

# FEDERATION OF REGULATORY COUNSEL, INC.

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### HEALTH CARE REFORM - INSURANCE COVERAGE EXPANSION:

#### *Maine's Experience in the National Context*

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As reported in the summer 2006 issue of this journal, An Act to Provide Affordable Health Insurance to Small Businesses and Individuals and to Control Health Care Costs was enacted by the Maine State Legislature in 2003. 1 Commonly referred to as the "Dirigo Health Reform Act" or "Dirigo Health," this legislation was meant to decrease health care costs, improve clinical quality and provide universal access to health coverage for all Maine citizens. The Act sought to achieve these goals using a three-pronged approach, including a state-sponsored insurance product ("DirigoChoice") to achieve universal access to coverage as well as several health care cost containment and quality improvement initiatives. This article will provide an update on health care reform efforts and related obstacles encountered to date in Maine and in other states and suggest key strategies necessary to achieve meaningful reform.

#### **The Impasse Continues in Maine**

##### Legislative Gridlock

Slower than anticipated enrollment, a flawed funding mechanism that assesses a "savings offset payment" on those currently insured to subsidize coverage expansion of the uninsured through the DirigoChoice product, and an ongoing ideological debate over government sponsored versus private market solutions to health care access triggered a political firestorm during this past session of the Maine Legislature. Re-elected in November and facing legal action from groups such as the Maine Association of Health Plans, the Maine State Chamber of Commerce and others, as well as significant pushback from providers, Governor John Baldacci proposed An Act to Make Health Care Affordable, Accessible and Effective for All, dubbed ("Dirigo 2.0") in May, 2007. 2

Dirigo 2.0 contained many of the measures discussed in our previous article. It included several new features, among them an employer and individual mandate and a broader based funding source for expansions in insurance programs covering the uninsured, and made permanent the voluntary hospital cost containment targets set to expire this year. The legislature adjourned, however, without taking action on this plan or on three alternatives put forth by the legislature's Insurance and Financial Services Committee, leaving Dirigo Health and its funding mechanism untouched.

##### Litigation Over Dirigo Health-Related "Savings" Continues

Although the Maine Law Court upheld the Dirigo Health Agency's ("DHA") broad authority to interpret the ambiguous Dirigo Health Reform Act in determining the amount of "aggregate measurable cost savings" ("AMCS")<sup>3</sup>, the Maine Insurance Superintendent, in this the third year of administrative hearings to set the amount of AMCS, dramatically reduced the actual savings figure from the \$98 million sought by DHA to \$32.8 million. He also directed DHA in future years to develop a new way of measuring hospital savings - the

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lion's share of the AMCS figure. These decisions still leave many questions unanswered, and the cloud of non-support for the funding approach still hovers over this program as it has for the past three years. Enrollment in DirigoChoice has not met expectations and there is no conclusive evidence that Dirigo Health has produced "savings" in the form of a significant reduction in healthcare costs, nor in the rate of cost growth.

## **Maine's Experience in the National Context**

Many of the reform elements proposed in Maine's 2007 legislative session and likely to re-surface in 2008 mirror those under consideration or currently in place in other states. Over the past few years, a number of states have enacted health reform laws to increase access to health care by expanding insurance coverage, with the goal, as in Maine, of attaining universal coverage. Other similarities among the various state health reform efforts include employer or individual mandates, cost containment measures, quality initiatives, health promotion programs, Medicaid expansions, and health information system development. Below is a brief summary of states that are most actively engaged in health care reform.

### Massachusetts

Undoubtedly the most widely publicized reform was passed by the Massachusetts legislature and signed by then Governor Mitt Romney on April 26, 2006.<sup>4</sup> The most controversial feature of the law was an individual mandate that went into effect July 1 of this year. With all citizens required to carry health coverage, the law also needed to ensure affordable coverage was available. Therefore, it created the Commonwealth Health Insurance Connector to offer a range of affordable plans and help "connect" businesses and individuals to coverage. This concept is in stark contrast to Maine's single DirigoChoice product, which costs as much as most comparable commercial plans. Like in Maine, the Commonwealth Care Health Insurance Program provides subsidies for those living at up to 300% of the federal poverty level ("FPL") with premiums waived for those at 100% of FPL and lower. The Massachusetts bill also includes an expansion of MassHealth, the state's Medicaid Program. Unlike Maine, the Massachusetts reform also contained a "play or pay" provision or employer mandate, collecting an annual "fair share" contribution (which many consider to be far too low to be meaningful) of \$295 per employee from employers with 11 or more employees that do not offer health coverage. Program funding comes from redirected federal Medicaid uncompensated care funds, generally paid to hospitals, along with employer contributions and general fund revenues.

### Vermont

Vermont passed a package of reforms in May of 2006 with the goal of insuring 96% of Vermonters by 2010 and addressing similar priorities as the Dirigo Health Reform Act.<sup>5</sup> The state's Catamount Health Insurance Product became active on Oct 1, 2007 and is being touted as an affordable and comprehensive plan for those who have been uninsured for 12 months or more. In Maine, one is eligible for subsidized DirigoChoice coverage with only one day of being uninsured in the year prior to enrollment. Vermont's product is much like DirigoChoice, offering a non-group product but requiring less cost sharing than DirigoChoice along with generous subsidies for individuals and families living at 300 percent of the FPL. The state will also offer financial assistance to low-income citizens to pay their employer coverage premiums.

Vermont chose not to impose an individual mandate, but will explore the idea in 2011 if the 96% threshold is not reached. Instead of a pure employer mandate, Vermont will require employers that do not provide coverage to pay an assessment for every full time employee. Employers who do provide coverage must pay the assessment only on workers who are ineligible to participate in the plan and uninsured workers who refuse the employer's coverage plan. The plan will be funded by an increased tobacco tax, the employer assessment, enrollee premiums and federal funding from a Medicaid waiver. The reform legislation also contained support for public health and chronic disease management through the Vermont Blueprint for Health, a public-private

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partnership that will work to help the chronically ill manage their disease. Like Maine, Vermont has also put a particular emphasis on the development of an integrated health information system for chronic disease and population health management.

## California

Although Maine, Massachusetts and Vermont are the first states to pass truly comprehensive reform, a number of other states, California chief among them, have put forth similar proposals. Governor Schwarzenegger unveiled his proposal to reform California's health care system in January 2007 and after some revision and work with the state legislature, the Health Care Security and Cost Reduction Act has now been passed by the California Assembly and is scheduled for hearing in the state Senate in January 2008.<sup>6</sup> The proposal included an individual mandate, guarantee issue regardless of age or medical history, broadly shared responsibility for funding, price and quality transparency requirements for providers, pay-for-performance initiatives, a minimum of 85% of premium to be spent by insurers on patient care, expanded access to public programs for children and low income adults, and a new state administered subsidized purchasing pool for those living at 101-250% of the FPL. It would provide incentives for participation in wellness programs and chronic disease management services. It places a greater emphasis than other states on information technology in health care, proposing to mandate e-prescribing by 2012.

Proposed funding includes accessing over \$4 billion in federal funds previously unavailable due to lack of state matching funds, a 4% hospital fee, employer contributions, tobacco revenues, and contributions from insured individuals within existing premium levels. California voters will be asked to approve the funding mechanism for this bill on the November 2008 ballot.

## Maryland

Maryland also tried to pass legislation with similar reforms including public program expansions, wellness incentives funded by assessments on providers and an increased tobacco tax. But none of these proposals has been able to garner the support needed to pass. Maryland received notable attention following a February 2, 2007 ruling that struck down the so called "Wal-Mart Bill," which mandated that employers with 10,000 or more employees provide employee health care coverage. The law was struck down by a Fourth Circuit Court of Appeals ruling that it violated the federal Employee Retirement Income Security Act ("ERISA").<sup>7</sup>

## **Synthesis**

While many states are attempting to implement comprehensive or incremental health care reforms, only Maine, Massachusetts and Vermont have done so, though if the bill pending before the California legislature passes, that bill would include many of the key provisions needed for sustainable health care reform as well. These New England states share several characteristics that may create the climate needed to enact significant reforms. When compared to the rest of the country, these states: already have generous Medicaid programs and low rates of uninsured; were able to pass legislation with at least some bi-partisan support, although we are seeing much of that erode in the Maine Dirigo Health debate; and have many high profile lobbying and advocacy groups supporting the notion of universal health coverage and other insurance and health service industry reforms.

From the enactment of Dirigo Health in 2003, there has been dramatic erosion of support for the funding mechanism among the key stakeholders, most notably the insurance industry, people currently insured who are required to pay the savings offset payment in addition to regular premiums, employers who offer fully-insured and self-funded insurance plans, and hospitals. Since its creation, Dirigo Health has been narrowly controlled by the Governor and the agency created under the act, the Governor's Office of Health Policy and Finance. Many of the problems surrounding Dirigo Health stem from the failure to include a

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funding mechanism that fairly distributes the cost among all stakeholders, including the Maine taxpayers, and a failure to meaningfully address the rate of growth and the high cost of health care and health insurance in Maine. While there has been some compromise, there has been significant reluctance to examine and accept the hard trade-offs necessary to implement successful reform. Lower costs will mean not only more affordable insurance plans with a narrower menu of benefits and provider choice, but also tighter regulation of hospital costs.

## Lessons Learned in Maine

### *The Need for a Sustainable Funding Source*

The most immediate lesson learned from Dirigo Health (and one that applies nationwide) is the need for a sustainable source to fund expansions of coverage for the uninsured. Insurers, providers, businesses and consumers all have very powerful and well-financed lobbies that have blocked many proposals here in Maine and in other states. That is why in more recent reform proposals introduced in Massachusetts, Vermont, California and others there has been a strong emphasis on the shared responsibility principle and a spreading of costs among all crucial players. The 2007 Maine legislative session ended without any agreement on a more equitable funding mechanism, leaving the insurance industry and insured individuals to pick up the tab.

### *Limited Access to Federal Funding*

While Maine has used the savings offset payment to fund the program going forward, it was first funded by a one time \$53 million federal Disproportionate Share Hospital payment. Massachusetts redirected federal uncompensated care funding - which will not continue - to pay for coverage expansions. Also like Maine, other states are using Medicaid waivers to expand Medicaid coverage to previously ineligible populations. However, Maine recently received notice that the federal DHHS denied this waiver request because the federal Medicaid match was not available when the state "seed" money came from "savings offset payments" made by privately insured individuals, as opposed to Maine general fund revenue. Without adequate general fund revenue, most states will attempt to use federal dollars to get health reform off the ground. In light of recent experience, however, this funding may also be unavailable or may be available only for the start-up period.

### *Impact of Medicaid and Medicare on a Rural Healthcare System*

Although expanding coverage in theory would provide savings to the health care system through reductions in cost-shifting, Maine has failed to adequately address some of the largest drivers of health care and insurance cost increases. Medicaid expansions have not been adequately funded, the state still owes millions to state hospitals, and many physician practices are closed to Medicaid patients because of low reimbursement levels; this increases cost shifting to those insured in commercial plans. Also, Maine is an isolated, rural market, with a high percentage of Mainers covered under Medicaid and Medicare, which do not pay even the full cost of providing care by hospitals and which causes more cost-shifting. As a result, many of Maine's hospitals have higher charges than their regional and national counterparts.

### *Impact of Technology and Chronic Disease*

Nationwide, the cost of technology and supplies is increasing at an alarming rate and will require close attention to supply chain management and cost benefit analysis in technology acquisition. So far, Maine's efforts at health system planning have been slow and met with much opposition. Maine also has a high incidence of chronic disease, especially among the Medicaid and low-income uninsured populations. Any health care reform must coincide with a bolstered public health presence and social marketing program to change behaviors such as smoking, poor diet habits and alcohol and drug abuse. The involvement of all

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stakeholders is necessary to address these factors.

## *Role of Mandates*

Of course, getting all those players to the table on a voluntary basis would be virtually impossible, and thus many of the reforms contain elements like employer and individual mandates, provider taxes, cost containment measures and regulatory controls. Mandates can work because they force equal participation and help stabilize insurance risk pools as younger, healthier people are brought into the market. In 1974, Hawaii enacted its Prepaid Health Care Act<sup>8</sup> and gained a Congressional exemption from ERISA to enable the state to mandate that employers provide health coverage to employees working more than 20 hours per week. This mandate has resulted in Hawaii having one of the lowest uninsured percentages in the country.

## *Funding Must be Broad-Based*

Cost containment measures and regulatory controls on hospitals and insurers, such as price transparency requirements, force them to find ways to operate more effectively. To expand coverage, many states are expanding their Medicaid programs and creating quasi-government agencies to administer subsidized plans. All of these elements together may be able to work as long as the most important elements of reform involve all players in the game. Any successful reform will be financed from a variety of sources, forcing everyone - consumers, providers, insurers, employers and taxpayers - to contribute to the cause. A broad-based solution will, unlike Maine's "savings offset payment," contain many funding mechanisms including employer assessments, general fund revenues, federal funds, provider and insurer taxes or assessments, tobacco taxes, savings from cost containment measures and more.

## **Conclusion**

It is clear that the country faces a growing crisis in the way health care is structured, delivered and financed. It is also clear that the only solution at the state or national level must be broad-based and must force all players to sacrifice and compromise to reach consensus. Here in Maine, the health care debate is not unlike the income tax debates of the early 1970's when then-Governor Kenneth Curtis<sup>9</sup> managed to pass the state's income tax in his first of two terms. He was able to do this by reaching across the aisle, keeping all stakeholders informed and involved, and perhaps most importantly by communicating the potential collapse of the state's economy and future development into the modern era absent this much-needed although extremely unpopular change.

Will a collapse have to occur in Maine's health care and insurance markets to spur true broad-based reform? This is not just a question for Maine and its policymakers, but for all states and the nation as a whole. Most of the presidential candidates running in 2008 have already come out with draft plans for overhauling our health care system. Some say we cannot afford to wait for a collapse, but many believe it will be the only way to put the pieces back together in a way that will truly achieve the goals of making health care available and affordable to all Americans.

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1. Public Law 2003, ch. 469 (effective Sept. 13, 2003), as amended by Public Law 2005, ch. 400 (effective Sept. 17, 2005).
2. L.D. 1890, H.P. 1322 (May 4, 2007).
3. *Maine Assoc. of Health Plans v. Superintendent of Insurance*, 2007 ME 69; 923 A.2d 918.
4. An Act Providing Access to Affordable, Quality, Accountable Health Care, Chapter 58 of the Acts of 2006, State of Massachusetts (later codified as ALM GL ch. 118H, §§ 1-6).
5. Act 190, An Act Relating to Catamount Health, and Act 191, An Act Relating to Health Care Affordability for Vermonters (May 25, 2006) (later codified as 33 V.S.A. §§ 1981-1986).
6. Governor's Health Care Proposal (January 7, 2007) was amended to the California Health Care Security and Cost Reduction Act (October 9, 2007). The bill currently before the state Senate is California Assembly Bill X1 1, the Health Care Security and Cost Reduction Act.
7. *Retail Industry Leaders Assoc. v. Fielder*, 475 F.3d 180 (2007).
8. HRS §§ 393-398 (2007).
9. Kenneth M. Curtis was Maine's Governor from 1968-1974. He was later appointed by President Jimmy Carter to serve as the United States Ambassador to Canada from 1979-1981. He was a founding member of the firm, Curtis Thaxter Stevens Broder & Micoleau LLC.

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## CONSTITUTIONAL LIMITS ON THE STATE REGULATION OF CAPTIVE INSURERS

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### Overview of the Use of Captives to Manage Risk

As an alternative to contracting with traditional insurers, a company may form a captive insurance company to insure the risks of the company and the company's affiliates.<sup>1</sup> A company may be attracted to forming a captive for a number of reasons. Funds set aside to self-insure risks may not be tax deductible as expenses, while insurance premiums paid to a captive are usually deductible in the current tax year.<sup>2</sup> Captives may also reduce the company's costs of insurance since the premiums paid to captives do not typically include a profit margin that traditional insurers include.<sup>3</sup> Captives may also provide a company with greater control of its risk-management strategy, including loss control, loss reporting, and safety procedures.<sup>4</sup> This may reduce the frequency and severity of insurance claims.<sup>5</sup>

The use of captives has grown substantially. Total captives in the U.S. increased approximately 15 percent from 2005 to 2006, from approximately 1,100 captives in 2005 to 1,250 captives in 2006. <sup>6</sup> Several states

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have also jumped on the captive bandwagon: over twenty states now have statutes that provide for the licensing and regulation of captives within their jurisdictions.<sup>7</sup> Offshore jurisdictions such as Bermuda and the Grand Cayman Islands also provide for the regulation of captives within their jurisdictions.<sup>8</sup>

## State Regulation of Insurance

In the rush to form and operate captives, companies may not realize that the captives they form may be the subject of substantial and costly regulation in states where the captive operates, resulting in regulatory compliance costs that could offset any expected benefits. In general, under the McCarran-Ferguson Act, states have the power to regulate and tax insurance.<sup>9</sup> Such regulatory power, among other things, allows states to require insurers transacting insurance in the state to obtain a certificate of authority or a license.<sup>10</sup> States may also renew or revoke licenses, fix minimum capitalization and surplus requirements, and approve or disapprove rates.<sup>11</sup>

Under this authority, the insurance laws of most states prohibit the transaction of insurance unless the insurer possesses a certificate of authority. The process of obtaining a certificate can be a very costly and burdensome process. However, unless a specific statutory exemption applies, a company may have no alternative. This situation is likely very common: although Vermont is a leading domicile for the formation of captives, it is unlikely that those captives are only operating or insuring risks within Vermont.

## Constitutional Limits on State Regulatory Power

The U.S. Constitution may shield captives from states' regulatory authority. The Due Process Clause provides that no state shall "deprive any person of life, liberty, or property, without due process of law."<sup>12</sup> A state may regulate or tax an out-of-state transaction only when the state has a "substantial connection" with that transaction.<sup>13</sup> A substantial connection exists if two requirements are met: (1) there are "minimum contacts" between the state and the person, property, or transaction the state seeks to tax; and (2) there is a "rational relationship" between the income attributed to the state for tax purposes and the intrastate values of the enterprise.<sup>14</sup>

The Due Process Clause is concerned with fundamental fairness.<sup>15</sup> Applied to captives, courts would consider whether the captive's connections with a state are sufficiently substantial to provide the captive with sufficient "notice" or "fair warning" that the captive should be subject to the state's jurisdiction.<sup>16</sup> Where the transaction of insurance has no conceivable connection with a state whatsoever, the Due Process Clause would prohibit state regulation since the captive would have no "fair warning" that it would be subject to regulation.

*State Board of Insurance v. Todd Shipyards Corp.* is the leading case that establishes limits on states' power to regulate insurers with insufficient connections.<sup>17</sup> In that case, the insured was a New York corporation doing business in Texas.<sup>18</sup> The insurer was not licensed to do business in Texas.<sup>19</sup> The insurer also had no office or place of business in the state.<sup>20</sup> Further, it did not solicit business in the state, had no agents in the state, and did not even investigate claims in the state.<sup>21</sup> Lastly, the contract was negotiated and paid for out of state.<sup>22</sup> The court held that the state's taxes and regulations violated the Due Process Clause because the only connection between Texas and the insurance transactions was that the insured property was located in the state.<sup>23</sup> The court's holding suggests that a captive not licensed in a state may be exempt from the regulation and taxation by the state when the only connection the captive has with the state is that it insures property there.

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While *Todd Shipyards* has not been overturned, in the years since *Todd Shipyards* was decided, the courts have limited the decision to its specific facts. For example, in *Associated Electric & Gas Insurance Services, Ltd. v. Clark*, the Supreme Court of Rhode Island held that the state could lawfully tax an out-of-state insurer not licensed to conduct insurance business in the state.<sup>24</sup> The insurer utilized the mail to negotiate business with four major gas utilities domiciled within the state.<sup>25</sup> Additionally, the insurer collected millions of dollars in premiums from the four utilities.<sup>26</sup> The court held that the insurer had purposefully availed itself of the benefits of the state's economic market, and therefore, the tax did not violate the Due Process Clause.<sup>27</sup>

Similarly, in *Risk Managers International, Inc. v. Texas*, the Court of Appeals of Texas held that Texas' injunction preventing an insurer from conducting business in the state was lawful.<sup>28</sup> In that case, the insurer was a British West Indies corporation not licensed to conduct insurance business within the state.<sup>29</sup> The insured was domiciled in Texas and received premium payments in the state.<sup>30</sup> Further, the insurer communicated with the insured by facsimile, mail, and telephone.<sup>31</sup> The court held that the state could regulate the insurer when, among other things, it negotiated with an insured who was domiciled in the state.<sup>32</sup>

Although narrowed, *Todd Shipyards* has continued to serve as a shield from state regulation when nearly identical facts have arisen. For example, the court in *Dow Chemical Co. v. Rylander* held that a state tax on insurance transactions occurring out of state violated the Due Process Clause.<sup>33</sup> In *Dow Chemical*, the insurers were not licensed to conduct insurance business in Texas.<sup>34</sup> In addition, the insurance agreements were contracted for and accepted out of state.<sup>35</sup> Further, all the premiums were paid out of state.<sup>36</sup> The insurers had no offices or agents in the state and did not solicit business within the state.<sup>37</sup> Notably, the insured was a Delaware corporation headquartered in Michigan.<sup>38</sup> As such, the court found that the state's tax violated the Due Process Clause because the only connection the state had was that the insured property was located in the state.<sup>39</sup>

The synthesis of the law is that when the only connection between the state and insurance transaction is that the insured property is located in the state, courts have found that the Due Process Clause precludes state regulation.<sup>40</sup> However, courts are less likely to apply a Due Process shield if there are any additional contacts, including providing insurance to a resident of a state, collecting premiums from within the state, or using the mail within the state. The findings in those cases suggest that any of the captive's activities beyond insuring property in the state may subject the captive's transactions to the state's regulations and taxes.

### Conclusion

In the rush to obtain the benefits associated with formation and operation of captives, companies may not realize that the captives may be subject to the taxation and regulation by the states in which the captives operate. Companies that are planning to form a captive should consult not only with tax and business counsel, but also with counsel familiar with the insurance regulatory framework in the states in which the company has risks that will be insured by the captive. In some cases, specific statutory exemptions may be available that permit a captive to transact insurance without a certificate of authority.

However, in cases where no specific exemptions are available and where the only relationship with the state is the existence of the insured property, a Due Process argument may be a company's only option for resisting state regulation. Although the U.S. Constitution may limit some of the states' powers to tax and regulate the activities of captive insurance companies operating within their borders, a company should consider relying on those limits only in narrow circumstances.

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1. See, e.g., MARY C. VEED, *The Re-engineering of the U.S. Commercial Insurance Market: Open Doors or Open Season?*, in 789 PRACTICING LAW INSTITUTE, COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK SERIES 129, 151 (1999).
2. Anne M. Unger, *Captive Insurance Can Help Manage Risk*, MidMarket Advantage 7 (2007).
3. *Id.* at 6.
4. *Id.*
5. *Id.*
6. Dennis P. Harwick, *The US: A Growing Acceptance of Captives* (2007) <http://www.uscaptive.com/07/article1.html>.
7. *Id.* (listing the following jurisdictions: Arizona, Arkansas, Colorado, Delaware, District of Columbia, Georgia, Hawaii, Illinois, Kansas, Kentucky, Maine, Montana, Nevada, New York, Oklahoma, Rhode Island, South Carolina, South Dakota, Tennessee, Utah, and Vermont).
8. VEED, *supra* note 1, at 151-52.
9. McCarran-Ferguson Act, 15 U.S.C. § 1011.
10. See, e.g., WASH. REV. CODE ANN. § 48.05.030(1)(LexisNexis 2007).
11. See LEER. RUSS & THOMAS F. SEGALLA, COUCH ON INSURANCE § 39.2 (ED ED. 2005).
12. U.S. CONST. amend. XIV § 1.
13. See, e.g., *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992).
14. See, e.g., *id.*
15. See, e.g., *id.* at 312.
16. See, e.g., *id.*
17. See *Todd Shipyards*, 370 U.S. at 453-55
18. *Id.* at 455.
19. *Id.* at 454-55.
20. *Id.* at 455.
21. *Id.*
22. *Id.* at 454.
23. See *id.* at 454-55.

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24. *See Assoc. Elec. & Gas Ins., Ltd. v. Clark*, 676 A2d 1357, 1362 (R.I. 1996).
25. *See id.*
26. *See id.*
27. *See id.*
28. *Risk Managers Int'l, Inc. v. Texas*, 858 S.W.2d 567, 568 (Tex. App. 1993).
29. *Id.*
30. *Id.* at 571.
31. *Id.* at 569.
32. *Id.* at 571.
33. *See Dow Chem. Co. v. Rylander*, 38 S.W.3d 741, 746 (Tex. App. 2001)
34. *Id.* at 743.
35. *Id.* at 746.
36. *Id.*
37. *Id.*
38. *Id.* at 742-43.
39. *See id.* at 746.
40. *See, e.g., Quill* at 306.

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### THE INDUSTRIAL INSURED IN ILLINOIS: TAX CONSEQUENCES - ARE THERE ANY?

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There has been some confusion in the insurance industry as to what tax consequences, if any, occur in an industrial insured transaction and who is responsible for those taxes. This article explains the industrial insured transaction under Illinois law and to whom the burden of relevant taxes fall.

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## An Industrial Insured May Transact Business with Unauthorized Insurers

The industrial insured provision of the Illinois Insurance Code permits an industrial insured to procure insurance from an insurer that does not hold a certificate of authority in Illinois. The general rule is that an insurer may not transact insurance business in Illinois without obtaining a certificate of authority issued by the Director of Insurance. Section 121-21 of the Illinois Insurance Code permits ten exceptions to the general rule. The section states, "Transacting business without a certificate of authority prohibited - Exempt transactions. It is unlawful for any insurer to transact insurance business in this State, (as described in Section 121-3,) without a certificate of authority from the Director. This Section does not however, apply to any transaction described in Sections 121-2.01 through 121-2.10."

The exemptions cited in the section are,

- § 121-2.01 Surplus line transactions under license.
- § 121-2.02 Reinsurance transaction.
- § 121-2.03 Policies solicited outside of Illinois.
- § 121-2.04 Attorneys acting in adjustment of claims or losses.
- § 121-2.05 Group insurance policies issued and delivered in another state.
- § 121-2.06 Policies or annuities issued before 1971.
- § 121-2.07 Marine insurance issued outside of Illinois.
- § 121-2.08 Industrial insured.
- § 121-2.09 Bankers' blanket bonds or directors' and officers' liability insurance issued by a captive insurance company.
- § 121-2.10 Exempt charitable gift annuities.

### The Industrial Insured Exemption

The statutory definition of industrial insured in the Illinois Insurance Code contains three elements. An "industrial insured" is an insured:

(a) which procures the insurance of any risk or risks other than life and annuity contracts by use of the services of a full time employee acting as an insurance manager or buyer or the services of a regularly and continuously retained qualified insurance consultant;

(b) whose aggregate annual premiums for insurance on all risks, except for life and accident and health insurance, total at least \$100,000; and

(c) which either (i) has at least 25 full time employees, (ii) has gross assets in excess of \$3,000,000, or (iii) has annual gross revenues in excess of \$5,000,000.<sup>2</sup>

Since its initial codification in 1937, the Illinois General Assembly has thrice amended the industrial insured provision. The latest amendment was in 1998. This latest amendment inserted "excepted for life and accident and health insurance" and substituted \$100,000 for \$50,000 in paragraph (b), and added clauses (ii) and (iii) in paragraph (c).<sup>3</sup>

What is "a regularly and continuously retained qualified insurance consultant" under subsection (a) of the industrial insured provision? Illinois, unlike some other states, does not have an insurance consultant license.<sup>4</sup> The Illinois Insurance Code requires that a person who for a fee offers advice, counsel, opinion or service with respect to the benefits, advantages or disadvantages under any policy of insurance that could be issued in Illinois, must hold an insurance producer license.<sup>5</sup> This restrictive language means that the consultant who is working with an industrial insured must have a producer license in order to be a qualified

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consultant. The only exceptions to the licensing mandate are Illinois licensed attorneys, limited insurance representatives, actuaries or certified public accountants working in a consulting capacity, trust officers of a bank, and licensed public adjusters performing duties incidental to their position.<sup>6</sup>

As for the "regularly and continuously retained" language, the only definition is normal usage. Aside from the industrial insured provision, the Illinois Insurance Code uses this term to describe a consultant on two other occasions,<sup>7</sup> but does not provide a definition. Even the Illinois courts have not addressed what is a regularly and continuously retained insurance consultant. Instead of defining what is a consultant, the courts favor the term "broker," especially when distinguishing between a broker and insurance agent. One Illinois appellate court described the distinction between the two as,

"We view this matter to be one essentially involving the question of agency. In insurance law it is generally accepted that an agent is one who represents a particular insurer, and a broker is one who represents an insured in the placing of insurance with a particular insurance company."<sup>8</sup>

Or as another Illinois appellate court put it,

"An insurance broker is one who procures insurance and acts as middleman between the insured and the insurer, and solicits insurance business from the public under no employment from any special company, but, having secured an order, places the insurance with the company selected by the insured, or, in the absence of any selection by him, with the company selected by such broker."<sup>9</sup>

The same court discussed insurance agents in terms of,

"Insurance agents have a fixed and permanent relation to the companies they represent and have certain duties and allegiances to such companies."<sup>10</sup>

Considering the definitions provided by the Illinois courts, the definition for broker best describes a qualified retained consultant since one of the tasks of a qualified insurance consultant is to procure insurance for an industrial insured. A necessary attribute of an insurance consultant is unfettered allegiance to the client. This is especially true in the case of an industrial insured. The industrial insured provision places the consultant on par with an employee since the industrial insured can hire an employee to perform the insurance tasks or hire a consultant. An ingredient in the employer and employee relationship is the employee's allegiance to employer.

### **Surplus Lines Tax and Stamping Fee Liability**

Under Illinois law, only a surplus lines producer is liable for the surplus lines tax.<sup>11</sup> A surplus lines producer must file a report with the Director of Insurance on or before February 1 and August 1 for the periods from January 1 to June 30 and July 1 to December 31 respectively for the gross premium, less returned premium, on surplus lines business procured. The surplus lines tax rate is 3.5 percent on gross premium, less returned premium, and the stamping fee rate is 0.1 percent of premium.<sup>12</sup> If a surplus lines producer fails to submit the reports and pay the requisite tax, the Director of Insurance may take action against the surplus lines producer. To recover any unpaid surplus lines tax, the Director of Insurance, through the Illinois Attorney General, may institute an action to recover the unpaid tax and penalties. The surplus lines statute specifically permits charging the insured the surplus lines.<sup>13</sup>

The industrial insured statute does not mention the surplus lines tax, nor does the surplus lines statute mention industrial insured. Had the Illinois General Assembly wanted to subject industrial insured transactions to the

# **FEDERATION OF REGULATORY COUNSEL, INC.**

surplus lines producer tax, it would have categorized industrial insured as a surplus lines transaction. There is nothing to indicate that the General Assembly equates industrial insured with surplus lines. Since 1937, the General Assembly has amended both the industrial insured provision and the surplus lines sections. Each time there was an opportunity to state that an industrial insured transaction involves the imposition of the surplus lines tax. Despite repeated opportunities to link the two, they remain separate and distinct insurance transactions. Therefore, an industrial insured may avoid using the services of a surplus lines producer in obtaining property insurance coverage. In such instance, since there is no surplus lines producer involved in the transaction, the industrial insured need not be concerned with the application of surplus lines tax or stamping fee to the transaction.

## **Tax Consequences in an Industrial Insured Transaction**

When a qualified insurance consultant interacts with insurers for the purpose of procuring coverage for an industrial insured, it is important for the parties involved to know that even though there is not a surplus lines producer involved, there remain other tax consequences. The industrial insured will not be responsible for the payment of these taxes; however, it is important to dispel any notion that an industrial insured transaction is a tax free transaction. The taxes discussed below for the most part are not the responsibility of the industrial insured, but instead of the insurer. However, the industrial insured will feel the impact of these taxes through the premium paid because the insured will consider these taxes when calculating the premium. Even though an industrial insured transaction is not tax free, the financial result for the industrial insured is that generally the taxes mentioned below are less onerous than the surplus lines tax, which should result in an overall reduced premium.

## **Corporate Income Tax and Personal Property Tax Replacement Income Tax<sup>14</sup>**

In Illinois, all companies earning or receiving income in Illinois must pay a 4.8 percent corporate tax on their net income.<sup>15</sup> In addition to the Illinois corporate income tax, there is also imposed a 2.5 percent personal property tax replacement income tax on a corporation's net income. If the taxpayer is a partnership, trust or Subchapter S corporation, the additional tax is equal to 1.5 percent of net income.<sup>16</sup> The taxpayer files such taxes on Form IL-1120 with the Illinois Department of Revenue.<sup>17</sup> Both the insurer and the industrial insured, unless it is an exempt organization, are subject to these taxes on net income by virtue of earning or receiving income in Illinois.

## **Retaliatory Tax<sup>18</sup>**

Foreign insurers engaged in an industrial insured transaction in Illinois are subject to a retaliatory tax if laws in such insurer's state impose more onerous or burdensome rules and regulations on Illinois insurers doing business in such state than would be imposed in Illinois on foreign insurers.<sup>19</sup> This tax imposes upon foreign insurers doing business in Illinois the same taxes and fees imposed upon Illinois-domiciled insurers doing business in the foreign insurer's state of domicile. The purpose of the retaliatory tax is to promote the interstate business of Illinois-domiciled insurers and to prevent other states from burdening Illinois-domiciled insurers with excessive taxes. The tax rate which the domicile of a foreign insurer charges Illinois-domiciled insurers doing business in the foreign domicile can affect the amount of income tax the foreign insurer pays in Illinois. If the foreign insurer's domicile charges less tax to Illinois-domiciled insurers doing business in the foreign jurisdiction, then in turn Illinois reduces the income tax upon the foreign insurer to the level charged in the foreign domicile.<sup>20</sup> This rate reduction for foreign insurers does not apply to insurers who are primarily reinsurers. The rate reduction is also limited. Such reduction cannot reduce the insurer's total of income and replacement taxes, privilege tax, fire insurance taxes, and fire department taxes below 1.75 percent of the net premiums subject to the privilege tax. The income tax rate reduction is determined by the insurer using a Schedule INS Tax for Foreign Insurers and attached to the Illinois income tax return.

# FEDERATION OF REGULATORY COUNSEL, INC.

## Privilege Tax<sup>21</sup>

Though the industrial insured provision makes a very strong case against paying the surplus lines tax, a company providing insurance for an industrial insured must pay the annual privilege tax. Generally the payment of the privilege tax is associated with companies licensed to do business in Illinois. However, the General Assembly, when drafting section 409 of the Insurance Code, used sweeping language that encompasses all companies. The relevant part of the section states, "every company doing any form of insurance business in this State ... shall pay, for the privilege of doing business in this State, to the Director for the State treasury a State tax equal to 0.5% of the net taxable premium written, together with any amounts due under Section 444 of this Code."

Subject to one exception, the words "every company" literally means what it states in that both licensed and surplus lines carriers are subject to paying the privilege tax. The General Assembly has not granted an exemption to section 409 for companies issuing insurance coverage to an industrial insured. A surplus lines transaction is exempt from the privilege tax since section 445 of the Insurance Code specifically exempts surplus lines from section 409.<sup>22</sup>

## Fire Department Tax<sup>23</sup>

This tax does not apply unless the insurer issuing a policy to an industrial insured issues a fire policy and applies only to foreign companies writing fire coverage. The municipality or fire protection district in which policies are written receives the tax proceeds. The tax is set by the municipality or fire protection district and cannot exceed 2 percent of gross receipts received from fire insurance issued on property situated in the municipality or district. The amount of fire insurance tax paid can be used to offset the privilege tax liability due.

## State Fire Marshal Tax<sup>24</sup>

Every fire insurance company, and any other company writing any other form of fire insurance business in Illinois, shall pay an amount not to exceed 1 percent of the gross premium less returned premiums for fire, sprinkler leakage, riot, civil commotion, explosion, and motor vehicle fire risk. A surplus lines producer must also pay this tax.<sup>25</sup> Section 445 specifically permits the surplus lines producer to charge the insured for this tax.<sup>26</sup> The revenue received from this tax is deposited in the Fire Prevention Fund.

## Conclusion

In an industrial insured transaction, taxes applicable under the laws of the state of the industrial insured and applicable to such transaction will be the responsibility of the insurer, not the industrial insured. It does not follow, however, that the industrial insured will not be impacted by the application of these taxes. In the case of an industrial insured in Illinois, several taxes are involved in an industrial insured transaction. Although such taxes will not directly apply to the industrial insured, those taxes will have some impact on the industrial insured through the insurer's setting of the premium. Most notably, the absence of application of the surplus lines tax in an industrial insured transaction is a favorable tax consequence of such a transaction. Therefore, while an industrial insured transaction will not be a tax free transaction for the industrial insured, it will generally be a favored tax transaction due to the absence of the surplus lines tax, resulting in a lower premium.

## FEDERATION OF REGULATORY COUNSEL, INC.

1. 215 ILCS 5/121-2.
2. 15 ILCS 5/121-2.08.
3. P.A. 90-794.
4. Oklahoma, for instance, offers a consultant license and defines "insurance consultant" as an individual or legal entity who, for a fee, holds himself or herself or itself out to the public as engaged in the business of offering any advice, counsel, opinion or service with respect to the benefits, advantages, or disadvantages promised under any policy of insurance that could be issued or delivered in this state. Okla. Stat. tit. 36, § 1424.
5. 215 ILCS 5/500.15(b).
6. *Id.*
7. See 215 ILCS 5/121-2.09 and 5/123C-1.
8. *Roby v. Decatur Steel Erectors, Inc.*, 59 Ill. App. 3d 720, 725 (4<sup>th</sup> Dist. 1978).
9. *Galiher v. Spates*, 129 Ill. App. 2d 204, 206 (4<sup>th</sup> Dist. 1970).
10. *Id.* at 207.
11. 215 ILCS 5/445.
12. 215 ILCS 5/445(3), and see *Surplus Lines Association of Illinois Procedures Manual*, Chapter 8 for the stamping fee.
13. 215 ILCS 5/445(3)(c).
14. 35 ILCS 5/201.
15. *Id.* at 5/201(b)(8).
16. *Id.* at 5/201(c) and (d).
17. Form IL-1120 Corporate Income and Replacement Tax Return.
18. 215 ILCS 5/444.
19. *Id.* at 5/444(1).
20. 35 ILCS 5/201(d-1).
21. 215 ILCS 5/409.
22. For the language granting the exception, see 215 ILCS 445(c)(12).
23. 65 ILCS 5/11-10-1.

# FEDERATION OF REGULATORY COUNSEL, INC.

24. 425 ILCS 25/12.
25. 215 ILCS 5/445(b) and 50 Ill. Admin. Code § 2801.130.
26. 215 ILCS 5/445(3)(c).

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## U.S. INSURANCE AND REINSURANCE INDUSTRY FACES SCRUTINY FOR ANTICOMPETITIVE PRACTICES

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U.S. insurers and reinsurers have recently come under increased scrutiny from state attorneys general for alleged anticompetitive behavior. Attorneys general in several states, including Connecticut, Florida, Illinois and Ohio, have issued subpoenas to insurers and reinsurers to investigate whether state antitrust laws have been violated, while Connecticut, Louisiana and Oregon have brought antitrust lawsuits against insurers, reinsurers and brokers. This all comes at a time where Congress is considering bills to repeal the McCarran-Ferguson Act.

This article examines the aggressive posture taken by state attorneys general to investigate and prosecute anticompetitive behavior in the U.S. insurance and reinsurance industry. It begins with a brief overview of the McCarran-Ferguson Act. It next provides an overview of some of the more noteworthy antitrust lawsuits and investigations involving the U.S. insurance and reinsurance industry brought this year by state attorneys general. Finally, it discusses recent legislative proposals aimed at repealing McCarran-Ferguson.

### 1. McCarran-Ferguson

The McCarran-Ferguson Act was passed in direct response to the Supreme Court's 1944 decision in *United States v. South-Eastern Underwriters' Association*, which held that insurance rate setting constitutes interstate commerce and therefore could violate the Sherman Act. Congress responded the following year by enacting the McCarran-Ferguson Act, which, generally speaking, left regulation of insurance to the states. The Act includes an exemption from federal antitrust enforcement for "the business of insurance" to the extent that the insurance business is regulated by state law, and as long as the challenged conduct does not constitute "boycott, coercion or intimidation." Under the protection of the McCarran-Ferguson exemption, insurance companies enter pooling agreements, exchange risk information and participate in collaborative rate setting without fear of antitrust attack.

McCarran-Ferguson is not a blanket exemption for all participants in the insurance industry. Rather, it exempts only "the business of insurance," a concept that the courts have narrowly drawn to cover conduct that:

# FEDERATION OF REGULATORY COUNSEL, INC.

- Has the effect of transferring or spreading policyholders' risk; or
- Is an integral part of the policy relationship between insurer and insured; and
- Is limited to entities within the insurance industry.

Reinsurance is generally considered to be within the "business of insurance" for purposes of the federal exemption. While the cases in recent years have been uniformly strict in narrowly interpreting the McCarran-Ferguson exemption, its mere existence has deterred plaintiffs and prosecutors from bringing antitrust claims against insurers and reinsurers.

## 2. State Antitrust Enforcement Actions

McCarran-Ferguson exempts the insurance industry only from federal antitrust regulation. McCarran-Ferguson intentionally left regulation of the insurance industry to the states, and insurers and reinsurers are subject to state antitrust laws. Over the last several years, the insurance and reinsurance industry has come under increased scrutiny from state attorneys general alleging violations of state antitrust laws by insurers, reinsurers and brokers. This trend started with the lawsuits brought by former New York Attorney General Elliot Spitzer against Marsh & McLennan Companies, Inc. ("Marsh") and various insurance companies based on allegations of bid-rigging and price fixing and the resulting settlements.

### Connecticut

Connecticut Attorney General Richard Blumenthal recently filed a lawsuit against the world's second-largest reinsurance broker and Marsh subsidiary, Guy Carpenter & Company, LLC ("Guy Carpenter"), alleging the company conspired with reinsurance companies to fix rates, eliminate competition and generate increased fees. The 107 page complaint, dated October 4, 2007 and filed in Connecticut Superior Court in Hartford (the "Complaint"), is based on violations of Connecticut's Antitrust and Unfair Trade Practices Acts. The Complaint, which may be viewed at <http://www.ct.gov/ag/lib/ag/antitrust/reinsurancecomplaint.pdf>, also names another Marsh subsidiary, Philadelphia based Excess Reinsurance Company, as a defendant in the lawsuit. Numerous reinsurers participating in reinsurance facilities managed by Guy Carpenter are alleged in the Complaint to be co-conspirators, but have not been named as defendants in the lawsuit.

The Complaint alleges "Guy Carpenter traded exclusive access to a lucrative book of business in exchange for excessive fees and other benefits by creating a series of reinsurance 'facilities' aimed at a large block of its smallest clients. Guy Carpenter created what was essentially a closed market for certain categories of business and then, rather than seeking competitive quotes on behalf of its clients, funneled business to the reinsurers participating in the facilities." The Complaint further alleges that "[r]einsurers, in order to gain access to this closed market, agreed not to compete on the prices and terms set by either Guy Carpenter or another 'lead' reinsurer and instead agreed to be bound by the same prices and terms as the other reinsurer participants." For a more comprehensive summary of the Connecticut Attorney General's allegations, please go to <http://www.insurereinsure.com/BlogHome.aspx?entry=238>.

Guy Carpenter responded to the Complaint in a press release by stating:

"The Connecticut Attorney General's complaint is based on a fundamental misunderstanding of reinsurance facilities that have been in operation for the benefit of small-and mid-sized clients for as long as 50 years. As many of our clients have confirmed during this investigation, these facilities result in improved availability and terms of reinsurance and ultimately benefit insurance buyers. Simply put, there is no basis for the Attorney General's lawsuit and we intend to defend ourselves vigorously."

# FEDERATION OF REGULATORY COUNSEL, INC.

By all accounts, it appears that more lawsuits are likely to follow, as attorneys general around the country continue to investigate the practices of insurers, reinsurers and brokers. "Thousands of consumers in Connecticut and many more in most states across the country paid premiums up to 40 percent higher, costing them potentially hundreds of millions of dollars," Attorney Blumenthal has stated. "We are drawing back the cloak of secrecy on industry practices that inflated prices and profits at the expense of 170 insurance companies and their customers. Our investigation is active and ongoing." Over the last several months, Attorney General Blumenthal's office has also issued subpoenas to numerous insurers and reinsurers.

## Florida

On October 16, 2007, the Florida Office of Insurance Regulation (the "Office") issued a subpoena to several subsidiaries of the Allstate Corporation which have requested rate increases in Florida "to appear in a public hearing in Tallahassee [on January 15, 2008] to testify before the Office about: the companies' reinsurance program, their relationships to risk modeling companies, insurance rating organizations or companies and insurance trade associations." The Office is investigating whether insurers may have colluded on rates on homeowner's insurance and/or violated legislation passed earlier this year requiring insurers to lower rates on homeowner's insurance. The subpoena may be viewed at <http://www.floir.com/pdf/allstatesubpoena.pdf>.

## Multi-State Settlement

On October 26, 2007, Oregon Attorney General Hardy Myers announced a settlement with ACE Group Holdings, Inc. and its subsidiaries ("ACE") over allegations of improper, fictitious quoting and steering of insurance businesses. The \$4.5 million monetary settlement will be divided among jurisdictions participating in a multi-jurisdiction task force, including the District of Columbia, Florida, Hawaii, Maryland, Massachusetts, Michigan, Oregon, Texas and West Virginia. Under the terms of the settlement, ACE will be required to abide by certain reforms and, in addition, disclose the actual amount of payments made to insurance brokers upon request from its customers and prospective policyholders. ACE entered into a settlement in 2006 with attorneys general from Connecticut, Illinois and New York stemming from the same anticompetitive practices.

## Louisiana

On November 8, 2007, Louisiana Attorney General Charles C. Foti, Jr. announced that his office filed a petition in New Orleans Civil District Court against Allstate Insurance Company, Lafayette Insurance Company, Xactware, Inc., Marshall & Swift/Boeckh, LLC, Insurance Services Office, Inc., State Farm Fire and Casualty Company, USAA Casualty Insurance Company, Farmers Insurance Exchange, Standard Fire Insurance Company and McKinsey & Company for alleged violations of the Louisiana Monopolies Act.

According to Attorney General Foti's press release, the petition alleges that the defendants participated in "an on-going scheme to rig the value of property damage claims paid by insurance companies to their insureds" and used "damage-estimating software programs to engage in horizontal price-fixing as well. The combination allegedly artificially held down property damage claim payouts with the intended goal of increasing the profits of each company involved."

## 3. Proposals to Repeal McCarran-Ferguson

The onslaught of state antitrust investigations and claims involving alleged anticompetitive activities of insurers, reinsurers and brokers comes at a time when some industry observers are calling for Congress to repeal McCarran-Ferguson.

## FEDERATION OF REGULATORY COUNSEL, INC.

In February, Senator Patrick Leahy (D-Vt.), Chairman of the Judiciary Committee, introduced the "Insurance Industry Competition Act of 2007," (S. 618), a bipartisan measure that would amend McCarran-Ferguson to give the Department of Justice and the Federal Trade Commission authority to apply Federal antitrust laws to the insurance industry. In March, companion legislation was introduced in the House of Representatives as H.R. 1081. Although these bills will not be acted upon this year, Congress will likely continue deliberations next year regarding repeal of McCarran-Ferguson. Further fueling these discussions will be a report issued in September by the European Commission questioning the need for the Block Exemption which, like McCarran-Ferguson, provides insurers with a limited exemption from European Union competition laws.

#### 4. Conclusion

The lawsuits and investigations of state attorneys general alleging violations of state antitrust laws by insurers, reinsurers and brokers will likely trigger other lawsuits by attorneys general, as well as private causes of action. One can only assume that the results of these lawsuits and investigations will greatly influence Congress with respect to whether to repeal McCarran-Ferguson. Only time will tell if there is a basis for the allegations made by state attorneys general against insurers, reinsurers and brokers and whether Congress will act to reform federal antitrust law as it applies to the business of insurance.

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