2010

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Recommended Citation

Jeffrey E. Thomas, *Insurance Perspectives on Federal Financial Regulatory Reform: Addressing Misunderstandings and Providing a View from a Different Paradigm*, 55 Vill. L. Rev. 773 (2010).
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2010]

INSURANCE PERSPECTIVES ON FEDERAL FINANCIAL
REGULATORY REFORM: ADDRESSING MISUNDERSTANDINGS
AND PROVIDING A VIEW FROM A DIFFERENT PARADIGM

JEFFREY E. THOMAS*

THE recent spectacular demise of American International Group (AIG), the world's largest insurer,¹ has raised issues about insurance regulation and its role in the financial crisis. As one who spends considerable time studying insurance law, I was very pleased to be invited to be part of this symposium. Although I feel a little like a "fish out of water" surrounded by securities and banking experts, I hope that my insurance perspective on federal regulatory reform will be useful.

I have subtitled this Article "Addressing Misunderstandings and Providing a View from a Different Paradigm" because I believe that much of the current call for federal regulatory reform of insurance is based on fundamental misunderstandings regarding AIG and the financial crisis, and because insurance, which is regulated predominately at the state level, provides a different, and potentially useful, regulatory paradigm. Part I of this Article analyzes the role of insurance in the financial crisis. It exposes the misunderstandings and explains how insurance had little, if any, role in the crisis. Part II outlines the current, state-based regulatory paradigm for insurance, and explains how this paradigm has become a barrier for federal reform in the insurance area. Finally, Part III addresses the powerful role played by the courts in insurance regulation, and suggests that financial regulatory reform could benefit from use of a similar model for other financial services.

I. INSURANCE WAS NOT INVOLVED IN THE FINANCIAL CRISIS

Although AIG is the largest and one of the strongest insurance companies in the world,² its collapse was not an insurance regulatory failure. Instead, AIG's collapse was caused by a non-insurance subsidiary's overinvestment in credit default swaps (CDS). While CDS are similar to insurance in certain respects, they were not insurance products and were not

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1. See Jerome A. Madden, *A Weapon of Mass Destruction Strikes: Credit Default Swaps Bring Down AIG and Lehman Brothers*, 5 BUS. L. BRIEF 15, 15 (2008).

2. See *id.* at 15 & n.3. In its 2007 Annual Report, AIG reported assets of \$1 trillion, operations in 130 countries, and some 70 million customers. See AIG 2007 ANNUAL REPORT (FORM 10-K) 1, 5, 13 (2008) [hereinafter AIG ANNUAL REPORT], available at <http://www.ezodproxy.com/AIG/2008/AR2007/HTML2/default.htm>.

subject to insurance regulation. Moreover, although some have suggested that CDS should be regulated as insurance, to do so would undermine key characteristics of CDS.

A. *AIG's Collapse Was Not an Insurance Failure*

AIG's collapse was caused by overinvestment in CDS. By 2007, AIG's Financial Products Corp., a London-based company that was created in 1987,³ had CDS on its books with a combined notional value of approximately \$440 billion,⁴ of which about \$57 billion involved securities with some exposure to sub-prime mortgages.⁵ Although "notional value" includes double counting and therefore is not an accurate portrayal of exposure,⁶ this is a big number. It is more than four times the \$95.8 billion in AIG shareholder equity as of 2007 (the holding company, not just the Financial Products subsidiary).⁷ It is also more than sixteen times the \$26 billion in insurance surplus held by AIG in 2008.⁸ AIG was able to write such a large amount of CDS with very little collateral because of its high credit rating.⁹

AIG's huge exposure for CDS did not cause any problems until the market started to decline. As long as there were no credit defaults or collateral calls, it was like free money. But when the housing market and the related mortgage-backed securities began a serious decline in late 2007, it began a chain reaction that led AIG to the brink of bankruptcy.¹⁰ While the securities that were the subject of the AIG CDS were highly rated initially,¹¹ the decline in the residential mortgage market caused a severe

3. See *AIG Financial Products Corp. Releases Innovative Academic Research on Commodities*, BUS. WIRE, July 11, 2007 [hereinafter *Research on Commodities*], available at http://findarticles.com/p/articles/mi_m0EIN/is_2007_July_11/ai_n27301078/.

4. See Madden, *supra* note 1, at 16 (citing AIG ANNUAL REPORT (FORM 10-Q), *supra* note 2, at 87).

5. See *id.*

6. See *id.* (noting that notional value is "the face amount of the insured debt"). This amount is inflated well beyond the actual risk because the face amount of each CDS is included in the total value, but many CDS are providing coverage for other CDS. In one report, the multiple counting amounted to 90% of the notional value. See Peter Wallison, *Comment*, REGULATION, Fall 2009, at 37 (commenting on Lynn A. Stout, *Regulate OTC Derivatives by Deregulating Them*, REGULATION, Fall 2009, at 30).

7. See AIG ANNUAL REPORT, *supra* note 2, at 1.

8. See Paul Walker-Bright & Timothy P. Law, *AIG's Financial Distress: How Credit Default Swaps and the Lack of Regulation Brought Down an Insurance Giant and Implications for the Insurance Industry*, in NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW § III.A.1 & n.79 (2009).

9. See David Henry, Matthew Goldstein & Carol Matlack, *How AIG's Credit Loophole Squeezed Europe's Banks*, BUS. WK., Oct. 16, 2008, available at http://www.businessweek.com/magazine/content/08_43/b4105032835044.htm.

10. See Madden, *supra* note 1, at 17.

11. See AIG Corporate Information, http://www.aigcorporate.com/aboutaig/pre_september_2008.html (last visited May 23, 2010) (explaining that many of these securities were initially rated as AAA).

decline in the value of the securities backed by the AIG CDS.¹² This decline resulted in demands for AIG to post additional collateral to support the CDS.¹³ Goldman Sachs, which held \$20 billion in AIG CDS, demanded \$1.5 billion in collateral in August 2007.¹⁴ AIG argued that this amount of collateral was excessive, so the parties compromised and AIG posted \$450 million to Goldman in collateral.¹⁵ Goldman asked for additional collateral in October, resulting in another \$1.5 billion posting.¹⁶ With the additional exposure from the market, AIG began to write down their CDS, which led to other holders of AIG CDS making collateral calls.¹⁷ In February 2008, AIG announced a \$5.3 billion quarterly loss, driven primarily by writing down CDS.¹⁸ In May 2008, AIG announced another \$7.8 billion quarterly loss again fueled by CDS write-downs.¹⁹ By July 31, 2008, AIG had posted more than \$16.5 billion in collateral for CDS.²⁰

AIG's financial problems reached true crisis proportions in September 2008. Several things happened nearly simultaneously. On the news of the continuing write-offs combined with a worsening market, rating agencies "slashed" AIG's credit rating.²¹ As a result, AIG was required to post another \$14 to \$20 billion in collateral for CDS.²² But it was virtually impossible for AIG to raise this capital. It had already raised some \$24 billion in collateral in the previous months,²³ so it had exhausted ready sources for capital. At about the same time, the bond markets "froze" on the news that Lehman Brothers had filed for bankruptcy.²⁴ In addition, AIG's ability to raise capital in the equities market was undermined by a precipitous drop in its share price from more than \$70 per share to a fifty-two week low of \$1.25.²⁵ AIG was poised for bankruptcy. Rather than risk the impact this would have on the world financial markets,²⁶ the federal govern-

12. *See id.*

13. *See* Carrick Mollenkamp et al., *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test*, WALL ST. J., Nov. 3, 2008, at A1.

14. *See id.*

15. *See id.*

16. *See id.*

17. *See id.*

18. *See id.*

19. *See id.*

20. *See id.*

21. *See id.*

22. *See* AIG Corporate Information, *supra* note 11 (stating that AIG posted \$20 billion in collateral for CDS); *cf.* Nannette Byrnes, *Where AIG Went Wrong*, BUS. WK., Sept. 18, 2008, available at http://www.businessweek.com/magazine/content/08_39/b4101040078511.htm (stating that AIG posted \$14.5 billion in collateral); Mollenkamp et al., *supra* note 13 (stating that AIG posted \$18 billion in collateral).

23. *See* Byrnes, *supra* note 22.

24. *See* Mollenkamp et al., *supra* note 13.

25. *See id.*; *see also* Byrnes, *supra* note 22.

26. *See* Mollenkamp et al., *supra* note 13.

ment stepped in with an initial \$85 billion loan,²⁷ which was shortly thereafter increased to \$123 billion,²⁸ and then to \$150 billion.²⁹

AIG's collapse was not an insurance problem. The entity responsible for AIG's CDS business, AIG Financial Products Corp., was not an insurance company.³⁰ Sales of CDS were not subject to insurance regulation.³¹ As derivatives, CDS were covered by the Commodity Futures Modernization Act of 2000,³² which allowed for speculation in CDS³³ and was one reason for the market's exceptional growth.³⁴ AIG's insurance businesses were capitalized as separate entities and maintained appropriate reserves for the insurance claims.³⁵

B. CDS Are Not Insurance

Even though CDS are not subject to insurance regulation, some have argued that CDS had the essential features of insurance.³⁶ This argument is based on the risk-transfer aspect of CDS. Because the seller of the CDS takes on the risk of a credit default, the buying party has "insurance" in the ordinary sense of the word against a default.³⁷ But this risk transfer

27. See AIG Corporate Information, *supra* note 11.

28. See Mollenkamp et al., *supra* note 13.

29. See Walker-Bright & Law, *supra* note 8, § II.B.3 & n.73.

30. See *Research on Commodities*, *supra* note 3; see also Madden, *supra* note 1, at 16 & n.20. The holding company became subject to the Office of Thrift Supervision (OTS) in 1999 when OTS approved its application to charter AIG Bank. See Press Release, Office of Thrift Supervision, OTS Approves AIG Acquisition of American General Bank (Aug. 1, 2001), available at <http://files.ots.treas.gov/77152.html>.

31. See Madden, *supra* note 1, at 16 & n.20; William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 988 (2009). See generally Robert F. Schwartz, *Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation*, 12 FORDHAM J. CORP. & FIN. L. 167 (2007).

32. Pub. L. No. 106-554, 114 Stat. 2763 app. E (codified as amended in scattered sections of 7, 8, 11, 12, and 15 U.S.C.).

33. See Walker-Bright & Law, *supra* note 8, § II.B.1; Schwartz, *supra* note 31, at 171-72; Sjostrom, *supra* note 31, at 983-87.

34. See John T. Lynch, Comment, *Credit Derivatives: Industry Initiative Supplants Need for Direct Regulatory Intervention—A Model for the Future of U.S. Regulation?*, 55 BUFF. L. REV. 1371, 1376-82 (2008).

35. See Eric Dinallo, *What I Learned at the AIG Meltdown*, WALL ST. J., Feb. 3, 2010, at A17. Nevertheless, while the separate insurance entities remained financially sound throughout the crisis, the interconnectedness between the insurance subsidiaries and other AIG companies put the insurance companies at some risk if AIG had gone into bankruptcy. See Walker-Bright & Law, *supra* note 8, § III.A.

36. See, e.g., *id.* § II.B.1 & n.31; Arthur Kimball-Stanley, Note, *Insurance and Credit Default Swaps: Should Like Things Be Treated Alike?*, 15 CONN. INS. L.J. 241 (2008).

37. Credit default swaps have been described in the following way:

A credit default swap is a contract, in which one party pays a "premium" over a set time period to the other party in exchange for the other party's promise that it will pay the buyer in the event that a credit event, like a default on a loan or a credit rating downgrade, occurs.

fundamentally is not insurance.³⁸ These sorts of risk transfers are all around us. A money-back guaranty, for example, transfers the risk of dissatisfaction from the consumer to the retailer. A disclaimer that a garage operator is not responsible for damage to a parked car transfers risk from the operator to the car owner. The limitation on liability for credit card fraud to a specified amount transfers risk from the cardholder to the issuer. None of these risk transfers are insurance.³⁹

What makes insurance different from these other transactions is that insurance both transfers *and distributes or pools* a risk.⁴⁰ The classic example is fire insurance. The risk is transferred from the owner to the insurer, and then because the insurer issues thousands of policies to similarly situated owners, the risk is distributed or pooled. Each individual home only has a small probability of burning down. By each owner contributing a relatively small amount to the pool, when one house out of the thousands in the pool actually does burn down, there are sufficient resources (reserves) in the pool to pay to rebuild the insured house.

CDS do not have this pooling dimension. They are unregulated, over-the-counter derivatives.⁴¹ Each transaction is individually negotiated and may or may not result in pooling.⁴² While a specific issuer like AIG might choose to issue CDS on multiple credit risks and thereby achieve some level of pooling, that is not a necessary prerequisite of the product. In addition, as the experience with AIG shows, combining similar risks by selling many CDS actually increased the risk rather than distributing or pooling that risk. These risks are influenced by market changes, so that a drop in the bond market, for example, increases the risk of default (and collateral calls) for all CDS related to bonds, not just those of a particular bond issuer.

Instead of “pooling” a risk, CDS are used to “hedge” risks. A hedging device is one that counterbalances another risk in a portfolio.⁴³ Thus, for example, if an oil buyer is worried that the price of oil will increase, it may buy futures on oil that will lock in a certain price, transferring the risk of an increase to the seller of the futures contract. The seller of the futures contract uses the risk of an increase in oil prices to offset some other risk in the portfolio. Although the other risk could be many different things, a

Walker-Bright & Law, *supra* note 8, § II.B.1; *see also* Schwartz, *supra* note 31, at 181 (applying dictionary definitions of insurance to CDS).

38. For a detailed analysis of how CDS are different from insurance using a contract and market analysis, *see* Schwartz, *supra* note 31.

39. *See* 1 Robert H. Jerry, II, *What Is Insurance?*, in *NEW APPLEMAN ON INSURANCE* LAW LIBRARY EDITION § 1.03[1] (Jeffrey E. Thomas ed., 2009).

40. *See id.* § 1.03[2].

41. *See* Schwartz, *supra* note 31; *see also* Madden, *supra* note 1; Sjostrom, *supra* note 31.

42. *See* Walker-Bright & Law, *supra* note 8, § II.B.1 (defining credit default swap).

43. *See* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 220-21 (2008) (explaining how hedging can be used with CDSs to diversify risk).

simple example would be the risk that oil prices would drop. By locking in the price for future oil sales, the seller has hedged against the risk of a price drop. Because the locked-in price will be above the current market price, but below the anticipated future price, the risk has been “balanced.”

This balancing, of course, is often much more sophisticated than my example. In the case of CDS, the seller of the CDS might hedge against the default by buying stock (or stock options) of a competitor of the reference entity (the company issuing the debt instrument covered by the CDS). For example, if AIG has given CDS on bonds issued by General Motors, the risk of GM defaulting on its bonds could be offset by AIG buying options on Ford stock, which would increase in value in the event of a GM default. The problem was that AIG did not properly hedge its CDS risk.⁴⁴ Goldman Sachs, which held billions in debt instruments covered by AIG CDS, did a better job of hedging. When Goldman learned that AIG may have trouble providing the requested collateral, Goldman bought CDS on the risk that AIG would default.⁴⁵

Goldman's purchase of CDS on AIG illustrates another major difference between CDS and insurance—CDS are freely bought and sold.⁴⁶ Because CDS are a derivative instrument that is essentially unregulated, holders of the CDS could sell them to others. The buying and selling resulted in holders of CDS that did not have any other relationship to the underlying debt. This would not be allowed in the insurance world, where the holders of insurance must have an “insurable interest” in the thing being insured.⁴⁷ The sales of CDS can happen by either issuers or holders. While the resale of insurance policies is not specifically forbidden under insurance regulations, apart from sales of entire companies or divisions, such sales are contrary to the custom and practice of the industry because of the time and effort that goes into the underwriting process.⁴⁸ Once an insurer has made the investment to determine whether a risk should be insured, it is generally inclined to hold on to that risk (the policy), and it would be suspicious of any insurer trying to sell its insured risks to others. The obvious implication would be that the risk was worse than expected, so a buyer would be unlikely to buy it without a deep discount.

44. See Madden, *supra* note 1, at 16-17.

45. See Mollenkamp et al., *supra* note 13.

46. See Walker-Bright & Law, *supra* note 8, § II.B.1.

47. See 1 Jerry, *supra* note 39, § 1.05[3]. Some commentators have suggested that CDS should be limited to those holders who have an insurable interest. See, e.g., Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 426 (2005).

48. This is sometimes known as the doctrine that an insurance policy is a “personal contract.” See Schwartz, *supra* note 31, at 191-92.

C. *Insurance Regulation Is Poorly Suited for CDS*

These differences between CDS and insurance make the insurance regulatory model poorly suited to CDS regulation. Because insurance is a pooling mechanism, one of the primary objectives of regulation is to protect that pool so claims can be paid. This is done through financial solvency regulation.⁴⁹ As part of that regulation, insurers are to maintain capital sufficient to address the insurer's collective risks.⁵⁰ Unfortunately, insurers have nowhere near the amount of capital it would take to collectively stand behind CDS. Estimates of the total notional value for CDS peaked at around \$60 trillion.⁵¹ This is a gargantuan number, nearly four times the GDP of the United States.⁵² Insurers obviously do not have enough capital to underwrite the full CDS market. Indeed, the total outstanding surplus for the property/casualty insurance industry in the United States at the end of 2008 was \$455.6 billion.⁵³ Thus, the notional value of CDS was about 100 times the combined property/casualty surplus.

A second reason that insurance regulation is not suitable for CDS is that it would not allow the market mechanism to function. As noted above, insurance regulation generally has an insurable interest requirement.⁵⁴ This requirement would interfere with the buying and selling of CDS because few secondary buyers would have an insurable interest in the underlying debt instrument. In addition, the insurable interest requirement would limit the use of CDS as a hedging mechanism. Buyers may want to use CDS to hedge against a counterbalancing risk even though they are not directly exposed to the risk covered by the CDS. This kind of access to a resale market also allows much broader access to capital because any investor in the market can take on the CDS risk (or for that matter, transfer the risk to someone else).

A third reason that insurance regulation is not suitable for CDS is that regulators simply do not have the expertise. CDS are a relatively new financial instrument, developed by finance experts. Insurance regulators would have a steep learning curve, which would be compounded by the

49. See 2 Gary M. Cohen, *The Framework of Insurance Regulation*, in NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION, *supra* note 39, § 8.02[d]. For more detail about solvency regulation, see 2 Gary A. Hernandez & Paige D. Waters, *Insurance Solvency Regulation*, in NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION, *supra* note 39, § 14.

50. See 2 Cohen, *supra* note 49, § 8.02[2][d][ii].

51. See Madden, *supra* note 1, at 15; see also *OTC Derivatives Market Activity in the Second Half of 2007*, BIS MONETARY & ECON. DEP'T (Bank for Int'l Settlements, Basel, Switz.), May 2008, at 1, available at http://www.bis.org/publ/otc_hy0805.pdf.

52. See Madden, *supra* note 1, at 15.

53. See Robert P. Hartwig, 2008, YEAR END RESULTS (Ins. Information Inst., N.Y., N.Y.), Apr. 9, 2009, available at <http://www.iii.org/FinancialResultsandMarketConditions/Commentary-on-2008-Year-End-Results.html>.

54. See ERIC MILLS HOLMES, APPLEMAN ON INSURANCE §§ 174.02-03 (2d ed. 2006).

fact that financial risk is substantially different than other kinds of risks covered by insurance.⁵⁵ Furthermore, insurance regulation, done in fifty different states, is slow and cumbersome compared to the speed at which things happen in the market.

II. THE STATE-BASED REGULATORY PARADIGM FOR INSURANCE

Although CDS are not insurance and AIG's collapse did not involve insurance, many are using the occasion to promote reform of insurance regulation.⁵⁶ The most commonly suggested reform is the adoption of an optional federal charter that would allow insurers to opt out of the state regulatory system.⁵⁷ Although support for the optional federal charter has grown in the wake of the AIG debacle,⁵⁸ a comprehensive and entrenched state regulatory system will not be easy to displace. Because so much of the financial regulatory system is federal,⁵⁹ most people naturally think

55. See Walker-Bright & Law, *supra* note 8, § III.C.3.

56. See, e.g., Jackie Calmes, *Both Sides of the Aisle See More Regulation, and Not Just of Banks*, N.Y. TIMES, Oct. 14, 2008, at A15; Peter Whoriskey, *AIG Bailout Revives Calls for a Federal Regulator*, WASH. POST, Sept. 30, 2008, at D03; Tom Wilson, *Regulate Me Please*, N.Y. TIMES, Apr. 15, 2009, at A29; see also *Trade Groups Applaud Fed Action on AIG*, BUS. INS., Sept. 17, 2008 (reporting statement from American Insurance Association arguing that AIG situation highlights need for insurance regulatory reform). These calls for regulation have resulted in congressional hearings. See, e.g., *Perspectives on Modernizing Insurance Regulation: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. (2009); *The Causes and Effects of AIG's Bailouts: Hearing Before the H. Comm. on Oversight and Government Reform*, 111th Cong. (2008).

57. See, e.g., Sean P. Carr, *The AIG Effect: AIG Impact on State/Federal Debate Unclear*, BESTWIRE, Sept. 8, 2009; Lori Widmer, *Is Now the Time for the Optional Federal Charter?*, RISK MANAGEMENT, June 1, 2009, at 26; see also *infra* note 59. For scholarly analysis of the optional federal charter, see Scott A. Sinder, *The Gramm-Leach-Bliley Act and State Regulation of the Business of Insurance—Past, Present and . . . Future?*, 5 N.C. BANKING INST. 49 (2001); Danielle F. Waterfield, *Insurers Jump on Train for Federal Insurance Regulation: Is It Really What They Want or Need?*, 9 CONN. INS. L.J. 283 (2002); William J. Warfel, *Insurance Regulatory Reform: An Evaluation of Options for Expanding the Role of the Federal Government* (Networks Fin. Inst. Working Paper No. 2006-WP-11, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=946457; Martin F. Grace & Hal S. Scott, *Optional Federal Chartering of Insurance: Rationale and Design of a Regulatory Structure* (June 26, 2008) (unpublished manuscript, presented at the GSU/Brookings/AEI Conference, "The Future of Insurance Regulation," in Wash., D.C. on July 9, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1175104.

58. See, e.g., *AIG Bailout Heightens Need for OFC*, REACTIONS, Aug. 2009; Sean P. Carr, *AIG Bailout Makes Case for OFC, Proponents Argue*, BESTWIRE, Sept. 8, 2009; Mark A. Hofmann, *White House Eyes Regulatory Revamp: Better Control Over Systemic Risk Sought; Boost for OFC Seen*, BUS. INS., Mar. 30, 2009; Arthur D. Postal, *AIG's New Failure Makes Federal Regulation Likely*, NAT'L UNDERWRITER, Oct. 13, 2008, at 42; Arthur D. Postal, *AIG Shows Feds Should Regulate Insurance, Paulson Says*, NAT'L UNDERWRITER, Sept. 29, 2008, at 6.

59. See Jonathan R. Macey & Geoffrey P. Miller, *The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role of Insurance Regulation*, 68 N.Y.U. L. REV. 13, 13 (1993) ("Among major financial institutions in the United States, only insurance firms are subject to plenary state regulation.").

about regulatory reform in terms of the federal system. Insurance, however, has developed a regulatory paradigm at the state level, which will be described in this section. We begin with a brief historical introduction, followed by a description of the scope and approach to state insurance regulation. The next subsection describes the development and functioning of the National Association of Insurance Commissioners (NAIC), a sort of “trade group” for state insurance regulators that works to improve (and protect) the state insurance regulatory system. The final subsection considers the lessons to be learned from the state regulatory paradigm.

A. *Historical Context: How Did We Come to the State Regulatory Paradigm?*

Insurance regulation began at a time when the federal government was relatively weak and not significantly involved in the regulation of commerce. It is difficult to pinpoint a precise time when state insurance regulation began, but it was well underway before the Civil War. In the late 1700s and early 1800s, state regulation was done directly through the legislature or by putting conditions on corporate charters.⁶⁰ By the 1820s, some states were requiring insurers to report to a state official.⁶¹ In the 1850s, states began to give regulatory power to a board or a designated insurance official.⁶² From the 1850s, state insurance regulation was “steadily extended and systematized.”⁶³

1. *The U.S. Supreme Court Holds that Insurance Is Not Commerce*

This early state regulation was insulated from federal interference in 1868 by the U.S. Supreme Court’s decision in *Paul v. Virginia*.⁶⁴ That case involved a challenge to a Virginia statute requiring insurance companies to post a bond as a condition of licensing, and making it illegal to sell insurance without a license.⁶⁵ A New York insurance agent was convicted under the statute for selling insurance policies of an insurer licensed in New York, but not Virginia.⁶⁶ The agent contended that the Virginia statute violated the Privileges and Immunities Clause and the Commerce Clause. The Court rejected both arguments. It held that corporations

60. See Spencer L. Kimball, *The Purpose of Insurance Regulation: A Preliminary Inquiry in the Theory of Insurance Law*, 45 MINN. L. REV. 471, 473 (1960).

61. See *id.* For example, in New York insurers were required to report to the state comptroller, and in Massachusetts they were required to make reports to the state treasurer. See N.Y. Rev. Stat. tit. 21, § 4 (1829); see also MASS. GEN. LAWS ch. 141 (1827).

62. See Kimball, *supra* note 60, at 473-74; see also, e.g., 1852 Mass. Acts ch. 231, § 5; 1859 N.Y. Laws ch. 366; 1851 N.H. Laws ch. 1111; 1854 R.I. Pub. Laws 17, § 17; 1852 Vt. Acts & Resolves no. 45, § 15; 1852 Vt. Acts & Resolves no. 46, § 16.

63. See Kimball, *supra* note 60, at 473.

64. 75 U.S. 168 (1868); see also 2 Cohen, *supra* note 49, § 8.01[1].

65. See *Paul*, 75 U.S. at 170.

66. See *id.* at 169.

were not "citizens" entitled to protection of the Privileges and Immunities Clause,⁶⁷ and that insurance was not commerce. The opinion states:

Issuing a policy of insurance is not a transaction of commerce. The policies are simple contracts of indemnity against loss by fire, entered into between the corporations and the assured, for a consideration paid by the latter. These contracts are not articles of commerce in any proper meaning of the word.⁶⁸

This opinion was upheld and prevented federal regulation of insurance for some seventy-five years.⁶⁹

In the period after *Paul*, the insurance industry experienced extreme boom and bust cycles. It took little capital to start up an insurance company, and because the obligation to pay was contingent and in the future, start-up insurers could generate significant revenue and profits by selling low-cost insurance.⁷⁰ Unfortunately, when catastrophic losses were incurred, as in the case of large-scale urban fires in the 1870s, many insurers were unable to pay policyholder claims and became insolvent.⁷¹ One report in 1877 suggested that of the 4,000 insurance companies that had been started in the United States, only twenty-five percent, or 1,000 of them, remained.⁷²

2. *Insurers Respond by Reducing Competition*

The bust part of the cycles encouraged insurers to find a way to avoid so many insolvencies. The initial answer was the creation of national insurance ratemaking boards, but competition led to regional compacts designed to set rates through local agents.⁷³ The regional compacts prevented insolvencies, but also were anticompetitive. Anti-compact legislation was introduced in various states, but it either did not pass or was ineffective.⁷⁴ By the early 1900s, states began to introduce insurance rate regulation.⁷⁵ This regulation was relatively ineffective.⁷⁶

67. *See id.* at 176.

68. *Id.* at 183.

69. *See* 2 Cohen, *supra* note 49, § 8.01[1]; *see also, e.g.*, Nat'l Union Life Ins. Co. v. Wanberg, 260 U.S. 71 (1922); Nw. Mut. Life Ins. Co. v. Wisconsin, 247 U.S. 132 (1918); New York Life Ins. Co. v. Deer Lodge County, 231 U.S. 495 (1913).

70. *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, 547-48 (1958).

71. *See id.* at 548.

72. *See* PROCEEDINGS OF THE EIGHTH ANNUAL MEETING OF THE FIRE UNDERWRITERS' ASSOCIATION OF THE NORTHWEST 17 (1877).

73. *See* Kimball & Boyce, *supra* note 70, at 548-49.

74. *See id.* at 549-51.

75. *See id.* at 551-52; *see also, e.g.*, 1909 Kan. Sess. Laws ch. 152, p. 279.

76. Kimball & Boyce summarize the situation in this way:

Thus, in 1944 fifteen states either had no control over insurance rates, or the unsophisticated anti-monopoly provisions which did not regulate rate making but rather sought to preserve competition. In the other thirty-

The weak regulatory environment combined with industry efforts to maintain solvency by reducing competition and increasing prices set the stage for reconsideration of the federal role for insurance regulation. Insurers became more comfortable with collusion, and increasingly took advantage of the lack of competition. Most states allowed the insurers to increase rates as requested.⁷⁷ Missouri, however, was an exception.⁷⁸ In the late 1930s, the Missouri Superintendent of Insurance refused to authorize the requested rate increases, and he was sued by some 139 insurers.⁷⁹ While the case was pending, the difference between the old and proposed new rates was collected and deposited with the court.⁸⁰ The Superintendent, a member of the Kansas City political “machine,” negotiated a compromise whereby the insurers received eighty percent of the deposited money, but the other twenty percent went to the state.⁸¹ The state attorney general complained about this “bribe” to the Department of Justice, which undertook antitrust investigations into the industry.⁸²

3. *The U.S. Supreme Court Permits Federal Regulation*

In 1942, the Department of Justice investigations led to grand jury indictments for violations of the Sherman Act, conspiracy to fix insurance rates, and monopolization of trade fire insurance.⁸³ The South-Eastern Underwriters Association, a cooperative rating bureau, and its ninety-eight members selling insurance in six states were subject to the indictments.⁸⁴ The allegations were supported by evidence that the members of the association controlled ninety percent of the market, fixed premiums rates and commissions, and enforced participation in the arrangement by boycotts and other kinds of coercion and intimidation.⁸⁵ These efforts resulted in

three states there was rate regulatory machinery, usually coupled with anti-monopoly provisions. The effectiveness of control varied from purely paper machinery in some states to relatively complete and effective control in others like New York, and direct state rate making in Texas. Even in states with fairly effective control in leading lines of insurance like fire and workmen’s compensation, the control was relatively ineffective or altogether lacking in other lines. It might be a reasonably accurate generalization to say that in 1944, though ostensibly there was control in two-thirds of the states, insurance rate making was as yet largely uncontrolled in the United States.

Kimball & Boyce, *supra* note 70, at 552 (internal citations omitted).

77. See Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U. L. REV. 625, 632 (1999).

78. See *id.*

79. See *id.*

80. See *id.*

81. See *id.*

82. See *id.* at 633.

83. See *id.*

84. See *id.*

85. See *United States v. Se. Underwriters Ass’n*, 322 U.S. 533 (1944). For a more complete description of the opinion, see 2 Nathaniel S. Shapo, *Regulation of*

exceptionally low loss ratios. During the ten years prior to the indictment, the members collected some \$488 million in premiums, of which only \$215 million were used to pay losses in the same period.⁸⁶ The district court, based on *Paul* and its progeny, dismissed the indictments.⁸⁷ In *United States v. South-Eastern Underwriters Ass'n*,⁸⁸ the Supreme Court reversed.

Although asserting that the Court was not overruling *Paul*,⁸⁹ the majority, in a sweeping opinion written by Justice Black, held that insurance was interstate commerce subject to federal regulation the same as other businesses. The Court found that insurance “holds a commanding position in the trade and commerce” of the United States, was “one of the largest and most important branches of commerce,” and that “[p]erhaps no modern commercial enterprise directly affects so many persons in all walks of life.”⁹⁰ It then reasoned that congressional power to regulate commerce was “essential” to an “indivisible Nation,” and that “[n]o commercial enterprise . . . which conducts its business across state lines has been held to be wholly beyond the regulatory power of Congress under the Commerce Clause. We cannot make an exception of the business of insurance.”⁹¹

The dissent by Justice Jackson foreshadowed congressional reaction. Although he was sympathetic to the constitutional argument,⁹² he criticized the majority opinion on practical grounds: “The Court’s decision at the very least will require an extensive overhauling of state legislation relating to taxation and supervision.”⁹³ In addition, the Court’s decision gave Congress responsibility for regulating interstate insurance transactions,

Rates and Risk Classification, in NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION, *supra* note 39, § 11.02[3][b].

86. *See Se. Underwriters*, 322 U.S. at 542. This is a loss ratio of about 44%.

87. *See id.* at 537-38.

88. 322 U.S. 533 (1944).

89. *See id.* at 545. The Court reasoned that it was refusing to strike down an Act of Congress (the Sherman Act) rather than refusing to uphold another state law. *See id.*

90. *Id.* at 539-40. In making this point, the Court noted that the total assets held by United States insurance companies exceeded \$37 billion, which was approximately “the equivalent of the value of all farm lands and building in the United States.” *Id.* at 540. It also noted that annual premium receipts exceeded “\$6 billion, more than the average annual revenue receipts of the United States Government.” *Id.*

91. *Id.* at 552.

92. *See id.* at 586 (Jackson, J., dissenting) (“Were we considering the question for the first time and writing upon a clean slate, I would have no misgivings about holding that insurance business is commerce, and, where conducted across state lines, is interstate commerce, and therefore that congressional power to regulate prevails over that of the states.”).

93. *Id.* at 590.

something that Congress had not asked for and for which it had virtually no experience or expertise.⁹⁴

4. *State Regulation Given Preference by the McCarran-Ferguson Act*

In the year following the Court's decision, Congress enacted the McCarran-Ferguson Act.⁹⁵ State officials were concerned that their entire regulatory structure, and a significant source of state revenue through premium taxes, was at risk.⁹⁶ Consensus between state regulators, who wanted to keep insurance regulation, and federal officials, who had no experience or expertise, quickly developed.⁹⁷ The Act, hurriedly drafted,⁹⁸ is only 415 words long. The key provisions provide:

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.⁹⁹

. . . .

No Act of Congress shall be construed to invalidate, impair or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance.¹⁰⁰

This preference for state law, however, did not on its own invalidate the Supreme Court's decision in *South-Eastern Underwriters*. The law created a three-year window of opportunity to provide additional insurance regulation. The Act provided that the Sherman and Clayton Acts, and regulation by the Federal Trade Commission, "shall be applicable to the business of insurance to the extent that such business is not regulated by state law."¹⁰¹ Thus, the states were left to provide the regulation that would displace and "reverse preempt" federal law.¹⁰² Although their motives were "undoubtedly mixed, combining in varying proportions the desire to improve the quality and scope of state regulation of insurance

94. *See id.* ("The recklessness of such a course is emphasized when we consider that Congress has not one line of legislation deliberately designed to take over responsibility for this important and complicated enterprise.").

95. Pub. L. No. 79-15, 59 Stat. 33 (codified as amended at 15 U.S.C. §§ 1011-1015 (2006)). For a description of the legislative history of the Act, see R.K. Powers, *A Year of S.E.U.A.*, 23 CHI-KENT L. REV. 317 (1945).

96. *See* Kimball & Boyce, *supra* note 70, at 554.

97. *See id.* at 554-55.

98. *See* Powers, *supra* note 95, at 324-25.

99. 15 U.S.C. § 1011.

100. 15 U.S.C. § 1012.

101. *Id.*

102. *See* 2 Shapo, *supra* note 85, § 11.02[3][b].

rating, the desire to enable insurance companies to escape the provisions of the federal statutes, and the desire to maintain intact state control and taxation of the insurance business,"¹⁰³ the states responded to this opportunity by adopting concerted rate regulation in virtually every state.¹⁰⁴

B. *State Insurance Regulation*

State insurance regulation is done through a comprehensive administrative structure that goes well beyond rate regulation. All states have some form of an insurance commissioner or an office of insurance, which has administrative authority to issue rules and regulations.¹⁰⁵ Statutes and regulations combine to create a regulatory system that covers licensing of insurers, policy forms, prices, premium taxes, market conduct, and solvency.

1. *Licensing of Insurers*

State regulation of insurance begins with licensure of insurance companies. Although there are some exceptions for "surplus lines" of insurance that do not require state licensure,¹⁰⁶ the vast majority of insurance sold in a state must be issued by insurers licensed in the state ("domestic" insurers) or by insurers authorized to do business in the state licensed elsewhere ("non-domestic admitted" insurers).¹⁰⁷ To obtain a license, an insurer must meet certain capital requirements,¹⁰⁸ obtain approval of its officers and directors, its financial plan, its business plan, and provide an actuarial justification.¹⁰⁹ Insurance intermediaries are also subject to licensing and supervision.¹¹⁰

A licensed insurer is subject to comprehensive supervisory authority of the state regulators.¹¹¹ State regulators have the authority to inspect the insurer's records,¹¹² issue subpoenas to review company documents, and compel testimony.¹¹³ Insurers must submit quarterly and annual financial statements to the regulators,¹¹⁴ and insurers must meet capital or surplus requirements, or in some cases must provide a custodial account

103. Kimball & Boyce, *supra* note 70, at 555.

104. *See id.* at 555-56.

105. *See* 2 Cohen, *supra* note 49, ch. 8.

106. *See* 2 Julie Mix McPeak, *Licensing of Insurers*, in NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION, *supra* note 39, § 9.09.

107. *See id.* § 9.02.

108. *See id.* § 9.01[1].

109. *See id.* § 9.01[2], [4].

110. *See generally* 2 Randall Doctor & Robert J. Cerny, *Regulation of Insurance Intermediaries*, in NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION, *supra* note 39.

111. *See* 2 McPeak, *supra* note 106, § 9.06.

112. *See id.* § 9.06[1].

113. *See id.* § 9.06[2].

114. *See id.* § 9.06[3].

or make a special deposit with the insurance department.¹¹⁵ The state regulators also supervise and impose requirements regarding insurers' investments.¹¹⁶

Control of the licensing also provides regulators with a system for administrative sanctions. Licenses may be revoked or suspended for violations of state insurance requirements,¹¹⁷ including violation of market conduct regulations.¹¹⁸ Such sanctions are subject to an administrative adjudication procedure.¹¹⁹ If an insurer becomes insolvent or starts to get into financial trouble, the regulators can increase their supervision and, if necessary, intervene in the insurer's operations.¹²⁰

The regulatory patchwork created by state licensing requirements is one of the main justifications for the proposed optional federal charter for insurance. Large insurers that conduct business in multiple states would prefer to have a single federal regulator rather than being subject to this maze of state regulation, which can be inconsistent or conflicting at times.¹²¹

2. *Approval of Policy Forms*

State regulators also have the power to regulate the forms used for insurance policies.¹²² This power is reflected in statutes and regulations, and is exercised through administrative review and informational directives from the insurance department.¹²³ Some states require that forms be approved prior to their use, but regulatory reforms in many states allow forms to be used once a specified time has passed (generally a matter of days) after the proposed form has been filed with the insurance department.¹²⁴ A few states are even more liberal, and allow the use of policy forms so long as it is filed within a certain period of time after the form is first used.¹²⁵ There are some exceptional circumstances in which form filing requirements do not apply.¹²⁶

115. *See id.* § 9.06[4].

116. *See id.*

117. *See id.* § 9.07[1]-[2].

118. *See* 2 A. Kenneth Levine, *Market Conduct Regulation*, in NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION, *supra* note 39, § 13.04[3][e].

119. *See* 2 McPeak, *supra* note 106, § 9.07[3].

120. *See id.* § 9.07[4]; *see also* 2 Hernandez & Waters, *supra* note 49, § 14.05[4].

121. *See* 2 McPeak, *supra* note 106, § 9.10[4]; *see also* INS. INFORMATION INST., OPTIONAL FEDERAL CHARTER (2010), available at http://www.iii.org/media/hot_topics/insurance/opt/.

122. *See generally* 2 Carrie E. Cope, *Regulation of Policy Forms*, in NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION, *supra* note 39.

123. *See id.* §§ 10.2, 10.3[2].

124. *See id.* § 10.04[1].

125. *See id.*

126. *See id.* § 10.06. These exceptions include some large commercial risks, unique risks, and manuscript policies. *See id.*

3. *Prices*

Regulation of insurance prices is one of the more controversial regulatory issues. States take a fairly broad range of approaches—from states that mandate prices to states that allow open competition with no price regulation.¹²⁷ Few states are at either extreme. Most states take a middle-ground approach that is similar to the regulation of policy forms. They allow rates to be changed by file-and-use or by use-and-file systems. Under these systems, the insurer does not have to obtain approval for rate changes before using them, but the state retains the authority to disapprove rates.¹²⁸

The public policy debate about the utility and appropriateness of price regulation is ongoing. Illinois is the one state that does not have rate regulation for personal lines of insurance, and its insurance commissioner reports favorable results.¹²⁹ California is often used as a counterexample. It has become more stringent in rate regulation in recent years through the initiative process that has required insurance rate reductions, and its proponents argue that those measures have been successful.¹³⁰ Federal regulation is not likely to resolve this debate, or even take sides in it, be-

127. See 2 Shapo, *supra* note 85, § 11.02[4][c]; see also Macey & Miller, *supra* note 59.

128. See 2 Shapo, *supra* note 85, § 11.02[4][c].

129. See *id.* § 11.02[4][e]; see also *Working with State Regulators to Increase Insurance Choices for Consumers: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. 154, 157 (2004) (statement of Philip R. O'Connor, Ph.D., former Illinois Director of Insurance) [hereinafter *Insurance Choices Hearings*]. Discussing the Illinois approach, Dr. O'Connor stated:

The Illinois Model is simple and requires minimal regulatory resources. It creates a climate that attracts the largest share of operating P&C companies . . . of any state in the nation and has been the key reason that periods of inadequate supply in any line of coverage have tended to be short. . . .

. . . Researchers have repeatedly compared Illinois to other states in terms of important outcomes and Illinois consistently fares well. Auto and homeowners insurance prices are always right in the middle of all states, residual market populations have been perennially low, over-the-phone price quotes are readily available in personal lines, the state has the largest number of licensed personal lines insurers and the Illinois Insurance Department has been able to devote resources to professionalizing its capabilities.

Insurance Choices Hearings, supra.

130. See 2 Shapo, *supra* note 85, § 11.02[4][e]; see also J. ROBERT HUNTER, CONSUMER FEDERATION OF AMERICA, WHY NOT THE BEST?: THE MOST EFFECTIVE AUTO INSURANCE REGULATION IN THE NATION 12 (2001), available at <http://www.consumerwatchdog.org/documents/7634.pdf>. (stating that California's Proposition 103 "reduced all automobile, homeowner, business, and most other property-casualty insurance rates and premiums to the levels in effect on November 8, 1987, then required that they be reduced a further 20%").

cause the federal proposals leave the pricing of insurance to the state regulators.¹³¹

4. *Premium Taxes*

Prices charged for insurance in the United States also include a premium tax imposed by the states. These taxes are an important source of revenue to the states, and are one of the key motivations for states to retain regulatory authority over insurance.¹³² As with any taxing system, especially one that is more than 150 years old,¹³³ the system has become more complex over time. In addition to the methods used to calculate the taxes,¹³⁴ the system has developed a number of credits, deductions, and offsets.¹³⁵ The system also has to address its interaction with related tax systems, such as corporate income or franchise taxes.¹³⁶ As the tax system became more sophisticated, insurers and policyholders developed arrangements designed to reduce state insurance premium tax liability.¹³⁷

One of the unique developments concerning premium taxes is the use of so-called retaliatory taxes.¹³⁸ These are premium taxes meant to equalize the difference in premium taxes from state to state. When a domestic insurer is subject to a premium tax in another state, if that tax rate is higher than the domestic premium tax, the home state “retaliates” against the other state by charging a higher premium tax for those insurers from that state.¹³⁹ This complex system has developed because of the differential taxes charged by states. The constitutionality of these retalia-

131. See Eli Lehrer, *Federal Optional Charter for Insurers: FAQ*, CEI ON POINT (Competitive Enterprise Inst., Wash., D.C.), Oct. 2, 2007, available at <http://cei.org/pdf/6170.pdf>.

132. See 2 Brian T. Casey & R. Dean Conlin, *State Insurance Premium and Other Insurance Taxes*, in NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION, *supra* note 39, ch. 12 Abstract. In 2008, premium taxes amounted to \$15.7 billion, which is approximately 2% of all state revenues. See *id.* That may seem like a small amount, but for comparison it is noteworthy that corporate income taxes produce only 6.5% of the state tax revenues. See *id.* One of the benefits of premium taxes is that they tend to be more stable and consistent than income taxes. See *id.*

133. The first taxes were imposed in 1832 in Massachusetts. See *Prudential Ins. Co. v. Comm’r of Revenue*, 709 N.E.2d 1096 (Mass. 1999). Originally, the taxes were to pay for insurance regulation, but now most states use premium taxes as part of their general revenue. See 2 Casey & Conlin, *supra* note 132, § 12.01[1].

134. See *id.* § 12.02.

135. See *id.* § 12.03. For example, Georgia grants insurers tax abatements for localized investments. See GA. CODE ANN. § 33-8-5 (2000). Some states provide insurers a reduction in premium tax with a salary tax credits for local employees. See, e.g., KAN. STAT. ANN. § 40-252d (Supp. 2009); FLA. ADMIN. CODE ANN. r. 12B-8.001 (2002). Many states that adopted the NAIC Model Acts allow premium tax credits for assessments paid to state insurance guaranty funds. See, e.g., COLO. REV. STAT. § 10-20-113 (2009); GA. CODE ANN. § 33-38-22; KY. REV. STAT. ANN. § 304.36-160 (LexisNexis 2006); N.H. REV. STAT. ANN. § 404-B:16 (LexisNexis 1998).

136. See 2 Casey & Conlin, *supra* note 132, § 12.01[6].

137. See *id.* § 12.06.

138. See generally *id.* § 12.09.

139. See *id.* § 12.09[1].

tory taxes generally has been upheld.¹⁴⁰ It has also given rise to its own reporting and payment system.¹⁴¹ Although the federal government does not impose premium taxes on U.S. insurers,¹⁴² a federal excise tax applies to foreign insurers.¹⁴³

5. *Market Conduct*

State insurance regulators have comprehensive power over insurers' market conduct, which is broad enough to include conduct with both consumers and competitors. Shortly after the passage of the McCarran-Ferguson Act, the NAIC prepared and approved a model unfair trade practices act.¹⁴⁴ All states have adopted some version of the model act.¹⁴⁵ These acts are considered remedial in nature and are broadly construed.¹⁴⁶ Regulators have the power to undertake market conduct examinations of insurers.¹⁴⁷ These market conduct examinations generally focus on sales, advertising, ratings, and the handling of claims.¹⁴⁸ State regulators also have the authority to review books and records as part of their investigatory powers.¹⁴⁹

The definitions of unfair trade practices are broad enough to cover a wide variety of insurer activity.¹⁵⁰ They include misrepresentations in advertising,¹⁵¹ applications,¹⁵² and the making of false statements or entries.¹⁵³ Unfair trade practices also includes a wide variety of improper

140. *See id.* § 12.09[4].

141. *See id.* § 12.09[10].

142. *See id.* § 12.01[2].

143. *See id.* § 12.13.

144. *See* 2 Levine, *supra* note 118, § 13.04[2].

145. *See id.* § 13.04[2] & n.54; *see also, e.g.*, ARIZ. REV. STAT. ANN. §§ 20-441 to -461 (2002); CAL. INS. CODE §§ 790-790.10 (West 2005 & Supp. 2010); CONN. GEN. STAT. ANN. §§ 38a-815 to -819 (West 2007); FLA. STAT. ANN. §§ 626.951-9641 (West 2004 & Supp. 2010); IOWA CODE ANN. §§ 507B.1-14 (West 2007 & Supp. 2010); KAN. STAT. ANN. §§ 40-2401 to -2421 (2000 & Supp. 2009); MO. REV. STAT. ANN. §§ 375.930-948 (West 2002 & Supp. 2010); N.H. REV. STAT. ANN. §§ 417-B:1-14 (LexisNexis 1998 & Supp. 2009); N.C. GEN. STAT. ANN. §§ 58-63-1 to -60 (West 2009); 40 PA. CONS. STAT. ANN. §§ 1171.1-15 (West 1999); TENN. CODE ANN. §§ 56-8-101 to -118 (2008 & Supp. 2009); VT. STAT. ANN. tit. 8, §§ 4721-4726 (1993 & Supp. 2009); VA. CODE ANN. §§ 38.2-516 to -600 (2007 & Supp. 2009).

146. *See* 2 Levine, *supra* note 118, § 13.04[3][a].

147. *See id.* § 13.04[3][b] & n.63.

148. *See id.* § 13.04[3][b].

149. *See id.* § 13.04[3][c].

150. *See generally id.* § 13.05.

151. *See id.* § 13.05[2][a].

152. *See id.* § 13.05[2][c].

153. *See id.* § 13.05[2][d].

sales activity,¹⁵⁴ such as “twisting,”¹⁵⁵ “churning,”¹⁵⁶ “sliding,”¹⁵⁷ unsuitable sales,¹⁵⁸ and unlawful rebating.¹⁵⁹ In addition, unlawful discrimination is an unfair trade practice,¹⁶⁰ and the regulations preclude such things as redlining;¹⁶¹ boycotts, coercion and intimidation;¹⁶² and discrimination based on physical or mental impairment.¹⁶³ Certain kinds of relationships between insurers and others are also precluded.¹⁶⁴

Claims handling is regulated as part of market conduct.¹⁶⁵ All states have adopted some version of the NAIC Model Unfair Claims Settlement Practices Act as part of unfair trade practices or as a separate statute.¹⁶⁶ Unfair claims practices include misrepresentations of facts or policy provisions, failing to promptly acknowledge and communicate regarding a claim, failure to conduct a reasonable investigation, trying to settle without a complete statement of the coverage, unreasonable or improper delays, and unreasonable settlement offers, among others.¹⁶⁷

Although the power to regulate in this area is comprehensive, the remedies are somewhat limited. As a general matter, penalties for violation are limited to cease and desist orders, suspension or revocation of licenses, or fines.¹⁶⁸ In addition, most administrative actions are limited to cases where the prohibited conduct is so common or regularly used as to amount to a business practice. State regulators “generally lack direct authority to intervene in specific cases.”¹⁶⁹ In some states, the statutes for

154. *See generally id.* § 13.05[3].

155. *See id.* § 13.05[3][b]. Twisting occurs when an agent or broker uses misrepresentations to convince a policyholder to cancel an existing policy and replace it with another. *See id.* As a result, the policyholder will forfeit certain rights or be subject to less favorable terms. *See id.*

156. *See id.* § 13.05[3][c]. Churning involves the unnecessary replacement of existing policies; the agent profits by collecting additional first-year commissions. *See id.* Churning often involves rewriting with a new policy, but also includes using policy values in an existing policy to purchase another policy without fully informing the policyholder of the consequences. *See id.*

157. *See id.* § 13.05[3][d]. Sliding occurs when agents coerce policyholders to purchase ancillary insurance products without informed consent. The agents misrepresent the insurance product as coverage that is required by law or fail to inform the policyholder of all applicable charges. *See id.*

158. *See id.* § 13.05[3][e].

159. *See id.* § 13.05[3][h].

160. *See generally id.* § 13.05[4].

161. *See id.* § 13.05[4][b].

162. *See id.* § 13.05[4][c].

163. *See id.* § 13.05[4][g].

164. *See generally id.* § 13.05[7].

165. *See generally id.* § 13.05[5].

166. *See id.* § 13.05[5][a] & n.194.

167. *See id.* § 13.05[5][a].

168. *See id.* § 13.04[3][e].

169. *Id.* § 13.05[5][a].

market conduct may provide a private right of action,¹⁷⁰ but courts have been reluctant to infer such a right of action.¹⁷¹

6. *Solvency*

One of the most important areas of state regulation addresses insurer solvency. This has been one of the more successful areas of regulation.¹⁷² State regulators use their comprehensive regulatory powers to supervise insurer solvency. They have a broad range of financial and analytical tools available.¹⁷³ Insurers are to submit to regular financial examinations,¹⁷⁴ and if the insurer is at risk of becoming insolvent, the state regulators have authority to intervene.¹⁷⁵ State regulators may require more frequent financial reports,¹⁷⁶ and if the situation requires, the regulators may take control of the insurer through administrative supervision.¹⁷⁷

C. *The National Association of Insurance Commissioners*

This comprehensive regulatory framework has given rise to an important quasi-governmental insurance organization, the National Association of Insurance Commissioners (NAIC). This organization is “quasi-governmental” because its members are state insurance commissioners, who are government officials, but the association itself is self described as a “voluntary organization”¹⁷⁸ that is organized under the corporate laws of Delaware.¹⁷⁹ It was organized in 1871, which it claims makes it the oldest

170. See, e.g., FLA. STAT. ANN. §§ 624.155(1)(a), 626.941(1)(i) (West 2004 & Supp. 2010).

171. See generally 2 Levine, *supra* note 118, § 13.06.

172. See Macey & Miller, *supra* note 59, at 18-19. Macey and Miller have noted:

[T]he overall level of insurance company insolvencies has been extraordinarily low, and the insolvencies that have occurred frequently have been triggered by unforeseeable downturns in real estate and corporate debt markets.

....

... Moreover, the federal government certainly has not acquitted itself well in the analogous field of banking regulation.

Id.

173. See generally 2 Hernandez & Waters, *supra* note 49, § 14.04 (describing IRIS ratios, FAST scoring system, RBC ratios, Risk-Focused analysis, rating agencies, and Early Warning Systems).

174. See *id.* § 14.04[8]. Generally, it is once every three years, but occasionally it is on a five-year cycle. See *id.*

175. See generally *id.* § 14.05.

176. See *id.* § 14.05[1].

177. See *id.* § 14.05[4].

178. See NAT'L ASS'N OF INSURANCE COMMISSIONERS, 2008 ANNUAL REPORT 2 (2009) [hereinafter NAIC ANNUAL REPORT], available at http://www.naic.org/documents/about_2008_annual_report.pdf. Professor Randall has concluded that “the NAIC is a private rather than a governmental entity.” See Randall, *supra* note 77, at 638.

179. See Bylaws of the National Association of Insurance Commissioners, http://www.naic.org/members_bylaws.htm (last visited May 23, 2010).

association of state officials.¹⁸⁰ The NAIC generated some \$68 million in revenue in 2008, of which about \$2 million came from state assessments.¹⁸¹ In 2008, its staff included 430 employees,¹⁸² and its operations budget was more than \$66 million.¹⁸³

The stated purpose of the NAIC is “to assist state insurance regulators, individually and collectively, in serving the public interest and achieving . . . fundamental insurance regulatory goals in a responsive, efficient and cost effective manner.”¹⁸⁴ While the mission no longer explicitly states it is to promote uniformity,¹⁸⁵ that is what the NAIC means by its reference to efficient and cost effective regulation.¹⁸⁶

The NAIC is playing a facilitating role that might be similar to a central federal agency. It creates model laws and regulations, prepares standardized forms, coordinates financial examinations, maintains extensive national databases to assist in monitoring insurers, trains many state regulators, and prepares statistical reports.¹⁸⁷ The NAIC performs these tasks strictly from the state regulatory paradigm. Professor Randall, in her study of the NAIC, found “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.”¹⁸⁸

This pattern, and the political power and lobbying influence of the NAIC, will make it very difficult to obtain new federal regulation of insurance. A couple of historical examples illustrate this point. Problems with collusion and price fixing gave rise to federal intervention into insurance regulation in the 1940s by Department of Justice efforts to enforce the antitrust laws. When the Supreme Court in *South-Eastern Underwriters* upheld that intervention,¹⁸⁹ the NAIC’s response was swift and powerful.¹⁹⁰ A year later, the NAIC’s draft legislation was passed by both the House and

180. See NAIC ANNUAL REPORT, *supra* note 178.

181. See *id.*

182. See *id.*

183. See *id.*

184. National Association of Insurance Commissioners, Our Mission, http://www.naic.org/index_about.htm# (last visited May 23, 2010).

185. Prior to 1980, the NAIC said that the “object of this association shall be to promote uniformity in legislation affecting insurance.” See NAT’L ALLIANCE OF AMERICAN INSURERS, NAIC IN TRANSITION: A DISCUSSION PAPER ON ISSUES FACING THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 13 (1982).

186. The more opaque version of the mission was adopted in 1980. As Professor Randall points out, the goal of uniformity was inconsistent with state regulation, and even the existence of the organization. See Randall, *supra* note 77, at 634-35.

187. See *id.* at 636-37.

188. *Id.* at 640.

189. *United States v. Se. Underwriters Ass’n*, 322 U.S. 533, 552 (1944).

190. See Randall, *supra* note 77, at 633 & n. 50.

the Senate and became the McCarran-Ferguson Act.¹⁹¹ That was not all. The NAIC then created the model legislation for unfair trade practices that allowed states to avoid federal regulation under the antitrust laws, which most states adopted in the following years.¹⁹²

A more contemporary example arose out of the insurance crisis of the 1980s. After several large insurers became insolvent, federal officials criticized state insurance solvency regulation.¹⁹³ Federal legislation was introduced to address the state regulatory weaknesses in the insolvency area.¹⁹⁴ The NAIC responded by creating an accreditation process seeking to improve individual state insurance departments.¹⁹⁵ Although some states criticized the accreditation process, resulting in some relaxing of accreditation standards, the NAIC was able to forestall federal regulation in this area.¹⁹⁶

D. *Lessons to Be Learned*

What these examples show is the formidable power of the NAIC to protect the state paradigm of regulation.¹⁹⁷ This is reflected in the current round of reform proposals. Although some have used the AIG collapse as a basis to call for the optional federal charter proposal,¹⁹⁸ it should be noted that the Consumer Financial Protection Agency, a major part of the administration's proposed reform package,¹⁹⁹ does not apply to most insurance.²⁰⁰ Similarly, while the effort to create a Federal Insur-

191. *See id.* at 633-34; *see also* KENNETH J. MEIER, *THE POLITICAL ECONOMY OF REGULATION: THE CASE OF INSURANCE* 68-69 (1988).

192. *See* Randall, *supra* note 77, at 634.

193. *See id.* at 642; *see also, e.g.*, GENERAL ACCOUNTING OFFICE, *INSURANCE REGULATIONS: STATE HANDLING OF FINANCIALLY TROUBLED PROPERTY/CASUALTY INSURERS*, GAO/GGD-89-129 (1991); STAFF OF THE H. SUBCOMM. ON OVERSIGHT AND INVESTIGATIONS OF THE H. COMM. ON ENERGY AND COMMERCE, 101ST CONG., *FAILED PROMISES: INSURANCE COMPANY INSOLVENCIES* (1990).

194. *See* Randall, *supra* note 77, at 644.

195. *See id.* at 645-46.

196. *See id.* at 657-58.

197. *See generally* Randall, *supra* note 77.

198. For further discussion of the proposals for the optional federal charter, *see supra* notes 57-59 and accompanying text. The NAIC, of course, opposes the optional federal charter. *See, e.g.*, Press Release, NAIC, NAIC President Questions Motives of OFC Supporters (Feb. 15, 2008), *available at* http://www.naic.org/Releases/2008_docs/president_questions_ofc_supporters.htm.

199. *See* U.S. DEP'T OF TREASURY, *A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION* 50-75 (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

200. *See, e.g.*, Arthur D. Postal, *New Reg System Proposed*, NAT'L UNDERWRITER, July 6, 2009, at 10; Press Release, NAMIC, Moore-Paulsen Amendment Provides Clarity to CFPA Legislation (Oct. 21, 2009), *available at* <http://www.namic.org/newsreleases09/091021nr1.asp>; *see also* Consumer Financial Protection Act of 2009, H.R. 3126, 111th Cong. § 101(18)(O) (2009) (providing that CFPA "shall not define engaging in the business of insurance as a financial activity (other than with respect to credit insurance, mortgage insurance, or title insurance, as described in this section)").

ance Office has gained momentum,²⁰¹ the NAIC recently obtained concessions to the proposal to protect state regulation.²⁰² To the extent that other reform measures intend to include insurance, passing such measures will require overcoming or addressing the NAIC.

The second lesson to be learned is that the state regulatory system is comprehensive and robust. It would be folly to act as if there is little or no regulation of insurance. Moreover, because state regulation of insurance has more than 100 years of history, valuable lessons have been learned that should be considered in connection with reform efforts.²⁰³ While state regulation certainly has some limitations, it provides a comprehensive framework and regulatory apparatus with extensive experience and expertise. Reform of insurance regulation needs to take this into account.

III. STATE JUDICIAL REGULATION OF INSURANCE

In addition to state administrative regulation, insurance law includes a considerable regulation through state common law. Although most people who study regulation might not consider the common law as a source of regulation, that would be a mistake in the case of insurance. Indeed, in some respects the common law regulation of insurance through the courts may be more important than administrative regulation.²⁰⁴ Insurance law casebooks generally include some discussion of administrative regulation, but it is a relatively small percentage.²⁰⁵ The common law regulation of

201. See, e.g., Sean P. Carr, *Obama Plans Class for Federal Insurance Office, Stops Short of Federal Regulator*, BESTWIRE, June 17, 2009; Sean P. Carr, *Insurers Welcome Obama Regulatory Plan*, TRADINGMARKETS.COM, June 17, 2009, <http://www.tradingmarkets.com/.site/news/Stock%20News/2377638/>.

202. See Arthur D. Postal, *Revamped U.S. Insurance Office Bill Clears House Hurdle, Draws Industry Praise*, NAT'L UNDERWRITER, Dec. 7, 2009, at 8 (noting that bill "now contains specific language denying the new agency any supervisory or regulatory authority over the business of insurance, while barring the FIO from preempting state insurance laws governing rates, premiums, coverage requirements, antitrust laws, underwriting or sales practices").

203. See, e.g., Macey & Miller, *supra* note 59, at 17-20 (recommending that current interpretations of McCarran-Ferguson be followed with regard to antitrust exemption, that solvency regulation be left to states, and that prices should be deregulated).

204. As will be discussed more fully below, the benefit of the common law remedies is that they are available to every consumer. While every consumer also can make an administrative complaint, after making the complaint the consumer has no influence or control over the matter. Moreover, the administrative remedies generally do not provide any specific relief for individual insureds. See 2 Levine, *supra* note 118, § 13.05[5][a] (noting "state insurance departments generally lack direct authority to intervene in specific cases where an insurer is alleged to act in an unfair manner").

205. For example, one casebook devotes the last 84 pages out of more than 700 to insurance regulation. See TOM BAKER, *INSURANCE LAW AND POLICY: CASES AND MATERIALS* 637-721 (2d ed. 2008). Another casebook puts insurance at the beginning, but it only devotes 34 out of 788 pages to insurance. See LEO P. MARTINEZ & JOHN WHELAN, *CASES AND MATERIALS ON INSURANCE LAW* 24-58 (5th ed. 2006).

insurance has created a remedy when insurers act in bad faith. My suggestion is that as part of financial regulatory reform a similar consumer remedy should be considered.

A. *Insurers Are Liable for Acting in Bad Faith*

One major common law doctrine that allows state judicial regulation of insurance is the doctrine of "bad faith."²⁰⁶ This doctrine makes insurers liable for damages beyond those promised in the policy when their conduct amounts to bad faith.²⁰⁷ The term "bad faith" is really a misnomer because the doctrine in its modern form has little to do with the insurer's state of mind.²⁰⁸ Instead, it is a shorthand way of referring to conduct which gives rise to extracontractual damages.²⁰⁹ Bad faith conduct is generally regarded as a tort and therefore gives rise to somewhat more generous tort remedies, including any foreseeable losses, emotional distress,²¹⁰ and in some cases, punitive damages.²¹¹

The doctrine of bad faith in insurance law arose out of cases involving third-party liability insurance whereby an insurer has agreed to defend and indemnify the insured for certain claims.²¹² Liability insurance is generally subject to policy limits for the amount that the insurer will pay under the policy. When an insurer is defending its insured against a third-party claim, the insurer also has a duty to respond to settlement offers.²¹³ A common tactic for claimants is to offer to settle for policy limits. From a straight contract standpoint the insurer has little reason to accept such a settlement offer because it represents the insurer's maximum exposure in the case.²¹⁴ Why should an insurer settle for the full amount when the trial of the case could reduce or eliminate the liability?

206. See STEPHEN S. ASHLEY, *BAD FAITH ACTIONS: LIABILITY AND DAMAGES* § 1:01 (2d ed. 1997).

207. See *Crisci v. Sec. Ins. Co.*, 426 P.2d 173, 177 (Cal. 1967).

208. See generally Jeffrey E. Thomas, *A Case Study of Bad Faith Refusal to Settle: A Doctrinal, Normative and Practical Analysis of Missouri Law*, 64 UMKC L. REV. 695, 711-12 (1996) (discussing limitations of state-of-mind approach to bad faith).

209. See ASHLEY, *supra* note 206, § 1:02.

210. For a discussion of the history and use of emotional distress damages in bad faith cases, see Jeffrey E. Thomas, *Crisci v. Security Insurance Company: The Dawn of the Modern Era of Insurance: Bad Faith and Emotional Distress Damages*, 2 NEV. L.J. 415 (2002).

211. See ASHLEY, *supra* note 206, §1:02.

212. See *id.* § 2:02.

213. See Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113, 1114 (1990).

214. The one exception to this would be where the liability seems clear and the defense's costs, which in general are not subject to policy limits, will be substantial. In such a case the insurer may accept a policy-limits settlement to avoid incurring substantial defense costs. While this defense-costs scenario will sometimes occur, a more likely scenario is where the insured has a possible defense in the case. When there is a possible defense, taking the case to trial holds out the possibility of a lesser verdict, or even a defense verdict. In such a scenario, there is little incentive for the insurer to accept a policy-limits settlement. See ASHLEY, *supra* note 206, § 2:02.

The problem with this approach is that it undervalues the interest of the insured. From the insured's standpoint, a settlement offer within the policy limits avoids any individual liability for the insured. This is a significant benefit, especially when the insured is facing exposure beyond the policy limits.²¹⁵ An insurer, who is controlling the defense, has little incentive under the contract to accept the policy limits settlement, but the insured has a strong interest in accepting such an offer.²¹⁶

The courts responded to this scenario by creating a liability rule for insurers under certain circumstances. The courts have found that each insurance policy includes an implied covenant of good faith and fair dealing, and that this covenant provides the basis for a tort claim for its violation.²¹⁷ It has been somewhat difficult for the courts to decide exactly what conduct amounts to "bad faith" in the settlement scenario. One view is that the insurer has an obligation to balance its interests with those of the insured, and if in rejecting the settlement the insurer fails to sufficiently protect that insured's interest, it is liable for bad faith.²¹⁸ Another view is that the insurer only has to accept reasonable settlements. If the settlement is unreasonable, then the insurer's rejection of it is not in bad faith.²¹⁹ A commonly accepted, but not universal, method for evaluating the reasonableness of the settlement is to consider whether an insurer would accept such an offer if there were no policy limits.²²⁰

While the bad faith doctrine developed in the context of third-party insurance, it moved fairly quickly into the realm of first-party insurance.²²¹ Nevertheless, because the basis for such liability was not quite as compelling, courts in only about half of the states have adopted the bad faith doctrine in first-party cases.²²² In addition to the common law remedy for bad faith, some states have a statutory remedy that awards attorney's fees and a statutory penalty if an insurer unreasonably refuses to pay a claim.²²³ In Missouri, for example, an insurer who refused to pay a claim "without reasonable cause or excuse" is subject to a possible penalty of

215. See Syverud, *supra* note 213, at 1128-30.

216. See *id.* at 1130.

217. See *id.*

218. See, e.g., *Glenn v. Fleming*, 799 P.2d 79, 85 (Kan. 1990); *Hartford Accident & Indem. Co. v. Foster*, 528 So. 2d 255, 265 (Miss. 1988).

219. See Syverud, *supra* note 213, at 1123.

220. See *Crisci v. Sec. Ins. Co.*, 426 P.2d 173, 176 (Cal. 1967); Robert E. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1148 (1954). I argue that this approach is underinclusive and that the better approach is the balancing of interest. See Thomas, *supra* note 208, at 717-18.

221. See *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032 (Cal. 1973); *Fletcher v. Western Nat'l Life Ins. Co.*, 89 Cal. Rptr. 78 (Cal. Ct. App. 1970).

222. See ROBERT H. JERRY, II & DOUGLAS S. RICHMOND, *UNDERSTANDING INSURANCE LAW* § 25G[b] (4th ed. 2007).

223. See *id.* § 25G[d][3]; see also KAN. STAT. ANN. § 40-256 (2000); MO. REV. STAT. ANN. § 375.420 (West 2002); WYO. STAT. ANN. § 26-15-124(c) (2009).

twenty percent for the first \$1,500, and ten percent of the remainder, plus a reasonable attorney's fee.²²⁴

B. *Financial Regulatory Reform Should Consider Consumer Remedies*

Experience with insurance bad faith law suggests that those involved in financial services regulatory reform might want to consider a similar kind of remedy. In particular, what I am suggesting is a private right of action that would allow consumers to use the courts to get relief from improper actions by financial institutions.

The primary benefit of this approach is to enlist the enforcement assistance of consumers nationwide. Regardless of the staffing and funding for a regulatory agency, it will always have limited enforcement resources. In the case of insurance regulation, the enforcement resources are typically an office with a modest staff in the department of insurance. It is somewhat difficult to get exact numbers, but in Missouri, the Department of Insurance, which was recently merged into a Department of Insurance, Financial Institutions and Professional Registration,²²⁵ had 534 full-time employees in 2008.²²⁶ Only a relatively small percentage of this staff handles consumer complaints. The organization chart for the Missouri department showed only three out of forty-eight people as directly involved in consumer complaints.²²⁷ The department received some 26,000 complaint phone calls in 2008, and handled 3,812 formal complaints.²²⁸ Those are not insignificant numbers, but they are relatively small considering the millions of insureds in Missouri.

California, the largest state, may have the largest insurance department, but it also faces limited resources. In 2008, it had only 106 full-time staff working on consumer complaints.²²⁹ That is only eight percent of the 1,336 staff that are authorized by law,²³⁰ presumably because of budget difficulties faced by the state and the department. A staff of 106 can only handle a limited number of claims. The annual complaint report for auto insurance, for example, shows a total of 384 justified complaints in 2008 on more than twenty-two million insurance policies.²³¹

224. See MO. REV. STAT. § 375.420.

225. See MO. DEP'T OF INS., 2008 ANNUAL REPORT, available at <http://insurance.mo.gov/Contribute%20Documents/2008AnnualReport.pdf>.

226. See *id.* at 3.

227. See *id.* at 15. This is about six percent of the management staff. Using that percentage as a basis for estimating the total staff for consumer complaints, the full-time employees working on consumer complaints would be about thirty-three.

228. See *id.* at 3.

229. See CA. DEP'T OF INS., 2008 ANNUAL REPORT OF THE INSURANCE COMMISSIONER 115 (2009), available at <http://www.insurance.ca.gov/0400-news/0200-studies-reports/0700-commissioner-report/upload/2008CDIAnnualReport.pdf>.

230. See *id.*

231. See California Department of Insurance, Consumers: Auto Complaint Composite Page, <http://www.insurance.ca.gov/0100-consumers/0040-studies->

National insurance complaint data is generally consistent with this analysis of Missouri and California.²³² Regulators receive and handle consumer complaints, but the scale is relatively modest considering the size of the market.²³³ A national report prepared by the NAIC showed approximately 131,000 consumer complaints received in 2009 by state insurance departments.²³⁴ Of this number, only eighty-five complaints resulted in fines.²³⁵ The most common resolution was for the insurance department to provide additional information (21,462 cases, plus another 13,260 cases where the department advised the complainant), followed by settlements in 19,292 cases.²³⁶ The insurance company's position was upheld or the company was found in compliance in 10,123 cases.²³⁷

These simple descriptive statistics raise some questions about the efficacy of administrative regulation to protect consumers. Although it is difficult to obtain statistical information on the frequency of bad faith claims, the availability of the bad faith remedy is a tool that can be used by *any* claimant dissatisfied with his or her settlement. This at least increases the scope of possible claims, and the potential number of actions seeking to enforce legal requirements. The threat of such action, if the sanctions are sufficient, can be a significant incentive to provide better service to consumers. Two studies have suggested that bad faith liability increases claim settlements. One study, done with data from uninsured and underinsured motorist claims, found a significant positive effect of bad faith liability on settlements.²³⁸ A second study looking at auto insurance cases found that bad faith liability had a significant effect on settlements, increasing the

reports/0020-complaint-study/AutomobileComposite.cfm (last visited May 23, 2010).

232. Two more state examples are discussed by Professor Randall, Indiana and Colorado, and in both cases the limited staff raises questions about the ability to protect consumers. See Randall, *supra* note 77, at 661-62.

233. The premium volume in the United States in 2008 was \$1.239 trillion. See *World Insurance in 2008*, SIGMA (Swiss Re, Zurich, Switz.), 2009, at 7 tbl.III (providing statistical appendix update), available at http://www.swissre.com/resources/c432ca8040822291b447f47869f3fb71-sigma3_2009_APPENDIX_DEC_09.pdf. The industry has more than 3,800 insurers who employ about 2.3 million people. See Insurance Information Institute, Industry Overview, <http://www.iii.org/media/facts/statsbyissue/industry/> (last visited May 23, 2010).

234. See National Association of Insurance Commissioners, Reasons Why Closed Confirmed Consumer Complaints Were Reported, https://eapps.naic.org/documents/cis_aggregate_complaints_by_reason_codes.pdf (last visited May 23, 2010).

235. See *id.*

236. See *id.*

237. See *id.*

238. See Mark J. Browne, Ellen S. Pryor & Bob Puelz, *The Effect of Bad-Faith Laws on First-Party Insurance Claims*, 33 J. LEGAL STUD. 355, 379 (2004) (finding that "model explained 46% of the variation in damage size in the economic-damages-only model, 47% in the noneconomic-damages-only model, and 59% of the variation in the total-damages model").

value of the settlement from twenty-one to fifty-two percent.²³⁹ The same study also found that bad faith liability reduced the possibility of underpayment, defined as the payment of less than the economic loss.²⁴⁰

What I am suggesting is that financial regulatory reform should consider allowing consumers to bring their own actions to enforce regulatory requirements. This substantially increases the enforcement resources, and allows those consumers who are injured to obtain relief with less governmental resources. I do not have a specific recommendation to make as to the substantive content for such claims. I am simply pointing out that consumer remedies developed through state common law have a meaningful effect on insurer behavior and, based on this experience in insurance, that reform in financial regulation generally should consider allowing consumers to enforce legal requirements directly through private rights of action.

IV. CONCLUSION

The financial crisis and the collapse of AIG certainly suggest that something is amiss in the regulatory environment in the United States. Nevertheless, that “something” is not insurance regulation. While state insurance regulation can certainly be improved, problems or weaknesses in the system did not lead to either the demise of AIG or the financial crisis. AIG was brought to the brink of disaster by overinvestment in CDS, a hedging device which, although it transfers risk, is not insurance because it is not designed to pool risk. While this overinvestment threatened AIG and its subsidiaries, this really was not an insurance problem.

Because insurance was not the cause of the financial crisis or AIG’s demise, these events do not justify reform of insurance regulation.²⁴¹ Moreover, while it is easy enough to consider some kind of reform in the abstract, insurance regulators are well organized and adept at protecting the state regulation of insurance. On one hand, this is a barrier to reform. On the other hand, the comprehensive and robust system of state regulation should be considered as part of the discussion of insurance regulation reform. The state regulatory system has been successful in the solvency area and may have contributions to consider for other areas of financial regulation. In particular, state judicial regulation that has created a cause

239. See Danial P. Asmat & Sharon L. Tennyson, *Bargaining in the Shadow of Law: An Empirical Study of Automobile Insurance Settlements* 16 (Dec. 9, 2009) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1520882.

240. See *id.* at 19-20.

241. The editors of the *New York Times* go even further. They suggest that the kind of “regulator shopping” provided by an optional federal charter for banks actually interfered with appropriate regulation, and therefore that an optional federal charter for insurance would make matters worse rather than better. See Editorial, *Regulatory Shopping*, N.Y. TIMES, May 21, 2009, at A34, available at http://www.nytimes.com/2009/05/21/opinion/21thu1.html?_r=2.

2010]

INSURANCE PERSPECTIVES

801

of action for insurer “bad faith” conduct may suggest a model for creating private rights of action for other financial services consumers. My goal has not been to present a specific proposal, but rather to present a different perspective—one that gives greater weight and consideration to states for both administrative and judicial regulation.