOR, Sept. 25, 1995, at 1.

217. See Meg Fletcher, *NAIC Prepares to Defend its Turf*, BUS. INS., June 16, 1997, at 30. Program-based budgeting has apparently not been implemented.

218. Members of the industry and state insurance commissioners in California, Illinois, Texas, and New York had called for this change. See Charles E. Schmidt, Jr., *Under Fire: The NAIC Struggles to Redefine Itself*, BEST'S REV. (Prop./Cas. ed.), June 1, 1995, at 35.

219. See, e.g., Robert H. Myers, Jr., *An Evolutionary View of Insurance Regulation*, BEST'S REV. (Prop./Cas. ed.), Dec. 1, 1994, at 50. Key NAIC officials defended the NAIC's practice of closing some meetings. The former NAIC vice president and Arkansas insurance commissioner, Lee Douglass, noted that only a small percentage of meetings were closed. See Mark L. Schussel, *Legislators to Ponder Legality of NAIC Program*, BEST'S REV. (Prop./Cas. ed.), Sept. 1, 1994, at 10.

220. See *infra* text accompanying notes 272-73.

221. See *supra* Part III.B.1.

222. See Robert H. Gettlin, *State Spending: The Price of Regulation Plateaus*, BEST'S REV. (Life/Health ed.), Mar. 1, 1998, at 55, 56 (noting fiscal conservatism resulting in lower

penditures of at least ten percent of premium taxes,<sup>223</sup> and the Risk Insurance Management Society suggests funding levels of at least twenty-five percent of premium taxes.<sup>224</sup> In short, although the accreditation program had the potential to ameliorate inadequate and ineffective state level regulation, it has largely failed.

The *Wall Street Journal's* recent profile of Indiana's Insurance Department, which has been accredited since 1994,<sup>225</sup> illuminates the limitations of the current accreditation program and the serious deficiencies in state insurance regulation.<sup>226</sup> The Department operates on a budget of approximately \$4 million, as compared to the \$140 million in premium taxes collected by the state. The Department staff has been reduced by twenty percent in the last decade, while the number of licensed insurers and of insurers headquartered in Indiana has risen by eight percent and almost thirteen percent respectively. The department has no market conduct investigators or actuaries, and the salaries of financial examiners are insufficient to attract and retain qualified individuals.

According to Indiana Insurance Commissioner Sally McCarty, the Department is unable to take appropriate action on numerous consumer complaints. In response to the more than 21,000 consumer complaints directed at the department between 1993 and 1997, the Department sent 211 warning letters to seventy-two companies, citing repeated violations of state law, but instituted only one disciplinary action. Ten additional disciplinary actions were not in response to consumer complaints. The Department has taken some measures in response to the criticisms voiced in the *Journal*, including the creation of a separate consumer protection unit, and the addition of a third investigator and an attorney.<sup>227</sup>

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increases in state insurance department budgets: 6.45% of total revenue collected from the industry from 1991 through 1995 and 7.18% in 1996).

Comparisons to banking regulation also provide some context. According to recent reports, insurance regulators spend a much smaller proportion of taxes and fees collected from their respective industries than banking regulators. Apparently, insurance industry revenues fund many other government services. See, e.g. Robert H. Gettlin, *The Price of Regulation*, BEST'S REV. (Prop./Cas. ed.), Oct. 1, 1997, at 60; *Do Insurers Pay More for Less?*, BEST'S INS. NEWS, Sept. 15, 1997, available in 1997 WL 7078726 (noting that banks paid \$28.5 billion in state and federal taxes, fees, and assessments, with \$2.3 billion, or 8%, spent by state and federal agencies on banking regulation; insurance companies paid \$21.5 billion, with \$647.6 million, or 3%, spent by state regulators).

223. See *supra* note 126 and accompanying text.

224. See *id.*

225. See 4 NAIC MODEL LAWS, REGULATIONS, AND GUIDELINES 690-99 (1997).

226. See Scot J. Paltrow, *A Matter of Policy: How a State Becomes Popular with Insurers but Not Consumers: Indiana's Regulators Have Little Budget or Clout; Conflicts at the Capitol*, WALL ST. J., Jan. 14, 1998, at A1.

227. See Doug Sword, *State to Step Up Scrutiny of Insurers*, INDIANAPOLIS STAR, Apr. 15, 1998, at B1.

Other recent reports indicate that the deficiencies in Indiana's protection of insurance consumers are not unique. An audit of California's Department of Insurance revealed a backlog of 5000 consumer complaints, cuts in the consumer complaint staff, and reassignment of remaining staff to other work.<sup>228</sup>

A former member of the Colorado Division of Insurance, Jay Gaffigan, recently requested that the governor audit the Division, charging that consumers receive virtually no protection from the Division, which received 7000 formal complaints in 1996 but only levied seven fines.<sup>229</sup> Only two lawyers handle complaints; staff investigators are forced to leave investigations unfinished due to lack of resources.<sup>230</sup> Although the audit is underway, the Chicago-based law firm of Sonnenschein Nath & Rosenthal, which has substantial ties to the industry, was selected to perform it. A number of the firm's clients, including Prudential, Allstate, Travelers, Aetna, and New York Life, were the targets of complaints in Colorado, which raises concerns about the firm's ability to conduct an objective inquiry.<sup>231</sup>

Third, just as the serious and systemic regulatory problems indicated by these examples demonstrate the failures of the NAIC's accreditation program, the reasons for the failures are evident from the history of the NAIC's accreditation program. The preceding account of the NAIC's accreditation program reveals the NAIC's lack of power and its susceptibility to influence. Despite the NAIC's central role as an accreditor of state regulators, it had no power to force states to conform to accreditation standards or to sanction them for failure to do so.

The accreditation controversy also provides proof of the NAIC's remarkable susceptibility to outside pressures, particularly those exerted by the insurance industry. Abetted by individual state legislators and regulators, many of whom have ties to the industry,<sup>232</sup> the industry waged a successful campaign to weaken accreditation standards and to avoid enhanced market conduct regulation through the accreditation program. Sustained public criticism, withholding of essential operating funds assessed by the NAIC against various companies, and informal lobbying and participation in the NAIC's proc-

228. See Editorial, *Audit's Blunt Appraisal*, SACRAMENTO BEE, Mar. 20, 1997, at B6.

229. See Michele Conklin, *Insurance Agency Inquiry Urged; Office Incapable of Enforcing State Laws, Ex-Official Says*, ROCKY MTN. NEWS, Mar. 27, 1997, at B1.

230. See David Algeo, *Insurance Division May Undergo Audit; Ex-Staffer Asks Romer for Probe*, DENVER POST, Mar. 27, 1997, at D1.

231. See Scot J. Paltrow, *Top Insurance-Industry Advocate is Hired to Audit State Agency*, WALL ST. J., June 11, 1998, at B2.

232. One-third of the insurance commissioners appointed in 1995 came from the industry; many commissioners obtain positions in the industry following their service. It is common for state legislators with ties to the industry to sit on insurance committees, and only a few states prohibit such service. See Paltrow, *supra* note 67, at A1.

esses accomplished the industry's objectives. Despite the NAIC's avowed commitment to protecting consumers, its long study of market conduct initiatives, and its recognition of the interrelationship between market conduct and solvency, the NAIC failed to adopt market conduct accreditation standards.<sup>233</sup>

A recent class action suit against Prudential Insurance Company provides further evidence of the need for enhanced market conduct regulation. More than eight million claimants from all fifty states and the District of Columbia alleged fraudulent and deceptive sales practices against Prudential.<sup>234</sup> The first exposure of Prudential's illegal activities began early in 1994 when the first lawsuits were brought against it.<sup>235</sup> The New Jersey insurance commissioner organized the Multi-State Task Force on April 25, 1995, to conduct an examination of Prudential's sales practices.<sup>236</sup> The Task Force issued its report in July 1996 and cited widespread evidence of fraudulent sales practices by agents, evidence of management's knowledge of those practices, and failure to investigate or discipline violators.<sup>237</sup> State regulators failed to detect ongoing, widespread fraud and failed to act until prompted by the plaintiff's bar and the media exposure of Prudential.<sup>238</sup>

Finally, the accreditation program itself suggests that the NAIC's efforts are often a matter of form rather than substance. The NAIC's purpose of avoiding federal regulation is explicitly stated.<sup>239</sup> Furthermore, the NAIC has accredited the weakest insurance departments in the nation while denying accreditation to one of the strongest—New York.<sup>240</sup> It is hard to avoid the conclusion that the accreditation program was and is directed primarily at maintenance of the

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233. See *supra* text accompanying notes 129-32, 212-17.

234. See *Schulte v. Prudential Ins. Co. of Am.* (*In re Prudential Ins. Co. of Am. Sales Practice Litig. Agent Actions*), 133 F.3d 225 (3d. Cir. 1998) (affirming the district court approval of a settlement establishing alternative dispute resolution mechanisms and protocols to determine the kind and amount of relief to be granted to each claimant).

235. See *N.J. to Lead Multi-State Probe of Prudential Sales*, BESTWIRE, Apr. 25, 1995, available in LEXIS, Ins. News Archive Library).

236. See *Prudential Task Force Finds Flaws Industry-Wide*, BEST'S INS. NEWS, July 10, 1996, available in 1996 WL 15585714.

237. See *id.*

238. See, e.g., Molly Baker, *Five Policyholders Sue Prudential Over Sales Practices*, WALL ST. J., March 1, 1995, at B10; Leslie Scism, *Fine Print Victims: Some Agents "Churn" Life Insurance Policies, Hurt Their Customers*, WALL ST. J., Jan. 3, 1995, at A1.

239. See 1995 NAIC PROCEEDINGS III, Sept. 10-12, 1995, at 616 ("NAIC crafted the Accreditation Program circa 1989-90 in response to an extraordinary situation, i.e., the growing call at that time in Washington, D.C., for federal regulation of insurance." (statement of Robert L. Zeman, NAII Vice President and Assistant General Counsel, in a June 30, 1995, memorandum to Steven T. Foster, Virginia Insurance Commissioner, regarding the NAIC accreditation program)). The memorandum suggested that having successfully staved off a federal regulation, the NAIC should "only involve minimum standards" and "accreditation should not be used to impose national uniformity." *Id.*

240. See *supra* text accompanying notes 163-68.

state regulatory system rather than at effective state-level protection of consumers.<sup>241</sup> Thus, although the NAIC's attempts have contributed to the preservation of the state system, the NAIC has not eliminated the problems that originally prompted federal inquiries.

#### IV. REASONS FOR THE CONTINUING DOMINANCE OF STATE INSURANCE REGULATION

Part IV examines reasons for continuing state regulation of insurance proffered by its proponents, focusing, where appropriate, on the examples provided by the accreditation controversies outlined in the previous section. Part IV first evaluates basic federalist arguments for state regulation generally and various attempts to justify state insurance regulation using those arguments. None of those attempts adequately accounts for the role of the NAIC in the system of state regulation. The NAIC's expansive role in state insurance regulation substantially undercut federalism arguments for continued state regulation.

Part IV then briefly evaluates recent economic justifications for continued state regulation. Although illuminating, those efforts are similarly flawed by their insufficient recognition of the NAIC's centralizing and enabling role in state insurance regulation. Finally, Part IV describes and attempts to explain continuing preferences for state regulation exhibited by various actors, including Congress's continuing deference to the states over what is clearly a global industry; the industry's preferences for state regulation; the relative lack of consumer involvement in insurance issues, including the issue of appropriate regulatory frameworks; and the views and motivations of state regulators who favor the continuation of the state system.

##### A. *The Classic Federalist Rationales*

The federalist argument for state regulation relies primarily on the presumption favoring state regulation created by the original delegation of limited power to the national government by the states. The federalist argument for state regulation of insurance relies on the presumption that the states have sole power to regulate unless that power was delegated to the federal government.<sup>242</sup> Favorable reasons for the of state regulation of the insurance industry include

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241. However, it is difficult to give the NAIC much credit for preserving state regulation of insurance, which is probably attributable in large part to the efforts of the industry and to the 1994 elections in which Democratic reformers lost power. See *supra* note 94 and accompanying text.

242. See, e.g., Kimball, *supra* note 10, at 510-11; Ronald Gift Mullins, *Strong Congressional Debate Role Urged for Industry Regulators*, J. COM., June 11, 1997, at A8 ("When in doubt, let the states do it." (quoting Governor Tommy Thompson of Wisconsin regarding the federal savings and loan debacle)).

each of the classic federalist arguments:<sup>243</sup> (1) increased opportunities for citizen participation in government;<sup>244</sup> (2) proximity to the citizenry and to the relevant issues and increased responsiveness as compared to a distant central administrator;<sup>245</sup> particularly since insurance is a "local" business;<sup>246</sup> (3) encouragement of healthy diversity and opportunities for experimentation with regulatory structures and content;<sup>247</sup> and (4) enhancement of democracy and liberty by widely dispersing decision-making power and the provision of checks on various levels of government.<sup>248</sup> These factors may provide grounds for continued state regulation. For example, according to Richard E. Stewart, a former New York insurance commissioner:

[A] final and unique advantage of state regulation is that the national alternative always hangs over it. The state agencies are subject to review, investigation and embarrassment by the Congress and others in the national government. Congress always has the power to abolish us if it finds us incorrigible; we all know it and it concentrates the mind wonderfully.<sup>249</sup>

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243. See, e.g., DAY, *supra* note 17, at 54-58. Most of these arguments are advanced in all discussions of the relative merits of state versus federal regulation, regardless of the substance of the regulation at issue. See Spencer L. Kimball, *State Versus Federal Regulation*, in INSURANCE, GOVERNMENT, AND SOCIAL POLICY: STUDIES IN INSURANCE REGULATION 411, 414-17 (Spencer L. Kimball & Herbert S. Denenberg eds., 1969).

244. See, e.g., Gregory v. Ashcroft, 501 U.S. 452, 458 (1991) (finding that the federalist structure "increases opportunities for citizen involvement in democratic processes").

245. See *id.* at 458 (noting that federalism "makes government more responsive by putting the States in competition for a mobile citizenry"); Scot J. Paltrow, *The Converted: How Insurance Firms Beat Back an Effort for Stricter Controls*, WALL ST. J., Feb. 5, 1998, at A1 ("[W]e believe insurance is a local business by its nature." (quoting Kevin Sullivan, Assistant General Counsel, Allstate)). The NAIC's position, articulated many times, is that because "the states are closer to the consumers they are protecting and the industry they are regulating, states do a better job of regulating insurance than the federal government could." NAIC, 1995 NAIC ANNUAL REPORT 15 (1996).

246. See Sara Marley, *Insurers, Legislators Criticize NAIC's Practices*, BUS. INS., May 30, 1994, at 3

247. See, e.g., Gregory, 501 U.S. at 548 (stating that federalism "allows for more innovation and experimentation in government"). The argument that multiple state systems permits experimentation is common in discussions of the advantages of state level regulation. See, e.g., Lewis B. Kaden, *Politics, Money, and State Sovereignty: The Judicial Role*, 79 COLUM. L. REV. 847, 854-55 (1979); Deborah J. Merritt, *The Guarantee Clause and State Autonomy: Federalism for a Third Century*, 88 COLUM. L. REV. 1 (1988).

248. See, e.g., Gregory, 501 U.S. at 458 (stating that federalism is "a check on abuses of government power"). According to Spencer L. Kimball, "[t]he values of federalism lie in the wide dispersion of decision-making power and in the probable enhancement of democracy and liberty by such dispersion." Spencer L. Kimball, *The Purpose of Insurance Regulation: A Preliminary Inquiry in the Theory of Insurance Law*, 45 MINN. L. REV. 471, 511 (1961).

249. James M. Jackson, *Commerce, Compacts and Congressional Consent: Federalism and State Insurance Regulation*, 10 J. OF INS. REG. 23, 39 (1991) (citing Richard Stewart, *The Future of Federalism in Insurance Regulation*, 65 AM. LIFE CONVENTION PROC. 110, 118 (1970)); see also JONATHAN R. MACEY & GEOFFREY P. MILLER, *COSTLY POLICIES: STATE REGULATION AND ANTITRUST EXEMPTION IN INSURANCE MARKETS* 36 (1993).

Finally, maintenance of the status quo provides an additional rationale in favor of continued state regulation. The long history of state regulation carries with it incentives to protect the states' long-term investments in their regulatory systems (in terms of expertise, reputation, and human capital).<sup>250</sup> A change in regulatory regimes carries substantial costs; in the absence of compelling reasons for change, continuation of existing systems seems appropriate.

Particularly following a resurgence of constitutional federalism as a constraint on national power in the Supreme Court's jurisprudence,<sup>251</sup> commentators have begun to question and criticize these federalist rationales on a theoretical level.<sup>252</sup> Regardless of their validity, many of them do not apply to the federalist system of state insurance regulation, largely due to the NAIC's role, and thus cannot explain or defend the persistence of the state insurance regulatory system. In many ways, the NAIC's structures and functions undercut each of the classic federalist rationales. By performing important policy-making functions as a central regulatory body and by attempting to force state conformance to various regulatory choices, the NAIC minimizes the related federalist values of states' responsiveness to local concerns and opportunities for local citizen participation in government. By requiring adoption of uniform laws and standardized regulatory procedures through its accreditation program, the NAIC, in large measure, eliminates the possibility of regulatory

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250. For example, Josephine Musser, the 1997 NAIC president and Wisconsin insurance commissioner, has made this argument repeatedly. She has stated: "States have the expertise. . . . The states are closest to the consumer, and the states have the tools and facilities to do the job." Ronald Gift Mullins, *Strong Congressional Debate Role Urged for Industry Regulators*, J. COM., June 11, 1997 at 8A (quoting Josephine Musser).

251. In *Gregory*, Justice O'Connor suggested that federalism prohibited some federal directives to the states. See *Gregory*, 501 U.S. at 457-64. By a six-to-three vote in *New York v. United States*, 505 U.S. 144 (1992), the Supreme Court held unconstitutional a federal statute that required states to choose a waste disposal site or assume the liabilities of hazardous waste producers. See *id.* at 188. Most recently, the Supreme Court ruled that the Handgun Violence Prevention Act unconstitutionally obligated state officers to execute federal laws by requiring them to conduct background checks on prospective handgun purchasers before the national system became operative. See *Printz v. United States*, 521 U.S. 898, 931-35 (1997).

252. See generally Edward L. Rubin & Malcolm Feeley, *Federalism: Some Notes on a National Neurosis*, 41 UCLA L. REV. 903 (1994) (noting that many of the supposed values of federalism are in fact values of decentralization). Because a federalist government necessarily entails decentralization, these values accompany federalism but could be accomplished in its absence. Specifically, the goals of public participation, ensuring responsiveness of the states, and encouraging experimentation, are "linked to federalism only by confusing that concept with decentralization." *Id.* at 915; see also Vicki C. Jackson, *Federalism and the Uses and Limits of Law: Printz and Principle?*, 111 HARV. L. REV. 2180, 2217 (1998) (suggesting that Rubin and Feeley fail to appreciate the relationship of decentralization and federalism and that abandoning constitutional federalism in favor of decentralization might diminish those values). But see Barry Friedman, *Valuing Federalism*, 82 MINN. L. REV. 317, 405 (1997) (agreeing with Rubin and Feeley that many judges and academics do not seriously examine the purported values of federalism).

experimentation. By operating as a centralizing mechanism permitting the states to circumvent and defuse attempted federal intervention in insurance regulation, the NAIC concentrates rather than disperses power.

In short, theoretical arguments for regulation at the state rather than the federal level become less compelling once the influence of the NAIC is taken into account. The following sections attempt to explain the continued dominance of state regulation through an analysis of the interests of consumers, the industry, the states, and Congress.

### B. *Scholarly Analysis of Regulation*

For two reasons, general theories of regulation and administrative process, although helpful in understanding and assessing insurance regulation, provide no firm basis for either supporting or opposing retention of the current system of state regulation. First, the literature focuses on federal rather than state regulation, typically examining the relationships between and among Congress, the President, federal regulatory agencies, regulated industries, and the public. To the extent that the structure of state government parallels that of the federal government, the literature provides some useful analogies. However, insurance regulation occurs not merely through the activities of individual state regulatory agencies, but also through the efforts of the NAIC. This is the second reason that general theories of regulation cannot be immediately applied to assess insurance regulation. As general theories, they cannot take into account the unique structures of insurance regulation in which a private, nongovernmental body composed of state government officials both performs central regulatory functions and attempts, at the individual state legislative and administrative levels, to implement joint decisions on regulatory issues.

The substantial body of literature developed in the last decade dealing with the phenomenon of the "private legislature"<sup>253</sup> in the

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253. See, e.g., Peter A. Alces & David Frisch, *Commenting on "Purpose" in the Uniform Commercial Code*, 58 OHIO STATE L.J. 419, 441-47 (1997) (noting the prominence of the Permanent Editorial Board and the National Conference of Commissioners on Uniform State Laws (NCCUSL) in the drafting and revision of the Uniform Commercial Code (U.C.C.)); Kathleen Patchel, *Interest Group Politics, Federalism, and the Uniform Laws Process: Some Lessons from the Uniform Commercial Code*, 78 MINN. L. REV. 83, 145-55 (1993) (arguing that due to a lack of political accountability, the NCCUSL and the American Law Institute (ALI) have not been adequately conscious of consumer interest in revising the U.C.C.); Larry E. Ribstein & Bruce H. Kobayashi, *An Economic Analysis of Uniform State Laws*, 25 J. LEGAL STUD. 131, 142-46 (1996) (arguing that the NCCUSL successfully lobbies for uniform state laws that are adopted because they are subject to interest group influence); Steven L. Schwarcz, *A Fundamental Inquiry into the Statutory Rule-making Process of Private Legislatures*, 29 GA. L. REV. 909, 917-21 (1995) (identifying a variety of flaws in the rulemaking process used to update the U.C.C.); Alan Schwartz & Rob-

context of uniform law revision provides some useful insight into the issues raised by the NAIC's role in drafting model insurance laws and regulations, but its analytical utility is similarly limited. The NAIC's model law drafting function is similar to that of the National Conference of Commissioners on Uniform State Laws (NCCUSL),<sup>254</sup> which creates model laws, and the American Law Institute (ALI),<sup>255</sup> which drafts restatements of the law and assists with drafting the Uniform Commercial Code. However, the significant differences between bodies such as NCCUSL, the ALI, and the NAIC preclude direct application of the "private legislature" analysis to the NAIC. First, the members of ALI and NCCUSL are private individuals—lawyers, academics, and judges—who devote some of their time to working to improve the law. The NAIC membership is composed of state officials with regulatory powers and responsibilities in their respective states, who may also wield substantial influence in their own state's legislatures and who are individually accountable to their governors, or in some cases, to the electorate. Second, unlike the NCCUSL and the ALI, the NAIC performs substantial and important regulatory functions in addition to the drafting of model laws.

Scholarly writing on insurance regulation generally supports state regulation of insurance but fails to account fully for the NAIC's centralizing and enabling role in the state system. In the 1960s, Spencer L. Kimball wrote on the purposes of insurance regulation in well-regarded articles<sup>256</sup> and a book. He examined the processes of state regulation and concluded that state regulation is appropriate, but he did not address the NAIC in any detail. Kenneth J. Meier produced

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ert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595, 650-52 (1995) (concluding that a variety of institutional factors drive the uniform legislation drafted by the ALI and the NCCUSL); Robert E. Scott, *The Politics of Article 9*, 80 VA. L. REV. 1783, 1813-15 (1994) (arguing that the average private legislative member does not have as strong a preference for revision as do members of drafting committees and study groups).

254. The NCCUSL consists of more than 200 commissioners (approximately four from each state) appointed by the governors of their states for three-year renewable terms. Its members are practitioners, academics, and judges. Appointments are typically renewed and the appointments are nonpolitical. NCCUSL creates uniform laws for recommendation to state legislatures for adoption. It is supported by state taxes and contributions by the ABA and others. See NATIONAL CONFERENCE OF COMMISSIONERS, A 100 YEAR TRADITION OF EXCELLENCE: THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS (1991).

255. The ALI is a private law reform group that creates the *Restatements of Law* and works with NCCUSL in drafting and revising the U.C.C.. It chooses its own membership, which includes practicing lawyers, academics, and judges. See generally *Symposium on the American Law Institute: Process, Partnership, and the Restatements of Law*, 26 HOFSTRA L. REV. 576 (1998).

256. See generally INSURANCE, GOVERNMENT, AND SOCIAL POLICY: STUDIES IN INSURANCE REGULATION (Spencer L. Kimball & Herbert S. Denenberg eds., 1969); Spencer L. Kimball, *Introduction: Unfinished Business in Insurance Regulation*, 1969 WIS. L. REV. 1019; Spencer L. Kimball, *The Purpose of Insurance Regulation: A Preliminary Inquiry In the Theory of Insurance Law*, 45 MINN. L. REV. 471 (1961).

an award-winning analysis of the politics of insurance regulation in 1988.<sup>257</sup> The book is a response to interest-group theories of regulation first articulated in the 1970s,<sup>258</sup> and concludes, contrary to the claims of those theories, that insurance regulation is not dominated by the industry. Meier articulates two basic reasons for his conclusion: the size and diversity of the industry itself suggests that monolithic industry domination is unlikely, and the dispersion of regulatory authority among the states (and to a much lesser extent, the federal government) suggests that domination would be very difficult. Both factors, in Meier's assessment, make interest-group domination unlikely. As this Article has demonstrated, the NAIC's role as a central regulatory body significantly undercuts Meier's reasoning. The history of the NAIC and, in particular, its continuing failure to enhance market conduct regulation or adopt market conduct accreditation standards demonstrates that the industry has utilized its power jointly to influence and even direct the NAIC's actions. Finally, in their important analysis of insurance regulation, Jonathan R. Macey and Geoffrey P. Miller conclude that insurance regulation is not subject to systematic bias in favor of either the industry or consumers and that federal regulation is thus not necessary to correct problems in the state regulatory structure.<sup>259</sup> Although federal regulation may not be necessary to guarantee effective regulation of the insurance industry, the history of the NAIC suggests, contrary to Macey and Miller's conclusions, a systematic bias in favor of the industry.<sup>260</sup>

In short, the literature, although illuminating in many ways, is critically flawed by its insufficient recognition of the important and often enabling role of the NAIC in the system of insurance regulation and the opportunities for industry participation in and control of the NAIC's functions.<sup>261</sup>

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257. See KENNETH J. MEIER, *THE POLITICAL ECONOMY OF REGULATION: THE CASE OF INSURANCE* (1988).

258. See George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

259. See MACEY & MILLER, *supra* note 249, at 41-44; Jonathan R. Macey & Geoffrey P. Miller, *The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation*, 68 N.Y.U. L. REV. 13, 40-43 (1993).

260. See *infra* Part IV.C.2. At the very least, the structure of the NAIC facilitates industry participation in and potential control over the content of various regulations; whether the NAIC has been controlled by the industry may be subject to debate, but it is clear that the potential for such control exists and has been exercised on at least some occasions.

261. Other works on insurance regulation take little notice of the NAIC's pivotal role. See, e.g., DOUGLAS CADDY, *LEGISLATIVE TRENDS IN INSURANCE REGULATION* (1986); PETER M. LENCISIS, *INSURANCE REGULATION IN THE UNITED STATES: AN OVERVIEW FOR BUSINESS AND GOVERNMENT* (1997); MCDOWELL, *supra* note 4.

### C. Interest Groups

#### 1. Public Disinterest

Consumers do not participate in insurance issues for a number of reasons. First, interest groups are more successful when they are small. Insurance consumers are, of course, an enormous group, comprising almost the entire population.<sup>262</sup> The larger the group, the more difficult and costly it is to organize for at least two reasons. Each member of a large group correctly perceives that collective action will likely result in relatively minimal individual benefits and that group members who do not contribute to the collective effort will benefit nonetheless—the free rider problem.<sup>263</sup> Second, collective action on insurance issues is impeded by the nature of those issues. Insurance issues are not typically characterized by broad scope and intense conflict; only rarely are insurance issues capable of generating broad public interest.<sup>264</sup> Third, insurance issues are typically complex, requiring special knowledge and expertise. Individual insurance consumers can obtain and understand information about the issues only with great effort and at great cost.

This combination of factors accounts for the low level of consumer involvement in insurance issues. According to political scientists, issues that are salient but not complex—like human rights—are most likely to capture public attention;<sup>265</sup> issues that are highly complex but not salient—like most insurance issues—are least likely to do so. The inherent difficulties of organizing consumer groups increases as salience decreases, and the possibility of effective participation in policymaking decreases as complexity increases.

The dearth of consumer organizations concerned with insurance bears out these observations. Although a number of insurance-oriented consumer groups exist, they seem generally to be small organizations held together through the efforts and energies of an individual and not by large and committed memberships. The National

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262. See *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533, 540 (1943). Justice Black observed: "Perhaps no modern commercial enterprise directly affects so many persons in all walks of life as does the insurance business. Insurance touches the home, the family, and the occupation or the business of almost every person in the United States." *Id.*

263. See generally MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* (1971).

264. There are occasional exceptions, such as no-fault automobile insurance in the 1970s and automobile insurance rate rollbacks in the 1980s. See, e.g., CAL. INS. CODE § 1861 (West 1988) (Proposition 103). Insurer insolvencies in the 1980s gave rise to the proposals for federal regulation discussed in Part II of this Article. In recent years, health insurance has been something of an exception, prompted by presidential attention to the issues and widespread notice of obstacles faced by many individuals in receiving adequate health care.

265. See MEIER, *supra* note 3, at 30-31.

Insurance Consumer Organization (NICO), founded in 1980 by J. Robert Hunter, was, in Kenneth Meier's assessment, "the effort of a single individual [Hunter] rather than the concerted effort of thousands of individual members."<sup>266</sup> The same seems to be true of the Center for Insurance Research, founded in 1991 by Jason Adkins, a Harvard Law school graduate who once worked for Ralph Nader and who has recently left the Center to form his own public interest law firm.<sup>267</sup> Prior to Adkin's departure, the center operated with a staff of four, two of which worked only part-time.<sup>268</sup> Hunter recognizes the difficulties inherent in organizing insurance-oriented consumer groups and states that one of his goals as a consumer advocate is "to get other people involved on our side because it was never anywhere near to being a close fight."<sup>269</sup> Speaking about another one of his goals, to educate consumers, Hunter said, "[O]bviously we haven't achieved it."<sup>270</sup>

In recognition of the very limited role of consumers in insurance issues generally and in the NAIC's processes in particular, the NAIC developed its Consumer Participation Program in 1991 to increase public participation in NAIC deliberations. In 1996 the NAIC Funded Consumer Program and Consumer Participation Board of Trustees was expanded to ten members, consisting of five NAIC members and five consumers.<sup>271</sup> At present, the NAIC funds the participation of

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266. MEIER, *supra* note 3 at 139. Meier's assessment is borne out by the history of the NICO. When Hunter resigned as NICO's president in 1993 to become the Texas insurance commissioner, two NICO board members, took over: James Hunt, former Vermont commissioner, and Kathleen O'Reilly, a consumer advocate. Hunt retained his job as a staff actuary for Savings Bank Life Insurance Company of Massachusetts, and O'Reilly stated she could not devote full-time efforts to NICO due to other commitments. See Mary Jane Fisher, *More Life Issue Focus Seen at NICO After Hunter*, NAT'L UNDERWRITER (Life & Health/Fin. Servs. ed.), Nov. 15, 1993, at 6. When Hunter left the Texas position, he became head of insurance issues at the Consumer Federation of America (CFA), and folded NICO into CFA. L.H. Otis, *Hunter and NICO Set to Join Consumer Federation*, NAT'L UNDERWRITER (Life & Health/Fin. Servs. ed.), Feb. 6, 1995, at 25. The CFA's priorities for insurance include enhancing competition among insurance companies through provision of consumer information, improving consumer awareness of the risks of life insurance and deceptive practices used in life insurance sales, strengthening state regulation of insurance, and promoting effective consumer representation at state insurance departments. See *id.*

267. See *Adkins Leaves Center for Insurance Research*, BEST'S INS. NEWS, Jan. 14, 1998, available in 1998 WL 6566074.

268. The Center for Insurance Research engages in numerous activities, including opposition to the demutualization of insurance companies through litigation, such as the 1995 settlement of a lawsuit against State Mutual Life Assurance Co. of America, a 38-state test of insurance department consumer help lines, and an attempt to enjoin the New England Mutual Life and Metropolitan Life Insurance Co. merger in 1996, which was ultimately approved by New York's insurance department. See Caroline Saucer, *Small Group, Big Impact*, BEST'S REV. (Life/Health ed.), Mar. 1, 1998, at 51.

269. *J. Robert Hunter: Consumer Advocate Challenges Conventional Wisdom in Insurance*, BUS. INS., Oct. 30, 1997, at 72.

270. *Id.* at 74.

271. See NAIC, 1996 NAIC ANNUAL REPORT 23 (1997).

twelve consumer representatives at the NAIC's quarterly meetings and conference calls. Representatives are chosen based on "[a]ctive participation at national and interim meetings and conference calls . . . substantive input on model laws, white papers, and other matters . . . diversity in terms of expertise, geography, [and] constituencies."<sup>272</sup> In 1997 the NAIC budgeted \$60,000 for consumer participation.<sup>273</sup> In addition, beginning in January 1996, the NAIC allowed members of the public to take part in conference calls of NAIC committees, subcommittees, task forces, and working groups.<sup>274</sup> It is clear, however, from even a cursory review of any of the NAIC proceedings that the industry's presence and input greatly exceeds that of consumers.

Although NAIC funds consumer representatives, and although there are insurance consumer advocates, there is very little interest in insurance issues. Because the public will not galvanize around insurance issues, groups with more at stake (the industry) will control.

## 2. *Industry Preference*

In contrast to consumers, industry groups will generally be more successful in asserting their regulatory preferences. Cohesive, organized interest groups, like the insurance industry, have an obvious advantage over large, dispersed, and disorganized interest groups, such as insurance consumers. Unlike consumers, industry groups have access to information in the course of their ordinary business operations.

The industry would enjoy these relative advantages over consumer groups whether insurance regulation occurred at the state or federal level. In fact, additional advantages would accrue to the industry with federal regulation. Centralized federal regulation would reduce the costs of regulatory compliance by eliminating multiple and possibly inconsistent licensing and regulatory frameworks. Federal regulation would also reduce lobbying expenses through the installation of a single regulatory authority. Under the present system, the industry lobbies in multiple states and at the federal level to ensure continuing federal deference to the states.

Given this balance of state/federal advantages, one might expect the industry to advocate federal regulation of insurance. The industry, however, prefers state versus federal regulation. That preference, although strong and long-standing, is neither constant nor uniform. At various times, the industry and individuals within the in-

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272. NAIC, *NAIC Consumer Participation Program Enters Sixth Year* (visited Mar. 19, 1999) <<http://www.naic.org/1news/releases/conspar.htm>> (news release dated Feb. 10, 1997).

273. See NAIC, 1997 NAIC ANNUAL REPORT 23 (1998).

274. See *id.* at 14.

dustry have advocated federal regulation.<sup>275</sup> However, in a recent survey of industry participants and regulators, brokers and insurers disagreed that the regulatory process would be handled better by the federal government.<sup>276</sup> In the recent debates over the integration of financial services, the industry has uniformly expressed unequivocal preferences for continued state regulation of insurance. In testimony before the House of Representatives Committee on Banking and Financial Services, Robert A. Gleason, Jr., chairman and CEO of the Gleason Agency, spoke on behalf of the Council of Insurance Agents and Brokers and voiced strong support for continued state regulation of the business of insurance.<sup>277</sup> The American Insurance Association (AIA), through its senior vice president and general counsel, Craig A. Berrington, also advocated functional regulation by existing state insurance regulators, provided by insurance companies or other financial institutions,<sup>278</sup> as did Brent Larsen, chair of the National Asso-

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275. In the early days of insurance regulation, the industry recognized that regulatory centralization would be more efficient. *See supra* text accompanying notes 18-28. During the height of the accreditation controversy, members of the industry expressed concerns about the state system. *See, e.g.,* Sara Marley, *Insurers, Legislators Criticize NAIC's Practices*, BUS. INS., May 30, 1994, at 3 ("Some days I am ready for federal regulation." (recording comments of H. Peter Hudson, Chairman and Chief Executive Officer of Monroe Guaranty Insurance Co., Carmel, Ind.)). Jay Angoff, director of the Missouri Department of Insurance also noted: "[T]he industry has assumed it was getting a better deal at the state level. Now it's not quite sure. Current trends are it might be better off with federal regulation." *Id.* Commenting on the industry's attitude, a well-regarded insurance text states:

Representatives of the larger national insurers have, from time to time, made guarded observations that perhaps federal regulation would not be all that bad. . . . The real attitudes of insurance company managers are sometimes difficult to discern. Although there are many insurance company executives who would welcome federal regulation, there is an understandable reluctance on the part of those favoring federal regulation to speak out, since any statements favoring a federal system might be taken as a criticism of the existing system by state regulators—a system to which the companies are still subject.

EMMETT J. VAUGHN, *FUNDAMENTALS OF RISK AND INSURANCE* 159 n.35 (4th ed. 1986).

276. *See* Etti G. Baranoff & Daniel Gattis, *Measuring Attitudes Toward Regulation*, BEST'S REV. (Life/Health ed.), Sept. 1998, at 60. The authors concluded, "All respondents strongly reject the idea that federal regulation might be better." *Id.* at 60-61. Possible responses ranged from 1 (strongly agree) to 5 (strongly disagree). Brokers' average score on the hypothetical effectiveness of federal was 4.3; the insurer's average was 3.8. *See id.* at 61.

277. *See Financial Modernization—Part I: Hearings Before the House Comm. on Banking and Fin. Servs.*, 105th Cong. 127 (1997) ("We are creating a body that would be responsible for establishing and operating a uniform licensing regime. . . . States would retain their proper role as the primary regulator of insurance activities." (statement of Robert A. Gleason, Jr., Chairman and CEO, the Gleason Agency on behalf of the Council of Insurance Agents and Brokers)).

278. *See id.* at 122-23 ("[W]e believe the legislation needs to be anchored to principles of functional regulation where insurance regulators have responsibility for insurance matters . . . . [W]e are skeptical of the need for an umbrella regulator." (statement of Craig A. Berrington, Senior Vice President and General Counsel, American Insurance Association)).

ciation of Mutual Insurance Companies and director of government affairs of Grinnell Mutual Reinsurance Company.<sup>279</sup>

Some members of the industry explain the reasons for their preferences, echoing the reasons listed above. For example, W. Craig Zimpher, vice president for government relations, Nationwide Insurance Enterprise, stated:

We believe, due to decades of business regulation by the states, as Congress mandated in the 1940's through the McCarran-Ferguson Act, that state insurance regulation works effectively and efficiently for both those regulated and those protected, the consumers.

....

A steady and sound insurance regulatory system has been in place for decades. State regulation of insurance is getting the job done effectively and efficiently.<sup>280</sup>

Explaining his company's support of state regulation, Kevin Sullivan, Allstate assistant general counsel, stated, "We believe insurance is a local business by its nature."<sup>281</sup>

It is possible that members of the insurance industry truly believe that it is a local industry, and it is possible that some segments of the industry are, in fact, local. It is also possible that the long tradition of state regulation and the purported efficacy of state regulation partly account for the industry's preferences for continued state regulation, after overcoming the costs occasioned by multiple regulatory systems. However, there must be more to the industry's preferences than these factors. An additional (and quite likely the primary) explanation for the industry's preference is its ability to influence and even to control state regulators.

The industry correctly perceives that federal regulation would diminish its substantial power over the regulatory system for several reasons. The first two reasons are systemic; the latter three reasons focus specifically on the NAIC. First, state-level regulation affords the industry numerous regulatory options and the potential for obtaining a more favorable regulatory environment by threatening exit from a state with a burdensome or invasive regulatory regime. Sec-

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279. See *id.* at 129 ("[I]t must provide for functional regulation of insurance . . . . Under a system of functional regulation, insurance activities would be regulated by the States . . . ." (statement of Brent Larsen, Chair of the National Association of Mutual Insurance Companies)).

280. *Financial Services Reform: Hearings Before the Subcomm. on Fin. and Hazardous Materials of the House Comm. on Commerce*, 105th Cong. 34-36 (1997) (statement of W. Craig Zimpher, Vice President of Government Relations, Nationwide Insurance Enterprise).

281. Scot J. Paltrow, *How Insurance Firms Beat Back an Effort for Stricter Controls*, WALL ST. J., Feb. 5, 1998, at A10 (quoting Kevin Sullivan, Allstate Assistant General Counsel).

ond, federal regulation of insurance would likely increase the level of public participation in insurance issues with attendant decreases in the industry's influence. Third, the NAIC affords the industry three advantages that federal regulation would eliminate or minimize. The NAIC's structure and operations permit substantial industry participation in the development of regulatory policy and in the creation of model regulations and laws. The NAIC also provides a centralized mechanism for the adoption of industry-approved policies and laws, which reduces the industry's costs for state-level lobbying (and preserves the opportunity for lobbying *against* the passage of NAIC standards if the industry fails to achieve favorable results at the NAIC level). Perhaps most importantly, the bulk of the NAIC's budget comes from industry assessments. The industry has exercised this budgetary power over the NAIC in public and direct ways and presumably in subtle, less public ways as well.

(a) *The Possibility of Exit and Regulatory Leverage*

State-level regulation carries significant systemic advantages for insurance companies, which typically enjoy a "strong presence" in their state of domicile.<sup>282</sup> A system of multiple (state) regulatory bodies affords the regulated industry choices among regulatory environments.<sup>283</sup> In a state system, insurance companies retain the possibility of exit from a particularly invasive or burdensome regulatory regime.<sup>284</sup> Threatened loss of coverage for state consumers, substan-

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282. See Kenneth W. Faig, Jr., *Diversity of State Valuation Laws and Regulations: Opportunity or Curse?* 15 J. INS. REG. 212, 212-14 (1996).

283. See, e.g., Richard A. Epstein, *Exit Rights Under Federalism*, 55 LAW & CONTEMP. PROBS. 147, 149 (1992).

284. States may try to prevent market exit by mandating renewal of existing policies, requiring withdrawing insurers to continue participating in the residual market, or preventing insurers who withdraw in one line from writing any other line of insurance in the state. See, e.g., CAL. INS. CODE § 1070 (West 1988); FLA. STAT. § 627.7013 (1997) (enacting law in 1993 following Hurricane Andrew to prevent total withdrawal of insurance companies from the Florida market); N.J. STAT. ANN. § 17:30 (West 1997) (codifying the Fair Automobile Insurance Reform Act of 1990); MASS. GEN. LAWS ANN. ch. 175 §§ 22E, 22H, 113E (West 1997). Courts in New York and California have held that states may not compel insurers to continue to do business in the state. See, e.g., *Travelers Indem. Co. v. Gillespie*, 785 P.2d 500, 506 (Cal. 1990) (holding that mandatory renewal provisions of Proposition 103 did not prevent market withdrawal); *People ex rel. Lewis v. Safeco Ins. Co. of Am.*, 414 N.Y.S.2d 823, 829-30 (1978) (finding that the insurer had the constitutional right to terminate business in the state under the Due Process and Takings Clauses). But see *Vesta Fire Ins. Corp. v. Florida*, 141 F.3d 1427, 1434 (11th Cir. 1998) (upholding summary judgment for the State of Florida because Florida statute did not impair the insurer's right of association or violate substantive due process and reversing summary judgment for the determination of whether Florida statutes constituted a regulatory taking in violation of the Fifth Amendment); *Maryland Cas. Co. v. Commissioner of Ins.*, 363 N.E.2d 1087, 1098-99 (Mass. 1977) (upholding the forfeiture of all lines of insurance upon withdrawal, without discussing the possible constitutional limitations); *In re The "Plan for Orderly Withdrawal from New Jersey" of Twin City Fire Ins. Co.*, 609 A.2d 1248, 1258 (N.J. 1992) (rejecting due process and takings claims and upholding the conditions on an insurer's with-

tial tax revenues, and employment opportunities if insurers leave a state may encourage a more favorable regulatory environment. Professor Kimball's classic article on insurance regulation argues for continued state regulation based partly on the fact that the insurance industry has the capacity to deal effectively with state legislatures because competition among the states provides leverage for the industry that is not possible at the federal level.<sup>285</sup> On the negative side, a system of state regulation may also require greater expenditures, particularly by companies who do business in multiple states. National companies may expend more resources to influence legislation and regulatory policy in multiple states.

However, insurance companies benefit in the sense that choices among regulatory environments make it easier for the insurance companies to protect their investments and diversify their risks. Action by a single (federal) regulatory body may have substantial negative impacts on the regulated industry that are difficult or impossible to reverse. In contrast, a system of multiple regulatory bodies affords the affected industry the choice of doing business in more hospitable regulatory climates.

(b) *Limited Visibility*

A second advantage of state regulation is that the influence exerted by insurance companies, although substantial, is less public and subject to fewer restrictions than it would be at the federal level. For example, a 1995 study performed by the Consumer Federation of America and Common Cause found that, among ten states surveyed, nineteen percent of state legislators serving on state insurance committees had substantial ties to the insurance industry. In Missouri, which had no laws regulating conflicts of interest, thirty-six percent of state legislators serving on state insurance committees had conflicts of interest.<sup>286</sup> Rules concerning conflicts of interest and disclosure requirements are more stringent at the federal level than in many states.<sup>287</sup>

Federal regulation also may generate greater public attention to and participation in insurance issues. As the regulatory stakes increase, so do the benefits of consumer participation. The multiple, decentralized layers of the state system make effective public participation in what are typically complex issues difficult and highly unlikely. The centralization afforded by the NAIC does not advan-

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drawal, including a five-year withdrawal period and a forfeiture of the affiliates' licenses to write any insurance in the state).

285. See Kimball, *supra* note 10, at 510.

286. See Steven Brostoff, *Insurer-Lawmaker Integrity Blasted*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), Sept. 4, 1995, at 1.

287. See *supra* text accompanying notes 82-86.

tage consumers, given its historical susceptibility to industry influence<sup>288</sup> and its status as a private organization.<sup>289</sup> Centralizing regulation makes the issues more visible and participation by consumers more rewarding. When regulatory power is widely dispersed, as it is under the present system, industry influence attracts less attention. Consumer and media oversight is more likely to occur where the stakes are greater. Effective participation at the federal level benefits all insurance consumers, not just those in a particular state.

These predictions are borne out by the public's reaction as the NAIC assumed greater power during the height of the accreditation controversy in 1994. The NAIC's expanded role generated greater attention by the media and public interest groups.<sup>290</sup> Various consumer-oriented reforms within the NAIC reflected that attention: the NAIC instituted its consumer participation program,<sup>291</sup> took steps to limit industry participation in policy making,<sup>292</sup> and opened its meetings.<sup>293</sup> As the criticisms leveled off, the NAIC subsequently undercut each of these efforts.<sup>294</sup>

Further, federal agencies are subject to various controls and procedures designed to enhance public access and participation in regulatory processes. The NAIC is not subject to these mechanisms.<sup>295</sup>

*(c) The NAIC's Role: Access, the Power of the Purse, and the Advantages of Centralization (with a Second Chance)*

Finally, the NAIC plays a substantial role in the industry's preference for continued state regulation for several reasons: (1) the NAIC provides multiple mechanisms for direct industry participation in regulatory issues; (2) the NAIC's budgetary reliance on the industry ensures its responsiveness to the industry's interests; and (3) the NAIC permits the industry to combine the advantages of centralized participation and lobbying (at the NAIC level) with the advantages of multiple (state) regulatory systems.

*i. Direct Industry Participation*

Historically, the industry has had enormous influence on the NAIC. Members of the industry participate directly in developing

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288. For a discussion of the industry's historical influence, see *supra* Parts II.B-C.; for more discussion of the industry's participation in current NAIC affairs, see *infra* Part IV.C.2.(c).

289. See *supra* notes 76-78 and accompanying text.

290. See *supra* text accompanying notes 126-45, 184-97.

291. See *supra* text accompanying note 271-74.

292. See *infra* text accompanying notes 305-12.

293. See *supra* text accompanying notes 271-74.

294. See *infra* text accompanying notes 316-20.

295. See *supra* text accompanying notes 82-87.

policies, regulations, and model laws through service on NAIC industry liaison committees, advisory committees, and technical resource groups. In fact, the connections are so deeply rooted that some members of the industry consider state regulators and the NAIC to be a part of the industry. Writing in the late 1960s, Professor Kimball observed:

The insurance regulator is conceived by far too many insurance executives, and too often he conceives himself, as part of the industry, existing to serve the industry. Indeed, I have heard life insurance men express the notion that it would be useful to have a national regulator to "represent" the industry in the executive branch of the national government. Nothing unsavory was intended—whatever else one may say about the insurance business, it is a business run by honorable men. However, the notion that a regulator should "represent" the industry is a subtly corrupted point of view.<sup>296</sup>

More recently, a member of the NAIC Industry Liaison Group recently created by the NAIC to give members of the industry an opportunity to participate in high-level policy discussions<sup>297</sup> stated: "I view regulators as part of the industry. I don't view it as a separate entity."<sup>298</sup> An attorney for the American Council of Life Insurers similarly views the industry as the NAIC's "foremost constituency."<sup>299</sup> The notion of regulators as representatives of the industry is troublingly common. Insurance scholar Banks McDowell recently stated that "organizations of insurance commissioners . . . can also serve as spokespersons for the industry, to either the public or the legislature, without appearing as clearly self-interested as official industry representatives would."<sup>300</sup>

Industry advisory committees and technical resource groups, which both are composed of industry members, play an important role in the industry's access to the NAIC. The NAIC performs numerous complex functions, and each member simultaneously retains full responsibility for insurance regulation in their respective states. Not surprisingly, members of the NAIC require substantial assistance, some of which is provided by the large NAIC staff and some of which is provided by industry advisory committees and technical resource groups. These groups are formed to provide information and

296. Kimball, *supra* note 90, at 432.

297. See *infra* text accompanying notes 316-19.

298. L.H. Otis, *NAIC Considers Reengineering Proposals*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), Mar. 31, 1997, at 5 (statement of Eric Gustafson, representing his employers, the Blake Agency and the Independent Insurance Agents of America).

299. *New NAIC Panel Raises Questions of Influence*, BEST'S INS. NEWS, Feb. 24, 1997, available in 1997 WL 7077380 (quoting Roy Woodall, an ACLI attorney).

300. McDOWELL *supra* note 90, at 58.

opinions to various NAIC committees and typically perform substantial work on NAIC projects.

The American Alliance of Insurers (AAI), an industry group, concluded in a 1982 study that "the NAIC functioned primarily as an evaluator and reactor to the work product of the industry advisory committee."<sup>301</sup> The AAI found that before and during the 1970s, the structure and operation of NAIC industry advisory committees afforded the industry enormous power over regulatory issues.

If a particular committee was charged with the responsibility to develop a model law or to conduct a study, a common response was to appoint an industry advisory committee to undertake the bulk of the work. . . . In other situations, the industry might initiate a particular project and seek the appointment of a NAIC committee to consider the work products or the appointment of an advisory committee to assist in carrying out the work.<sup>302</sup>

The report ultimately concluded that the NAIC had limited its use of industry advisory committees due to expansions of NAIC staff and greater visibility of insurance issues,<sup>303</sup> and it applauded the NAIC for its greater independence "in fact and in appearance."<sup>304</sup> However, the AAI's assessment was clearly premature, as similar concerns about industry influence continued to surface throughout the years following the report and accelerated as the NAIC's power increased in the early years of the accreditation program. These concerns centered on the appearance of industry control fostered by use of advisory committees and the fact that advisory committees could set the regulatory agenda and direct regulatory policy.

In March 1993 the NAIC's Executive Committee voted at a closed meeting to disband all industry advisory committees.<sup>305</sup> Advisory committees had remained active even without specific mandates and became an official means of industry lobbying, thus undercutting the independence and credibility of the state regulatory system. In recognition of the NAIC's technical needs, however, the Executive Committee authorized NAIC committee chairs to obtain outside advice and assistance through the use of technical resource groups (TRGs), which would be subject to greater control than advisory committees. The TRGs would be given specific tasks and exist only as long as authorized by the committee chair.

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301. NAIC IN TRANSITION, *supra* note 14, at 65.

302. *Id.*

303. *See id.*

304. *Id.*

305. *See* 1994 NAIC PROCEEDINGS II, June 12-15, 1994, at 1042; *see also* L.H. Otis, *Advisory Process Up in the Air After NAIC Move*, NAT'L UNDERWRITER (Life & Health/Fin. Servs. ed.), Apr. 5, 1993, at 29.

The decision to eliminate industry advisory committees was controversial in all quarters. Consumer advocates applauded the goal of eliminating industry influence but questioned the use of the nonofficial TRGs. One commentator noted, "When you take the advisory role off the books you surrender control [of it]."<sup>306</sup> Industry officials felt the decision was unwise because of the NAIC's necessary reliance on industry experts for technical assistance.<sup>307</sup> At least one insurance commissioner criticized the new system of using TRGs as "confusing" and "unworkable."<sup>308</sup> That opinion is supported by the minutes of a NAIC meeting at which participants seemed to be confusing advisory committees and the new technical resource groups by attributing to the TRGs the aspects of advisory committees that they were designed to eliminate.

These [TRGs] are groups consisting of representatives of the insurance industry that provide information and opinions to various NAIC committees, task forces and working groups. It was indicated that such groups often act as contacts for all "interested parties" to send comments on drafts and engage in other activities that might not be consistent with NAIC policy. Director Walsh indicated that he would ask for clarification of the activities of these groups and would provide the members with information at a later meeting.<sup>309</sup>

As the confusion within the NAIC itself suggests, the change from industry advisory committees to technical resource groups appears to have been largely cosmetic. Many in the industry, including individuals sitting on industry advisory committees turned TRGs, were unaware of the change even more than a year after it had been effected.<sup>310</sup> Advisory committees continued working with the primary change being their designation as Technical Resource Groups. The example of the Actuarial Advisory Committee to the NAIC Property

306. Otis, *supra* note 305, at 29 (quoting Lawrence D. Cluff, Assistant Director for Financial Institutions and Markets, General Accounting Office). The NAIC does not officially recognize technical resource groups. See *Year-Old NAIC Policy Shift Surprises Industry*, INS. REGULATOR, Oct. 10, 1994, at 3. [hereinafter *Year-Old Policy*].

307. See Otis, *supra* note 305, at 29. The National Association of Independent Insurers has sought a return to the advisory committee structure. See L.H. Otis, *NAIC Acts on Database Fees and 'Liaison' Groups*, NAT'L UNDERWRITER (Life & Health/Fin. Servs. ed.), Nov. 25, 1996, at 1 [hereinafter Otis, *NAIC Acts*].

308. Cynthia Crosson, *NAIC Grapples with Public Access*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), Dec. 5, 1994, at 4 (quoting Illinois Insurance Commissioner James Schacht).

309. 1994 NAIC PROCEEDINGS II, June 12-15, 1994, at 1042.

310. The elimination of industry advisory committees and their replacement by TRGs went unnoticed by many, including (apparently) members of the TRGs that had formerly been industry advisory committees. A member of a TRG was prevented from testifying before the relevant NAIC Working Group because of the unofficial status of TRGs. This event appears to have been the first indication for many in the industry of the change. See *Year-Old Policy*, *supra* note 306, at 3.

Casualty Risk-Based Capital Working Group demonstrates the point. All members of the former industry advisory committee were appointed to an American Academy of Actuaries Task Force on Risk-Based Capital, which will advise the NAIC Working Group “from a professional actuarial perspective.”<sup>311</sup> Similarly, the former Model Law Advisory Committee has continued to function as a technical resource group.<sup>312</sup>

The potential for these industry groups to bias regulation in their favor is clear, regardless of the name given them. One commentator noted, “[Y]ou can’t get unbiased number crunching from anybody who has an ax to grind.<sup>313</sup> . . . [O]n some [technical] issues it’s tough to get away from the industry bias.<sup>314</sup> Another wrote, “[The NAIC] committee structure results in excessive dependence on industry advisory committees . . . in performing staff work. . . . because all NAIC members are all part-timers—their primary function being running their respective state insurance departments—controlling the agenda of the technical resource groups can be a difficult chore.”<sup>315</sup>

For the NAIC to avoid the inevitable bias accompanying the use of industry advisory committees or technical resource groups, it would be necessary to utilize independent experts, such as NAIC staff or state insurance department technicians, in lieu of the industry experts currently used. Budgetary constraints would likely preclude immediate implementation of either option.

In addition to the extraordinary influence and power afforded the industry through advisory committee and resource group participation, the industry now has an official policy-making function at the NAIC. The NAIC Executive Committee backed an industry proposal to establish a formal industry/NAIC liaison committee. The American Council of Life Insurers (ACLI), with the endorsement of other industry groups, proposed “a mechanism that will foster dialogue between and among NAIC and industry leaders.”<sup>316</sup> The new liaison committee consists of fifteen members: half regulators, half executives from individual companies (not trade group representatives).<sup>317</sup> Its purpose is to foster discussion. Then NAIC President Josephine Musser defended the new liaison group, stating that its purpose was

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311. Otis, *supra* note 305, at 29.

312. See 1993 NAIC PROCEEDINGS II, June 20-23, 1993, at 514.

313. Otis, *supra* note 305, at 29 (quoting Lawrence D. Cluff, Assistant Director for Financial Institutions and Markets, General Accounting Office).

314. *Id.* (quoting David G. Hartman, Senior Vice President, Chubb & Son, and Chair of the former Actuarial Advisory Committee to the NAIC Property Casualty Risk-Based Capital Working Group).

315. Michael V. Fasano, *Is the NAIC Up to the Challenge?*, BEST’S REV. (Life/Health ed.), Nov. 1, 1993, at 37.

316. Otis, *NAIC Acts*, *supra* note 307, at 1 (quoting a May 3, 1996 memorandum from the ACLI to the NAIC).

317. See *id.*

not to provide technical advice but input and interaction at a higher level.<sup>318</sup> In some ways, this is a positive move: at least it is open, unlike the operation of TRGs and “the wining and dining that goes on after hours between regulators and companies at quarterly meetings and in other settings.”<sup>319</sup> However, in other ways, the move is troubling: the industry now has an explicit and acknowledged policy-making function in addition to the implicit and largely unacknowledged policy-making power it has always enjoyed informally through advisory committee or resource group participation.

In addition to the organized structures by which the industry can exert its influence, there are many opportunities for informal lobbying. Not until 1993 did the NAIC Executive Committee eliminate the practice of industry sponsorship of official and unofficial NAIC events at its quarterly meetings.<sup>320</sup> According to a recent *Wall Street Journal* article, a dinner between executives and state insurance regulators, who also served as NAIC officers, changed the course of insurance regulation.<sup>321</sup> In order to end the industry’s boycott, the regulators agreed to utilize database fees for solvency regulation only; to limit market conduct regulation; to establish the industry liaison committee; and to hire a new executive vice president, Catherine J. Weatherford, a former lobbyist for Liberty Mutual Insurance Co. and someone with whom the industry felt comfortable.

## ii. NAIC’s Budgetary Reliance on the Industry

In addition to the industry’s opportunities for influencing regulation through technical or policy assistance to NAIC committees and informal contacts, the industry exerts substantial control over policy through its financing of the NAIC. The industry funds approximately one-half of the NAIC’s annual budget through database assessments. The industry claims that the NAIC uses database fees to finance a

318. See *id.* (quoting Josephine Musser, 1997 NAIC President and Wisconsin Insurance Commissioner).

319. *New NAIC Panel Raises Questions of Influence*, BEST’S INS. NEWS, Feb. 24, 1997, available in 1997 WL 7077380 (quoting J. Robert Hunter, Director of Insurance of Consumer Federation of America).

320. See Albert B. Crenshaw, *Regulators Eye “Cozy” Ties to Insurers; Policy Change Would End Industry-Paid Dinners, Parties, Outings*, WASH. POST, Mar. 3, 1993, at A13; see also L.H. Otis, *NAIC Permanently Disbands “Host” Committees*, NAT’L UNDERWRITER (Life & Health/Fin. Servs. ed.), Mar. 15, 1993, at 4.

321. See Scot J. Paltrow, *The Converted: How Insurance Firms Beat Back an Effort for Stricter Controls*, WALL ST. J., Feb. 5, 1998, at A1. The dinner was attended by Illinois Insurance Director Mark Boozell, then NAIC President Brian K. Atchinson, then NAIC President-elect Josephine Musser, and current NAIC President Glenn Pomeroy. Some commentators openly refer to the industry’s lobbying advantages in the state system. For example, a recent article addressing state valuation laws argue for continued state regulation by observing that the industry’s abilities to lobby would suffer if insurance was subject to federal rather than state regulation. See generally Faig, *supra* note 282.

range of activities unrelated to solvency regulation. The NAIC's dependence on the industry for the bulk of its operating expenses provides the industry with substantial leverage over regulatory issues. The NAIC's failure to implement market conduct accreditation standards is, in part, attributable to the industry's withholding of database fees and its continuing attacks on the NAIC for using database fees for regulatory activities unrelated to solvency.<sup>322</sup>

In response to industry criticism concerning the use of database fees, the NAIC Executive Committee passed a resolution that future budgets would minimize what they and the industry have termed "cross-subsidization":

[I]t is in the best interests of state insurance regulation and the industry it regulates for the fees related to annual statement filings with the NAIC to be based on the cost of defined solvency regulation activities of the NAIC and not used generally to subsidize unrelated NAIC programs.<sup>323</sup>

The NAIC membership delayed discussion of this resolution at a plenary session and passed a motion to take up the resolution at the next meeting.<sup>324</sup> It does not appear that they did so.

If the conclusion that the NAIC's current funding structure provides significant advantages to the industry is correct, then the industry's challenges to the structure constitute an unlikely argument against its own self-interest.<sup>325</sup> Several explanations are possible. First, the industry's immediate goal during the accreditation controversy was discrediting the NAIC. That immediate goal may have superseded (intentionally or inadvertently) the long-term advantages of control over a substantial portion of the budget. Second, it is possible that the industry was so comfortable with its abilities to influence state legislatures that it was willing to forego the sizeable advantages of direct monetary control over the NAIC in favor of a less powerful NAIC. Ultimately, the NAIC has taken no action on fee-for-service and program-based budgeting, which suggests that the industry's objective in raising funding issues was to discredit the NAIC generally and not to eliminate basic funding structures.

### *iii. Centralization*

A final advantage provided by the NAIC is centralization. The central structure of the NAIC gives the industry an advantage by

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322. See Fletcher *supra* note 217, at 30.

323. L.H. Otis, *NAIC May Minimize Cross-Subsidies*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), Nov. 25, 1996, at 4.

324. See L.H. Otis, *NAIC to Set Up Insurance Industry Liaison Committee*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), Jan. 6, 1997, at 40.

325. Fee-for-service budgeting would minimize or eliminate the industry's influence.

permitting it to avoid costly state-by-state lobbying. The industry can attempt to shape regulatory policy at the NAIC through the various mechanisms discussed above. If its efforts are successful, it can rely largely on the NAIC's efforts at state adoption. If, however, the industry fails to enact favorable laws and policies, it has a second chance in the state legislatures to revise or defeat NAIC models.

### 3. *Congressional Deference*

Congress clearly has the power to regulate insurance under its expansive commerce power, but has chosen not to do so. The holding of *South-Eastern Underwriters* permits federal regulation of insurance under the Commerce Clause,<sup>326</sup> but the McCarran-Ferguson Act specifically defers to the states:

Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.<sup>327</sup>

Working with the NAIC and state regulators, the insurance industry drafted the McCarran-Ferguson Act, which was accepted almost without change by Congress.<sup>328</sup>

A number of reasons may explain congressional deference to the states on important issues of national interest like insurance. First, the industry and state regulators have made substantial investments in state regulation. State regulators have developed expertise in insurance regulation. The industry and the regulators have developed long-term relationships with each other. State regulation is an asset that federal preemption would dissipate. In these conditions, Congress may defer to the states, even on what are arguably national issues, in exchange for the political support of state regulators and the industry.<sup>329</sup> The individuals with the greatest stake in the continuation of state regulation are state legislators, state regulators, and the industry. In the absence of a powerful consumer group or an issue around which consumers can organize, Congress can maximize its political support by maintaining the status quo.

Deference to the states may also permit Congress to shirk difficult regulatory responsibilities. Financial services integration will create

326. See *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533, 552-53 (1944).

327. 15 U.S.C. § 1011 (1994).

328. See 90 CONG. REC. A4403-08 (1944). Congress rejected the NAIC's proposal excluding insurance from the operation of the antitrust laws. See *id.*

329. See Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265, 274-75 (1990).

complex questions, and the necessary period of adjustment may be difficult. By preserving the existing regulatory structures, Congress may be able to take the credit for modernizing financial services and enhancing the international competitiveness of U.S. firms while avoiding blame for the inevitable problems that will accompany the changes.<sup>330</sup> Of course, some of the same strategies are possible with a federal agency (and perhaps would be even more effective),<sup>331</sup> but the political climate favors state level control.

#### D. State Regulators and Legislators

Not all state regulators support the status quo. During the beginning of the accreditation program, Maryland Insurance Commissioner John Donaho called for federal oversight of state regulation through minimum standards for solvency regulation as well as minimum funding requirements for state departments of at least ten percent of premium taxes.<sup>332</sup> For the most part, however, state regulators believe that regulation should remain at the state level without federal involvement. Josephine Musser, Wisconsin insurance commissioner and 1997 president of the NAIC, makes the common argument that the federal government cannot regulate insurance as efficiently as the states. She explained: "The states have the expertise. The states are closest to the consumer, and the states have the tools and facilities to do the job."<sup>333</sup> Governor Tommy Thompson of Wisconsin articulated a lesser variant of the sentiment and cited the federal savings and loan debacle: "When in doubt, let the states do it."<sup>334</sup> Testimony of various commissioners before the House Committee on the Financial Services Competitiveness Act also demonstrates support for continued state regulation.<sup>335</sup>

State regulators' support for continued state regulation may be viewed pejoratively as demonstrating extreme self-interest or more

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330. See *id.* at 275-77; see also Morris P. Fiorina, *Legislative Choice of Regulatory Forms: Legal Process or Administrative Process?*, 39 PUB. CHOICE 33, 33-34 (1982).

331. Congress could preempt state insurance regulation, empower a federal agency to regulate insurance, and let the agency make decisions regarding the difficult issues that integration of financial services will inevitably create. Members of Congress could then take credit for sound (or at least popular) decisions, while blaming the agency for poor or unpopular decisions. Although some members of the public understand the connections between Congress and agencies and hold Congress accountable for the failures of agencies, many do not. This permits members of Congress simultaneously to take credit and avoid responsibility. However, it is reasonably clear that passage of a financial services bill will require the support of the industry and the states.

332. See Mary Jane Fisher, *NAIC Moves to Bolster State Insurance Solvency Regulation*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), Apr. 29, 1991, at 2.

333. Ronald Gift Mullins, *Strong Congressional Debate Role Urged for Industry Regulators*, J. COM., June 11, 1997, at A8.

334. *Id.*

335. See *supra* notes 277-81 and accompanying text.

neutrally as demonstrating confidence in the ability of the state system to provide effective regulation. Comments of some former state regulators suggest that self-interest may play at least some role. Several months after his tenure as Maryland insurance commissioner ended, Dwight K. Bartlett, III, publicly advocated federal intervention in insurance regulation. Although he identified areas in which he believed federal regulators could not perform as well as the states, such as the handling of consumer complaints,<sup>336</sup> he concluded that some federal insurance regulation was necessary to achieve consistent and coordinated regulation of a national industry and to prevent insurance company “shopping” for the least intrusive state regulation.<sup>337</sup> J. Robert Hunter, former Texas commissioner, also called for a federal role in insurance regulation, noting several trends he believed necessitated federal intervention: the insurance industry’s control over the NAIC, the internationalization of insurance, the increasing size of insurance companies following numerous mergers, and the integration of segments of the financial services industry.<sup>338</sup>

#### V. RECOMMENDATIONS FOR RESTRUCTURING AND REFORMING INSURANCE REGULATION

Decisions about appropriate regulatory structures are enormously complex. The decision is not merely a question of federal versus state regulation. Despite the frequent phrasing of the question in that way, the real question is what kind and what level of federal regulation, what kind and level of state regulation, and what combination of dual or cooperative regulation is most effective and appropriate. The basic point is that these questions should be reexamined in the context of the changing structures of the financial services industry.<sup>339</sup>

This Article suggests several alternative methods to accomplish insurance regulation reforms. First, the existing regulatory structures could be dismantled and replaced with federal regulation, but state regulatory failures examined in this Article do not, in themselves, suggest a need for federal regulation. Weakness, ineffectiveness, and susceptibility to influence can occur at federal as well as state levels. As commentators have repeatedly observed, the failures

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336. *But see supra* notes 228-33 and accompanying text (concerning the inability of state regulators to handle consumer complaints).

337. *See* Dwight K. Bartlett, III, *Former Commissioner Says It's Time to Reconsider McCarran-Ferguson Act*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), May 25, 1998, at 19.

338. *See* J. Robert Hunter, *The Case for a Federal Role*, NAT'L UNDERWRITER (Prop. & Cas./Risk & Benefits Mgmt. ed.), June 22, 1998, at 31.

339. This Article assumes functional regulation will continue—regulation of the banking, securities, and insurance functions of providers of financial services, with some centralized oversight.

of the Federal Home Loan Bank Board to prevent the thrift industry insolvencies demonstrates that federal oversight will not necessarily eliminate significant problems in a regulated industry.<sup>340</sup>

However, it is clear from the history of insurance regulation and the efforts of current members of the NAIC that some centralization is necessary to ensure effective insurance regulation. Centralization, in itself, will not eliminate regulatory errors and omissions, but some measure of centralization can eliminate uneven state regulation, failure to share information, and the inability of individual states to monitor worldwide insurance and reinsurance networks that have contributed to regulatory problems.

This Article stops short of advocating complete federalization of insurance regulation simply because it is not likely to occur in today's political climate. The first subsection below briefly discusses federalization of insurance regulation using previous proposals as a starting point, as well as federalization of some parts of insurance regulation. These less radical centralized reforms might entail federal government regulation of some aspects of the insurance industry where uniformity would be particularly helpful, such as nationalized licensing or monitoring of the reinsurance market. Alternatively, as discussed in the second subsection, the federal government could pursue the implementation of a federally conceived regulatory program utilizing existing state regulators and regulatory structures. Alternatively, the state system could be retained with implementation of substantial reforms through action of the states collectively or individually.

#### A. Federal Regulation

The federal government could repeal the McCarran-Ferguson Act and replace existing regulatory structures with federal regulation. New proposals for federal regulation would be necessary. Proposals, proffered in the early 1990s by Representative Dingell,<sup>341</sup> posed problems warranting rejection on substantive grounds, as well as dismissal based on the current political climate. Interestingly, Representative Dingell's bill, the Federal Insurance Solvency Act, adopted some of the NAIC's structural features and funding mechanisms, which this Article identifies as problematic because they permit excessive industry influence.<sup>342</sup> The Act would have established a Federal Insurance Regulation Advisory Committee, consisting of twenty-five members chosen by the five-member Federal Insurance

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340. See, e.g., MACEY & MILLER, *supra* note 249, at 77.

341. See *supra* notes 1-2 and accompanying text.

342. Representative Dingell's efforts concentrated on solvency regulation. The GAO, which conducted investigations for Dingell's committee, did not address questions of industry influence in state regulation. See generally WISHFUL THINKING, *supra* note 67.

Solvency Commission (FISC) for three-year terms, including five "fairly representative" members of each of the following groups: certified insurers, certified reinsurers, agents and brokers, state insurance regulators, and individuals representing the public interest.<sup>343</sup> Although all constituencies would be represented, members of the regulated industry would clearly dominate. Of course, the Federal Advisory Committee Act would apply to the Committee<sup>344</sup> and eliminate some of the problems that attend the NAIC's use of industry advisory groups.

The funding mechanisms for FISC also recall some of the questionable practices of the NAIC.<sup>345</sup> The Commission would assess certification fees to cover the costs of its certification activities based on a percentage of the insurer's net direct written premium.<sup>346</sup> Unlike the NAIC, however, FISC would be funded by substantial general appropriations (\$300 million) as well as amounts necessary to carry out rehabilitations and liquidations under the Act.<sup>347</sup> Also, FISC would be subject to various federal laws designed to minimize inappropriate influence and enhance agency accountability: the Administrative Procedure Act, the Federal Advisory Committee Act, the Freedom of Information Act (FOIA), the Government in the Sunshine Act, and the Paperwork Reduction Act of 1980.<sup>348</sup>

Finally, the dual state/federal regulatory structures would result in at least some initial confusion and complexity. States would have complete regulatory authority over uncertified insurers and would continue to regulate both certified and uncertified insurers with regard to rates and policy forms, market conduct, assigned risk plans, and regulation of insurance producers, among other areas.<sup>349</sup> This proposed dual regulatory structure is complex and would inevitably result in continuing struggles for control over various aspects of insurance regulation. Interestingly, the proposal once again recalls some of the negative aspects of the regulatory structures implemented by the NAIC. Despite its own recognition of the close relationship between solvency regulation and market conduct regulation, the NAIC divided the two by ignoring market conduct in its accreditation program at the industry's urging.<sup>350</sup> The Dingell proposal replicates the artificial and potentially harmful division between market conduct and solvency regulation.

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343. H.R. 1290, 103d Cong. § 110 (1993).

344. *See id.* § 110(j).

345. *See supra* text accompanying notes 296-309.

346. *See* H.R. 1290, 103d Cong. § 111(2) (1993).

347. *See id.* § 112.

348. *See supra* notes 82-86 and accompanying text.

349. *See* H.R. 1290, 103d Cong. § 207 (1993).

350. *See supra* notes 122-24 and accompanying text.

If the federal government reasserts its power over insurance regulation, which appears to be highly unlikely in the near future, the scope and structure of a federal regulatory system should be revisited to improve upon the Dingell and Metzenbaum proposals.

### *B. Implementation of Reforms to Existing State Regulatory Structures*

Alternatively, state regulatory structures could be preserved and reforms implemented to address the problems identified previously. Several basic reforms are necessary. First, additional power could be given to the NAIC or a similar body to enforce uniform or coordinated state action where necessary and to perform national or international oversight functions that are beyond the competence of individual states.<sup>351</sup> Second, adequate nonindustry funding could be provided to the NAIC or any similar body either through the federal government or mandatory increased state assessments, and enhanced funding could be provided to the state insurance departments. Third, limitations could be established on industry participation in and direction of regulatory policy, and fourth, public accountability could be increased through open meetings, disclosure, opportunity for public notice, and comment.<sup>352</sup> A number of possible alternative means could accomplish these reforms.

#### *1. Not the NAIC*

As a preliminary matter, the necessary reforms cannot be accomplished by the NAIC. Some of the reforms could not be addressed by voluntary implementation of internal policy: the NAIC cannot increase its nonindustry funding, for example, by forcing the states to increase their funding of the NAIC, nor can it enhance its ability to force the states or the industry to act according to its direction. Al-

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351. Such reforms might include, for example, minimum funding levels for state insurance departments (expressed as a percentage of premium taxes), minimum standards for regulatory content and procedures, creation of a centralized body to address national insurer producer licensing, liquidation of multistate insurers, regulation of the reinsurance market, or other issues which arguably require national solutions.

352. These are suggestions made regularly by different groups, but most notably consumer groups. In a March 1998 letter to the state governors, Ralph Nader, Mary Griffin of the Consumers Union, E. Mierzewski of the U.S. Public Interest Research Group, and J. Robert Hunter of the Consumer Federation of America called for independent funding of the NAIC:

As we move toward the millenium, it is clear to the consumer advocacy community that NAIC cannot be an effective or trustworthy organization without independent funding . . . . The NAIC should never be put into the position of having to go, hat in hand, to the regulated to beg for money and to shave the agenda to meet the demands of the regulated.

*Consumer Groups Warn Governors of "Breakdown of Regulation,"* FED. & STATE INS. WK., Mar. 9, 1998, at 1.

though the NAIC could address other problems internally, its past attempts to do so demonstrate the inadequacy of NAIC-initiated reforms. For example, for many years, the NAIC closed important meetings to the public.<sup>353</sup> Although it adopted a new open meeting policy,<sup>354</sup> the NAIC has violated its own policy<sup>355</sup> by holding closed meetings on industry advisory groups,<sup>356</sup> Holocaust claims,<sup>357</sup> mutual holding company conversions,<sup>358</sup> and a closed CEO panel on financial services.<sup>359</sup> Its attempts to minimize industry influence have also been largely unsuccessful. The NAIC merely substituted a new form of industry group for the industry advisory committee<sup>360</sup> and undercut those efforts almost immediately by creating an industry liaison group to participate in policy matters.<sup>361</sup>

The NAIC's failures to conform to its own policies may be noted by the press, but apart from what is likely to be minimal and little-noticed adverse publicity,<sup>362</sup> there are minimal incentives for the NAIC to abide by its own rules. In short, most of the necessary reforms cannot be implemented internally, and those that can are subject to unilateral reversal by the NAIC because they would not be subject to systematic external oversight to ensure compliance.

## 2. Federally-Implemented Reforms

A reform suggested in the past is for the federal government to delegate power to the NAIC, thus enabling the NAIC to force action by the states and industry compliance with its regulatory dictates.<sup>363</sup>

353. See, e.g., Robert H. Myers, Jr., *An Evolutionary View of Insurance Regulation*, BEST'S REV. (Prop./Cas. ed.), Dec. 1, 1994, at 50. Key NAIC officials have defended the NAIC's practice of closing some meetings. Lee Douglass, former NAIC president and Arkansas insurance commissioner, noted that only a small percentage of meetings are closed to discuss "particular companies." *Id.*

354. Meetings involving confidential information about individual companies could still be closed, but other meetings were to be open to the public. See *supra* text accompanying notes 271-74.

355. The NAIC recently held closed meetings with industry CEOs and also decided on the abolition of industry advisory committees at a closed meeting. See *supra* text accompanying note 305.

356. See *id.*

357. *Closed NAIC Panel to Focus on Financial Reform*, INS. REGULATOR, Jan. 19, 1998, at 1 [hereinafter *Closed NAIC Panel*].

358. See *Mutual Issues Continue to Confound*, INS. REGULATOR, May 11, 1998, at 1.

359. The NAIC has held ongoing closed-door meetings on financial accounting and solvency with Federal Reserve bank officials. See *NAIC Briefs Fed Staffers on Insurance Capital Accounting Rules*, INS. ACCT., June 29, 1998; see also *Closed NAIC Panel*, *supra* note 357, at 1.

360. See *supra* text accompanying notes 305-12.

361. See *supra* text accompanying notes 316-19.

362. On balance, for example, the NAIC may prefer negative publicity about closing meetings to negative publicity about the substantive issues discussed during improperly closed meetings.

363. See, e.g., WISHFUL THINKING, *supra* note 67.

The delegation could also address other NAIC problems by making the NAIC subject to various federal laws that constrain government conduct<sup>364</sup> and by providing independent funding. GAO first noted the difficulties with this approach in its assessment of the NAIC.<sup>365</sup> In reviewing options for reform of the NAIC, particularly its lack of power, the GAO concluded:

Empowerment by the federal government is also undesirable. NAIC is composed of state insurance commissioners. Those commissioners are accountable to their states and should not be made accountable to federal authority as well, since this would create an irreconcilable conflict of interest. Moreover, given NAIC's organizational structure, congressional delegation of the regulatory authority necessary to establish NAIC as an effective public regulator could raise constitutional questions.<sup>366</sup>

Subsequent Supreme Court case law demonstrates the prescience of the GAO report. In *Printz v. United States*,<sup>367</sup> the Court ruled that the Brady Handgun Violence Prevention Act unconstitutionally obligated state officers to execute federal laws by requiring state officers to conduct background checks on prospective handgun purchasers before the national system became operative.<sup>368</sup> Although some confusion remains over the NAIC's status as a public or private organization,<sup>369</sup> it appears clear that a federal delegation to the NAIC would run afoul of the *Printz* holding.<sup>370</sup> Even if the NAIC is considered a

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364. See *supra* notes 82-86 and accompanying text.

365. See *NAIC Assessment*, *supra* note 97.

366. WISHFUL THINKING, *supra* note 67, at 93.

367. 521 U.S. 918 (1997).

368. See *id.* at 922 (finding that federal commandeering of state executive officials violates the structural concept of dual sovereignty by infringing on the states' abilities "to represent and be accountable to the citizens of the state").

369. See *supra* text accompanying notes 76-81.

370. In a number of instances, Congress has made references to the NAIC in legislation and delegated very limited authority to the NAIC, particularly in the Internal Revenue Code. See, e.g., 26 U.S.C. § 806 (1994) (adopting NAIC reserve valuation methods for some contracts); *id.* § 1749bbb-8 (providing that the director of the Federal Emergency Management Agency may decrease or increase reinsurance premiums for coverage against property losses resulting from riots or civil disorders after consultation with the NAIC); *id.* § 101(g)(2)(B)(ii)-(iii)(II) (recording viatical settlements which meet the requirements of the NAIC Viatical Settlements Model Act, model regulations, and standards, if any, not included in gross income); *id.* § 807(d)(3)(A)(i) (adopting NAIC methods for reserve valuation for specified contracts); *id.* § 811 (providing for insurance company computations to be made in a manner consistent with that required by the NAIC annual statement); *id.* § 832 (recording computations for taxable income based upon the NAIC annual statement); *id.* § 7702B(g)(2)(B) (adopting NAIC Long-Term Care Insurance Model Act); 42 U.S.C. § 300gg-44(c)(1) (recording NAIC Small Employer and Individual Health Insurance Availability Model Act as an alternative to requirements of § 300gg-41); *id.* § 1395w-26 (referring to solvency standards developed by the NAIC for risk-based health care delivery organizations for the establishment of solvency standards for provider-sponsored organizations); *id.* § 1395ss (recording standards for certification of Medicare supplemental health insurance

private organization, it is composed of elected or appointed officials with responsibilities to their states. An overlay of federal responsibility would be unworkable and unconstitutional.

However, even though a federal delegation of power to the NAIC would be unconstitutional, the same results could apparently be accomplished through traditional forms of cooperative federalism.<sup>371</sup> Under the Spending Power,<sup>372</sup> Congress may provide conditional funding for state participation in and implementation of federal regulatory programs<sup>373</sup> as long as the conditions bear some relationship to the purpose of the federal spending, do not violate an independent constitutional prohibition, and are unambiguous.<sup>374</sup> The federal government could subsidize state insurance regulation if the states complied with specified conditions, including, for example, minimum state regulatory standards and procedures and insurance department funding (set out either in federal law or by the NAIC); limitations on the NAIC, enforced through the states (including compliance with specified state or federal procedures and standards designed to ensure openness, impartiality, fairness, and accountability);<sup>375</sup> and state rather than industry funding of the NAIC (through state assessments or allocation of a specified percentage of premium taxes paid to the state by insurance companies).

Alternatively, the federal government could threaten preemption if the states failed to implement a federal proposal or regulate along federal guidelines. This alternative would be similar to what occurred on the passage of the McCarran-Ferguson Act, which provided that unless the states regulated the business of insurance, the federal government would enforce a preemptive federal plan. Congress could enact a specific regulatory scheme and delegate regulatory

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policies and stating that these standards are equal to or more stringent than standards proposed in an NAIC model).

371. Presumably, Congress's use of conditional grants and preemption threats are so entrenched that *Printz* will not affect it. On the other hand, the Court's simultaneous acceptance of these traditional means of state control and rejection of *Printz* is arguably inconsistent. See generally Evan H. Caminker, *Printz, Sovereignty, and the Limits of Formalism*, 1997 SUP. CT. REV. 199 (1997); Roderick M. Hills, Jr., *The Political Economy of Cooperative Federalism: Why State Autonomy Makes Sense and "Dual Sovereignty" Doesn't*, 96 MICH. L. REV. 813 (1998). If either falls, it will presumably be the *Printz* limitations. Academic debate over Congress's ability to expand federal power through conditional federal spending is irrelevant here, since Congress's commerce clause power to regulate insurance is unquestioned.

372. U.S. CONST. art. I, § 8, cl. 1.

373. One of the earliest cases is *Steward Machine Co. v. Davis*, 301 U.S. 548, 590-91 (1937).

374. See, e.g., *South Dakota v. Dole*, 438 U.S. 203 (1987).

375. Congress may impose procedural conditions, such as public participation. See, e.g., Individuals with Disabilities Education Act, 20 U.S.C. § 1412(7) (1994) (requiring states to assure consultation between school districts and the parents of disabled children); Occupational Safety and Health Act of 1970, 29 U.S.C. § 667(c)(4) (1994) (requiring the selection of qualified personnel).

power to the states on the condition that they submit an acceptable plan for implementing that scheme.<sup>376</sup> The congressional scheme would become effective in any state that did not enact the standards within a specified period of time. A combination of threats and inducements is also possible.

### C. State-Implemented Reforms

The states could individually delegate some power to the NAIC, possibly including the power to sanction the state. However, state courts often invalidate delegations of governmental authority to private individuals, citing the state constitution's vesting clause<sup>377</sup> or relying on fundamental notions of representative democracy.<sup>378</sup> Although the NAIC has defined itself differently in the past, its current position is that it is "a group of public officials imbued with the public trust" as well as an "an instrumentality of the states."<sup>379</sup> If these characterizations are accurate, any delegation of legislative authority to the NAIC should not constitute a private delegation.

At least two additional problems could arise. First, such delegations may interfere with basic governmental structures by establishing a subfederal entity that might encroach on the power and authority of the federal government. Second, as a practical matter, the delegation could be rescinded at the will of the delegating legislature.

Although all members of the NAIC are either elected or appointed by a government body or official,<sup>380</sup> their "public" would change as they acted nationally on behalf of all the states. In such actions, they clearly would not be jointly accountable to the voters of an individual

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376. See, e.g., *FERC v. Mississippi*, 456 U.S. 742 (1982) (upholding the Public Utility Regulatory Policies Act of 1978, which encouraged states to develop energy conservation programs through conditional preemption); *Hodel v. Virginia Surface Mining and Reclamation Ass'n*, 452 U.S. 264 (1981) (upholding the Surface Mining Control and Reclamation Act of 1977, which permitted the federal government to regulate if the state did not submit a regulatory plan that complied with the Act).

377. Despite frequent judicial reliance on the vesting clause in ruling a private delegation unconstitutional, the basic concerns of vesting clauses are typically separation of powers and that they provide no real guidance in assessing the validity of a private delegation. For a full discussion, see David M. Lawrence, *Private Exercise of Governmental Power*, 61 IND. L.J. 647, 664-68 (1986).

378. Such delegations may violate concepts of representative democracy by empowering individuals who are not publicly accountable either through election or through appointment by elected officials. Opponents argue that governmental power should be exercised only by elected individuals or by persons directly accountable to elected individuals. See *id.* at 669-72.

379. L.H. Otis, *NAIC Votes to Open Its Highest-Level Meetings*, NAT'L UNDERWRITER (Life & Health/Fin. Servs. ed.), June 12, 1995, at 3. The Strategic Framework Working Group of the NAIC, charged with determining the NAIC's identity, split over which characterization was correct. The full membership of the NAIC ultimately concluded that it had characteristics of both. See *id.*

380. See *supra* notes 12-13.

state. An individual state's delegation of power to the NAIC involves a delegation of state power to a group of individuals who are accountable neither to the state's voters nor to its elected officials; only one member of the NAIC will be directly accountable to a state's voters or their elected representatives. The cumulative effect of the states' individual delegations would be to empower the NAIC beyond the power of the individual states.

Finally, as a practical matter, such delegations could prove problematic in addressing the issues raised above because they could presumably be rescinded at the will of the delegating legislature. The power to enforce uniform standards or to sanction is meaningless if a state can withdraw delegated authority from the NAIC at any time.

A second way in which states could effect reforms would be the use of interstate compacts. Minority members of the House Committee on Energy and Commerce recommended interstate compacts as "the most comprehensive alternative to either the current system or [f]ederal regulation."<sup>381</sup> Others have suggested the possibility of interstate compacts as an alternative to federal regulation or the present system.<sup>382</sup>

An interstate compact is a binding agreement between or among states that provides for cooperative action, including joint action on common problems, exchange of information, or establishment of uniform rules. Interstate compacts preempt conflicting state laws and are generally governed by principles of contract law.<sup>383</sup> The compact is treated as a federal statute and cannot be altered by a court.<sup>384</sup> While the U.S. Constitution recognizes that states may want to enter into such agreements, it specifically requires prior congressional approval. The Compact Clause provides: "No State shall, without the consent of Congress . . . enter into any Agreement or Compact with another State."<sup>385</sup> Case law has modified this directive somewhat, holding that congressional approval is necessary for any compact that "may tend to increase and build up the political influence of the contracting States, so as to encroach upon or impair the supremacy of the United States or interfere with their rightful management of particular subjects placed under their entire control."<sup>386</sup> Congress-

381. WISFUL THINKING, *supra* note 67, at 129.

382. See, e.g., James M. Jackson, *Commerce, Compacts, and Congressional Consent*, 10 J. INS. REG. 23 (1991); James M. Jackson *Enhancing State Regulation Through the Compact Clause*, 9 J. INS. REG. 151 (1990); John M. Manders et al., *Insurance Regulation in the Public Interest: Where Do We Go from Here?*, 12 J. INS. REG. 285 (1994).

383. See, e.g., *New Jersey v. New York*, 523 U.S. 767 (1998).

384. See *id.* at 74. In *Texas v. New Mexico*, 462 U.S. 554, 564 (1983), the Supreme Court found it could not constitutionally order the appointment of a person to break a tie vote by an interstate compact commission and leave the commission deadlocked due to a poorly drafted compact.

385. U.S. CONST. art. I, § 10.

386. *Virginia v. Tennessee*, 148 U.S. 503, 518 (1893).

sional consent is required only if the compact authorizes member states to exercise power they could not exercise in the compact's absence and if the compacting states delegate sovereign power to an interstate commission.<sup>387</sup>

An interstate insurance regulation compact could set out minimum standards. An example could be the NAIC accreditation standards, modified as appropriate to correct existing deficiencies such as lack of specificity.<sup>388</sup> In turn, these standards would become state law upon state adoption of the compact. The NAIC could be identified as the accrediting body. In addition, an interstate compact could conceivably resolve the issue of the NAIC's lack of power to force state compliance with accreditation standards:<sup>389</sup> first, a compact would be enforceable at law,<sup>390</sup> unlike the NAIC accreditation standards, which are voluntary. A compact supersedes prior<sup>391</sup> and subsequent<sup>392</sup> state law. Second, a compact could be structured specifically to grant the NAIC or a similar administrative body enforcement powers through delegations of sovereign power. An interstate compact could also provide methods for state supervision of the NAIC such as annual reporting requirements, open record requirements, audits, public meetings, hearings on important issues, gubernatorial vetoes, or legislative approval requirements.<sup>393</sup>

In addition, compacts would almost certainly be constitutionally permissible. The Supreme Court has upheld compacts that create and empower multistate administrative authorities such as the Multistate Tax Commission.<sup>394</sup> The Multistate Tax Compact was created by twenty-one member states to coordinate taxation of busi-

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387. See *U.S. Steel Corp. v. Multistate Tax Comm'n*, 434 U.S. 452, 473 (1978).

388. Additional standards and modifications might include specified levels of insurance department funding or market conduct standards.

389. It would be possible to draft a compact such that the NAIC or some other body had the power to sanction states which failed to comply with the compact. However, such power would likely render the compact invalid as an interference with the federal government's supremacy, since it would grant the sanctioning body power beyond that of the individual compacting states. See, e.g., *U.S. Steel*, 434 U.S. at 473 (upholding the formation of the Multistate Tax Commission because it did not increase state power).

390. In disputes between parties to the compact, the Supreme Court has jurisdiction under Article III and the power to interpret and enforce the compact. If a dispute involving a private party is heard in state court, the construction of the compact is a federal question for purposes of Supreme Court review. See, e.g., *West Virginia ex rel. Dyer v. Sims*, 341 U.S. 22, 28 (1951); *Virginia v. West Virginia*, 246 U.S. 565, 601 (1918).

391. See, e.g., *Hinderlider v. La Plata River & Sherry Creek Ditch Co.*, 304 U.S. 92 (1938).

392. See, e.g., *Green v. Biddle*, 21 U.S. (8 Wheat.) 1 (1823).

393. For general discussions of these methods of control, see RICHARD H. LEACH & REDDING S. SUGG, JR., *THE ADMINISTRATION OF INTERSTATE COMPACTS* (1959), and Richard H. Leach, *Interstate Authorities in the United States*, 26 *LAW & CONTEMP. PROBS.* 666 (1961).

394. See *U.S. Steel Corp. v. Multistate Tax Comm'n*, 434 U.S. 452, 473 (1978) (upholding the compact creating the Multistate Tax Commission); see also *Multistate Tax Compact*, reprinted in *ICCH ALL STATES TAX GUIDE* ¶ 351 (1995).

nesses operating in multiple states. The legislation adopted by each of the member states created the Multistate Tax Commission, which is similar to the NAIC, and is composed of the states' tax administrators. The Commission's purpose is to study state tax systems, propose uniform state laws and regulations, and conduct audits of member states.<sup>395</sup> Even though the compact created a multistate authority, it did not encroach on the powers of the federal government or impair its integrity, and the consent of Congress was, therefore, not necessary to its validity. The member states were free to withdraw from the compact at any time. The Commission possessed only the power of each individual member state and could not force state adoption of its recommendations.

However, despite the advantages of using a state insurance compact, there are a number of potential difficulties for insurance regulation reform. First, as a practical matter, it may be overwhelmingly difficult to establish a multistate insurance regulatory compact. In itself, this burden is not a good reason for abandoning a particular reform proposal. Experiences with attempts to federalize insurance regulation in the early 1990s and with the financial services modernization bills demonstrate that any wide-reaching reform may involve a difficult and lengthy process of negotiation and approval. However, it seems unlikely that the states could agree to uniform minimum standards or procedures given the difficulties with such attempts during the NAIC accreditation controversy. This type of compact would involve enormous complexities, going far beyond the typical compact. Moreover, interstate compacts are rarely used;<sup>396</sup> generally, they are used for small or regional groups of states and almost never for insurance issues.<sup>397</sup> The most typical compacts involve boundary disputes<sup>398</sup> or interstate projects, such as building bridges

395. See, e.g., ALA. CODE § 40-27-1 (1994); ARK. CODE ANN. § 26-5-101 (Michie 1997); IDAHO CODE § 63-3701 (1997); MICH. COMP. LAWS ANN. § 205.581 (West 1988).

396. See generally COUNCIL OF STATE GOVERNMENTS, INTERSTATE COMPACTS AND AGENCIES (1983) (noting 175 compacts during the history of the United States); see also Jones & Reuter, *Interstate Compacts and Agreements*, 28 THE BOOK OF THE STATES 565 (1990-91) (discussing 20 interstate compacts).

397. Of course, a comprehensive compact or a series of compacts could substantially improve insurance regulation even if only a portion of the states participate.

398. See, e.g., Brevard Crihfield, *Interstate Compacts, 1783-1977: An Overview*, in 22 THE BOOK OF THE STATES 580, 580 (1978-79). Examples of these compacts can be found in *Virginia v. Tennessee*, 148 U.S. 503 (1893), and *Rhode Island v. Massachusetts*, 37 U.S. (12 Pet.) 657 (1838).

or allocating shared resources.<sup>399</sup> Only a few compacts created ongoing administrative agencies.<sup>400</sup>

Second, although insurance compacts have been debated for a decade, only one very limited insurance compact has been formed.<sup>401</sup> The midwest zone of the NAIC, working in conjunction with the National Conference of Insurance Legislators and members of the industry, attempted to draft a compact dealing with rehabilitations, liquidations, and guaranty associations. In 1995 the Interstate Insurance Receivership Compact was inaugurated, but only five states entered into the compact (California, Illinois, Michigan, Nebraska, and New Hampshire),<sup>402</sup> and two of those quickly dropped out.<sup>403</sup> Particularly without an imminent threat of federal takeover, a compact seems unlikely.<sup>404</sup>

Third, a compact would require participating states to relinquish some part of their power over insurance regulation, and all indications suggest that most states would be unwilling to do so, particularly if the compact limited the ability of the states to withdraw.<sup>405</sup> A

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399. See, e.g., The Colorado River Compact of 1929, ch. 42, 45 Stat. 1057 (1928) (recording congressional approval of the compact); *Ham v. Maine-N.H. Interstate Authority*, 30 A.2d 1, 3 (N.H. 1943) (recognizing the regulatory authority of the Maine-New Hampshire Interstate Authority over a bridge on the basis of an interstate compact that did not encroach on the power of the federal government).

400. The Multistate Tax Commission is an example of an ongoing administrative agency. See *supra* notes 394-95.

401. Other proposals considered by the NAIC, but not adopted, include licensing reciprocity agreements, a U.S. Reinsurer and Alien Insurer Regulatory Compact Draft, and an Interstate Insurance Regulation Compact. Under the licensing reciprocity proposal, states would license insurers domiciled in compacting states on a reciprocal basis. The Reinsurer Compact would establish a commission to regulate and license reinsurers and alien insurers. See *U.S. Reinsurer and Alien Insurer Regulatory Compact Draft*, 1995 NAIC PROCEEDINGS IV, Dec. 2-6, 1995, at 182-91. The NAIC Accredited States Insurance Regulatory Compact would create the Interstate Insurance Regulatory Commission, composed of representatives from each compacting state. The Commission would establish minimum standards for admission and licensure of U.S. and non-U.S. insurers, approval of forms, and financial examination of compacting insurers. The Commission would be empowered to authorize insurers domiciled or transacting business in a compacting state to transact business in all compacting states.

402. See L.H. Otis, *N.H. Leaves Interstate Compact*, NAT'L UNDERWRITER (Life & Health/Fin. Servs. ed.), July 21, 1997, at 29.

403. California left the compact in November 1996 because it was inconsistent with state laws. New Hampshire left the compact in July 1997. Its official reason was the compact's failure to attract greater participation; off the record, a source suggested that New Hampshire removed itself to increase the chances that it could recover funds for policyholders. See *id.*

404. States' comments on various compact proposals often allude to the proposal as an alternative to federal intervention, but object to any encroachment on state authority in the absence of a real threat. See, e.g., 1995 NAIC PROCEEDINGS IV, Dec. 2-6, 1995, at 193 (comments of the Oklahoma insurance commissioner on the *U.S. Reinsurer and Alien Insurer Regulatory Compact Draft*).

405. For a discussion of the permanence of compacts, see Jill Elaine Hasday, *Interstate Compacts in a Democratic Society: The Problem of Permanency*, 49 U. FLA. L. REV. 1 (1997).

perennial criticism of NAIC interstate compact proposals is that the proposed compact would remove state regulatory authority.<sup>406</sup> The states grudgingly permitted the NAIC to institute its accreditation program only to thwart an attempted federal takeover and strongly criticized the NAIC's aggrandizement of power as those threats receded. New Hampshire's withdrawal from the Interstate Insurance Receivership Compact underscores this point. Although its purported reason for withdrawing was the lack of broad participation in the compact, its true reason was quite likely its desire to accomplish the liquidation of a troubled company under its own (more favorable) rules rather than according to the compact. In short, there is no reason to believe that states would be any more willing to cede authority to an interstate compact mechanism than to the NAIC or, for that matter, to the federal government.<sup>407</sup>

Individual state oversight of the NAIC might resolve some of the problems with current state regulation. The Vermont Oversight law subjects the NAIC to various reporting and disclosure requirements and imposes significant restraints on the accreditation program.<sup>408</sup> Earlier versions of the law, as well as bills proposed by New York, New Jersey, and Michigan imposed more substantial requirements with real limitations on the NAIC. In some ways, of course, such bills create additional problems by further limiting the NAIC's power. However, a well-designed oversight law might minimize the NAIC's susceptibility to industry influence and increase the accountability of the NAIC to its constituents.

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406. See, e.g., 1995 NAIC PROCEEDINGS IV, Dec. 2-6, 1995, at 192-98. Various states objected to the *U.S. Reinsurer and Alien Insurer Regulatory Compact Draft* because the compact would encroach upon state authority. Tennessee "reiterates our concerns regarding authority that would be taken away from the states by giving this compact licensing authority." *Id.* at 192. Oklahoma stated that the form of a compact that "takes away the individual state's right to license and regulate the companies is and will always be unacceptable." *Id.* at 193. Arizona objected because, *inter alia*, "the compact . . . debilitates a Commissioner's authority to regulate the business of insurance in his or her own state." *Id.* at 197.

407. This conclusion conflicts with that reached by Manders. See Manders et al., *supra* note 382, at 338. In their view, federal regulation would deprive the states of their sovereignty, while participation in a compact would permit the states to retain their sovereignty and exercise it through binding cooperation with other states. Professor Robert Klein recognizes the potential unwillingness of states to limit their power:

The appeal of an interstate compact is that it allows state legislatures to affirm their participation in and delegation of authority to the compact. However, state legislatures may not be much more enthusiastic about this approach than they are about *de facto* delegation to the NAIC through the accreditation program.

Robert W. Klein, *Insurance Regulation in Transition*, 62 J. RISK & INS. 363, 364 (1995).

408. See VT. STAT. ANN. tit. 8, § 3351 (1995).

## VI. CONCLUSION

Because financial services integration presents such daunting regulatory challenges, current structures and processes of state insurance regulation, including the NAIC, raise serious concerns about the efficacy of the state system of insurance regulation. Many state insurance departments are hopelessly underfunded and understaffed and are sometimes unable to carry out basic regulatory functions adequately, much less oversight of complex international insurance networks. As a result, the states have increasingly turned to the NAIC for assistance. The NAIC is perhaps well-suited to the model law drafting functions, which were its original mission. As a private, nongovernmental organization with no power of its own, the NAIC is inadequate to perform the more complex tasks it has taken on and which financial services integration will demand of it. Most critically, the NAIC is closely identified with the insurance industry. Although it pays lip-service to the goal of protecting consumers, its actions often present a different reality. The stability of the insurance industry, and the protection of the consumers who rely on it, are at stake. Regulatory reform is essential.