Insurance Regulation

2

State Government's Role

For most of our nation's history, regulation of insurance has been considered a matter for state regulation. For many agents, their initial interaction with insurance regulators concerns state insurance licensing requirements and the general requirement for continuing education. In addition to agent licensing, the state insurance departments' main responsibilities include the oversight and solvency of insurers' operations as well as their marketing practices.

Despite their lack of uniformity, state insurance laws contain common themes. Through their laws and regulations, the states establish rules of practice that provide compliance and ethical guidelines by spelling out what an agent is permitted to do or prohibited from doing. Some of the more common rules deal with the:

- requirement that only approved policies may be sold,
- prohibition against misrepresentation,
- guidelines that must be followed in the replacement of coverage,
- returning of premiums or other consideration to a client, i.e. rebating, and
- requirement that agents perform their duties in a timely way.

Specific Florida laws are explored in greater detail in the following Chapter.

Federal Government's Role

While states play the primary role in regulating the insurance industry, the federal government exerts control over the insurance market -- directly and indirectly -- in four areas:

- the Internal Revenue Code and its special tax treatment of insurance products,
- health insurance and pension legislation (most notably HIPAA and ERISA),
- regulation of insurance products considered securities by the Securities Exchange Commission, and
- the anti-trust powers reserved to it under the McCarran-Ferguson Act,.

The tax code provides insurance products special tax treatment: such as tax-deferred growth of cash values within life insurance and annuities, income tax-free death benefits, and deductions for

© 2009 Wall Street Instructors, Inc. No part of this material may be reproduced without the written permission of the publisher.

employers who provide group health insurance. These often play an important role in the sale of insurance. Furthermore, the Internal Revenue Code also exerts control over taxation of mutual and stock insurance companies. Taxes provide incentives and disincentives, and changes in tax policy can significantly affect how the insurance market evolves.

A second area of federal influence relates to the areas of health insurance and pensions. The federal government enacted Medicare and Medicaid -- a basic health care framework for the elderly and poor. The insurance industry responded with products that work in concert with that federally-created and administered framework, such as Medicare supplement policies and qualified long term care policies. Subsequently, the passage of the Health Insurance Portability and Accountability Act (HIPAA), further defined the health insurance playing field. ERISA (The Employee Retirement Income Security Act) applies to employer-provided benefit programs such as pensions and health care plans offered by HMOs. Some observers expect that the federal government's move towards standardization will eventually apply to basic health care plans.

The federal government, through the SEC, exerts considerable influence in both licensing and product registration of securities products, and that influence is increasing in the insurance industry due to the many new insurance products that have a dual character as insurance products and investment products.
Lastly, the federal government retains the power to control the insurance industry under the McCarran-Ferguson Act. This law was passed in response to a Supreme Court decision in 1945 that declared insurance to be "interstate commerce" subject to federal jurisdiction. The McCarran-Ferguson Act effectively overturned that decision, leaving most insurance regulation to the states, but retaining federal jurisdiction to the extent that the issues involved are deemed to be national in character. So, ultimately, oversight of state insurance regulations is a power reserved to the federal government. Although the states are specifically charged with the responsibility of regulating matters relating to ethical conduct of insurance agents, the federal government could consider it to be of sufficient national concern to step in -- as is the case of the Gramm-Leach-Bliley Act (or Financial Services Modernization Act), which mandates standardized nationwide licensing requirements of insurance agents and privacy of customer information.

Although the federal government has considerable power to affect the insurance industry through regulation, it is important to remember that the major burden of insurance regulation falls to the states.

If these federal and state regulations were the only rules that applied to agent and insurer marketing practices and conduct, they would be sufficient to hold both agents and their companies liable for errors and omissions. Insurers, however, have liability for agent conduct that predates these laws. That liability derives from the common law and its concept of agency.

Common Law

Common law refers to a body of law that has evolved "organically" through the centuries. Various legal cases have come before the courts and the courts have applied and reapplied previous legal precedents to new settings. In this way, common law differs from "statutory law" -- that is, specific laws passed by legislative bodies to address particular situations. English common law -- growing out of the decisions of the English judicial system -- became the basis for law in the English colonies and expanded as our country grew. The legal systems of forty-nine of the fifty states are based, in part, on English common law. (Louisiana, initially a French colony, bases its legal system on the Napoleonic Code -- a statutory system of justice predicated on precepts of Roman law.)

Several important concepts, derived from common law, have an impact on insurers and their agents. Among these are:

- Law of Agency
- Fiduciary Responsibility, and
- Defenses against Liability

The Law of Agency

This legal concept applies when someone (the agent) acts on another's (the principal's) behalf. This concept applies to a wide range of everyday situations -- especially in the business world. For example, trusts and corporation (non-human legal entities) can only act through human intermediaries such as trustees, corporate officers or employees. Insurance companies rely on an outside sales force to market their products, so the law of agency -- and the salesperson's contract with represented insurers -- determines whether the individual is, in fact, an "agent" of the company.

The question sometimes arises: "To what extent is the principal bound by the agent's actions?". Only authorized acts of the agent can bind the company. So, the answer to that question depends, to a large extent, on the authority the principal confers on the agent. The law of agency recognizes three types of authority that may be given to agents:

- Express authority
- Implied authority
- Apparent authority

Express Authority

Express authority is conferred by a contract. Express authority is given to the agent through his or her contract with the insurer and any amendments made by the company to that contract. The con-

tract explicitly announces the detailed grant of authority to the agent -- and outlines his or her duties. Clearly, if the agent does only what he or she is given express authority to do, those actions would bind the company. As a result of this specificity, few compliance problems arise out of express authority.

Implied Authority

Unlike express authority, which is granted via a contract, implied authority comes from the powers that the company customarily gives its agents. For example, an insurer may give an agent the express authority to solicit applications for life insurance on its behalf; by doing so, it also gave the agent the implied authority to telephone prospects on its behalf to arrange sales appointments. Implied authority arises when it:

- is intended to be given by the insurer,
- usually relates to the general customs of the business,
- is not contractually provided, and
- is not specifically delineated.

Implied authority can lead to significant liability for insurers, especially if the company knowingly or negligently permitted its agents to engage in unethical sales practices. By the insurer's failure to stop the agents' unethical sales practices, a plaintiff could maintain that the company gave the agents implied authority to act in that fashion. To the extent that the insurer authorized that conduct -- in this case through implied authority -- it is responsible for it just as though it had specified that activity in the agent contract. If the insurer is deemed to have conferred that implied authority, the company could be held liable for any damages resulting from those acts. Implied authority has provided the legal basis for some of the successfully -- maintained lawsuits alleging unethical marketing practices.

Insurers, in order to limit their liability, generally provide considerable direction to their field force regarding acceptable sales practices and advertising. Although implied authority creates many of the insurer's liability concerns, the type of authority that causes most of the compliance problems is the last type: apparent authority.

Apparent Authority

The most troublesome level of authority, from the insurer's perspective, is apparent authority. This is authority that a third party, such as a prospective client, can reasonably assume to be given to the agent by the principal. Apparent authority:

- is not provided by contract,
- is not intended by the insurer, but
- appears to the client to be given to the agent based upon the agent's believable statements.

For example, an agent has a rate book and other internal literature from a major insurer and the agent holds himself out to be appointed by the insurer, even though he is not. A prospective client

sees this literature and assumes the agent does indeed represent the company. The company can be held liable for the actions of the agent under the guise of apparent authority. Not surprisingly, apparent authority causes a majority of the liability for life insurers.

Even if the agent has none of those three types of authority, it is still possible for an insurer to be liable for the agent's acts. That outcome may result from the insurer's ratification of the agent's acts.

Ratification

Insurers can, by their actions, confirm or approve of an agent's actions. This confirmation, known as "ratification", can bind the principal (the insurer) to the agent's actions if:

- the agent represented himself as an agent acting on behalf of the insurer;
- the customer believed the agent's representations;
- the insurer subsequently validates the agent's actions by ratifying them in some fashion; and
- the insurer ratifies the entire agent transaction.

It should be clear that agent actions may create both personal liability and insurer liability. The principal motivation of any insurer’s compliance efforts is to mitigate the liability caused by agent actions. Despite the fairly clear concepts that may result in liability, the issue of liability is anything but straightforward. In fact, there are a number of other elements that affect an agent’s liability.

Fiduciary Responsibility

Those who voluntarily agree to act in the capacity of a "caretaker" of another's rights, assets and/or well being are acting in a fiduciary capacity. A fiduciary has an obligation to carry out his or her responsibilities with the utmost degree of "good faith, honesty, integrity, loyalty and undivided service of the beneficiaries' interest." Many times, the fiduciary responsibility is clear cut: a trustee of a trust must manage the trust assets with an eye to the trust beneficiary's best interests. The common law standard applied to fiduciaries is the "prudent man rule". Fiduciaries are supposed to exercise the diligence and foresight that a "prudent" or careful person would under the similar circumstances. In many jurisdictions, the common law standard has given way to new, statutory regulations governing a fiduciary's responsibilities – creating standardized rules that address commingling of assets, proper investment standards, etc. But whether the standard is the old common law "prudent man rule" or a series of statutory obligations, the underlying premise is the same: The fiduciary must place the interest of others above his or her personal interests.

Insurance agents who solicit applications and collect premium monies on behalf of insurance companies clearly have a fiduciary responsibility to the company. Insurance agents owe their primary allegiance to the company that appointed them.

But agents also have a responsibility to their clients. As the Florida Attorney General stated: "Licensed insurance agents and representatives place themselves in a position of fiduciary duty to the consumers who enter their business looking for guidance in their insurance purchase".

These conflicting duties -- to the insurer that appointed them and to the customers who rely upon them -- pose a real dilemma for insurance agents. The solution to this conflict is honest dealing with all parties and full disclosure, or at a minimum, disclosure of the conflicting duties. An insurance agent's fiduciary responsibilities to his or her clients, as well as the appointing company, will be discussed in greater detail in later chapters.

Defenses Against Liability

While the Law of Agency and concept of fiduciary responsibility impose obligations on the agent, there are several common law concepts that can act to mitigate the agent's or insurer's liability: waiver, estoppel, election and "course of conduct and custom".

The ***Course of Conduct and Custom Doctrine*** considers how parties to a transaction have conducted themselves in the past. The premise being that if the parties handled their affairs in a particular manner for a long period of time, it is not unreasonable to conclude that such actions were acceptable to both parties. Suppose, for example, a client purchases annually renewable term life insurance policy from an agent. The agent never sent a notice of expiration to the client, yet year after year, the client would contact the agent to renew the coverage. The coverage remained in force for twenty years, after which, the client did not contact the agent. The policy lapses, and a short time thereafter the inevitable occurs -- the insured dies. The beneficiaries are at a loss to explain why there is no death benefit forthcoming from the insurer. The beneficiaries sue the company and the agent alleging that the agent had a duty to inform the client of the expiring coverage. Under the common law doctrine of "Course of Conduct and Custom" the court would review the facts in light of how the parties behaved in the past. Since it was not customary for the agent to send a notice of expiration -- and the client operated under those circumstances for twenty years -- the court could decide that the agent does not have a duty to inform.

Another defense against liability is a ***waiver.*** In a waiver, an individual voluntarily and intentionally give up of a right the individual knows he or she has. Once waived, the individual cannot reassert that right. For example, a client signs an absolute assignment, in effect transferring a life insurance policy to someone else. By doing so, the client is aware that she will give up control over the policy to the assignee. By assigning the policy, she has waived her rights under the policy and cannot claim at a later date that she continues to have them.

A related concept is that of ***estoppel***. For example, a health insurance policy states that if the policy lapses and the policyholder wishes to reinstate the policy, all delinquent premiums must be sent directly to the home office. Assume that the policy lapses and the policyholder drops off the premiums at the agent's office -- who forwards them to the insurer, which then reinstates the policy. A couple of months later the insured is injured in an accident. The insurer cannot now claim that the policy is not in force because the premiums were not paid directly to the home office, as required in

the policy documents. The insurer is said to be "estopped" from asserting the policy's written provisions due to its action of reinstating the policy. (By accepting the payments via the agent, it "waived" its right to a home office payment -- and is "estopped" from using that as an excuse to not pay the claim.)

The last defense we noted is called ***election***. The concept works in the following fashion. When a party to an insurance contract has a choice of actions and chooses one, he cannot subsequently change his choice if the change would be detrimental to the other party. If a client agrees to repairs of damaged property but later attempts to change the choice to a cash settlement after repairs are started, the court might say that the client had elected the repair option, and he would be held to that position. To do otherwise would injure the other party -- the insurance company.

Judicial Review

As we've seen from the discussion of "common law" -- the law is constantly evolving. Each year we see advances in technology that were not contemplated by the law. Courts must interpret laws written at one time for the circumstances of another. How is a constitutional protection written in the 18th century against unreasonable searches and seizures to be applied to 21st century telecommunications?

Courts routinely adjust old legal concepts to fit new situations, often in the hopes of maintaining stability within the law. But over time, a changing judicial climate can sometimes lead to a different focus or emphasis. For example, the raw market forces of capitalism were once predicated on the notion of *caveat emptor:* "Let the buyer beware". Under this legal principle, each consumer is responsible to weigh the risks and benefits of a possible purchase and look out for his or her best interests. This legal doctrine works fine when the purchaser is relatively well-informed of the risks and benefits of the product. After all, it is easy to smell spoiled milk or tainted meat. But as society advances, and products become more sophisticated, how is a consumer to be informed of all the possibilities being presented? Are lithium ion batteries in a laptop computer more likely to catch fire than other types of batteries? Are trans fats healthier for the human body than butter? Is group credit life insurance sold through banks a better way to pay off a mortgage than other types of coverage? The modern world presents us with myriad choices, yet fewer and fewer of us are competent to analyze all the risks and benefits those choices offer. As a result, the courts have edged away from *caveat emptor* toward *caveat vendor*: "Let the seller beware". This creates a legal system in which sellers are held accountable for their products -- and an environment in which lawsuits are filed against the real or imagined shortcoming of today's products. In this litigious environment, full disclosure becomes an increasingly important feature of the sales process.