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CONGRESS, ONCE AGAIN, DEBATES INSURERS' ANTITRUST EXEMPTION UNDER MCCARRAN-FERGUSON ACT

by

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Senator Patrick Leahy – with bipartisan support – has introduced legislation to repeal the McCarran-Ferguson Act's antitrust exemption for insurance. Identical legislation has been introduced in the House of Representatives. McCarran-Ferguson debates in Washington are always great dramas of politics, power, revenge, envy and, every now and then, law. And these debates are also about a most critical element of a democratic free market economy: insurance. So, the outcome of this debate really will make a difference.

All of us think about insurance in the most personal of terms – our auto or homeowners or business liability policy. And all of that is just right. But there is another truth about insurance. And that truth is that the only way we can have a free market economy is if people are willing to take risks. And the only way that people will take risks is if they can spread those risks. That is what insurance is all about. Helping people and companies spread risk so they can take risk.

Here is where McCarran-Ferguson comes into the picture. Its underlying premise is that the only way insurers can safely spread risk is to collect huge amounts of information so they can make predictions about how costly claims will be in the future. With these predictions, they can then price the insurance policy. As insurance is a product whose true cost is never known at the time it is sold, the accuracy of these predictions can be the difference between the solvency and insolvency of an insurer.

In most instances, the only way insurers can collect these huge amounts of information is to work together, as no single insurer generally has enough information to do it on its own. This means sharing claims information, analyzing that information and predicting what that information will mean for the likelihood of future losses and claims. It also means working together to develop common insurance policy forms. It means creating mechanisms called pools to allow insurers to get together so that each insurer can take a small financial piece of a very big risk. And it can mean the creation and use of the consistent underwriting factors for their businesses.

The McCarran-Ferguson antitrust exemption allows insurers to do all these collaborative things – and more – so long as they are doing them under state regulation. The states set the rules, review and approve the

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actions, monitor the activities and take action to correct and punish when the rules are broken. The implicit deal is that insurers will be allowed to behave collectively or collaboratively in a stable, predictable legal environment, while the state regulators will make sure that the public interest gets served.

To antitrust critics, this collaborative behavior challenges all they hold dear. Antitrust principles are not about competitors getting together to cooperate or share information that goes into a price. Antitrust is about just the opposite. If what we learned in kindergarten was the need to share and cooperate, what we learn from antitrust law is that sharing and cooperating is a quick way to court or even jail.

Within an antitrust legal construct, therefore, it just seems wrong that insurers should get a special antitrust deal. So whenever there is a crisis in the insurance marketplace, those who are either antitrust activists or insurance industry critics call for the repeal of McCarran-Ferguson as the magic elixir that will cure whatever insurance related problem exists at the time.

In the 1980s, we were told by prominent senators that repeal would magically cure the sharp increase in commercial insurance premiums after the wave of massive product liability class actions that followed the improvident placement of swimming pool diving boards in shallow deep ends, or the construction of grammar school playgrounds that had dangerous equipment installed over gravel-covered ground. Last year, it was the “answer” to the scandal over bid-rigging in commercial insurance policies organized by a large brokerage house. This year, there are some in the Senate who believe that repealing McCarran would be the magic elixir to prevent claims disputes like those that grew out of Hurricane Katrina, or at least afford an opportunity for revenge against the misbehaving insurers.

That none of these issues was caused by McCarran or would have been prevented by repeal of McCarran’s antitrust provisions is rather beside the point. Nevertheless, since getting rid of McCarran’s antitrust provisions is so much an article of faith among the insurance industry’s critics it’s worth taking a little time to gain some perspective.

So how did we get here? In 1864 – so the story goes – the New York Underwriters Agency was established by one Alexander Stoddart. Through the underwriting agency, Stoddart organized insurers in a cooperative arrangement to share the risk of fire losses. At this time American cities were at the leading edge of an enormous growth surge and industrialization – and they had a bad habit of burning down. The Great Chicago Fire was only seven years in the future.

Stoddart’s cooperative arrangement has been called a cartel – and it probably was. And of course it was wholly legal – being decades before the federal antitrust laws were enacted. Working with the National Board of Fire Underwriters, Stoddart unsurprisingly sought a federal legislative solution. When that failed, they tried to get the same results in the courts by initiating litigation through a Virginia insurance agent, Colonel Samuel Paul, who refused to pay his state license fee.

Paul was challenged and the case went all the way to the U.S. Supreme Court. Paul argued that the states had no authority to regulate a business like insurance, which moved in interstate commerce. That power, Paul argued, resided solely with the Congress, under the Constitution’s Commerce Clause. The Supreme Court, however, concluded differently in a decision that seems rather odd to us, today. The Court – in its 1869 decision – held that insurance was so local a transaction that it didn’t even meet the threshold requirement for Congress to get involved under the Commerce Clause; rather it was only the states that could constitutionally regulate it.

So, now, the action moved to the states, and what followed was an uneasy compromise that the insurance industry would be allowed to have its cartels – mandatory risk sharing devices – while the states would be allowed to have review authority over the cartels. In a lot of ways this worked reasonably well for consumers, as well as insurers. But at the end of the Nineteenth and the beginning of the Twentieth Century, Congress passed the federal antitrust laws. These laws, inspired by public revulsion over other monopolies and cartels were designed to bust them up. But the one type of cartel they couldn’t get at was in the insurance industry because insurance – under the Supreme Court’s *Paul v. Virginia* decision – was not subject to federal law.

This changed dramatically in 1944, with the Supreme Court’s decision in the *South-Eastern Underwriters*

case. The *South-Eastern Underwriters* case had been brought as a criminal antitrust conspiracy under the Sherman Act, alleging that the members of an insurance rating bureau – a price-setting organization to which all insurers were required to belong – had engaged in a conspiracy to fix prices and boycott non-members. Thus, when the Supreme Court held that insurance was subject to Commerce Clause jurisdiction, the first piece of federal law to be applied was the Sherman Act and its antitrust regime with regard to the activities of insurers in creating and operating rating bureaus across the country to collectively obtain and analyze data, agree on prices, and agree on common policy forms.

The decision engendered a mad scramble in the Congress between June, 1944, when *South-Eastern Underwriters* was handed down, and March, 1945, when the McCarran Act was passed and signed by President Roosevelt. When enacted, McCarran had four principal themes. First, it reaffirmed the authority of the states to “regulate the business of insurance.” Second, it stated that “to the extent” that a state so regulated the business of insurance, the federal antitrust laws would not apply to it, except if insurers engaged in acts of boycott, coercion or intimidation. Third, it reaffirmed the premium tax authority of the states, which the states relied on and were convinced they were going to lose, if the bill didn’t get passed. And fourth, it gave the states three years from the 1945 enactment to meet the law’s state regulation requirements.

During that three year period between enactment and the 1948 effective date, the states enacted comprehensive insurance codes and state-specific antitrust laws, including state versions of the Federal Trade Commission Act. In enacting these insurance codes, there was arguably a “deal with the devil” between insurers and their state regulators. It has always been a matter of debate, however, as to who played the devil in the deal.

Here is how the deal goes. Insurers are permitted to engage in just about any collective activity they think they need without risk of disruptive antitrust litigation, but the price they pay for this protection is government price controls over what they can charge for their products in the marketplace. This is particularly true with regard to property/casualty insurance. While public policy in just about every other industry has been to eliminate government price controls, state government policy for insurance has been just the opposite – focused around price controls. If this fixation on price controls has not been to the exclusion of everything else, it certainly has risen above everything else.

The use of McCarran as a cure-all to any perceived insurance problem became such a constant irritant – and perhaps threat – to the insurance industry that during the early 1990s, the American Insurance Association (AIA) began an effort to get rid of the issue by initiating negotiations with the House Judiciary Committee to overhaul McCarran. Under that overhaul, the industry would trade the general McCarran antitrust exemption for targeted “safe harbor” antitrust exemptions. Those negotiations, which included the Consumer Federation of America, resulted in an agreement in the summer of 1994, which was incorporated into a pending bill, H.R. 9, that was then favorably reported by the Judiciary Committee.

Most non-AIA insurers – especially smaller ones – opposed the H.R. 9 legislation. They argued that the safe harbors might not be safe enough, and that if they were not, the overwhelming majority of all smaller insurers would be put at a competitive disadvantage or put out of business. They argued that as smaller companies, with smaller databases, they couldn’t survive without all the collaborative activities: data sharing, common policy forms, forward looking analyses and predictions about future claims patterns. This effort stalled when control of the House shifted in the 1994 mid-term elections.

Now, thirteen years later, control of Congress has changed again. And the McCarran issue is back, too. But now there are four new twists. First, there seems little initial interest in Congress in discussing safe harbors; rather the bills would provide for a flat repeal of the antitrust exemption. Second, the repeal effort has developed some bipartisan support arising from the fact that many Gulf States Senators and Representatives of both parties believe that McCarran’s antitrust provisions are at the root of the problems their constituents had with their insurers after Hurricane Katrina. Third, there is the movement in the industry toward federal insurance regulation, which would eliminate the McCarran antitrust protections for insurers that chose the federal charter, but provide them with a quid pro quo: the elimination of government price controls on their products. And fourth, the association that represents all the state insurance commissioners, the National Association of Insurance Commissioners, may be softening its historic opposition to any change in the McCarran antitrust exemption.

So, this brings us back full circle to Senate Judiciary Committee Chairman Leahy's new bill to repeal the McCarran antitrust exemption. It is co-sponsored by the Ranking minority member of the Committee, Senator Arlen Specter, and is supported by among others, Senator Trent Lott. The Committee held a hearing recently where everyone took their predictable positions, except for the NAIC, whose testimony suggested that the state commissioners may accept – indeed may welcome – the imposition of federal antitrust enforcement against insurers. This startling change in position has floated totally under the radar screen, but at some point the radar alarm will go off. The industry has united against the repeal bill and has sent a unified letter expressing its opposition. This unified opposition may well work—but the pressures are unlikely to let up any time soon.

There are three ways that those pressures might be manifested. The first, of course, is by having a bill reported out of the Senate Judiciary Committee. Senator Leahy may well have the votes to do that right now, but it would be unusual, to say the least, to have such an important bill voted out of committee without it first having been vetted by the Antitrust Subcommittee, whose chair, Senator Herb Kohl, of Wisconsin, has not signaled that McCarran as an issue for him. However, just having a Committee reported bill that could be brought up in the Senate at any time would be a continuing threat.

A second way is by bringing pressure to bear by holding up other important insurance legislation, most likely the extension of the Terrorism Risk Insurance Act (TRIA), which was passed in the wake of 9/11 and has been extended once, but will expire at the end of the year unless reauthorized. It only takes one Senator to put a Hold on a bill.

A third way would be by throwing a lot of insurance issues – among the candidates would be TRIA, federal regulation, Natural Disaster legislation and McCarran – into the political Osterizer at the same time. Although unlikely, there have been hints from time-to-time that this might happen.

Having described these problems, there is one potential – albeit long shot – way out of the dilemma. It is the “Optional Federal Chartering” (OFC) legislation. Under OFC, the McCarran antitrust protections would go away for those insurers that chose to become federally regulated, while the McCarran protections would remain for those insurers that would choose to remain state regulated.

This legislation was introduced in both the House and the Senate in the last Congress and is almost certainly going to be reintroduced in this Congress, and may have more supportive committees dealing with it this time around. It is a complex piece of legislation, but on the antitrust issue it offers the opportunity for a grand bargain. While the federally chartered insurers would get rid of state regulation and government price controls, they would, in return, become subject to all the federal price fixing antitrust laws. The result would be that if OFC were enacted, the larger insurers would be likely to opt for the federal charter, thus losing their McCarran antitrust protections, while the smaller insurers would be likely to opt for retaining their state regulation, thus keeping all the McCarran antitrust protections they have now.

This type of compromise could work for everyone, but key actors in the debate, including the anti-McCarran Senators, may not have much interest in pursuing it, right now. If, however, at the end of the day it looks like the McCarran antitrust exemption is really in jeopardy – with continuing legislative attacks that cause disruption and dissension in the insurance industry – this long-shot may start looking a lot more interesting to all sides of this divisive debate. After all, the possibility of everyone winning a little and losing a little – while staying alive for tomorrow – is generally better than a gamble that your opponent will be the one to bite the political dust. Because, the order of mortality – even for insurers – is tough to predict.