

## KANSAS ENACTS THE SELF-AUDIT PRIVILEGE

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### *Introduction*

Kansas recently enacted H.B. 2357, which makes self-evaluative audits conducted by insurance companies privileged information and not subject to discovery in any civil, criminal, or administrative proceeding.<sup>1</sup> This privilege does not extend to exclude evidence, including records or information, at hearing or trial that is uncovered during the internal audit. The privilege only protects the audit document itself, as well as the person or persons doing the audit.

Before enactment of the bill, insurers that conducted self-audits in an effort to ensure compliance with insurance laws were burdened with the fact that these self-evaluative audits could be used as evidence against the insurer by insurance regulators or in court, even if the problems that were identified in the audit had been corrected by the insurer. Therefore, the intended effect of the Kansas bill is to allow insurers to conduct self-evaluative audits in an effort to ensure that the insurer is in compliance with various laws and to not penalize the insurer for efforts to maintain compliance with such laws. Without such a privilege for self-audit reports, insurers would be hesitant to produce a “smoking gun” for insurance regulators and plaintiffs in possible future litigation.

The Kansas law contains several exceptions to the privilege including if: (1) the insurer expressly waives the privilege; (2) the privilege is asserted for a fraudulent purpose; (3) the material sought is not subject to the privilege; or (4) the insurer did not undertake appropriate corrective measures upon discovery of noncompliance. The insurer asserting the privilege has the burden of proving that the privilege is applicable. Once this burden is met, the party seeking disclosure of the report has the burden of proof to claim an exception.

There are strong public policy arguments in favor of allowing a self-evaluative audit report to be inadmissible as evidence against the insurer. The self-evaluative audit encourages voluntary self-correction, which is an important component of the regulatory structure governing insurance companies. Such a privilege allows self-audits to be undertaken on a more frequent and comprehensive basis.

### *Description of the Self-Audit Privilege*

The Kansas self-audit privilege makes an insurance compliance self-evaluative audit document privileged information and, as a result, it is not subject to discovery or admissible as evidence in any civil, criminal, or administrative hearing. Any company, person, or entity performing or directing the audit, officer, employee, or agent involved in the audit, or any consultant hired for that purpose, would not be examined in any proceeding related to the audit.<sup>2</sup> The privilege creates a “qualified immunity” for insurers who discover violations of laws and regulations during the course of a self-audit. This allows an insurer not be subject to an administrative penalty from the insurance department for disclosing a violation which was discovered through the self-audit process.

However, the privilege only protects audit documents which were created separately from other records. The privilege does not protect documents that are created in the normal course of business. The self-evaluative privilege does not limit discovery of the documents, processes, or procedures upon which the report is based. The privilege only limits access to the self-audit report. Therefore, after the privilege is enacted, access to an insurers’ records would remain the same as before privilege was enacted.

Without the self-audit compliance privilege, when an insurer discloses these documents to an insurance regulator it is feared that these documents will lose the other privileges associated with them. For instance, it is feared that disclosure of these documents may waive the attorney-client privilege and subject the documents to disclosure under the rules of civil procedure. Additionally, some believe that disclosure to insurance regulators may make the documents a public document and thus available to the public under freedom of information laws.

### ***Purpose of the Privilege***

The self-audit privilege protects the interests of insurance consumers who are protected by an insurer's voluntary monitoring and review of its compliance with state insurance laws. Ultimately, the public benefits from an insurer's voluntary compliance, as discussed below.

By allowing self-audit reports to be privileged, the states encourage internal audits. Therefore, the self-evaluative privilege encourages self-correction. A regulatory environment that encourages voluntary self-correction is in the public's best interest. Self-correction allows insurers to inform state insurance regulators of corrected conduct without fear of repercussion from the regulator, or in the courts, and such self-correction is free to the taxpayer.

The self-evaluative privilege also enhances regulatory enforcement. Because of limited resources, regulators may be unable to address the breadth of conduct identified and corrected by these audits.<sup>3</sup> While insurance department investigations, lawsuits, and criminal investigations are valuable in ensuring compliance, they are not necessarily the best method for ensuring compliance with laws. According to John Marlow, American Insurance Association, Assistant Vice President, Southwest Region, "The self-audit privilege will essentially serve as a supplement to the limited resources of the Kansas Insurance Department by enabling insurers to conduct full and complete audits without fear of retribution. In turn, increased compliance vigilance by insurers and regulators benefits consumers by making sure that insurance products purchased meet the letter of the law."<sup>4</sup>

The privilege also encourages a cost effective and efficient resolution of compliance issues. According to Marlow, "[t]he purpose of the self-audit privilege, like the judicially created attorney/client privilege, is to allow insurers, in effect, to undertake their own internal market conduct examinations without penalizing them for doing so. It will permit full and frank internal discussions about compliance with laws and regulations, and encourage companies to remedy violations discovered during the audit process."<sup>5</sup>

Eight states have enacted a self-audit privilege, including the District of Columbia,<sup>6</sup> Illinois,<sup>7</sup> Kansas, Michigan,<sup>8</sup> New Jersey,<sup>9</sup> North Dakota,<sup>10</sup> Oregon,<sup>11</sup> and Texas.<sup>12</sup> While these laws are not identical, they each include a provision allowing a self-audit report to be privileged information and not discoverable or admissible in a legal action. While most of these states' laws are similar to the bill which was enacted in Kansas, there are some notable differences.

For example, The Illinois law has an additional exception from the privilege when an insurer fails to correct a problem raised during the self-evaluative audit. The North Dakota law only allows the insurance commissioner to impose an administrative penalty against the insurer regarding a self-audit, except when there is "clear and convincing evidence" that the insurer knew of a violation, yet took no corrective action.

Finally, the self-audit privilege is a matter of substantive law, and is an more than simply a procedural, evidentiary privilege such as the privileges which are grounded in federal common law. Other privileges which have been enacted in Kansas and other states include (1) statutory privileges for medical peer reviews,<sup>13</sup> and (2) self-evaluative privileges that encourage companies to identify and correct environmental hazards.<sup>14</sup> Additionally, some states have a self-evaluative privilege for products liability and employment discrimination.

### ***Procedure for Claiming or Challenging the Privilege***

This section outlines the requirements for an insurer to claim the privilege, as well as the procedures for a party seeking disclosure of the report to challenge the privilege. Once a disclosure request is made by a third party, the insurer has 30 days to request an *in-camera* hearing regarding whether the self-audit document is subject to disclosure. Failure to request a hearing waives the privilege for this specific request only. The court is required to issue an order scheduling the hearing within 45 days of the filing of the petition.

Only the court is allowed to compel the disclosure of portions of the self-evaluative audit that is relevant to the issues at dispute in the proceeding. Companies asserting the privilege are required to submit, at the time of filing, the date of the audit document, the identity of the entity conducting the audit, the general nature of activities that are covered by the audit, and identification of the portions of the audit for which the privilege is being asserted.<sup>15</sup>

Therefore, once the privilege is requested and proven applicable, the party seeking disclosure of the report must prove that one of the exceptions is met,<sup>16</sup> namely, that (1) the insurer expressly waived the privilege; (2) the privilege was asserted for a fraudulent purpose; (3) the material sought was not subject to the privilege; or (4) that the insurer cannot show that appropriate efforts to achieve compliance with such laws and regulations were made, and that the insurer failed to promptly initiate and pursue corrective measures with reasonable diligence upon discovery of the noncompliance. If one of these exceptions apply, and the judge orders disclosure of the information, only the portion of the report relevant to the dispute is discoverable. This material is still not considered a “public document,” and disclosure in the immediate dispute does not waive the privilege for any other civil, criminal, or administrative proceeding.

Additionally, if an insurer voluntarily submits a self-evaluative report to the insurance commissioner, the report must be treated as a confidential document. It can only be viewed to determine whether the insurer’s policies or procedures are defective, and whether such inappropriate treatment of customers has been remedied or is being remedied. Voluntarily submitting the report does not waive the self-evaluative privilege or any other privileges.

### ***Conclusion***

The self-audit privilege is an important tool in identifying and correcting an insurer’s compliance problems. This privilege allows insurers to review their procedures and policies for noncompliance without fear that the report generated from such an investigation will be used against the insurer. The self-audit privilege is narrowly drawn, so that it does not protect the documents uncovered during the audit – it only protects the audit and those performing or involved in the audit. Such a privilege will encourage self-audits, enhance the regulatory environment, and makes good public policy.

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<sup>1</sup> Kansas H.B. 2357, was based on the National Conference of Insurance Legislators (“NCOIL”) 1998 Model Act, and was originally introduced by House Insurance Committee.

The NCOIL model states that an insurer’s self-evaluative audit document is privileged, and is not discoverable or admissible in any legal action. There are exceptions for when the privilege is expressly waived, if the privilege is asserted for a fraudulent purpose, or if the material is not subject to the privilege.

The NCOIL Access to Information Working Group was created to develop a white paper on this subject. While the Working Group finalized its white paper in December 1999, it chose to not recommend that the NAIC develop a self-evaluative privilege model. In 2001, the NAIC Market Conduct & Consumer Affairs (D) Committee took up the issue again, and appointed a Self-Critical Analysis Working Group. This Working Group concluded that there was not strong support among regulators for drafting model legislation, and instead, decided to develop principles for regulators to reference when self-critical analysis legislation is introduced in their state. *See Testimony by Rep. Eric Carter in Support of HB 2357: A Self-Evaluative Privilege for Insurance Companies.*

The National Association of Independent Insurers provided a letter to the NAIC’s Working Group, which offered some simple suggestions for future legislation, including:

Principle 1-The Legislation should not create new substantive or procedural restrictions on the regulator’s ability to access any information that is available to regulator in the absence of the Legislation.

NAII acknowledges that summary reviews of company data are not necessarily information that a company should be obligated to provide. There is a

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distinction between underlying data and information and any subsequent documents that provide a review or analysis for that underlying data and information. The NAII believes the latter should be privileged information.

Principle 2-The self-critical analysis privilege should be narrow in scope, with the purpose of ensuring that internal evaluative information not otherwise available to the public or third parties does not become publicly accessible solely because it is in the possession of a state regulator.

NAII supports the Illinois Department's suggestion to not retain a copy of the analysis information to avoid any type of inadvertent disclosure and hopes that this suggestion can be folded into the NAIC's draft principles.

Principle 3-In conjunction with Principle 1, the Legislation should narrowly define self-evaluative documents to be only those documents or portions of those documents that evaluate, analyze objective data, or involve mental impressions or opinions regarding compliance with applicable laws and regulations. Objective data should not be subject to the privilege even if compiled for the purposes of the self-evaluation.

The NAII reiterates the concern mentioned in Principle 1.

Principle 4 - The Legislation should specify that privileged information should be shared with other regulators to the extent the privilege can be maintained under a confidentiality agreement or state law governing the conduct of the regulator receiving the information.

This principle confuses two concepts, information that is privileged and information that is confidential. Absent a statutory privilege in a state to which information may be disclosed to the regulator, the laws in that particular state may not recognize the ability of the regulator to agree to keep the information confidential. Absent a statutory self-critical analysis privilege, therefore, disclosure of otherwise confidential information from a regulator in a state with the statutory privilege to a regulator in a state without the statutory privilege may waive any confidentiality granted the information-even if a confidentiality agreement exists....

Insurance Journal, *Insurers Support NAIC's Draft on Self-Audit Privilege*, Feb. 20, 2002, available at <http://www.insurancejournal.com/news/national/2002/02/20/16674.htm>.

<sup>2</sup> See "Session of 2005: Supplemental Note on House Bill No 2357," 3-2357, available at <http://www.kslegislature.org>.

<sup>3</sup> Statement of Brad Smoot, Legislative Counsel, American Insurance Association, Senate Financial Institutions and Insurance, Regarding H.B. 2357 (Mar. 17, 2005) (stating "Internal audits can correct flaws in a process or practice that otherwise might go unnoticed for years and cause significant cost and inconvenience to customers, regulators and the insurer itself.").

<sup>4</sup> See Insurance Journal, *AIA Applauds Enactment of Kan. Self-Audit Bill*, April 18, 2005 available at: <http://www.insurancejournal.com/news/midwest/2005/04/18/53885.htm>.

<sup>5</sup> See Insurance Journal, *AIA Applauds Enactment of Kan. Self-Audit Bill*, April 18, 2005 available at: <http://www.insurancejournal.com/news/midwest/2005/04/18/53885.htm>.

<sup>6</sup> D.C. Code Ann. § 31-851, *et seq.*

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<sup>7</sup> 215 Ill. Comp. Stat. § 5/155.35.

<sup>8</sup> Mich. Comp. Laws Ann. § 511.221.

<sup>9</sup> N.J. Stat. Ann. § 17: 17:23C-1, *et. seq.*

<sup>10</sup> N.D. Cent. Code § 26.1-25.1-51-01, *et. seq.*

<sup>11</sup> Ore. Rev. Stat. § 731-760, *et. seq.*

<sup>12</sup> See Tex. S.B. 14 (2005). This bill becomes effective September 1, 2006.

<sup>13</sup> See K.S.A. 60-4915.

<sup>14</sup> See K.S.A. 60-3332, *et. seq.*

<sup>15</sup> See “Session of 2005: Supplemental Note on House Bill No 2357,” 2-2357, *available at* <http://www.kslegislature.org>.

<sup>16</sup> The actual requirements differ depending on whether it is a civil or criminal case that is being brought against the insurer. The specific requirements regarding what must be demonstrated are contained in H.B. 2347 §4(a)&(b).