THE REGULATOR™
INSURANCE REGULATORY EXAMINERS SOCIETY

Sunshine State confronts the dark side of viaticals

by Kevin McCarty
Florida Department of Insurance
Deputy Commissioner

EDITOR'S NOTE: *Florida insurance regulators have been tested over the past few years by various viatical settlement companies that failed to live up to their promises to Florida residents. In this article, author Kevin McCarty summarizes the State's efforts to address the problem and outlines several current legislative proposals designed to provide additional protections for Florida residents.*

Florida's "Viatical Settlements Act," which took effect on October 1, 1996, was the first legislative initiative to address the viatical settlement problems that had arisen in Florida. The Act recognizes that the business of viatical settlements serves a legitimate business purpose and establishes a framework for its regulation. Initially, the Act was intended to protect "viators", *i.e.,* those who sell life insurance contracts, but eventually was expanded to protect the rights of investors.

In 1996, around the time of the initial Act, the United States Securities & Exchange Commission (SEC) alleged in a complaint filed in federal court in Waco, Texas *(SEC vs. Life Partners, Inc.)* that viatical settlements were securities and therefore subject to all applicable federal securities laws and regulations. The court, however, ruled in favor of the defendant, concluding that such investments or transactions were not securities.

That decision, which was affirmed on appeal, has had a far-reaching adverse impact on legitimate viatical settlement companies, consumers and regulators. As a result of these court rulings, many viatical settlement companies immediately embarked upon outlandish advertising campaigns, touting viatical settlements as "guaranteed," "fully insured," "no risk" and "can't lose" investments.

The truth is that viatical settlements were not (and are not) "guaranteed" nor "insured" and were and continue to remain "high risk". In addition, investors stand to lose their entire investment for a myriad of reasons. For example, policies can lapse due to the non-payment of

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The UPS tax case: Where were the insurance regulators?

by Mark L.Gardner

$1.79 billion.

$1.79 billion.

What is that? The amount of President Bush's proposed tax cut? The national debt remaining after the Clinton pay-downs? The annual payroll of the New York Yankees?

Nope. It's the amount of cash reserves that have been set aside by the United Parcel Service (UPS) as a result of a 1999 federal tax court decision. The court held that UPS had evaded U.S. taxes by funneling money to an offshore insurance subsidiary.

And, since this arrangement had been in place for nearly 15 years, this figure is likely to grow. *The Wall Street Journal* has reported that UPS's total after-tax exposure could reach *$2.35 billion*.

The U.S. Tax Court decision *(UPS of America v. Commissioner of*

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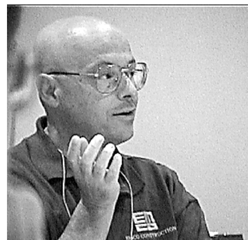
From the President

Some of you have asked from time to time: "How does IRES function?" Here's my answer: There are 24 members on our Board of Directors elected by our members to four-year terms, plus 3 "at-large" members appointed by the Board. We hold two Board of Directors meetings each year at the annual CDS.

During the year, our Executive Committee meets monthly via telephone conference call. Standing committee reports are given and we approve the activities of both IRES and our administrator, David Chartrand, and his staff. Our Treasurer (currently,Weldon Hazlewood) and the Finance Committee provide us with a proposed budget, which we review, revise if necessary, and eventually adopt.



Most of you probably noticed a small increase in your annual dues. Our Executive Committee gave much thought and consideration to the decision to raise dues. It was felt that any increase should be nominal, but reflect the needs necessary to run a professional organization in a first-class manner.

This is also the time of year that ballots are prepared for our annual Board of Directors election. This year we will be electing six of our fellow members. I urge all of you to vote.

You'll notice on this year's ballot is an amendment to change our bylaws. The purpose is to clarify the definition of a "Retired Member" so that only those individuals no longer involved in the field of insurance (whether or not employed) will be considered retired and entitled to reduced annual dues.

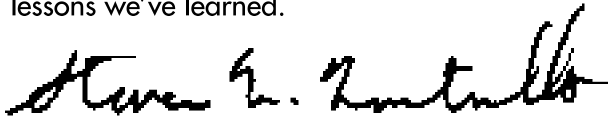
Those no longer involved in regulation, but who remain active in the business of insurance will be placed in a new membership category designated as "Active Former Regulator." Individuals put in this category will not have voting rights but still will be required to pay full dues. Special thanks to members of the Past Presidents Council for drafting this change.

On a different note, I recently attended a fascinating seminar at the New York Insurance Department in which the Government Accounting Office (GAO) and the NAIC explored the regulatory ramifications of the Martin Frankel fraud case. The GAO, which issued a report on the subject (see

November '00 issue of *The Regulator*), noted that they had observed "repeated instances of inadequate tools, policies, procedures and practices, as well as a lack of information sharing among different regulators within and outside the insurance industry."

Undoubtedly, insurance regulators need to improve their sharing of information. To remain strong in the years ahead, we must foster solid relationships with other U.S. and world-wide financial service regulators. We should also be more proactive in adopting policies and procedures to share regulatory concerns with other state insurance departments. Our annual CDS certainly helps in that regard.

Lastly, GAO discussed the need to exercise appropriate levels of professional skepticism when indicators of fraud or other irregularities surface. I believe this is something all of us should remember when performing our jobs. Be skeptical. Don't be afraid to ask questions. And don't give up without an adequate answer. The positive aspect to this unfortunate episode is that state regulation will become stronger and more effective as a result of the lessons we've learned.



IRES PRESIDENT

IRES 2001 bylaws amendment

The Board of Directors voted to adopt a recommendation by the IRES Past Presidents' Council that the definition of "Retired Member" be clarified so that only those no longer involved in the field of insurance (whether or not otherwise employed) would be considered retired and would be given the reduced annual dues. Those who were no longer involved in regulation (and thus not meeting the definition of a "General Member") but who remained active in the field of insurance would be placed in a new membership category designated "Active Former Regulator." Members placed in this category would not have voting rights, but would be required to pay full dues as is required for "General Members."

C.E. News

What is the deadline for completing courses for this compliance period?

Courses or seminars submitted for credit must be **completed** during the current compliance period Sept. 1, 2000 to Sept. 1, 2001. **The reporting deadline is Oct. 1, 2001.**

Can I obtain a CE compliance reporting form from the IRES website?

Yes, the NICE manual is available for downloading from the IRES website – www.go-ires.org All continuing education forms, including the compliance reporting form, are available online and may be downloaded and printed for your convenience. The hard copy may then be sent to the CE office for processing. Please include a certificate of attendance or comparable proof of your attendance when submitting your compliance reporting form.

When will I receive confirmation that my credits have been received?

Transcripts are sent in May of each year. However, future plans are to provide this information on our website. Watch for more details in the next REGULATOR.

How do I file an extension if I am unable to meet the compliance deadline?

The extension request form is on page 19 of the NICE manual (hard copy) and in the downloadable version of the manual on the IRES website. Please indicate you are requesting a one-year extension for the annual reporting period Sept. 1, 2000 to Sept.1, 2001. Your written request must be received by the IRES CE office prior to Sept.1, 2001.

I am planning to retire. How do I keep my designation in good standing?

Retirement status as an IRES member does not automatically grant you retirement under the NICE program. You must affirmatively opt to place your designation in retirement status under the NICE program by submitting the "Permanent Retirement Status Notification Form", located in the NICE manual and on the IRES website, to the IRES CE Office in order for your designation to remain honorary.

N · I · C · E

Confronting the darker side of viaticals

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premiums; rescission by an insurance company for misrepresentations or fraud in the procurement of the policy; or the inability of the viatical settlement company to locate, obtain and file a death claim for a viator on behalf of an investor. In addition, as seen in a separate case involving Life Options International, a viatical company could cease doing business leaving an investor unable to determine whether policy premiums are being paid, who owns or is in possession of the policy, or the status of the policy or the insured.

In 1997 and 1998—shortly after the advent of the outlandish advertising campaigns referenced above—investor complaints to the Florida Department of Insurance began to escalate. However, due to the lack of statutory authority in the Viatical Settlement Act regarding investments, the Department had no statutory basis for pursuing corrective or punitive actions.

With the implementation of the new Viatical Settlement Act in 1998 (see Legislation section), applications for licensing as a viatical settlement provider entity (a company that buys and sells viaticated insurance policies) began to be processed by the Department.

What is a Viatical Settlement?

A viatical settlement is a written agreement under which the owner of a life insurance policy (the "viator") sells the policy to another person for less than the expected death benefit under the policy. The amount paid for the policy is usually based upon the projected life expectancy of the insured. The person purchasing the policy usually assumes responsibility for the premium payments and upon the death of the insured, receives the death benefit from the policy.

Cleansheeting

A unique feature of the 1998 Florida Viatical Settlement Act gives the Department the authority to conduct a pre-licensing examination of an applicant. Early in 1998 the Department elected to conduct such a pre-licensing examination of a Pompano Beach company. Evidence obtained during the course of the examination revealed that the company knowingly and willfully engaged in the business of buying and selling "cleansheeted" insurance policies.

"Cleansheeting" is the practice by a viator or the viator's agent of obtaining insurance policies by presenting materially false information or by concealing any fact material to the policy with the intent to defraud the policy's issuer. Thus, life insurers were selling policies to individuals who, had they not submitted false information, would not have met the company's underwriting standards. The policyholder would then turn around and sell the policies to viatical settlement firms.

The evidence obtained during the pre-licensing examination was submitted to the Department's Division of Insurance Fraud for further investigation. As a result, the viatical company and two of its officers were indicted and are currently awaiting trial. Subsequent examinations conducted by the Department of other licensed viatical companies and applicants for licensure disclosed that similar business practices appeared to be commonplace and widespread throughout the viatical industry.

Information of possible criminal activity was provided to the Department's Division of Insurance Fraud and shared with other regulatory and law enforcement agencies having an interest in companies or individuals within their jurisdictions. As a result of Florida's investigations, a statewide grand jury was convened which has thus far resulted in three indictments charging seven individuals and one corporation with 155 felony counts relating to criminal activity in the viatication of life insurance policies.

Legislation

1998

In view of increased consumer complaints and the

Viaticals

appearance of fraudulent activity within the industry the Department sought legislation in addition to the 1996 Act. In 1998, legislation was enacted that required persons selling viatical investments to disclose to investors in writing pertinent information regarding proposed investments. The disclosures required notice to the investor that the return represented is directly tied to the projected life span of the viator. Further, the investor may be responsible for premium payments should the viator outlive the projected life expectancy. Finally, the legislation made it a violation to misrepresent the nature of the return or the duration of time to obtain the return.

1999

In 1999, the Department again sought legislation to include increased consumer protections and an expansion of the Department's authority to regulate viatical settlements. The Florida Legislature agreed, and expanded the disclosures required to be made to investors who were purchasing interests in the death benefits of insurance policies. The Legislature also prohibited the use of certain words and representations in advertising and declared certain acts, to include the buying and selling of policies obtained by means of a false, deceptive, or misleading application for the life insurance policy, unlawful.

2000

In February 2000, the Fifteenth Statewide grand jury released its report on the viatical industry in Florida. In addition to the grand jury indictments, the grand jury recommended a number of legislative changes designed to curtail the fraudulent activity occurring within the viatical industry and to provide essential consumer protections and regulatory authority under the Act. Most of the grand jury's recommendations were enacted by the Florida Legislature in the 2000 Legislative Session. Among other changes included in the new legislation, which the Department supported, were the following provisions:

1. Expands viatical settlement regulation to apply to senior or life settlement agreements. Life settlement agreements are sales of life insurance policies for cash by healthy individuals. Senior settlements are sales of life insurance by senior citizens who no longer need the coverage or cannot afford the premiums;

2. Provides to investors a three-day rescission period following receipt of specified disclosures required to be provided to them at least five days prior to naming the investor on a policy or policies;
3. Adds criminal penalties ranging from a felony of the third degree to a felony of the first degree depending upon the value of the life insurance policy;
4. Clarifies that companies operating in Florida, from offices in Florida, or who transacted business with Florida residents were required to be licensed under the Act;
5. Clarifies that viatical settlement purchase agreements and viatical settlement contracts used in transactions with residents of states other than Florida were subject to the requirements of the state in which the resident resides;
6. Requires a person to provide notice to an insurance company that a policy has become the subject of a viatical settlement; and
7. Requires the filing of anti-fraud plans by licensees of the Department with the Department's Division of Insurance Fraud.

Legislative Considerations-2001

While the Department strongly supported the 2000 legislative changes, many issues remain. For example, the Department is currently considering whether to

continued on next page

Florida scrutinizes viatical settlements

continued from previous page

seek amendments to the Act to address all or any portion of the following issues:

1. **Secondary Market Sales**—The issue is whether an unlicensed entity should be licensed and therefore subject to the Act if it simply acquires lawfully viaticated policies and re-markets such policies to individual investors in Florida from offices in Florida.
2. **Centralized Tracking System**—Inasmuch as policies are sold based upon a projected life expectancy, it is often years before an investor will experience any return on his or her investment. This creates a need for "servicing" policies once a policy is sold. Servicing includes, among other things, tracking a viator and paying of premiums and filing of a death claim upon the death of a viator. Often these functions are performed by one or more persons who may or may not be related to a viatical settlement provider. If a provider goes out of business, has its license revoked or is indicted, it may cease servicing its viaticals. Inasmuch as failure by a servicing agent to perform any one of these critical functions would have a severe adverse impact on an investor, the Florida Department is currently considering the creation of a centralized tracking system in which all licensees would be required to participate.
3. **Applicable portions of the NAIC Viatical Settlement Model Act**—After several years of review, analysis and negotiations, on December 4, 2000, the NAIC adopted a Model Act for Viatical Settlements. This model is proffered by the NAIC for consideration by the various state legislatures in whole or in part. The Department should and is considering whether or not to adopt the NAIC Model Act in whole or in part. Many of the provisions in the NAIC Model currently exist in the Florida Act.
4. **Escrow of Investor Funds**—Florida's Viatical Settlement Act currently includes escrow requirements for the protection of viators by having money and documents effectuating the transfer of rights under a policy through the use of an escrow agent. No such protections exist for viatical settlement purchasers.

Florida Viatical Business

The eight licensed companies doing business in Florida during 1997, 1998 and 1999 reported the following Florida business to the Department:

	Total Face Value of Viaticated Policies	**Total Amount Paid To Viators**
1997	$ 57,654,474	$ 31,432,540
1998	112,543,865	42,743,129
1999	52,095,357	18,039,153
Total*	$222,293,696	$92,214,822

* Does not include senior settlements or life settlements.

In 2000, the Department received nine additional applications for licensure as viatical settlement providers.

Enforcement Actions

Since inception of the Act, the Department has initiated the following actions with respect to persons engaged in the viatical settlement industry in Florida:

6 Administrative Complaints/Orders to Show Cause
6 Cease & Desist Orders
6 Immediate Final Orders
3 Companies Indicted
16 Individuals indicted
3 Companies fined for violations of the Act

Consumer Complaints

Since the spring of 1997, The Department has received approximately 577 written viatical-related complaints from Florida consumers.

Conclusion

Viatical settlements serve a legitimate business purpose. In some cases, individuals may need to sell their life policies to pay for medical treatments or simply to provide comfort in their final days. As the industry expands, Florida will continue to provide effective regulatory oversight over these entities. However, regulation of the viatical settlement industry is still in its infancy and a legitimate and viable industry may never be established without a cooperative effort between regulators and the viatical industry.

Many unscrupulous individuals established a foothold in the viatical business in Florida prior to the enactment of legislation and are slowly but surely being weeded out. To this end, additional legislation and enforcement actions are expected. Legislative and enforcement initiatives are essential not only for the protection of viators, but also for investors who supply the funding for the purchase of viaticated policies from legitimate viators who need cash in their final days. ■

Who Regulates Viatical Settlement Companies?

Type of Viaticals Regulation by State

(as of October 2000)

Principal Regulator

Insurance	Securities	Insurance/Securities	None
Arkansas	Alabama	Alaska	Colorado
California	Arizona	Iowa	Washington D.C.
Connecticut	South Dakota	Maine	Georgia
Delaware		Mississippi	Hawaii
Florida		North Dakota	Idaho
Illinois		Ohio	Maryland
Indiana		Tennessee[b]	Missouri
Kansas			Nebraska
Kentucky			Nevada
Louisiana			New Hampshire
Massachusetts			Pennsylvania
Michigan			Rhode Island
Minnesota[a]			South Carolina
Montana			Utah[c]
New Jersey			West Virginia
New Mexico			Wyoming
New York			
North Carolina			
Oklahoma			
Oregon			
Texas			
Vermont			
Virginia			
Washington			
Wisconsin			

Please note: In many of the states with no regulatory authority, securities regulators review investment contracts of viaticals.

[a] Commerce Commissioner regulates both insurance and securities

[b] Department of Insurance & Commerce regulates both insurance and securities

[c] No regulator specified in Utah viaticals law

Source: NAIC

Are elected commissioners closer to the people's pulse — or too close?

By Scott Hoober
REGULATOR staff writer

Roughly a quarter of the nation's insurance commissioners are elected, giving them longer tenure, greater political independence and, in theory, a more direct line to the will of the people.

Yet in two recent incidents, the elected commissioners in Louisiana and California got into highly publicized financial and legal trouble.

Is there a connection? Is there any genuine advantage to being elected on your own? Or is it more trouble than it's worth to ask commissioners to run for office in statewide elections, just as if they were seeking to be governor or attorney general?

"It's six of one, half a dozen of the other," said one neutral observer who asked not to be quoted by name.

"Do you want a politician in charge, or do you want a technician? I do think generally the elected ones tend to be a little closer to the people because they have folks actually voting for them."

The counterpoint to that of course is that perhaps elected commissioners are close to the wrong people — people, including company people, with cash to contribute to their next campaign. As another regulatory official put it, "The hand's always out." But then again, if a commissioner has been appointed by the governor and one of the governor's supporters wants something inappropriate, does even the best technician have the right to say no?

Clout

"The problem that commissioners always have, whether we're elected or appointed, is whether we have the legislative support," said Jim Long, longtime elected commissioner in North Carolina.

"And equally important, whether we have the budget support to run a shop that can do a quick turnaround time for the companies on their filings with us or the appointment of agents, or looking after consumer complaints. That's what really makes the real test — whether or not we have that legislative support we need to run our shops."

When a commissioner has been elected on his own, Long said, that automatically gives him a little additional clout with legislators. In addition, being elected means you're a little more likely to stick around long enough to learn the ropes and make alliances with key players.

"I started off as a state legislator 30 years ago," Long added. "I had a leg up when I got here in '85 — knowing the legislative process, especially the appropriations process. I know people in the General Assembly who are still there after 30 years, from when I was a freshman.

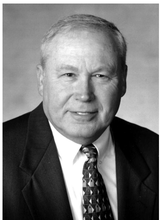
"I've got that rapport. And a lot of it is just having the constituent service work, just like we do for the public."

L. Tim Wagner, the appointed insurance director in Nebraska, feels that even if you haven't been on the ballot, you can work with legislators.

"You get to know them fairly well," said Wagner, who celebrated his second anniversary in office this past January. "I have not made a habit of being around the Legislature that often. I maybe go to four cocktail parties a year and appear before the committees, and if they have a specific question or issue, I will address that with them."

Yet most of the nonelected commissioners are appointed by a governor who's been elected statewide, even if they themselves haven't been.

The Appointed


Wagner of Nebraska

Shapo of Illinois

Montemayor of Texas

The Elected

Ex-commissioner Quackenbush

Long of North Carolina

Dale of Mississippi

"Speaking in generalities here," said Long, "I think probably the elected commissioner is more sensitive to the public out there, because, for one reason, he's got to go out and give speeches all the time to get ready for the next election. So I think by and large, they pay more attention to the electorate.

"I spoke to the Raleigh Lion's club yesterday — I do this several times a week — and it gave me a chance to be out there and see what's going on and get a feeling of the pulse, if you will."

Of course, whether a commissioner is willing to, say, admit a company that normally wouldn't be, or even take cash under the table, depends on a whole lot more than who they report to — the people or the governor. Although there are those quick to blame malfeasance on the political side of things — both Louisiana and California have seen calls recently for an appointed commissioner — it comes down to people.

"If someone had the opportunity and was so inclined, it wouldn't matter whether he was elected or appointed," said our anonymous observer. "It depends on what his personal fortitude tells him to do.

"Either he thought he could get away with it, or he was arrogant enough to think that, or he got bad advice about how it would be perceived. You'd think that an ordinary person would go, 'Nah, there's something about this that just doesn't seem right.'"

States with Elected Commissioners

California	Mississippi
Delaware	Montana
Florida	North Carolina
Georgia	North Dakota
Kansas	Oklahoma
Louisiana	Washington

Accountability

North Carolina's Long agrees. Yet he feels that being elected on his own makes it easier for a commissioner with moral fortitude to do the right thing.

"It does give us some independence that the appointed commissioners don't have," he said. "I think you actually have more of a problem with that with appointed commissioners, because they're beholden to the governor, in most cases, for that job. And well over half of the appointed commissioners serve at the will of the governor.

"If the governor says, 'I want my buddy's insurance company admitted to do business in our state,' and the commissioner says, 'They can't meet our standards here,' the governor can say, 'Let 'em in.'

"In 16 years, I've never had that call," Long said. "I've had calls like 'What about this company?' and I say, 'Well, governor, we've looked at it and they don't meet our requirements.' [And they say] 'OK.'

"I established that with the governor when I got here in '85. I didn't know him real well, we were in different parties. And I just sat down with him before we took office, and I said, 'Governor, now I'm not going to get into issues like paving highways and locking up prisoners and mental health, if you'll keep out of insurance.' And he said, 'You got a deal.' We got along beautifully for eight years."

Wagner said that he too never gets a call like that, from the governor or a legislator.

"Insurance is one of the largest employee bases in Nebraska. But our governor's simply been hands-off. That may not be true in all states."

The question of elected vs. appointed is one aspect of a larger question: How do we get accountability and professionalism in one package?

Wagner, who comes from a progressive state with a tradition of good government (the state has the only unicameral legislature in the nation, for instance), recalls that Colorado used to allow the governor to appoint the insurance commissioner. But then he or she would serve without interference unless removed for cause.

In general, he said, the greatest political accountability comes with a competent professional who's been appointed directly by the governor.

"I'm not trying to pick a fight with anybody," he added, "but one of the worst systems is appointment by the public service commission."

Tenure

On average, insurance commissioners last 18-20 months. Since most of the nation's 12 elected commissioners serve four-year terms, the appointed ones obviously average less than a year and a half.

Not that there aren't exceptions.

Darla Lyon was appointed South Dakota's commissioner nearly a decade ago, and she served many years before that as deputy commissioner. And until his recent departure, another appointed commissioner, West Virginia's Hanley Clark, had served since the late '80s. (The overall record is still held by George Dale of Mississippi, who was first elected in 1975.)

"Generally the elected officials stay on a lot longer and bring some stability," said Long, who's No. 2 nationally behind Dale.

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Elected vs. appointed commissioners

continued from previous page

He pointed out that longevity applies not only within the state and the department, but also to relations with other states, either directly or through the NAIC.

The downside of that is that it takes longer to get rid of a bad apple if he's been elected to office. An appointed commissioner can be kicked out at any time for cause, whereas an elected one has to be indicted or convicted — or be willing to resign under fire when the fire gets too hot.

"If you get somebody who is no good, you can get them removed," Wagner said. "If they're elected, it just doesn't happen. Even the voters may not get it."

Then there are those elected commissioners who not only want to be re-elected, they want to move up to higher office. There's always that temptation to behave like a demagogue, making exaggerated claims to the public so they'll vote for you later. Or to make promises to the folks with the money or influence to help you run for governor.

"I don't want to be governor or president," said Long. "I'm happy where I am.

"But that's just a difference in style. Some people are better at the process than others."

"The shortcomings," he added, "are more a function of the person's personality than anything else."

Despite the occasional problem, there's been little change over the years in the ratio of elected to appointed commissioners.

There have been an even dozen elected commissioners for about a decade now, since California switched in the early '90s, according to Eric Nordman of the NAIC. And before that, it was 11 for at least another decade.

When it goes bad

Even if we agree that whether a commissioner does a good job comes down to how they do the job, not how they got the job, we need to face one harsh reality: The two most widely publicized cases in recent years both involve elected commissioners—Louisiana and California.

On top of that, when Louisiana commissioner Jim Brown was convicted of lying to the FBI during its investigation of Gov. Edwin Edwards, he was the third consecutive insurance commissioner to be convicted on federal charges.

The original indictment included 56 charges, and Brown was convicted on seven, although the judge threw out two of those counts. He's been sentenced to six months in prison and fined $50,000, and he was suspended without pay until his appeals are exhausted.

Many of the charges involved allegations that the commissioner helped create a bogus liquidation settlement that allowed the owner of Cascade Insurance to pay policyholders less than they deserved.

> **"How do we get accountability and professionalism in one package?"**

Some observers blame Louisiana's sorry record on a too-aggressive local federal attorney's office. But then again, the state has a tradition of political chicanery that most other states seem to have put behind them in recent decades.

State Rep. Chuck McMains of Baton Rouge and Sen. Ken Hollis of Metairie, both Republicans, say the combination of a commissioner with too much power and an industry with millions of dollars to spend is a recipe for disaster, and they want the post converted to an appointed one. They are joined by the Public Affairs Research Council, which has proposed such a change since the '60s as a way to streamline government.

The problem, they all agree, is that as an elected post, the commissioner's office simply wields too much power.

Yet in Florida, the elected, already powerful commissioner's position has been elevated to cabinet-level post— turning the Commissioner into what amounts to that state's chief financial officer.

In California, the resignation last June of Chuck Quackenbush continues to reverberate.

Quackenbush clearly saw the commissioner's post as a stepping stone to higher office — some political observers say he might have made a great presidential candidate one day — and most observers blame his woes on his ambitions. The $12.8 million he solicited from insurers appeared to come at the expense of victims of the Northridge quake, a belief that, true or

false, doesn't help companies, regulators or policyholders over the long haul.

Since the Quackenbush scandal there is a movement in California to return the post to appointive status. Norris Clark, longtime deputy commissioner, who's worked under both appointed and elected commissioners during his more than quarter century at the department, may be among those who would support such a change. Clark has been quoted as saying that he felt more political pressure after the position became elective in 1990.

"There is no way I would like to relive last year," he said in an interview on the Quackenbush controversy with *Insurance Accounting*. "That was not what I signed up for when I joined the department."

Quackenbush isn't the first commissioner to harbor political ambitions. Florida commissioner Bill Nelson successfully ran for the U.S. Senate last year, and former North Dakota commissioner Earl Pomeroy made a successful run for the U.S. House in '92 (the same year his brother Glenn ran, successfully, for insurance commissioner).

Deborah Senn tried to move up from commissioner to U.S. senator in Oregon last year but was soundly defeated in that state's primary. And Kansas' Kathleen Sebelius, NAIC's new president, is being touted as the front-runner for the Democratic nomination for governor in '02.

When it works right

In a way, it's unfair to talk about the commissioners who have sinned. Not when so many have done such a great job over the years serving both the industry and their states' consumers.

It's a tough enough job to balance those two competing constituencies at any time, and any need to fend off interest groups along the way makes success all the more admirable.

Bill Bailey, special counsel to the Insurance Information Institute, singles out former Florida commissioner Tom Gallagher for praise in a book on Hurricane Andrew.

"There are times when a leader has to ignore established procedures to get things done," Bailey wrote in *Andrew's Legacy: Winds of Change,* which is based on his 15 months running the Hurricane Insurance Information Center in 1992-93.

"Gallagher was willing to do that. The Department of Insurance issued at least 45 emergency orders, covering such items as claims settlement procedures, licensing of public adjusters and one that caused an uproar with the construction trades — recommending a price freeze on construction materials and labor."

Bailey was also in Oklahoma City in the summer of 1999 following tornadoes there, and he said another elected commissioner, Carroll Fisher, showed the same kind of willingness to use the bully pulpit provided by his political independence. He held companies' feet to the fire but never demanded more than was reasonable, and he was everywhere, helping the public rebound from the devastation.

"Carroll Fisher set the standard," said Bailey.

Perhaps the ideal would be a competent professional, appointed and backed by a strong, smart governor who knew enough to deflect political pressure.

"That would be nice," said North Carolina's Jim Long, "but it's not a perfect system that any of us work in."

In most states, in most years, the insurance department simply is not a very high priority with most governors.

"With the crime problems, mental health issues and budget shortfalls from year to year, or an electricity shortage in California, there are so many issues the governor has to deal with, this is probably not high on his list," Long said.

Wagner agrees. "The governor's got a thousand people coming after him, from all walks of life, whereas an insurance commissioner has two [kinds of] people coming after him: insurance companies and consumers."

Only a good, strong commissioner can keep his or her department's focus on the job at hand. And fend off the occasional threat to regulators' independence. Does an elected commissioner have the clout to do things right? Or should the commissioner be appointed, so as to remain insulated from political pressure?

"History would show that appointed commissioners historically have simply done a better job," said Wagner.

The Nebraska regulator couldn't recall a recent scandal involving an appointed commissioner, though elected ones seem to be hauled into court with some regularity. "Regulation can't afford those types of incidents," he said.

"Sometimes the greatest guy in the world can get elected, but that doesn't mean he's a great administrator or has any knowledge of insurance — or sometimes very much interest in it," Wagner added.

"Either system can work real well," Long said. "It depends on the local situation in the various states. That makes more of a difference than anything." ■

Insurance regulators in the UPS case

continued from page 1

Internal Revenue, TC Memo 1999-268 (1999)), issued in August 1999, held that UPS had developed a tax shelter that improperly avoided millions of dollars in income taxes. The court ruled that UPS had unlawfully sheltered $77 million in profits during the 1984 tax year.

As a result, UPS now owes the U.S. government income taxes for that year, as well as interest and penalties. And that judgment relates only to 1984, not to any subsequent year. Since the judgment came down, UPS has placed a total of $1.79 billion in escrow to cover taxes it may owe for those 15 years.

The case was appealed to the 11th Circuit Court of Appeals in Atlanta in 2000, and should be heard sometime this year. The ultimate decision promises to have a huge impact not only on UPS's financial future, but also on the future of other companies with similarly structured tax shelters.

The convoluted tax shelter arrangement devised by UPS positively reeked of insurance regulatory issues.

Although the case made a big splash in the business press, it attracted little interest from insurance regulators. *Insurance regulators?* Isn't this an income tax case? Sure, but the convoluted tax shelter arrangement devised by UPS positively reeked of insurance regulatory issues.

Indeed, as a former insurance regulator, I believe that a case can be made that insurance regulators should have been examining UPS's arrangement long before it ever hit the media. However, based on a search of relevant legal documents and various media reports, it appears only one state showed even a modicum of interest in the situation.

To understand how regulators may have missed an opportunity to probe into the propriety of the UPS arrangement, one first needs to see exactly what UPS did.

Mark Gardner is an insurance attorney and former Deputy Superintendent of the New York State Insurance Department.

A Fateful Meeting

A meeting was held at the corporate headquarters of power broker Frank B. Hall (now defunct) on February 24, 1983 in Briarcliff Manor, New York.

At the meeting, representatives of Frank B. Hall and UPS discussed the "self-insured" system that UPS was currently using to safeguard the value of the packages it shipped for its customers.

In its self-insured system, UPS had been offering customers coverage whenever the declared value of a package exceeded $100. UPS would charge 25 cents in "excess value charges" for each additional $100 of declared value beyond the initial $100 of value. Thus, if a package was worth $1,000, UPS charged $2.25 (the first $100 was covered by UPS without charge) to "insure" the value of the package. UPS collected a premium and, if the customer's package was damaged, destroyed or lost, UPS paid the customer the declared value of the package.

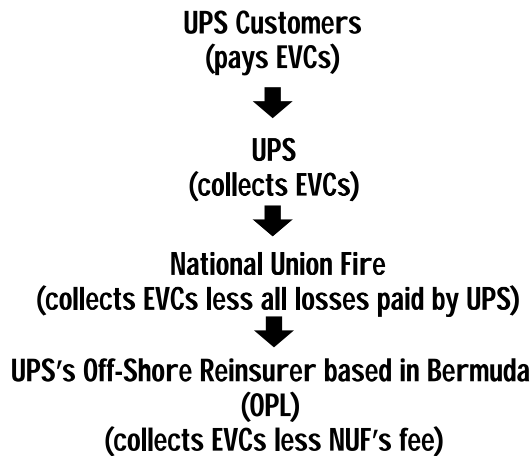
Apparently, UPS's risk manager thought that the EVCs looked a lot like premiums. Furthermore, he thought that the payments made by UPS to its customers looked like claim settlements. Consequently, he became concerned that it might appear to insurance regulators that UPS was engaged in the "unauthorized transaction of insurance." Ultimately, during the 1999 court case, UPS was asked whether its new tax shelter-based system had been inspired by a desire to avoid income taxes. UPS said no, asserting that it was actually the risk manager's insurance regulatory concerns that prompted UPS to revamp its system!

At the Frank B. Hall meeting, one of UPS's attorneys suggested that UPS establish a captive, off-shore reinsurance company to replace the wholly

self-insured mechanism that UPS was employing. With that suggestion, the stage was set, 16 years in advance, for one of this country's largest tax judgments.

Under UPS's new system, two new entities were introduced. First, a subsidiary of AIG (National Union Fire Insurance Company of Pittsburgh) was contracted to insure UPS. Then UPS set up a new captive, off-shore reinsurance company called Overseas Partners Ltd. (OPL), and used it to reinsure National Union Fire (NUF). However (and this was ultimately fatal to UPS) in this arrangement, UPS forwarded *all* of the premiums to NUF, and UPS continued to administer and pay all claims. NUF simply collected the premiums less losses, took its fee and forwarded the remaining funds to OPL.

The arrangement looked like this:



The premiums, er, I mean EVC's, paid by UPS customers to protect their packages flowed to UPS, to National Union Fire and eventually to UPS's own subsidiary, Overseas Partners Ltd.

This business, as you might suspect, was extremely profitable. In the 1999 tax trial, the court evaluated UPS's EVCs to determine whether they were comparable to rates charged by other insurers in the market at that time. According to experts who testified for the U.S. government at the trial, the EVCs were excessive. In other words, UPS was charging its customers far more than a competitive insurer would have charged for similar coverages.

Part of the experts' testimony focused on the loss ratio produced by the "insurance program" that UPS was operating. For example, for the years 1984 through 1989, the overall loss ratio for the program was approximately 33%. In 1989, which was the worst year for the program in terms of loss ratio, UPS collected $208 million in EVC's, paid out $77 million in claims and reported $131 million in profit. Even that year produced only a 67% loss ratio.

UPS's customers paid these premiums directly to UPS employees. However, the UPS employees were not licensed as insurance agents or brokers. In addition, losses were adjusted by UPS employees, who were not licensed as adjusters.

Thus, the regulatory questions that this case generates are:

Did UPS act as an insurer without a license?
Did UPS charge excessive rates?
Did UPS sell insurance without an agent's license?
Did UPS adjust losses without a license?

Irrespective of these four insurance regulatory issues noted above, the U.S. Tax Court ultimately determined that UPS's arrangement did not operate like a legitimate insurance or reinsurance plan. Rather than "*transferring risk,*" UPS was found to have merely "*assigned income*" to NUF and OPL. Why? Because UPS collected premiums from customers, administered and paid all of the claims to its customers, and then forwarded the remaining premiums to National Union Fire.

Unlike an arrangement in which NUF would receive some of the premiums and handle all claims adjustment, all claims were settled and deducted from the premiums before the funds were forwarded to National Union Fire. The insurer then forwarded them (less a fee) to OPL. NUF never assumed any risk; it merely acted as a conduit for the funds.

As a result of its finding that UPS merely assigned income, the Court held that UPS had failed to pay sufficient taxes. Thus, depending of course on the outcome of the appeal, one governmental entity — the IRS — has discovered wrongdoing and rectified it. However, why didn't the insurance regulatory community ever notice the transaction and probe it accordingly?

A Letter to Regulators

In October 1993, the IRS apparently sent a letter to several insurance departments requesting information regarding the agency's ongoing investigation of UPS.

continued on next page

Insurance regulators and UPS case

continued from page 13

However, my repeated attempts to obtain specific information about this letter from the IRS and the IRS staffer—now retired—who initiated the letter proved unsuccessful. The IRS's letter was directed to at least one regulatory agency, the New York State Insurance Department, which crafted a response that was subsequently published by NILS *(New York State Insurance Department OGC Opinion 94-70)*.

The New York opinion responds to a series of questions by the IRS probing into the nature of the insurance transaction struck between UPS, NUF and OPL. The Department opined that under New York Law, UPS was acting as both an agent and an independent adjuster under this particular arrangement, and questioned the legality of the group policy issued by National Union Fire. To what extent other states were contacted by the IRS or responded to this letter is not known.

A Big Target

UPS is one of the largest shippers of packages in the United States. In 1998, on revenues of $24.9 billion, UPS reported $1.7 billion of net income. In addition, UPS collected as much as $208 million in annual premiums from the program. Wouldn't there have been at least a few consumer complaints filed somewhere to reflect a pattern of problems that, when scrutinized, would have given rise to the big picture insurance regulatory issues? Perhaps yes; perhaps no.

And what about the size of UPS's captive reinsurer? UPS continued to reinsure UPS until 1999. By the end of 1998, OPL reported net income of $488.3 million on revenues of $1.2 billion. Compared to many of the meagerly capitalized off-shore, unauthorized reinsurers, OPS was a behemoth. Didn't this significantly capitalized reinsurer show up on anyone's radar screen? Wouldn't an unauthorized reinsurer of this size, especially one owned by UPS, have raised some regulatory concerns. Perhaps yes; perhaps no.

Some may argue that it is difficult enough to oversee the operations of licensed insurers and that thousands of borderline insurance transactions occur every day that never register on most regulatory radar screens. However, regulators should be alert to transactions that may slip through the cracks, but still *significantly* impact on a state's residents or commercial enterprises. UPS was such a case; there may be others.

As for UPS's financial future — even if it somehow wins the case on appeal — there is one other sizable roadblock. As might be expected, lawyers representing UPS customers who felt overcharged by excessive EVCs have filed class action lawsuits against UPS. One such suit, filed in state court in Ohio, alleges that UPS effectively defrauded its customers by acting as an unlicensed insurer. The lawyers have asked for *$14 billion* in compensatory damages and will seek to *treble* these damages under a special Ohio law.

As Senator Everett Dirksen once said, "A billion here, a billion there, pretty soon it adds up to real money." ■

Welcome, New Members

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Marta Barela, NM
Opal W. Bennett, AIE, FL
David Crim, GA
Ann M. Fletcher, DE
John M. Ginley, ME
Kendra L. Godbout, Multi-state
Ted Greenhouse, MO
Melissa Sue Guinn, VA
Cathy Isadore, AK
Gina K. McBride, ID
Patrick McCann, DE
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Insurance Quote of the Month

"If they're not a quadriplegic, a paraplegic or losing some part of their body, there's no way I'm going to take that case."

—Plaintiff attorney Craig Hilborn explaining the criteria he uses to determine which liability cases to accept.

To learn more about the impact of rising jury verdicts on insurance rates, watch for the next issue of THE REGULATOR

REGULATORY ROUNDUP

**By
Stroock & Stroock
& Lavan LLP**

Congress introduces legislation that would further restrict the use and disclosure of consumer financial and health information by financial institutions

On Jan. 22, 2001, the U.S. Senate introduced Senate Bill 30, the proposed Financial Information Privacy Protection Act of 2001. Senate Bill 30 would amend the Gramm-Leach-Bliley Act ("GLBA") to prohibit a financial institution from disclosing a consumer's nonpublic personal information to an affiliate or non-affiliated third party unless the financial institution has first provided the consumer the opportunity to prevent, or "opt-out" of, such disclosure. This amendment represents an expansion of the existing opt-out requirement, which applies only to disclosures of nonpublic personal information made to non-affiliated third parties. Senate Bill 30 would also amend the GLBA concerning an insurer's receipt of a consumer's health information in connection with the decision whether to offer or continue offering a financial product. The Bill would require a financial institution to obtain a consumer's affirmative consent before obtaining or receiving individually identifiable health information about the consumer from an affiliate or non-affiliated third party. Senate Bill 30 would also give consumers new rights to access and correct information available to a financial institution. To view Senate Bill 30, visit **www.thomas.loc.gov.**

MASSACHUSETTS — Division of Insurance issues Bulletin regarding original equipment manufacturer crash parts

The Massachusetts Division of Insurance issued Bulletin B-2000-15 on Dec. 8, 2000. Effective since Jan. 1, 2001, the Bulletin permits all private passenger automobile insurers to offer an optional endorsement that provides for the use of original equipment manufacturer ("OEM") parts when replacing crash parts under Coverages 7, 8 and/or 9 of the Massachusetts Personal Automobile Insurance Policy. "Crash part" is defined in the bulletin to mean a sheet metal or plastic part on the automobile's visible exterior, including inner and outer panels but excluding a glass or mechanical part. "Original equipment manufacturer parts" is defined in the bulletin to mean new parts that are manufactured by or under the licensure of the original equipment manufacturer. The bulletin directs insurers to calculate OEM endorsement rates based on the formulas approved by the Division of Insurance in the decision issued on Sept. 29, 2000. The OEM endorsement may not be sold in connection with vehicles for which no aftermarket crash parts are available, or any vehicle for which new OEM crash parts are not available. Bulletin B-2000-15 may be obtained on Westlaw using the citation "MA Bulletin B-2000-15 (Revised)".

The New York-based Stroock & Stroock & Lavan LLP Insurance Regulatory/Corporate Practice Group includes Donald D. Gabay, Martin Minkowitz, William D. Latza, and Vincent Laurenzano, an insurance finance consultant. They gratefully acknowledge the assistance of Todd Zornik, law clerk. This column is intended for informational purposes only and does not constitute legal advice.

MONTANA — Senate introduces legislation that would restrict insurers' use of non-original crash repair parts

The Montana Senate introduced Senate Bill 86 on Jan. 3, 2001. The bill would prohibit an insurer from authorizing the use of a non-original crash repair part on a motor vehicle that is five years old or less, unless the insurer first obtains the written consent of the insured. "Non-original crash repair parts" refer to specified automobile parts that are made or remanufactured by a company other than the original manufacturer or its licensed affiliate. Senate Bill 86 would also prohibit, absent the insured's written consent, the use of a non-original crash repair part that is not certified by the U.S. Department of Transportation. Moreover, the submission by an automobile repair shop of an invoice for an original equipment part when, in fact, a non-original crash repair part was installed, would constitute insurance fraud. Any insurer, insurance producer or other person with knowledge of such fraud would be required to comply with the reporting requirements of Montana Insurance Code Section 33-1-1303. Senate Bill 86 has been criticized by some observers as being likely to contribute to delays in automobile repairs and higher prices for Montana consumers. If enacted, the Bill would become effective upon passage and approval. The Bill may be obtained on Westlaw using the citation "2001 MT S.B. 86 (SN)".

NEW YORK — Insurance Department issues Circular Letter regarding advertisements, referrals and solicitations on the internet

On Feb. 1, 2001, the New York Insurance Department issued Circular Letter No. 5 (2001) to address advertisements,

referrals and solicitations on the internet. The Circular Letter states the Department's position that the mere maintenance of a Web site containing information or advertisements with respect to specific insurance products does not constitute solicitation under the New York Insurance Law. However, if an insurance product referenced in an internet advertisement is not offered by a New York authorized insurer, the advertisement must include a disclaimer indicating that the advertised products are not available in New York. The Circular Letter provides that a disclaimer stating "not available in all states" would be sufficient. The Circular Letter also states that any advertisement that contains a recommendation by a non-licensee of an insurance product would constitute a referral. Referrals by a non-licensee to licensed insurance agents or brokers are permitted, subject to certain conditions (*see, e.g.,* recently revised Insurance Law Section 2114). However, the referral of New York residents to unlicensed agents or brokers is prohibited. Finally, the Circular Letter states that any insurer, agent or broker engaging in the solicitation of insurance over a Web site must be licensed as required by Insurance Law Sections 1102 and 2102. To view Circular Letter No. 5 (2001), visit **www.ins.state.ny.us.**

NEW YORK – Insurance Department issues Circular Letter regarding the withdrawal of approximately 400 circular letters

On Jan. 22, 2001, the New York Insurance Department issued Circular Letter No. 1 (2001) announcing the withdrawal of approximately 400 circular letters. The announcement follows an exhaustive review of all circular letters issued prior to April 1, 1997 for consistency with current Department policy and practice. Approximately 350 Circular Letters remain in effect. To view Circular Letter No. 1 (2001), visit **www.ins.state.ny.us.**

OKLAHOMA — Senate introduces legislation to ensure the fair transfer of payment rights under structured settlements

The Oklahoma Senate has introduced Senate Bill 545, the proposed Structured Settlement Protection Act of 2001. The Bill defines "structured settlement" to mean "an arrangement for periodic payment of damages for personal injuries or sickness established by settlement or judgment in a resolution of a tort claim or for periodic payments in settlement of a workers' compensation claim." Senate Bill 545 is intended to protect payees who choose to sell their right to payments under a structured settlement. For example, the Bill would require the proposed purchaser of structured settlement payment rights to provide to the existing payee a disclosure statement at least three days before the payee signs the transfer agreement. Among other information, the disclosure statement must include the following: the amount and due dates of the structured settlement payments to be transferred; the aggregate amount of the payments; the gross and net advance amounts; and a statement that the payee may cancel the transfer agreement not later than the third business day after the payee signs the transfer agreement. Senate Bill 545 would also prohibit the transfer of any structured settlement payment rights unless the transfer has been approved in advance by a responsible court or administrative authority. Senate Bill 545, if enacted, would become effective on Nov. 1, 2001. Approximately a dozen other states have already enacted similar legislation. To view Senate Bill 545, visit **www.state.ok.us.**

TEXAS — House introduces legislation that would require automobile insurers to offer mileage-based policies

The Texas House of Representatives has introduced House Bill 45, which would require automobile insurers to offer drivers the option of purchasing a mileage-based automobile policy beginning on Jan. 1, 2004. Premium rates used by an insurer under a mileage-based rating plan would be exempt from rate regulation under Subchapter A of Chapter 5 of the Texas Insurance Code and from the benchmark rates established under Subchapter M of Chapter 5. However, each insurer would be required to file annually with the Insurance Commissioner: (1) a schedule of premium rates for motor vehicle insurance based on the insurer's mileage-based and time-based rating plans; and (2) a statement of any fee to be charged to policyholders or applicants for insurance for participation in the mileage-based rating plan. House Bill 45 directs the Insurance Commissioner to adopt rules necessary to govern the following issues pertinent to mileage-based rating plans: (1) prepayment arrangements; (2) proof of financial responsibility; (3) auditing of the odometer of a vehicle for the purpose of determining whether coverage is in force; and (4) policy forms. The Insurance Commissioner would be required to adopt any implementing regulations by December 31, 2001. House Bill 45 is intended, in part, to reward insureds who drive less by charging them for insurance coverage based upon the number of miles they drive. According to news reports, House Bill 45 was recommended by the National Organization for Women, whose statistics show that women, as a whole, drive approximately half as many miles as men. To view House Bill 45, visit **www.state.tx.us.**

Editor's Note: The November 2000 edition of *The Regulator* featured an article on a mileage-based automobile rating system that was being tested in Texas by Progressive Casualty Insurance Company.

Baltimore Welcomes You!

by Debbie Rosen McKerrow
Director of Communications & Consumer Services
Maryland Insurance Administration

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Not far from the Inner Harbor, Baltimore's popular tourist attractions include the B & O Railroad Museum and roundhouse (home of the original Tom Thumb locomotive), the Baltimore Zoo, Port Discovery (an interactive children's museum housed in the city's former Fish Market), the Pier Six Concert Pavilion, Fort McHenry (birthplace of our national anthem), the Meyerhoff Symphony Hall, the Lyric Opera House and Morris Mechanic Theatre (both featuring Broadway road shows), the Walters Art Gallery, the Baltimore Museum of Art, the Great Blacks in Wax Museum and the Baltimore Streetcar.

Familiar attractions one might find in many international hubs are here at the Inner Harbor too, including Planet Hollywood, a Hard Rock Café and the ESPNZone (from which "ABC's Monday Night Football" airs its pre-game show).

Local transportation options include the conventional—taxis, buses, light rail and Metro subway—to the less common: water taxis, pedi-cabs, mock trolleys and horse-drawn carriages. There is even an amphibious conveyance that takes riders from city streets into the harbor for a tour!

Maryland's historic state capital, Annapolis—once our nation's capital, as well as home of the United States Naval Academy—is a short half-hour drive away. Calling itself the sailing capital of the world, the colonial town presents the opportunity to sit at the City Dock and watch everything from magnificent yachts to kayaks float by. Annapolis also offers many historic homes open to the public.

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If registering after July 1, add $40.00. No registration is guaranteed until payment is received by IRES.

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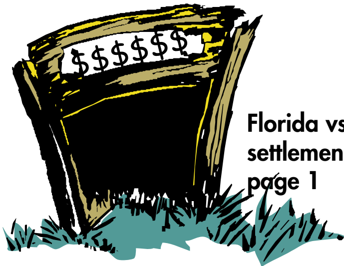
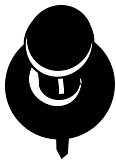


Florida vs. viatical settlements. Story, page 1



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√ The Texas Department of Insurance has a market conduct field examiner position available that requires a minimum of two years experience and an AIE or CIE certification. Contact TDI at 512-322-5073 or www.tdi.state.tx.us to apply or for additional information.

Virginia insurance regulator **Warren E. Spruill**, 53, of Mechanicsville, Va., died in an auto accident on Feb. 10. Mr. Spruill was employed by the Virginia Bureau of Insurance for more than 18 years, was a long-time member of IRES, and was both an attendee and participant at past CDS's. He was also active as a member of the NAIC's Producer Licensing Working Group and was a member of the Society of Insurance Licensing Adminstrators. Mr. Spruill served in the United States Marine Corps, was a former sergeant with the Richmond City Police Dept. and was currently working as the agents licensing supervisor for the State Corporation Commission's Bureau of Insurance.

√ Insurance Financial and Market Conduct Examiners — Arthur Andersen LLP, a leading international professional services firm, is seeking experienced insurance examiners to perform financial and market conduct examinations of insurance companies. The position requires travel and no relocation is necessary. Requirements include a Bachelors degree and two plus years of financial or market conduct examination, public accounting or other insurance audit experience. Accredited/Certified Financial or Insurance Examiner designations or CPA designation a plus. Significant opportunity for advancement. Salary commensurate with experience. Please submit your resume along with salary history and requirements to: Arthur Andersen LLP, Director of Human Resources, One Financial Plaza, Hartford, Conn., 06103. We are an Equal Opportunity/Affirmative Action Employer.

√ Do you have a regulatory colleague who deserves to be recognized? He or she could be the next recipient of the Society's **Al Greer Award**. Call the IRES office to get an award nomination form.

In next month's REGULATOR:

- √ **Jury verdicts and liability insurance rates**
- √ **The whys and wherefores of custodial agreements**