

INSURANCE COMPANY LIABILITY FOR FRAUDULENT ACTS OF INDEPENDENT AGENTS UNDER THE MAINE INSURANCE CODE

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Background

For the past two years, the Maine Bureau of Insurance, the Maine Securities Division and the Maine Department of Attorney General have been engaged in an extensive market conduct investigation of an unprecedented series of misrepresentations, non-disclosures, twisting and outright theft, as a result of the actions of a single, independent insurance agent who was also a licensed securities broker. The producer sold single-premium annuities on behalf of several companies to hundreds of individuals. The agent was charged with insurance twisting¹ and misrepresentation² under the Maine Insurance Code as well as the unlicensed sale of securities, and the sale of unregistered securities. Criminal charges of theft and sale of unregistered securities are pending. The Maine Securities Division has issued a cease and desist order prohibiting the agent from making further sales of securities. The Bureau of Insurance has revoked the agent's insurance producer license. As a result of a multi-count complaint against the agent filed in the Superior Court, a permanent injunction prohibiting the further sale of securities has been issued, and the agent has agreed to a restitution order under which he is required to repay over \$100,000 to numerous policyholders of several companies, in addition to having already repaid over \$100,000 to other policyholders.

Although the Maine Bureau of Insurance has not to date alleged any negligent supervision of the agent's activities by any of the affected companies, it has sought accommodations from the companies to "remedy" the "injuries" to consumers caused by this producer. Given the number of transactions and affected policyholders in question, the Maine Bureau has to date gone beyond what many states' insurance departments have done in such cases, in terms of requiring companies to assume responsibility for the fraudulent actions of its producers. As in the case of insurance suitability, the current situation in Maine raises the industry fear that existing laws making the company "responsible for the injuries to consumers" caused by its producers, and holding it "accountable" and subject to "penalty" for those actions of its producers, will be applied whenever there is an unfavorable outcome, irrespective of any disclosures made at the time of sale.³

The Maine Bureau and the affected companies have not yet agreed on the appropriate standards for assessing company liability for injuries to policyholders, how to measure the "injury," particularly in a time of steeply declining stock prices, and the nature and extent of statutory penalties, if any, that should be imposed upon the companies. There is to date also no precedent in the form of decisions rendered by the Maine Bureau, nor any judicial decision in Maine, defining the applicable standards of company liability and accountability. This is a case of first-impression in Maine given the sheer magnitude of the series of transactions in question. If the companies and the Bureau do not reach an agreement on these issues, the Bureau will likely commence formal proceedings against the companies.⁴ Examining the circumstances of these cases and the allegations of the Bureau in light of Maine's statutory scheme concerning company liability for actions of its producers may be useful in developing an analytical framework for understanding the extent of company liability for consumer injuries and statutory penalties and for developing appropriate defenses in any enforcement action brought by the Bureau.

Statutory Basis for Insurance Company Liability

As the result of its extensive investigation, the Maine Bureau has alleged that during late 2000 and early in 2001 the producer engaged in affirmative misrepresentations that the single-premium annuities in question were appropriate short-term investments. Specifically, the Bureau has alleged that the producer falsely assured clients that these annuities were appropriate vehicles for "parking" these funds during a period of two years or so for which he projected, correctly as it turns out with the benefit of hindsight, an otherwise negative investment market. Many of these consumers had previously purchased annuities with the funds invested in equities or equity funds, and the producer recommended replacing these investments with fixed or in some cases indexed, interest-bearing annuities. Many of the annuities were set up as Individual Retirement Accounts. The agent also falsely assured clients that they would not incur a penalty on the surrender of the annuities he was moving them out of in order to purchase the

new annuities. Despite the consumer receiving written disclosures about the surrender provisions and applicable charges, as well as periodic account statements detailing total value and surrender value, the Bureau has alleged that due to the producer's affirmative misrepresentations, the clients entered into the new products without appreciating the ramifications of their long-term nature. The Bureau has specifically alleged that given the producer's affirmative misrepresentations about the applicable surrender charges, one of the ramifications of taking the producer's advice was the levying of surrender charges for liquidating the annuities within the time frame which the agent represented as appropriate. It should be noted that many of the policyholders in question did not file complaints until late in 2001, after the stock market suffered a large drop in value, and following press reports about the investigation involving the producer. Many policyholders had owned the policies in question for two to four years at that time.

The Bureau has alleged that the producer's actions violated the misrepresentation and twisting provisions of the Maine Insurance Code. The Bureau has alleged that these violations of the Maine Insurance Code caused "injury" to consumers in the form of the imposition of one or more surrender charges. Despite the above-referenced restitution order involving many of the affected consumers, and the fact that he has already repaid over \$100,000 to other policyholders, the Bureau has contended that the companies are responsible for those injuries and are accountable for penalties as a result of these actions of their producer, under 24-A M.R.S.A. § 1445, which provides:

Responsibility of insurer, health maintenance organization, fraternal benefit society, or nonprofit hospital or medical service organization; prohibited activities.

1. Responsibilities for training and supervision. In addition to any other applicable provisions of law, the insurer, health maintenance organization, fraternal benefit society or nonprofit hospital or medical service organization:
 - A. Shall ensure adequate training for its appointed producers;
 - B. Shall provide supervision of its appointed producers who sell insurance on its behalf;
 - C. Is responsible for injuries to consumers resulting from the actions of its appointed producers to the extent of restitution, reimbursement of money or payment of interest to the consumer; and
 - D. Is accountable and may be penalized by the superintendent, as provided for in this Title, for the actions of its producers....
3. Nothing in this chapter abrogates the common law principles of apparent or implied authority as available remedies or defenses.

Maine appears to be one of the few states that have enacted this type of statute, which seems to impose a strict liability-type standard for injuries to consumers caused by producers, based solely on the agency relationship. Other states have enacted statutes that authorize the Insurance Commissioner to suspend or revoke an insurer's certificate of authority for knowingly permitting a producer to commit fraudulent acts such as misrepresentation or twisting.⁵ Virtually all states have also enacted provisions that authorize imposing penalties on companies that knowingly participate in or commit insurance fraud.⁶ Most states would apply common law agency principles to determine the extent to which a company is responsible for injuries to consumers or for penalties resulting from its producer's action, but have stopped short of enacting a statute like Section 1445.

Moreover, the Maine statute sets forth no standards nor criteria to determine the nature and extent of a company's liability for the actions of its producers, nor how to determine the extent of any injury to the consumer, nor the nature and extent of any penalty to be imposed on the company for the producer's actions.

Analysis

Section 1445 is a relatively new statute and its legislative history is sparse. The obvious purpose of this statute is to prevent insurers from operating through a third person (e.g. agents) and later denying responsibility for the acts of those persons. While the statute appears to create broad liability for insurers, it preserves certain agency defenses. Specifically, it provides that "nothing distracts or abrogates the common law principles of apparent or implied

authority as available remedies or defenses.”⁷ Thus, the scope of agency liability created by the statute appears to be determined by general principles of agency law.

Traditional agency defenses can be raised, such as asserting that policyholders should have known that the producer’s actions and misrepresentations were beyond the scope of his actual or apparent authority. In addition, there appear to be several potential legal and factual defenses available to a company, including the following.

- (a) **Was there any “injury” to the consumer?** This is a critical question, because if there was in fact an “injury” to the consumer, under agency principles, the company is responsible for those injuries unless it can be shown, for example, that the producer was acting beyond the scope of his apparent or implied authority. This inquiry relates closely to whether the consumer reasonably relied on the producers’ misrepresentations, in light of all of the relevant circumstances, such as policy forms, disclosures and account statements that the consumer had received. Nonetheless, if an “injury” can be proven, it is likely that the Bureau will seek to impose something close to a strict liability standard in holding the company responsible.

There is no case law interpreting what constitutes an “injury” under the Maine statute. Clearly, in situations where the producer took money from a consumer and never invested that money, there is clearly an injury to the consumer. In many cases policyholders have complained, seeking a waiver of applicable surrender charges, but want the policy rescinded with accumulated interest, either on the grounds that they did not have the opportunity to exercise their right to a “free look” because the producer never delivered their policy, or based on the producer’s affirmative misrepresentations about the surrender charges. If the net return of the substituted fixed-return annuity, after deducting applicable surrender charges, exceeds the projected return of the replaced, equity-based annuity, it would appear that the consumer has not in fact suffered any “injury.”

- (b) **Was the “injury,” if any, caused by the actions of the producer?** Policyholders have claimed that the producer did not recommend and sell suitable investment products. They have claimed they were injured because the rate of return on their investment was low, or that they were unable to access their money without penalty. It is not always clear whether the producer made any misrepresentations to them about these products to induce them to purchase such annuities, either with respect to projected returns or applicable surrender charges. To the extent that the consumers were given information about the type of products that they were purchasing and the risk level, and received annual account statements, it could be argued that, although the consumers might be dissatisfied with their net returns, any “injury” was not due to the producer’s actions.
- (c) **What is the appropriate remedy?** Under Section 1445(1)(C), to the extent that an injury to a consumer was caused by the actions of its agent, the company would be responsible for restitution, reimbursement of money or payment of interest. With respect to those individuals from whom the agent took money and did not invest it, a restitutive remedy would be appropriate. Restitutive remedies specifically deal with situations in which one person is accountable to another on the theory that he would unjustly benefit or the other would unjustly suffer loss.⁸

The Maine Bureau has indicated that it would be seeking rescission of several of the policyholder contracts. Rescission is a remedy that is typically used in the real estate arena and is available to a purchaser who seeks to “unmake” the contract within a reasonable time after conveyance.⁹ In Maine as in other states, consumers have the right to a so-called “free-look” and may cancel a sale of a policy for any reason by giving notice to the company within ten (10) days of delivery of the policy, and have the right to receive a full refund of the premium paid.¹⁰ In addition, the purpose of rescission is to put the parties in substantially the same positions that they were in prior to the transaction. Moreover, the purchaser cannot retain any benefit from the contract and yet to seek to disaffirm it by rescission. Rescission must be complete or not at all.¹¹ Accordingly, to the extent certain policyholders want to rescind a contract, such rescission should result in returning the initial premium without accumulated interest. The policyholders should not be able, in an administrative or court hearing, to prevail in reforming the original annuity contract by receiving back the initial premium with accumulated interest and a waiver of any applicable surrender charges.

Maine has not yet enacted a “suitability” statute and, at least for the moment, has not sought any remedies for

consumers nor to impose any penalties on the companies on suitability grounds. Nonetheless, the actions of the Maine Bureau to date are highly suggestive of a regulatory approach that resembles a “suitability” analysis, albeit under the guise of Section 1445 of the Maine Insurance Code.

General Observations

What is the applicable standard of liability under section 1445? The Maine Bureau has given significant weight to the basic agency relationship that exists between the company and the producer. The fact that the agent is an independent and represents several companies does not seem for the Maine Bureau to be a significant mitigating factor, especially when the producer’s conduct is particularly egregious, and even absent any proof of negligent supervision or training. The statutory standard is probably higher than negligent supervision, and probably lower than strict liability. There is little guidance in the Maine statute, and there is virtually no precedent in Maine to look to for answers.

Absent any guidance in the statute or relevant precedent, what are some of the factors to be considered in setting the applicable standard? From a public policy standpoint, the Maine Bureau wants, through its consumer complaint and market conduct enforcement investigations, to provide a suitable deterrent to reduce the likelihood of similar actions by producers in the future. There is clearly the need to preserve the integrity of and the public confidence in the insurance markets and the agency/producer system. These factors weigh in favor of a fairly strict standard for the company’s liability for the actions of its producers, but it is not clear where the line should be drawn between negligence and a strict liability standard. To date the Maine Bureau seems to be proposing that the more egregious and widespread the behavior of the producer, the closer to a strict liability model it will seek to impose, if an “injury” in fact has occurred in a particular consumer’s case.

To the extent that the company is responsible for the “injury” to the consumer, how should that injury be measured? When a consumer is advised to roll out of equity-based annuity products and into fixed interest products, thereby incurring surrender charges, it should be relevant to look at what those equity-based investments would have done in the sharply declining stock market since the year 2000. To what extent is there any real “injury,” if, even after deducting applicable surrender charges, the consumer realizes a net gain on the newly acquired, fixed-return annuity, having sold an equity-based annuity? If the consumer has received disclosure statements and annual account statements with surrender values, should those facts be considered in determining whether the company should be responsible at all for an alleged injury?

What is the appropriate basis for determining whether a penalty should be imposed on the company and if so, what should be the nature and extent of the penalty? The company’s role in the actual sale through an independent agent is fairly limited. In the cases in question, it appears that the companies did not know, nor should they reasonably have known, about the fraudulent actions of their producer. The Maine Bureau seems to recognize that when the agent is a “renegade” and there is little or no evidence of negligence on the part of the company, perhaps a large fine or penalty might not be appropriate. This would seem to be the case in particular when the “injury,” after netting out limited gains in a replacement, fixed-return annuity against losses the consumer would have experienced had they retained their equity-based annuities, turns out to be minimal or non-existent.


Conclusion

It is not clear what the outcome will be of these cases in Maine. They would be a good candidate for testing and defining the applicable standards of liability, the measurement of consumer injury and the appropriate penalties, if any. The issues would also make an excellent subject for a clarifying regulation or advisory bulletin from the Insurance Superintendent. Pending further clarification of these points, however, companies are at significant risk of being held responsible for the actions of its producers, solely because of the agency relationship that existed at the time of the sale. Even in states like Maine, that do not currently have a suitability statute, there is likely to be a greater number of consumer complaints when, due to a falling stock market or low interest rates, the consumer experiences an unfavorable outcome from an investment in annuities.

Companies would therefore be well advised to implement tighter internal controls to confirm that agents are in fact delivering policies to consumers, as many complaints stem from claims of non-delivery of the policy by the producer. Written disclosures should be made as clear and straightforward as possible. Companies should require

producers to provide a copy of a receipt signed by the consumer attesting that the consumer has received the policy and associated disclosures. Finally, companies should have tighter controls on frequent turnover of annuities. This is admittedly difficult in the case of independent agents who represent numerous companies and can conceal movement of policyholders from an annuity with one company to an annuity with another company.

Endnotes

1. 24-A M.R.S.A. § 2155 prohibits insurance “twisting,” by prohibiting any person from making or issuing, or causing to be made or issued, any written or oral statement misrepresenting or making incomplete comparison as to the terms, conditions, or benefits contained in any policy for the purpose of inducing or attempting to induce the policyholder to lapse, forfeit, borrow against, surrender, retain, exchange, modify, convert or otherwise effect or dispose of any insurance policy.
 2. 24-A M.R.S.A. § 2153 in pertinent part prohibits misrepresentation of the terms of any policy issued or to be issued or the benefits or advantages provided thereby. 24-A M.R.S.A. § 2152 prohibits unfair trade practices including unfair or deceptive acts or practices in the business of insurance.
 3. Gary C. Harriger, Esq., “Suitability in the Sale of Fixed Life and Annuity Products,” FORC Quarterly Journal, Vol. XIV, Edition III, September 9, 2002 at p.16.
 4. 24-A M.R.S.A. § 12-A sets out civil penalty and enforcement provisions, either before or after an adjudicatory hearing, that are available to the Insurance Superintendent. These include fines of up to \$15,000 for each violation of any provision of the Maine Insurance Code, equitable relief, actual damages incurred by consumers, cease and desist orders, reprimands and censure, refunds of overcharges and restitution.
 5. See e.g, CAL. INSURANCE CODE § 783.5.
 6. See e.g., N.Y. INSURANCE LAW, Art. 4 § 404; ILL. COM. STAT. ANN. 5 § 432.
 7. 24-A M.R.S.A. § 1445(3).
 8. See generally Restatement of Restitution § 1; See *Bartner v. Carter*, 405 A.2d at 202 (Me.1994).
 9. See *Ficek v. Coastal Harbors, Inc.*, 568 A.2d 1055, 1056 (Me. 1996) (two years after dock reconfiguration before seeking rescission of purchase of boat slips is too long a delay).
 10. 24-A M.R.S.A. § 2515-A.
 11. *Getchell v. Kirkby*, 113 Me. at 94 (1915). 
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