FORC QUARTERLY JOURNAL
OF
INSURANCE LAW AND REGULATION

Winter 1997 December 7, 1997 Vol. IX, Edition IV

THE EXTRAORDINARY SCOPE AND POTENTIAL REGULATORY PITFALLS OF THE INSURANCE FRAUD PROTECTION ACT

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On September 13, 1994, President Clinton signed into law the Insurance Fraud Protection Act (the "Fraud Act") as part of an omnibus anti-crime bill entitled the "Violent Crime Control and Law Enforcement Act of 1994".[1] Although the Fraud Act is now three years old, it includes regulatory requirements and potential pitfalls which are unfamiliar to many insurers and regulatory attorneys. In addition to the prospective regulatory requirements found in the law, insurers and their employees may already be unknowingly subject to the criminal penalties contained in the Fraud Act.

The legislative history of the Fraud Act makes it clear that the purpose of the law was to protect consumers and insurance companies from white-collar insurance fraud which was allegedly driving rising numbers of insurance companies into insolvency. Notwithstanding this laudable objective, the broad language used in the Fraud Act and its subsequent interpretation by the National Association of Insurance Commissioners ("NAIC") created a multitude of regulatory obstacles that insurers and their employees may be required to confront. For instance, the law includes a provision which prohibits any person who has been convicted of a criminal felony involving dishonesty or breach of trust from engaging or participating in the business of insurance unless that person has the written consent of an insurance regulatory official authorized to regulate the insurer.[2] The law provides penalties for both the employer and employee if that consent is not obtained. However, the language in the statute provides no guidance with respect to regulatory standards or procedures for complying with this provision. Nor does it address the case of persons having prior qualifying felony convictions who were hired before the law's enactment. To date, no state regulators of which we are aware have affirmatively addressed either of these issues on other than an *ad hoc* basis. Insurers, their employees, and the regulatory officials charged with granting or denying consent are unfortunately left with little guidance with respect to the enforcement and application of the Fraud Act.

Particularly troublesome is the fact that the law may be presently affecting insurers whose employees were convicted of a felony involving dishonesty or breach of trust and were employed prior to enactment of the law. The law prohibits such a person from "engaging or participating" in the business of insurance, strongly suggesting that the requirements of the Fraud Act apply to insurers and their employees regardless of the fact that the employee's date of employment occurred prior to enactment of the Fraud Act. Consequently, regulatory attorneys should familiarize themselves and their clients with the Fraud Act and recommend such actions as may be appropriate to minimize the likelihood that their clients will be found to be in violation of the law.

Legislative History

The genesis of the Fraud Act occurred in May of 1988 when the House Subcommittee on Oversight and Investigations (the "Subcommittee") began an in-depth inquiry into the insurance industry. This inquiry was precipitated by the rising number of insurance company insolvencies and ensuing questions related to the adequacy of the state regulatory system charged with the responsibility of protecting the insurance buying public from fraud, mismanagement, and poorly capitalized insurance companies. The Subcommittee investigated numerous insurance insolvencies, held hearings over several years, and eventually produced two reports reflecting the findings of the investigation.

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In February 1990, the Subcommittee focused public attention on the need for Federal criminal legislation to address problems in the insurance industry in a report entitled *Failed Promises: Insurance Company Insolvencies*. In this report, the Subcommittee examined four major insurance company failures and concluded that existing State remedies were ineffective against the fraudulent behaviors that drove these companies into insolvency:

[M]ost people involved with obvious wrongdoing at insolvent insurance companies simply walk away with no real investigation of their activities. Many of them continue to be active in the insurance business.[3]

The report roundly criticized management incompetence, malfeasance, and fraud at insurance companies.[4] The report further delineated the perceived inadequacies in the state-based system responsible for regulating the solvency of insurers.[5]

The Subcommittee's subsequent report entitled *Wishful Thinking: A World View of Insurance Solvency Regulation*, analyzed additional examples of management error and wrongdoing resulting in insurance company insolvencies. The Summary of Findings in *Wishful Thinking* states:

Although the outright freebooters make fascinating reading, they are just the most visible symptoms of a much larger solvency threat presented by mainstream opportunists selling themselves and their products as too clever to be matched by prosaic competitors. These marauders include the takeover specialists who use accounting gimmicks to create impressive paper profits from combining otherwise unimpressive companies, as well as the insurance companies which continue to rent their licenses to uncontrolled managing general agents, in exchange for generous earnings that are obviously suspect. In addition, there remains a constant erosion of industry financial strength attributable to the plodding incompetence of certain management officials who are noticeably unfit for the positions of responsibility they occupy.[6]

Based on this report, the earlier report *Failed Promises*, and the years of hearings and investigations, the Subcommittee introduced the Insurance Fraud Protection Act in 1994. This law was enacted that year and is codified at United States Code, Title 18, Chapter 47, Sections 1033 and 1034.

Extraordinary Scope of the Statute

The Fraud Act requires that a person who has been convicted of any crime involving dishonesty or breach of trust must obtain the consent of an insurance regulatory official prior to engaging in the business of insurance[7] The statute does not, however, specifically limit the applicability of this provision to any particular class or level of employees or individuals such as those involved in the management or financial affairs of the company. As written, the prohibitions in the statute apply to all officers, directors, agents or employees of an insurer whose activities are necessary or incidental to the writing of insurance. The legislative history of the Fraud Act suggests that the intent of the statute was to protect against white collar insurance fraud and abate the rising number of insurance insolvencies.[8] When drafted, the provisions of subsection (e) of the statute were apparently specifically aimed at those individuals who had been previously involved in an insurance fraud scheme and were migrating to other insurance companies and repeating their actions. In fact, the Judiciary Committee Report on the law stated:

Under present laws, all too often the perpetrators of fraud and deceptive practices in the insurance field not only are able to carry out their schemes with impunity, but -- equally troubling -- they move on to another insurance company to inflict still more harm to the good name of insurance. Insurance fraud frequently involves complex "paper trails" . . . [9]

Notwithstanding this relatively narrow legislative intent, the NAIC has formulated draft guidelines with respect to the Fraud Act which make it clear that the NAIC is of the view that the statute is applicable to <u>*any*</u> employee previously convicted of a felony involving dishonesty or breach of trust, if that employee in any way engages or participates in the business of insurance.[10] The guidelines further state that the prohibition against engaging in the business of insurance without regulatory consent is applicable to prospective employees as well as current employees. The draft guidelines state:

And as to what activities a barred or prohibited person may not engage in, it is certain that the statues include "all acts necessary or incidental to" the writing of insurance or the reinsuring of risks by an insurer and the "activities of persons who act as, or are, officers, directors, agents, or employees of insurers or who are other persons authorized to act on behalf of such

act as, or are, officers, directors, agents, or employees of insurers or who are other persons authorized to act on behalf of such persons."[11]

Clearly, the Fraud Act, as written, and the NAIC's interpretation of the law are extremely broad and, while unambiguous, appear to be contrary to the drafters original legislative intent where the House Congressional Record indicates that the purpose of the law is to "provide adequate enforcement against insurance fraud" and to foster an honest and soundly financed insurance industry.[12 & 13] Both the NAIC guidelines and the Fraud Act are written in such a way as to apply to individuals who are not now and will likely never be in a position to commit insurance fraud. As a consequence of the broad nature of the statute, the blanket prohibition and consent requirements apply to any individual engaged in the business of insurance whether or not he or she is in a position to cause financial harm to the company or to the public. Thus, every insurer and every regulatory attorney representing insurers must be aware that practically every employee or potential employee of an insurer, insurance agency, or other entity "engaged" in the business of insurance that has been convicted of a felony involving dishonesty will be required to obtain consent from an insurance regulatory official despite their position or potential position in the company. This potentially onerous regulatory requirement obviously takes on a new meaning in those situations involving a current employee.

Regulatory Obstacles

The Fraud Act provides that a person convicted of a crime involving dishonesty or breach of trust may "engage in the business of insurance or participate in such business if such person has the written consent of any insurance regulatory official authorized to regulate the insurer, which consent specifically refers to this subsection."[14] The statute provides no guidance with respect to the manner in which an individual should seek consent nor does it provide direction to insurance regulatory officials when deciding whether to grant or deny consent to an individual under this provision.

The statute as written raises a number of questions. If there are numerous regulatory authorities which regulate the insurer involved, can any state grant consent? Is consent necessary in every state or in any particular state (such as the domiciliary jurisdiction) authorized to regulate the insurer? Even though the law appears clear that consent in only one jurisdiction is required, will state regulators take a contrary position? What procedures exist for a request for consent? Is an application required? What are the factors a regulatory official should consider in granting or denying consent? Can consent be obtained on mere documents or will a hearing be required? If the regulatory official requires a hearing, what are the applicable procedures? How can the privacy of individuals be protected where these proceedings may be in the public record?

The statute merely states that an individual who has been convicted of a felony involving dishonesty or breach of trust may engage in the business of insurance only after obtaining written consent. It does not provide direction as to the method of obtaining that consent. The Fraud Act also raises due process implications because a valuable property right is obviously involved, particularly in the case of a current employee. More specifically, through the Fraud Act, a regulatory official is ostensibly granted the power to take away a persons livelihood.[15] If an individual is working in the insurance industry at the time he is convicted of the felony, he may be denied the right to continue employment because of the requirements of the Fraud Act. On the other hand, if an individual has previously been convicted of a felony and has applied for employment in some capacity in the insurance industry, he is precluded from doing so until he obtains the required consent. Thus, the Fraud Act creates a number of situations where regulatory agencies must develop policy and procedure to ensure appropriate procedural safeguards.

Currently, no state has adopted an official policy with respect to the procedures to be followed in granting or denying consent under the Fraud Act. Thus far, only a few states have addressed these issues and then have done so on an *ad hoc* basis. However, as discussed above, the NAIC as proposed draft guidelines which attempt to address some of the questions posed above. Unfortunately, the guidelines also raise additional questions and regulatory concerns.

The guidelines suggest an application form to be used by individuals who are requesting consent from a regulatory official. The suggested application includes an affidavit which requires considerable information that may require substantial time and effort on the part of the individual requesting consent. For example, the suggested affidavit requires:

Names and locations of all persons and entities which the applicant has advised, represented, or in any manner worked for concerning the writing of insurance, the reinsuring of risks by an insurer, including all acts necessary or incidental to such writing or reinsuring and the activities of persons who act as, or are, officers, directors, agents, or employees of insurers or who are other persons authorized to act on behalf of such persons, together which [sic] a description of the activities

who are other persons authorized to act on behalf of such persons, together which [sic] a description of the activities performed in each such person or entity.[16]

Requiring an applicant for consent to provide the names and locations of all persons and entities which he or she has advised or represented as well as a description of the activities that the individual requesting consent has performed for those persons could be incredibly onerous in some situations. For instance, if the applicant has been an insurance broker for twenty years, providing the names, locations and a description of the activity for every person advised regarding insurance coverage could be next to impossible. This requirement is obviously very broad and could in some instances be nearly impossible to complete accurately.

The NAIC's proposed application would also require an abundance of information that is highly personal and of questionable bearing upon the evaluation process. For instance, the application suggested by the NAIC requires inclusion of an applicant's education as well as the applicant's family history. Further, the application requires the applicant to divulge net worth, liabilities, and sources of all income.

In addition, the NAIC recommends that regulatory officials require that each individual applying for consent submit six (6) character endorsements from persons vouching for the character and reputation of the applicant. The character endorsement may not be submitted by relatives by blood or marriage, prospective employers or insurance related business entities, or persons serving in any capacity with the insurer or reinsurer, its employees or agents.[17] In some situations, this requirement could be quite difficult to comply with. It is likely that an individual who has been convicted of a crime involving dishonesty or breach of trust may have intentionally become disassociated with the people with whom he or she associated before the conviction. Individuals in such a situation often decide not to advise new acquaintances of their prior criminal history. Hence, obtaining six (6) character endorsements could, in practice, be an insurmountable -- or at least very difficult -- task for some applicants.

Pursuant to the NAIC guidelines, written consent must be obtained "from each jurisdiction he or she intends on working in or providing services to policyholders in that jurisdiction."[18] This requirement is clearly contrary to the language of the statute which provides that written consent may be obtained from "any insurance regulatory official authorized to regulate the insurer."[19] Furthermore, the inherent problems with this condition proposed by the NAIC are twofold. First, as discussed above, the Fraud Act purportedly applies to all employees working in the business of insurance. Hence, it applies to employees who may be based at a central office and in the course of their duties provide services to policyholders or potential policyholders in every jurisdiction in which the employer-insurer does business. In some cases this could involve every state in the United States. Thus, under the NAIC guidelines, the employee would be required to obtain consent from fifty (50) different insurance commissioners. This could obviously be quite time consuming and costly to both the individual and the employer.

Secondly, the guidelines suggest that an individual who is prohibited from engaging in the business of insurance under 18 U.S.C. 1033 "must immediately refrain from conducting insurance activity until such time as they have obtained written consent from the appropriate regulatory jurisdictions."[20] Thus, an individual must cease working or may not be hired to work in virtually any position in the business of insurance until the application process is complete and consent is actually granted.

Conclusion

Although the legislative history of the Fraud Act suggests an intent to protect insurers and their consumers from the pernicious impacts of wide spread white-collar insurance crime, the laws actual implications far exceed this desirable goal. Very few regulators -- and fewer insurers -- are aware of this law and its potential administrative and regulatory implications.

As the law is written, no insurer may employ an individual previously convicted of a felony involving dishonesty or breach of trust without first obtaining the consent of an insurance regulatory official authorized to regulate the insurer. Even if the NAIC's interpretation of the consent requirement, as requiring consent from *all* insurance regulators having authority over the insurer, are ignored, the law could have a chilling impact on the ability of previously convicted individuals to obtain subsequent employment. Perhaps more problematic are the implications with respect to insurers having unknowingly hired individuals either prior to or after the enactment of the Fraud Act.

To date this law seems to have created little disruption in the insurance industry. In fact, few are even aware of its existence. Based upon our experience, however, awareness of the law is increasing and, absent Congressional action, could provide

Based upon our experience, however, awareness of the law is increasing and, absent Congressional action, could provide serious future challenges for insurers, their employees, and regulatory counsel.

Endnotes

1. 18 U.S.C. 1033, 1034.

2. 18 U.S.C. 1033(e).

3. Cong. Rec. - - H1914 (daily ed. March 23, 1994) (statement of Congressman Dingell).

4. House Energy and Commerce Subcommittee on Oversight and Investigations, 101st Cong., *Failed Promises: Insurance Company Insolvencies* (Comm. Print 1990).

5. *Id.*

6. House Energy and Commerce Subcommittee on Oversight and Investigations, 103rd Cong., *Wishful Thinking: A World View of Insurance Insolvency Regulation* (Comm. Print 1994) p.1.

7. 18 U.S.C. 1033(e).

8. *Failed Promises*, p. 5.

9. House Judiciary Comm., 103rd Cong., Report on Insurance Fraud Protection Act of 1994 (1994).

10. Guidelines for State Insurance Regulators to the Violent Crime Control and Law Enforcement Act of 1994: *18 United States Code Sections 1033 and 1034*. These guidelines are in draft form and to date have not been adopted by the NAIC.

11. NAIC Guidelines, p. 8, *citing* 18 U.S.C. 1033(f)(1).

12. Cong. Rec. -- H1914 (daily ed. March 23, 1994) (statement of Congressman Dingell).

13. *Failed Promises*, p. 5.

14. 18 U.S.C. 1033(e)(2).

15. 18 U.S.C. 1033.

16. NAIC Guidelines, p. 30.

17. NAIC Guidelines, p. 30.

18. NAIC Guidelines, p. 14.

19. 18 U.S.C. 1033(e)(2).

20. NAIC Guidelines, p. 12.