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Market Conduct Issues for Small Companies

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Summary: A short section business meeting provides an effective opportunity to network. The panel discusses the implications of marketing ethics on smaller companies as they relate to large company sales practice litigation. Implications of market-conduct reports and other industry surveys will also be discussed.

Ms. Norma Y. Christopher: I'm the vice president and chief actuary at Cotton States Life in Atlanta, Georgia, and your outgoing chairperson, and I'm going to be turning the reins over to John Wade, who's the executive vice president at American Memorial in Rapid City, South Dakota. We both wear many hats, just like most of the people in this room. We have many members who have served on the council and have done an excellent job. Outgoing council members are Jim Pilgrim and Jim Van Elsen. Jim has helped us a lot with issues with the National Association of Insurance Commissioners (NAIC). We appreciate his support, and I hope that he continues to do that for us. We have three new council members this year: Rod Keefer and Stephen Marco, who are not here, and Lori Truelove from BMA, who is here. She's going to be the Program Chair for next year's annual

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meeting, and she's going to be working on setting up small-company sessions next year. The other officers for next year, in addition to John Wade, are Chris DesRochers, the Vice Chair, and Jack McKay who is the Treasurer and Secretary. The other Council members, who were already on the Council and will still remain so for another two years are Norm Hill, John O'Sullivan, and Paul Sulek. Other members who do a lot of work for us who aren't actually on the council are Jim Thompson, who's done a great job as the editor of the newsletter *Small Talk* but is not here with us, Carol Marler, the Spring Program Chair, and E. Perry Kupferman, who served for several years as the Annual Program Chairman, and has done a great job as well.

We're going to be talking about market conduct, and we have three speakers, of which two are attorneys. I don't know if you can handle that this early. They're probably so tired of lawyer jokes, but not any more tired than we are of actuary jokes. Our first speaker is Wayne Schrader. He joined Gibson, Dunn, & Crutcher in 1976, and has been a partner since 1983. He is a member of the litigation department and has extensive experience in defending insurers and other financial institutions in a variety of matters, including consumer fraud, class actions, individual fraud, bad faith, breach of contract cases, white-collar criminal prosecutions, and insurance coverage disputes such as daily bonds, environmental claims, and errors and omissions (E&O) coverage.

He also has extensive experience representing employers in employment-related lawsuits and proceedings. Recently, he has had a variety of experiences in different consumer fraud, price fixing, and anti-trust actions filed in federal and state courts in Alabama, California, Mississippi and Colorado. He recently represented a subsidiary of Chase Manhattan in a civil false claims act proceeding brought in federal court in Mississippi. This year he spoke at the ACLI meeting on the topic of litigating agent fraud claims in Alabama. He's also served as an instructor for the National Employment Law Institute Trial Advocacy Program. He has a long list of clients, and he's helped many insurance companies. He's going to speak to us about some of the terrible things that can happen, and some of the good things that have happened.

Mr. Wayne A. Schrader: I wanted to share with you my thoughts on where I see sales practices and market conduct litigation heading in the future, what kinds of developments I think we're going to see based, of course, on my experience, however limited or extensive it may be, and then to field any questions that you may have on that topic or any other. I want to talk first about the subject of class actions and where I see that area heading in the future, specifically market conduct or sales practices class-action litigation.

We're, of course, all aware that there have been many sales practices class-action cases filed against insurers over the past five years or so, and that there have been a good number of settlements of class sales practices litigation within the last two or three years. I think, as we look into the future, that there is a significantly reduced threat with respect to class-action litigation. And why is that? Because over the past year or two, the judiciary, mostly the federal courts, have begun to issue decisions that cast great doubt on the viability or the ability of the plaintiff's bar to bring sales practices or market-conduct litigation in the form of a class action.

Many of these cases have been outside of the context of insurance company market practices litigation, but the principles that the U.S. Supreme Court and the various other federal courts have enunciated apply to the sales practices litigation. In essence, these courts have said that cases that are based upon fraud or misrepresentation theories are not appropriately brought as class actions because the individual transactions, the damages, and the reliance issues are so incredibly individualized that these cases lack what's called the commonality or the typicality that is necessary to bind together all of these transactions and to make appropriate a single resolution of the issue of, for example, whether there has been a misrepresentation, whether somebody really did rely on it, the extent to which they relied on it, and whether or not somebody has been damaged.

In very recent times there have been some decisions by courts specifically confronting the issue of whether a market practices or sales practices case can be brought as a class action, such as the case by Judge Keaton in federal court in Massachusetts. I wasn't involved with it, but it's Guardian Life, I think, in which Judge Keaton wrote a very thorough and thoughtful opinion in which he said these kinds of cases cannot be pursued as class actions.

What does that mean? Well that means that the ability of the plaintiff's bar to threaten the company with the prospect of a class action and a class-action determination is substantially reduced. It's not completely eliminated because, as I'll get to later, the plaintiff's bar has the ability to bring these cases in state courts, and there are still some state courts that, for a variety of reasons—some of which are legitimate and some of which might not be legitimate—are willing to recognize these cases as class actions. But I think the basic message is that companies will, in most instances, be able to successfully defeat efforts to litigate their sales practices or market-conduct issues in the class-action context.

That may be good news for some, but for others, it could be bad news, depending upon how you want to address your market conduct problems, because the corollary is that it will become more difficult to settle your market conduct or sales practices problems or issues in the form of a class-action settlement. Obviously,

some of the larger companies have thought it was to their advantage to try to address their sales practices problem, if you can call it that, in the form of a class-action settlement, which allowed them to go out to all of their policyholders and to offer them some form of relief from whatever wrong the policyholder may believe was done to them in the context of either the sale or the replacement of a whole variety of different products.

Some companies have thought that it's in their best interest to try to wrap up their problem in that fashion as opposed to proceeding as cases come through the door and complaints are made, addressing and settling them on an individual basis. That option may be taken away from companies now because the federal courts may not let you settle your problem on a class basis. That doesn't mean, obviously, that companies can't generate programs of general application to try to reach out to policyholders to determine whether they're dissatisfied and felt that some wrong had been done to them and to try to address this through—I don't know how to describe it—processes that are of general application. There are, of course, a number of companies that have gone out and taken affirmative steps to reach out to every single policyholder, meet with those policyholders, and to determine whether there has been a perception of wrongdoing. Manufacturer's Life is a classic example of a company that systematically has reached out to people. But you won't be able to do that and wrap up the resolution within a so-called class-action settlement, which then theoretically bars any future cases filed after you've made that class-action settlement.

The class-action settlements, therefore, are probably more difficult to obtain or to sustain; that's the corollary to the removal of the threat that someone's going to haul you into court and litigate your sales practices conduct on a class basis. The two go together. I think, by the way, that the jury is probably out as to the wisdom of class-action settlements because I think it's very difficult for the companies that have entered into class-action settlements to figure out, at this point, whether there has been a net gain through that process, because I don't think many of them have figured out yet what the true cost of these settlements will be as they're being implemented. In addition, I don't know if the companies have been able to evaluate the effect of those settlements at this point in time on the satisfaction or happiness of the policyholder, whether they've received it well or whether there's any net gain in terms of the reputation of the company. And I don't think they know yet, and may never know, what the effect is on the producers, whether producers are unhappy and taking the view that this company's settlement was not sufficient, or adequate, didn't help me out with my clients and customers, and I'm not doing business with that company anymore. That's sometimes the downside of some of these settlements if you buy them too cheap.

Having said that, because these developments in the class-action area have been primarily in the federal court, I think there will be a renewed interest or an increasing interest on the plaintiff's bar in trying to haul companies into some of the state courts that are still recognizing the ability to bring these cases as class actions. And what do I mean by that? There has always been a certain degree of class-action activity in the Alabama state court, although, for a number of years the plaintiff's bar hated to bring cases as classes in Alabama because they preferred to pick you off on an individualized basis and get huge punitive damage awards. What's happening in Alabama now is that the Alabama Supreme Court, somewhat sensing the political winds, is cutting back substantially on the ability of plaintiffs to get hideously large punitive damage awards.

The plaintiff's bar is now saying, OK, if we can't get the really big dollars in the individual case it's no longer cost-effective. We'll now turn our attention to some of these rural judges, for example, in Green County, Alabama, who will certify any case that comes through the door as a class action. We may go that route because we can't get the class action in federal court. Maybe we can't get punitive damages in the state court, but we can still threaten these companies with huge class-action verdicts in Green County, Alabama. If you haven't been there and you're an insurance company, you would appreciate the threat of litigating in Green County, Alabama. So I think there will be more and more cases filed in Alabama.

There are some state courts in Wisconsin and Missouri that are extraordinarily favorable to the plaintiff's bar and give them whatever the plaintiff's bar serves up. I think there probably will be an increase of class- action filings in those state courts. Where that's all going to end up, I can't predict because ultimately the supreme courts in those states will have to address the issue of whether what the trial judges are doing, i.e., certifying these cases, is appropriate. They will look ultimately to the federal precedent to decide whether these classes are appropriate. So I'm hopeful, at least, that they will follow the federal guidelines and precedents in evaluating their own state class-action laws. That's class actions.

Let me move on to developments that I see in what I'll call individual actions, the kinds of cases that I think will be brought, and the kinds of legal theories that I am seeing the plaintiff's bar developing. By the way, the plaintiff's bar, in these kinds of cases, is becoming increasingly sophisticated. They're learning every day about these products, and developing greater insight in terms of how the products are built, priced, and so forth, and this is in part because of the class- action litigation that has caused many law firms on the plaintiff's side to become very knowledgeable in the areas of product development, pricing, dividends, establishing of dividends, and so forth. These plaintiff's lawyers have formed alliances.

First of all, the best plaintiff lawyers have been drawn to the insurance side because there's a lot of money to be made there. They've moved from the securities litigation, where they became very sophisticated, into this area of market conduct, so you have some very, very smart lawyers who have formed alliances that stretch throughout the country, and they're teaching each other about these products, and, as they teach each other, they're sitting around dreaming up new ways to assault what you're doing or have done with your products—the way you priced them, the way you've established dividends, and so forth. You will encounter this increasing development of theories and say, you know, I never thought of that. These guys are good. I'm not saying they have good theories, ultimately, but they're very sophisticated. And so, you have to try to stay one step ahead of them.

Stepping back for a minute, from that thought, I'm seeing an increasing judicial willingness to honor the written contract and the written disclaimers that are provided to policyholders in the sales process. What do I mean by that? That's really very simple. More and more courts are rejecting individual cases in which there's a fraud theory posed: where the fraud theory is inconsistent with the written disclaimer or discloser, the sales illustration disclaimer, and the fact that the contract itself says that premiums are due for life or whatever the fixed period is. There's an increasing willingness on the part of the judiciary to accept the position that they're not going to allow fraud cases to go forward based upon alleged oral assurances by the broker or the agent that are inconsistent with the written materials given to the policyholder.

There was an earlier period when judges were letting these cases go and not throwing them out on what we call summary judgment. In actuality, the judges were saying, this product is so incredibly confusing that I don't understand it, I can't believe the policyholder understood it, and if that agent made some sort of oral representation, I think this plaintiff ought to get his or her day in court. We saw many cases moving forward. And now we're seeing it cycle back somewhat, where the judges are saying, wait a minute, the company made a legitimate and good effort to communicate in writing the terms of this policy or this deal. What are we doing if we open this thing up and allow oral evidence to vary or contradict the writing?

How can the company ever keep itself out of court? Where's the end to this litigation? We're seeing it cycling back in a number of decisions in several states, including Alabama state courts, where the court is saying, no, you can't bring that fraud theory because you have the illustration and it has a disclaimer, or your contract says that premiums are due for X number of years, and we're not going to proceed on a fraud theory claiming that your agent said you only have to pay for five years, six years, seven years, or whatever. In addition, the courts are

increasingly willing to bounce these cases on statute-of-limitations grounds by saying that whatever the agent may have said to you back in 1991, the written materials that were presented to you should have put you on notice that there was a variance, and if you were somehow euchred into this deal, you should have brought your case in a timely fashion. It's now six years later and assuming you're in a state where there's a three- or a four-year limitations period—or Alabama, where it's two—you're not going to bring this case.

The agent has disappeared off the map, we can't find him, and, besides, how do you expect the agent to even remember a transaction six years ago? There is an increasing willingness of the courts to say, you have to bring that kind of case on a timely basis within our statute of limitations, or you need to show, in order to gain the right to bring this case, six, seven, or eight years later, that there were affirmative efforts made to hide the fraud; that if you had written to the company and said, what is the real deal here, the company had to have lied to you again or misrepresented the circumstance to you. So I think there's some hope there, in terms of the judiciary being willing to honor the written contract or the written disclaimers and throw these cases out.

There's an increasing willingness of the judiciary to take control over punitive damage awards too. That will reduce the incidence of the filing of cases that are more on the extreme, where people were just filing them hoping they could get some sort of punitive award, even though there was only a nickel's worth of economic damage. Even in Alabama, the supreme court has shown a significant willingness to cut back on punitive damage awards. This is the product, fundamentally, of the Supreme Court. The efforts at the Supreme Court level have established a standard for examining the appropriateness of punitive damage awards. We have the BMW case, in which the court started talking about punitive damages that are beyond a ratio of two, three, or four times the real economic damages as being inappropriate, which brought a dose of reality to these insurance cases because many times it's difficult to show substantial economic damage in many of these market conduct cases and sales practices cases.

If you can't show large economic damages, the courts are willing to say, then you're not getting punitive damages that are in excess of two, three, or four times the economic loss. That just cuts the legs out from a number of cases. The federal courts have shown a great willingness to cut back punitive damages, and as I say, now Alabama, and even the Supreme Court, is telling the plaintiff's bar that the times are changing. And I think that's good news.

Now, what's the effect of all this? The plaintiff's bar dreams up new theories and new approaches and tries to end run this whole process. I'm seeing an increasing

resort, on the part of the plaintiff's bar, to bringing cases under the various state unfair business practices, deceptive trade practices, and unfair insurance practices laws in those states where you can bring a private cause of action.

Of course, New Jersey just recognized that you can bring these cases as a private cause of action under their statute. California has, for years, allowed private plaintiffs to bring cases that are almost either of an actual class- action nature, but to bring cases that are of a quasi-class-action nature.

Why do they bring them under the deceptive trade practices statute? Because in many states, they don't have to show that the company intended to mislead anyone. With respect to the presentation, they simply need to show that it had the potential to confuse or mislead the customer, whether intended or not. They don't have to show what we think of as central to the fraud case, the intent to mislead people. That's true in California. I'm virtually positive it's true in New Jersey, and I believe it's true in Texas, and a number of states where they have these laws, so it substantially reduces the plaintiff bar's burden to prevail in these cases.

In addition, these cases shift the focus from whether there was an effort to mislead to the question of whether there was sufficiently conspicuous disclosure. And so even if you disclosed or disclaimed, they started focusing on whether it was sufficiently conspicuous and pointed so that the policyholder would fully appreciate the consequences and the meaning of the disclaimer.

In California, and it may happen in other states, the plaintiff's bar can bring a case against your insurance company without getting it certified as a class action, and yet, purport. An individual plaintiff can purport to represent all of your policyholders in California in pursuing against you a deceptive trade practices claim, and can literally seek to recover damages for every one of your policyholders, based upon a theory that says that your presentation to that particular plaintiff was misleading or confusing. They don't even have to get the case certified as a class action. The California statute lets them assume the mantle of a private attorney general. And so I think we're going to see an increasing resort to that kind of case.

What's the threat of those cases? The threat of those cases is not only damages, but the threat that some court can say, well, I think everybody ought to have the option to rescind their deal as the relief for this thing, and we're going to send out a notice to everyone that says, if you think you were confused, and we have found these materials to be sufficiently misleading, then you should have the option to rescind your deal with the company.

There has been an increasing effort on the part of the plaintiff's bar to attempt to characterize the agent and the company as the fiduciary of the policyholder or the insured. What does that mean? They're pushing a theory that says the company somehow has the obligation to advise and to evaluate the appropriateness of this particular insurance transaction for this particular policyholder. What does that mean? Maybe it's obvious but, for example, the company has the obligation to assess the suitability of this particular kind of insurance for this particular kind of policyholder. And the way they try to get to that theory is by establishing that the company or the agent is somehow a fiduciary.

Many courts have refused to recognize that. I think it's a dangerous area. There may be a breakthrough in what I think of as a fairly important case in San Francisco against the Prudential. Merrill Lynch is also a party to that case. I think it's very dangerous for the large brokerage houses too. This case was brought by a premier firm in that town that normally represents defendants, so they're elite lawyers and they're going to push hard on this case. The whole theory of the case is that they're trying to hold Prudential to an obligation to have advised people with respect to, for example, whether they should have been put into universal versus a whole life product versus some other kind of product. I don't know the facts of the case that well, but I picked up a copy of the complaint and read it and a bunch of cases against that firm, and they're really creative. I can see where they're trying to go with this thing, and I think it's a dangerous area. I'm worried that, like I said, if there's a breakthrough, two or three judges may adopt this theory and somehow it becomes the law of the area, and the plaintiff's bar then runs around the country saying, look here, the judge in federal court or superior court in San Francisco said these firms have some obligation to advise these people.

I think they might try to pin that obligation on the company vis-a-vis the unfair trade practices law without calling it a fiduciary responsibility or obligation. They will simply say that, under the unfair trade practices act, you somehow have some obligation to assess what I call the suitability or the appropriateness of the transaction. That's a very disconcerting prospect because I don't know how you'd do that, and the problem is compounded if you don't have captive agents and you're dealing with brokers. I suppose, in your underwriting process, you can begin to do it in a really close way, but to me it probably jacks up the cost of underwriting the transaction tremendously. You'll hear more about that whole area, though, from the other panelists.

Let's move on to the assault on dividend practices. Some of the plaintiff's bar have shown a real interest in trying to pick apart and figure out a way to assault the company dividend practices. I don't have a case yet in which they've directly assaulted it, but they're writing about it in their briefs and they're talking about it in

private meetings enough that I know that people like Mel Weiss, who was one of the premier securities litigators and has brought so many of these class actions, is trying to dream up ways to attack, literally, the way the company sets and pays dividends.

Ultimately I think he knows that he has a problem there because of the corollary or the parallel on the business—you really can't attack the way dividends are set in a company under the business judgment rule that applies on the corporate side where you're setting dividends for a corporation, unless you can show that the company has somehow varied from its own written standards with respect to how dividends are set, or there has been some sort of self-dealing in the setting of the dividend.

But Mel Weiss is out there trying to figure out how to attack the way companies set dividends. There's one other obvious way to go at this. I guess this isn't a dividend issue as such, and I don't know why I put it under this, but I suppose many of you are familiar with the cases out there that have attacked the companies that assign the cost of the deferred acquisition cost (DAC) to the cost of insurance. Maybe you went over this last year, but I'm just seeing Mel Weiss, and for every case I have he's looking at that issue.

And where is that going? This looks at the question of whether your cost of insurance practice was consistent with your policy because the policy in that case said, basically, that the cost of insurance will be driven by mortality experience, and the company tacked on the DAC tax cost. The court found, as a matter of law, that was inappropriate because it wasn't consistent with the way you described how that would price your insurance and your cost of insurance.

Now, I see Mel Weiss and some of these better plaintiff lawyers sitting down with these policies and seeing if companies have written statements of the way they calculate their dividends. I know in Canada, Mony Life has to publish a dividend policy, and I must confess I don't know if in the U.S. you're bound to have a published dividend policy in terms of how you set it. But they're going to try and find a way to say, somehow, that the way you're doing it is inconsistent with either what they thought somebody might glean from the way the policy reads, or, if you have your own internal standard for setting dividends, then they're going to try to say that you're not even following it; therefore there's a cause of action on behalf of the policyholder if you varied in a way that they say lowered the dividend, or if you varied it from what it would have been. I think people have to sit down and start to look at their policies, look at anything they said about dividends, and then look at the way they're constructing them, and make sure that they're not giving somebody an opening there.

I don't know how to express the issue any better than that. I'm not sophisticated in this area, but I've seen the way these guys operate on the plaintiff side; that they're going to go after that. You really want to sit down and take a hard look at what you put out there to the policyholder in describing dividends, and what you may even say in a formal way, internally, with respect to how you're supposed to construct the dividend, and make sure you're living up to that. If you're not, take a look at why you're not and whether you're open to attack there. That's dividend practices.

Shifting gears, I guess this is a sales practices issue. In California, there's a case that I'm involved in right now in San Francisco. It involves about 30 different companies. It's brought by the same firm that is bringing that case against Prudential that I just mentioned, which is trying to say Prudential and Merrill have a fiduciary responsibility to analyze the suitability of transactions.

This case that they're bringing, and many of you may have heard of this, I'll call it an assault on the delivery in good health provision. What's the attack in the case? The plaintiffs in this case figured out that maybe most if not all companies deliver policies through their company operations division (COD), in some circumstances, where you don't have a automatic binder to the insurance.

Many policies are issued so that they're only effective upon delivery in good health and the receipt of the premium. These plaintiff's attorneys hired a broker who went through about 30 different companies' policies, and they figured out that many of these companies set the policy date on these things. Some of them actually set them on the date they issue the policy. Some of them tried to set it maybe seven or eight days or two weeks hence. But the net effect of it is that many of policies get delivered after the policy date.

In some cases, for whatever reason, there are examples where the policy gets delivered a month after the policy date. The plaintiff's theory is that you calculated the premium as though the insurance was effective from the policy date; you hand delivered this to the policyholder, he or she didn't really figure this out, but the first premium they paid only bought 11 months of insurance instead of 12. That's a deceptive trade practice, and it's an unfair trade practice. You're confusing the customer and charging them insurance for a period in which you were not incurring risk.

Now, you clearly weren't on the risk from the policy date in virtually every case. The companies have had situations where they denied coverage, where somebody died before delivery but after the policy date. There's almost no question that the company would deny that it was on the risk because the delivery in good health clause says you're not on the risk. Anyway, they're bringing this case, and it looks

like the judge is going to let the case go forward. They're only suing 30 companies. I don't know why they're only suing 30.

This same theory applies to anyone who has delivery in good health clauses. Part of the claim in the case is that you have a liability, which is the amount of the premium, for what they call this lag period between policy date and when it was delivered and became effective. And so, they're asking for that recovery. Anybody who has delivery-in-good-health clauses should be aware of this case because if it goes forward and it's successful in California, it's going to get played out in a number of other states, and it will become a class action in Green County, Alabama, and so forth. You may want to look at the practice, and how you will justify that practice, or how you want to characterize it. I see that as a fairly significant case, although I don't think many companies are aware of its existence at this stage.

I guess Phil Stano's group may have sent out a heads up to its members on this. I haven't seen it if it's gone out. But I think of that as a sales practices type of issue, and I wanted to give everybody a heads-up that it's out there. I'm only aware of it in California, but this same group can sue any insurance company that they want to sue in California. They don't even need to have a customer of your company, they can just name any person in California as the private attorney general and bring this case and proceed to try to get this relief. They're going to litigate this case through, and if they're successful, my guess is, they have complaints set up for every company they can think of that's doing business in California. They will walk into whatever appropriate superior court in California and sue the remaining companies on this same theory. It only applies in California, but there's no reason that they're not going to export it or the theory, won't export to other states.

From the Floor: If you're licensed in only one state, and it's not California, Alabama, or Wisconsin, then how concerned are you?

Mr. Schrader: Significantly less concerned on all of these issues that I talked about. I don't know how to answer it other than that.

From the Floor: You have some exposure, though, right?

Mr. Schrader: Sure.

From the Floor: If one of your policyholders moves to California and later decides to come after you?

Mr. Schrader: Probably, yes, I know. The premiums are paid in California. There's an issue, though, of whether they actually have jurisdiction in California over that claim because it arose in a different state, and the payment of the premiums may not give them a sufficient constitutional nexus. I'm litigating that issue right now in Alabama; rather, I have a case in Alabama where somebody from New York came down. There is a legal issue there that I think you might prevail on. Certainly on the last kind of case that I'm talking about, you're not. I don't think they can bring that case, in California, because I think it's the payment of that first premium that is the basis for the case. Although I can come up with an argument that, at least for people who lapsed, somehow they should have had an extra 30 days coverage. On the other end, if you delivered it 30 days late, and you lapse them, their argument is, I actually had 30 more days that you owed me. But that's a much smaller group.

From the Floor: In all the different facets of your talk, do you feel there's a difference in the liability of the company, depending upon the agency relationship, whether it's career, brokerage, general agency, managerial, etc.?

Mr. Schrader: I think the answer is yes. I forgot to mention, first of all, that this may not be strictly liability. I think it's harder for someone to sustain a class action against a company that operates through independent brokers because it's harder to say that you command your forces on a uniform basis to go out and rape, pillage, and plunder. Because there are people out there who're just not going to show communications with your brokers. For example, one of the problems Prudential had was that there was apparently some evidence that suggested they had, on a systematic basis, told their captive agents to go out and replace business.

I had never seen anything like that with a company that operated through independent brokers. Now, I'm not saying it doesn't exist—I notice people are starting to look at each other kind of funny in the room—but it's much harder to say that you operated on a uniform, systematic, and consistent basis. So, as to class actions, it's more difficult.

In addition, I've got a case in Michigan right now that has just been filed. It has about $30 million of face value involved, and the guy who sold the policies is alleged to have misrepresented the premium payment period. It's actually UL, so it's slightly strange, but it turns out the broker was on the payroll, as a business adviser, of the insured.

He had an appointment as an agent for purposes of placing and binding our company to the policy. But there's been an increasing willingness of the courts to say, wait a minute, this broker might be more of an agent of the insured for purposes of assessing things like suitability. Let's assume we're going to get to the

suitability or the appropriateness issue; that the insured really asked the agent to shop around and look at about four or five different companies. What about something the agent did in terms of trying to peddle the policy, particularly if there are misrepresentations alleged that are verbal, or in this case, the broker constructed his own charts and presentations and wasn't using company product, the standard illustration, to sell it? I'm going to argue that whatever he did was as the adviser of the insured.

Now, this is a double-edged sword, because as your brokers think you're cutting them loose on these policies, you can have some repercussions there. But, if he did it, and I don't concede that the guy actually did anything wrong, the argument is, he's not our agent for purposes of making those kinds of representations and giving advice with respect to whatever UL was appropriate in this context versus a joint and survivor whole life or a mixed kind of whole life with a term rider type of policy. And so, if that guy was our captive agent and our employee, I probably would have a much more difficult time making that argument because we'd probably end up embracing the guy for everything he does.

I don't think I can make that argument. So there's some room to argue, in some kinds of cases, where it's what I call a broker, even though they're appointed. The states, if you look, say they're an appointed agent. In Alabama you don't. The guy is appointed an agent, even though he's a broker. I think of him as a broker.

From the Floor: You know the Metropolitan Case out of Tampa, Florida, don't you?

Mr. Schrader: No.

From the Floor: Well, this substantiates your argument because there's some sort of Metropolitan manager hooked on the idea of working the nurses' associations all over the state and the country, and selling ordinary life for their pension plans.

Mr. Schrader: Oh, I'm familiar with that case, but is he an employee?

From the Floor: Yes, I think so.

Mr. Schrader: Met, they're stuck with him.

From the Floor: A direct employee of the Met.

Mr. Schrader: Theoretically, they should be stuck with him. But if it's a broker relationship, and the broker is making these representations, and there's no way that it's based on materials that you've put out, I think you can develop an argument that

says he's not our agent for purposes of those presentations. He can bind us, obviously, by delivering the product, and bind the company, but most of it may depend also on the particular relationship between the broker and that insured. For example, if the broker went to that insured with the idea of selling one product, yours, and doesn't sell a variety of products, and didn't present two or three other options, the argument becomes more difficult. If the broker has a preexisting relationship, though, to that policyholder, and indeed placed some other company with him ten years ago, and went back to show them your company, and they got three or four other quotes, then I'm making that argument. Some judges are willing to accept that, and it's appropriate that they would do that. So, yes, I think there can be a real difference.

From the Floor: How much of this class-action suit has filtered down to the smaller companies, those with less deep pockets?

Mr. Schrader: My impression is much less of it, and perhaps, for obvious reasons—although I confess, I don't have a list, and I haven't checked Phil Stanno's list, but the suits that I know of are against companies that I certainly think of as very large. Where the breaking point is between big or small I don't know. I don't represent that many is, but I do represent some, and none of them have class actions filed against them.

From the Floor: You talked about the agents soliciting the companies. What about the agents of other companies soliciting against the companies that have had class-action suits. Is that a no-no? If people are upset with some of the companies because of this, then why not go after them? Maybe they've gone after the smaller companies. Why not do it the other way around?

Mr. Schrader: Do you mean telling the policyholder that you don't want to do business with this company because it's obviously a bad company?

From the Floor: I wouldn't go that far.

Mr. Schrader: That's the directly stated message, whether or not that's appropriate.

From the Floor: It's probably not inappropriate, but all's fair in love and war, and selling life insurance.

Mr. Schrader: Not anymore. I haven't run into that, but you're posing the question of whether the company might incur some liability if it sanctions, ratifies, or directs its sales force to go out and try to replace big company business. I think anytime you're doing that you're asking for trouble, if that's your theory for the replacement.

These guys are going to be able to address the replacement issue in much more detail than I can, but I think you're asking for trouble if you do it that way as opposed to the simple point that such-and-such company's rating has gone significantly down.

From the Floor: Subtlety helps, yes.

From the Floor: You mentioned the dividend issues of the DAC tax. A related issue is excess interest and adjusting interest. I read about a case within the last week or two, I think it's in California, but I don't remember the company name.

Mr. Schrader: I'm not familiar with it, so this is news to me.

From the Floor: The company is being sued on the basis that their policy read that the interest rates would be adjusted based on market conditions. Market conditions improved, yet the interest rate went down. I would submit that if you're using that kind of language, you want to rewrite your policy to say, excess interest is declared at the privilege of the board.

Mr. Schrader: Yes. It's the same point I was trying to make, though, that plaintiff's lawyers are beginning to understand how the dividend works, and, at the same time, are sitting there studying what these policies say and dreaming up these new theories. So the idea is, you have to stay, to the extent you can, a step ahead of these people and realize what they're doing.

From the Floor: Know what you're doing—what you're actually doing.

Mr. Schrader: Yes. You have to know what you're doing, and what you said. You have to put the two together. The inference is that people are going try to twist or stretch this language to mean something that runs inconsistent with what I'm doing. So I just take the policy and put my plaintiff's hat on and try to wring every last ounce of confusion and vagueness out of this thing because if it's there, the plaintiffs are going to take it and turn it into its worst interpretation. The only message I was trying to say to all who are involved in setting the dividends is you have to be reading that policy and thinking about how you construct the dividend, and thinking about how these guys operate on the other side because that's one of the places they're going.

From the Floor: I have had a painful personal experience with a small company that had some reinsurance. Because reinsurance existed, the plaintiff's bar went through the pockets of the y to get at the large pockets.

Mr. Schrader: The large company.

From the Floor: Of the reinsurer, and also, because of the existence of reinsurance and alleged Racketeering Influence and Corruptions (RICO) violations. Have you seen that anywhere at all?

Mr. Schrader: No, I haven't. They were successful in doing that? I assume it's settled?

From the Floor: It's on appeal.

Mr. Schrader: So it's a public record then, the case? What can you tell us about who's involved?

From the Floor: Well, it's my company. It was a $41 claim that ended up with a $16 million judgment.

Mr. Schrader: Where?

From The Floor: A small town in Georgia. The circumstances were that the claim was denied because of wrong answers on the application, and when it was discovered that the agent had lied and submitted a second application, by the time we offered to pay the $41 claim, the attorney was involved; it happened to be a major medical policy. It had a $2 million lifetime maximum, so it was a $2 million claim on a $41 claim. The wife could have applied for insurance also, but she didn't, but because she might have, the existence of her other insurance was not admissible, and it turned into a $4 million claim. And the fact that reinsurers were involved quadrupled the damages under RICO to $16 million.

It's supposed to be a federal statute designed for racketeering, where entities conspire to commit fraud, for example, to rip off the public. I'm just putting it in lay terms, but it shouldn't have applied.

From the Floor: It's supposed to be the original, the criminal—

Mr. Schrader: Oh, absolutely. But it has a civil side.

From the Floor: And against organized crime, but it's been brought down to the civil level, and it's been applied to everybody for everything.

Mr. Schrader: Although, I can't figure out how they're going to sustain the RICO part of the case on appeal. Are you in federal court or state court?

From the Floor: State Supreme Court. Appeals Court.

Mr. Schrader: Because it was a $41 claim, you couldn't get it into federal court in the first instance to remove it. That's what happened to you, yes?

From the Floor: Well, I don't know the details.

Mr. Schrader: What companies were involved, is it Life of Georgia?

From the Floor: Well, the y was mine, a Minnesota company.

Mr. Schrader: Who were the reinsurers?

From the Floor: They were quite large.

Mr. Schrader: I'm surprised they could bring them into the case. I can't imagine there was any proof of any conspiracy with respect to claims or that claim. I'm shocked. But then, I'm not familiar with the case.

From the Floor: With regards to the statute of limitations and vanishing premiums, the companies would issue policies with nonguaranteed premiums, which vanishes for seven years or ten years, and the policyholder might be cruising along thinking everything's great, and then in the eighth year, they get a notice saying, I'm sorry, your premium's continuing. But then there's the statute of limitations. How are the courts going to view those kinds of things when the policyholder is upset enough to complain?

Mr. Schrader: The point I was trying to make is that some of the courts are saying, you were on notice at the time you bought the policy that you might have to pay for a period of longer than seven or eight years, so we're not going to permit you to base a fraud claim on the fact that the agent may have given you some sort of oral assurance at that time. The writings, the insurance contract itself, the illustration, and the disclaimers put you on notice that whatever the agent said was inconsistent with the written document; therefore you should have brought your action at the time the policy was issued.

From the Floor: That would almost seem to take away, though, the vanishing premium problem. I guess I find it difficult to believe that that's really going to happen.

Mr. Schrader: Well, it has happened. The courts have done that. The court in Indiana—did you all read about the big case? In *The New York Times*, there was a

big case involving Manufacturer's Life. They went on and on about how these terrible things had been done to this policyholder in Indiana, but about a month later, the court dumped that case by saying, look, this guy had gotten the illustrations and the policy back in, was it 1986? He was on notice that whatever claims the agent said orally were inconsistent with the policy and illustration, and was on notice that there had been a fraud, if indeed the agent had misrepresented it. He should have brought his case long ago.

Now, having said that, how do I say this? There are some defense lawyers who dreamed up this wonderful theory that to get vanishing pay cases dismissed, where they were brought before the pegged vanish period, they say these cases are premature and have not ripened. There was one firm that went around and won that theory in a case in New York, and started bragging about it, saying what a wonderful thing we did because they can't bring this case now. It's a seven-year vanish, and this is only the sixth year, and even though we have now told them it isn't going to vanish in the seventh year, somehow theoretically it could happen. There has to be a case or controversy ripe for the court to decide it. The firm was bragging about this, and I said to my client, this is really not good news because that argument runs counter to any effort toward a statute-of-limitations cutoff on this case. Because if the court says you can't bring the case, then you can't say it's barred by the statute before you can ever bring the thing.

So you've just shot yourself in the foot. In addition, in this particular case, if you couldn't settle on a class basis, for any of your vanishing pay customers who hadn't yet come to their vanish points, you couldn't even settle on a class basis. But, yes, your point is well-taken. Not every court agrees with this theory that I enunciated, but there are courts that have done it, and there are several that are increasingly willing to do it. Some of them base it not just on the disclaimers, but on the annual report the customer may get on the policy and its performance, saying that puts you on notice, too. Now that, on the universal side, may be truer than on the whole life side of the vanish question.

Ms. Christopher: I do want to point out that our panelists are not speaking in the order that they're numbered. Our next speaker is a person who's near and dear to my heart, my husband, David Christopher. He is an independent consultant specializing in product development and market-conduct issues. He's an FSA with over 20 years experience in the life insurance industry, and he was among the first group of independent Insurance Marketplace Standards Association (IMSA) assessors appointed.

Mr. David A. Christopher: Anybody remember what the name of this room is? The military room. I thought that was quite appropriate because of all the battles that

we've had to wage in the last few years with market conduct. As Wayne alluded to, most of the market conduct problems that I've seen over the last several years have all involved life insurers and life insurance products, whether it's vanishing premium or some other sales practice. But as Bob Dryer alluded to, the first one I saw was about four weeks ago in *The National Underwriter*. There was a big article about a lawsuit being brought against an annuity writer because of the way that the annuity interest rates were being credited. I think the Equitable of Iowa has been involved with one, and that may be the one that you're talking about. So, there's been probably two situations out there now that have involved annuities.

Here you have *The National Underwriter*, in every issue, with these large illustrated first-year credited rates, but what's going to happen to those credited rates in the second year? Because the interest rates drop down, you have surrender charges, and in many instances people can't get out without losing money, and so you may see many more suits like that in the near future.

From the Floor: Probably appropriate, too.

Mr. Christopher: I'm not going to argue that. I'm here to talk about the Insurance Marketplace Standards Association (IMSA). I just want to state that IMSA does not stand for "I'M Sued Already," because I've seen that in several things. I think it's very appropriate to address this to this particular audience, because many of you are involved in much more than just actuarial issues. Many of you have the issue of underwriting claims, many of the operational areas reporting to you, and perhaps even marketing. I was talking to Kevin last night about marketing, and he has the marketing area reporting to him now.

This is something that you will have to be aware of in the near future, even if you haven't had any problems yet, because as a y actuary you wear many different hats. Norma mentioned that you wear so many different hats that you can't just sit there and say, it's not applicable to me, and I don't have to really worry about it, so I'll let somebody else worry about it. That's not the way it is. You are going to have a lot of work to do.

Anyway, IMSA was the result of a two- to three-year effort by the ACLI, with all of the market-conduct problems. What they did about two or three years ago was create this chief executive officer (CEO) task force to look into the market- conduct problems. From that CEO task force came the basic recommendation for IMSA. And in March 1996, the ACLI Board of Directors approved the market-conduct initiative and started working on the details. It took them five or six months to get all the details worked out. Finally, in November 1996, IMSA was officially formed as a voluntary membership organization for life companies. It was incorporated in

Delaware. It's organized as a not-for-profit business under the Internal Revenue Code. The Executive Director is Bob Googins. He's a former Commissioner of the Connecticut Insurance Department, and there have been at least two articles written about IMSA in the *Best's* insurance magazines. You may have seen a couple of interviews about him. He was also Director of Insurance Law Center at the University of Connecticut. And I think he was with one of the big insurance companies in Hartford for many years.

The backbone of IMSA are the six principles of ethical market conduct. And quickly, we'll go through these quickly, because they address some of the things that Wayne was talking about, and some of the questions that came up afterwards. First, to conduct business according to the high standards of honesty and fairness, and to render that service to its customers, which in the same circumstances it would apply to or demand for itself. The second is to provide competent and customer-focused sales and service. Third is to engage in active and fair competition. Fourth is to provide advertising and sales materials that are clear in their purpose and honest and fair in their content. Number five is to provide a fair and expeditious handling of customer complaints and disputes. Last is to maintain a system of supervision and review that is reasonably designed to achieve compliance with these principles of ethical market conduct. And these principles are supplemented by the Code of Ethical Market Conduct, which brings it down to more of an operational level.

Under each of these six principles there are three or four other components or statements with regard to that particular principle that brings you to an operational level.

One of the challenges is that from the 6 principles and the Code come 27 questions; there are 27 IMSA questions that you have to answer. But it's not just 27. Each of these 27 questions has 3 aspects to them, those aspects being approach, deployment, and monitoring. Approach asks the question, do you have the policy and the procedures? Deployment is, do you use them? And obviously monitoring is, do you monitor the procedures and take action from them? Again, for each one of these 27 questions, you will have to address these 3 different aspects. Not only do you have the 3 aspects, you also have the 2 component questions of those 3 aspects, which really means that you're asking 6 sub-questions for each of those 27 questions, so it comes up to be 162 questions that you actually have to answer in the affirmative. One "no" means that you cannot join IMSA. You have to have 162 "yes" answers.

So, a company goes through the self-assessment process, and I doubt if they would call in the independent assessor until they had all 162 questions answered yes. But

when the independent assessor is going through the independent assessment and disagrees with something, perhaps one of the questions, then you might have to have some dialogue as to whether or not that particular answer is acceptable, and the independent assessor agrees with that.

As I said, under approach, the two component questions are, do you have the policies and procedures that are the objective of the question? I'll give you a couple of questions in just a minute so you'll have a feel for it. Have any of you been through the IMSA training? Has anybody attended one of the IMSA sessions? I know Norma went; when I went. Much of this may be new to you, and again, you may have seen some of the articles written, but not gotten into the details. But under the approach, the two questions that you have to ask are, do you have the policies and procedures in place, and do you have somebody responsible for those policies and procedures and for deploying, maintaining, communicating, monitoring, and establishing either a team or an individual? You have to have somebody responsible for that. Much of that means that you might have to go in and change some job descriptions. There's a client I'm working with right now who, like many smaller companies, doesn't really have job descriptions.

I'm advocating to them now that they go through and take the time to establish these job descriptions so that people know what their responsibilities are, and you can point to them and say, yes, we have people responsible for that particular area. I think it should be taken one step further and built into their incentive compensation, that following these 27 questions and policies and procedures that you've set up, it should be part of how they're compensated. But I think it's very important that you take the time to identify whoever those people are who are going to be responsible for that.

Under deployment, the two questions are, do you communicate these policies and procedures? It doesn't do much good to have them if you don't tell people about them. One of the big issues with communicating is the training issue. When you start thinking about the training of independent agents, that can cause a little difficulty because if you have independent agents who are licensed with four or five companies, how are they going to receive training from four or five different companies with regard to that particular company's sales practices? How are they going to handle market conduct issues? It's going to be interesting to see how independent agents receive this. When it was a captive agent, you didn't really have as much of a problem.

Like I said, the first question is, is it communicated, and then do you use it consistently? You can't just use it once in a while. Again, it's going to be very difficult. There's a lot of stuff about replacement; we mentioned that a few minutes

ago. There are several questions in there about suitability and replacement, and if you have a huge producer who is doing a lot of replacement business, but he's one of your top producers, are you going to take the same kind of actions against that producer that you might against another producer? You will have to use them consistently.

As for monitoring, again, do you routinely monitor it? Do you take action? Again, it doesn't do any good to set these things up, communicate them, and then say, now I've done my job, and let's forget about it, I'm not going to worry about it anymore. Because if you don't follow up on it and make sure that the agents are doing the things that you want them and trained them to do, that your home office personnel is not doing the things that you've trained them to do, if they're not following these policies and procedures that you set up, it doesn't do any good to set them up if you're not going to use them and then monitor it and follow up on what you find out about it.

So, quickly, here are just 2 of the 27 questions. As most of you have not attended the seminar, how many of you have actually seen the IMSA handbook? At least several of you have seen it, which has all 27 questions. But here is just a sample. The first one, Question 2-1-3, are there polices and procedures designed to reasonably assure that the distributors and employees involved in the sales process receive training to help customers meet their insurable needs or financial objectives? As I said, training is going to be a very, very important aspect of IMSA, because you're communicating to the people and, again, they cannot use the policies and procedures if they don't know what they are and don't understand them.

The second question, does the company have policies and procedures designed to reasonably assure compliance with the laws and regulations related to advertising and sales material? I'm sure most of you already have procedures that you go through when you're developing advertising and sales material, so this is just going to be more of a formalization, possibly, of some informal procedure that you already have. You'll probably find that in much of the IMSA stuff, as you go through the self-assessment, if you decide to join IMSA, you will have many of these policies and procedures already set up. It may be just a matter of enhancing them just a little bit, or formalizing some possibly informal or verbal procedure that you might use. You're probably going to feel more comfortable having it written down, but we'll get into some potential problems with that in a minute.

How do you get “yes” answers for these questions? IMSA has identified what they call indicators. Some examples of indicators are that the company has policies and procedures, that's just about on every one of the questions; that there are

individuals who have been assigned responsibility; and the company has programs and provides the materials to the agents or home office employees, or whoever needs to know that particular type of information. But they do give you another way of answering the questions with what they call alternative indicators. Let's say that you have some type of procedure that just doesn't fall under one of the indicators that they have identified, and there may be as few as 3 or so indicators in the IMSA handbook, and as many as 10, 12, or 13 listed there for you to choose from and say, yes I have that kind of policy and procedure, and yes, we do that kind of training. We have newsletters to send out, we do this, we do that. But let's just say that you had a procedure that didn't really fall under that, so that gives you the opportunity to use an alternative indicator. But the alternative indicator must be clearly defined. The independent assessor, after he does the independent assessment, must include that alternative indicator in the report, and if more than three questions use an alternative indicator, then all alternative indicators have to be approved by IMSA.

Now, when I say 3 questions, that means the 3 big questions, the 27 questions. If you had 1 alternative indicator for 4 of the 27, you would have to get IMSA approval. But you could have actually up to 18 and not need approval because you have 6 subquestions. Remember? Let's say that you used 6 alternative indicators for each of those 2 questions that I just showed you, so that's 12, but only two of the big questions have been affected by those alternative indicators; therefore, in that particular arrangement you wouldn't have to go to IMSA to get approval of that. I'm not sure why they did it that way; it does seem unusual that they would do it, but that's the way that they've written it up.

Let's talk about IMSA. I don't remember checking the attendee list at any of the meetings on whether or not any Canadian companies were represented. To me this means that if there are some Canadian companies that are doing business in the U.S., they could join IMSA if they wanted to. But you don't have to be a member of ACLI to join IMSA. It's not a requirement to be a member of IMSA if you wanted to join ACLI. Not many of you are members of ACLI, but if you decided to join IMSA you would not have to join ACLI at the same time.

ACLI has made a financial commitment to support IMSA for the first two years, which means that right now there are no dues and no membership fee. All you have to do is to adopt the principles and then go through the self-assessment and the independent assessment. How many of you have started a self-assessment? Three. One of the big considerations in starting a self-assessment is where are you going to get the resources because as a smaller company, you may not have as many resources as some of the larger companies. And again, because of the roles

that you all play, you might have a very big role in going through the independent assessment.

Again, you may not have enough resources, and the resources that you do have are probably very busy right now, and you can't spare the time to work on something like this anyway. Many companies have contracted with outside resources to help them go through the self-assessment. That may be an independent assessor who may have carried on and helped do the independent assessment thereafter because there is no restriction on the independent assessor having a preexisting relationship with the company. But again, as something that you're really looking at, you might want to consider getting some outside resources to help you go through or to establish your policies and procedures.

Most of the companies that I've talked to indicate that they think it could take three to six months to do the self-assessment. Again, much depends on the policies and procedures you already have available, what kind of resources that you have, and what kind of time those resources can spend on something like that. You have to go back and do all the research to identify these policies and procedures that may be informal or verbal, and you're going to have to compile all this stuff so that, again, independent assessors can come in and look at it. It may take three to six months.

Ms. Christopher: Closer to six, I would guess. Once you've gone through the self-assessment, and all 162 questions and answered them affirmatively, and you feel comfortable that you have completed the self-assessment, you can call in the independent assessor. One thing that you're going to probably think about when you're trying to decide who to retain as an independent assessor is the cost of the assessment. In the December 1996, issue of *Best's* Magazine, which featured one of the first articles written about IMSA, they estimated that it would cost about $10,000 for a y to do this.

And remember, IMSA only applies to individually sold life insurance and annuities. I don't think I said that earlier. It doesn't apply to any kind of A&H or long-term care but the individually sold life insurance and annuities. As it said in that article, smaller companies could expect to spend around $10,000, and larger companies maybe $100,000. But I think that, from talking to people over the last five or six months, to me that seems very low.

I think that you can probably spend, for a smaller company, assuming that you have a straightforward type of distribution system, easy products, etc. you're probably looking at a minimum of $15–20,000 to have somebody come in and do the independent assessment.

From the Floor: And the internal costs are going to be three or four times that?

Mr. Christopher: Yes.

From the Floor: To get this stuff ready for the interview, we felt starting out that we were in good shape. We thought we followed many of the principles. It's just a nightmare. But it shouldn't take a lot of work. It should be cheaper in renewing.

Mr. Christopher: Oh, most definitely. When you join IMSA now, that membership is good for three years. And then, at the end of the three-year period, you'll go through the same self-assessment and the independent assessment again. And one of the by-products, in my opinion, of going through the self-assessment and the independent assessment—but really the self-assessment is that you set up procedures, and some kind of documentation, so that you can keep track of all this stuff. Three years from now it won't take six months; you can do it in a month, three weeks, or whatever because you're going to look back and say, what new policies and procedures have we developed over the last three years that need to be incorporated in this.

If you've done a good job of monitoring it, you've documented the monitoring that you're doing and changed the job descriptions, and you've done the things that you said you were going to be doing three years earlier, then the re-joining of IMSA should be much easier. I would advise a company to think about that when they're going through this because you don't want to go through another six-month process three years from now. Think about how you're going to document and maintain that documentation so that you can use it again six months later, or three years from now. Management can change considerably in three years in a y, so you might be dealing with a whole new team and a whole new portfolio. That's always possible.

Ms. Christopher: You should probably do continual updates of it. It's very difficult in a smaller company to think, I'll take care of that tomorrow because I have so much to do right now, and I don't have time to worry about it right now. Or, I'll do it in two weeks, and then all of a sudden, you have all these things backed up and you don't get it done.

To keep up with that stuff, and I'm not saying it's going to be easy, you all might have a difficult time with the resource problem, identifying one particular person. I think the ACLI, in their little book that they put out for compliance, for smaller companies they advocate having one person responsible for compliance. There she is, she's also the actuary, and he or she is responsible for also issue and underwriting. As I said earlier, you wear many different hats, and it's not going to be easy. But, if you decide to join IMSA again, I would suggest that you do

whatever you can to make future processes go a lot easier. But the quality of your documentation can have an influence on the self-assessment, or on the cost of the self-assessment. If you go through it and you don't really have very good documentation, and your independent assessor comes in and says, this is terrible, I disagree with this, and you have to go back and forth and argue for two or three weeks, that's going to potentially run the cost up, depending on what your fee arrangement is with the independent assessor. Or how many distribution systems do you have, or how many people does the independent assessor have to go out and interview to verify that these policies and procedures are being used? If you have three different distribution systems, they might have to go out and interview at least one for each of those three different systems.

But, I want to make it perfectly clear that the independent assessor is not there to judge what you have done. His or her role is to verify that you have those polices and procedures, you use them, and you monitor them. Now, when you're first setting up policies and procedures, it may be difficult to prove that you're monitoring. You will have to prove that you have systems, or some kind of methodology set up, to monitor those systems, policies, and procedures. But that's what the role of the independent assessor is, not to judge whether or not you've done a good job.

Now, this came up, and maybe Scott can address this, at the National Association of Life Companies (NALC) meeting in Vancouver last month. The NALC had a panel discussion, and one of the attorneys there suggested that independent assessors be required to post a $500,000 bond or something like that. I'm totally against that. But I think that attorney was trying to say that there should be more responsibility put on the independent assessor with regard to how these policies and procedures work. But that was not the intent at all.

The second thing about the independent assessor is the availability. Bob Googins has said in several speeches that at one time he had it up to 300; now he's cut back to 200. They expect 200 companies to be members by April 1, 1998. But many companies, again, have taken a wait-and-see attitude. They're still in the early stages of doing a self-assessment, or they're still deciding whether or not to do a self-assessment. Many of them have indicated that. Or the ones that are doing self-assessments now are probably going to need independent assessors come January, February, or March, that is some time during the first quarter. Many if not all of the big accounting firms have independent assessors and that's their primary time for doing the audits and all the financial things that they have to do.

You have to keep in mind, if you have the goal to join IMSA by the April 1 date, to arrange for an independent assessor to help you. Although, in my conversations

with many smaller companies, that April 1 date doesn't really mean much to people. They're not going to start their self-assessment until at least the first quarter, or maybe even the second quarter.

The April 1 date was chosen to give companies an equal opportunity to go through the self-assessment process, and the independent assessment process, and all be ready by April 1. So, on April 1, they announce, here's the 150 companies or so that are members of IMSA, and those members get to advertise with the IMSA logo.

What are some other considerations? What's the cost of not joining? If you decide that you don't want to join IMSA, is there a possibility you might be hurt competitively? Many of the companies might look at it now and see no reason to join IMSA, but if some of your competitors do join IMSA and you start losing business, then you may need to reconsider your position on that.

Last, there's one more aspect that you should consider—a financial rating. Again, Scott may address this briefly. A.M. Best's Larry Mayewski at the IMSA kick-off meeting in Dallas in February indicated that joining IMSA would be looked upon very favorably. But it's not the only thing that they're going to look at. They're going to look at market conduct and your financial rating, but joining IMSA is not the only way. If you have a good compliance area, and good ethical market conduct standards, and you can show that commitment to A.M. Best, you may not see a reason to join IMSA.

Right now A.M. Best is not requiring IMSA membership, but I think it would be looked upon favorably. So, are you going to be at a competitive disadvantage? I don't think so, at least not initially. It depends on how many other companies that you consider prime competitors are becoming members of IMSA, and if you see the agents out there saying, I'm going to use this IMSA-approved company or IMSA-member company.

Quickly, I just wanted to mention a couple of current things that have happened. Again, the attorneys can talk about this. First, in the October 6 issue of *National Underwriter*, there was a real controversy with regard to self-assessment—is the internal audit confidential? That is a real debate right now among attorneys as to whether or not that is confidential, and it's also involved in some market-conduct examinations by state insurance departments. In the highlights from the NAIC fall meeting from last month it said they talked about IMSA and they decided to take no action right now and just monitor the compliance of IMSA. They're not recommending or condemning IMSA right now.

Then, last Friday, in *The Wall Street Journal*, there was an article in which Mutual of New York managed to get a dismissal of a suit on their vanishing premium policy. The judge said many things that Wayne alluded to. She didn't think that insurance agents had a fiduciary relationship with their clients, as plaintiff's lawyers contend, so there are many things in here, again, that relate to what Wayne was saying. And there was a thing on the SEC, worrying about the sales practices of variable annuities. So, every week you see something in the newspaper about market conduct.

From the Floor: We have made a corporate decision already that this is not cost-effective and it is too disruptive. I'm wondering if anybody else in the group has decided that this is a definite no. I think the only thing that would get management to change its mind would be if Best said, we're going to lower your rating if you don't.

Ms. Christopher: Well, our management has determined only that if Best told them that, then they were going to lose. And that's how I felt. If I were trying to persuade them to look at that, and they didn't think it was cost-effective until Best threatened a lower rating, that would probably make people feel even more pressured.

From the Floor: There's been no evidence that IMSA is going to bring about change. In other words, it's too recent to say that it is going to change anything, or that if agents of a company that belongs to IMSA are doing better in the conduct area, maybe, as Bob said, it's not cost-effective, and maybe it's just more verbiage out there and another expense. Best is certainly an authority, maybe not an expert authority necessarily, and the ACLI is pushing this. But has there been any evidence that it's doing any good? That's really a moot question.

Ms. Christopher: Scott is the executive director of the NALC. I'll let him tell us exactly what it is. He is very visible to this section and a speaker at many of our programs.

Mr. Scott J. Cipinko: Well, let me just start with IMSA, and if David ever wants to hold this debate, he knows we can do that. Our packet here contains our statement on market conduct, regarding IMSA, to the National Conference of Insurance Legislators, which deals with a great number of issues in connection with IMSA.

With regard to A.M. Best, let me assure you that the NALC met with A.M. Best immediately after Larry Mayewski's article in the *Forum 500* newsletter that said, if you do not belong to IMSA, we want to know why, and you have to justify your reasons. We met with Larry afterward, and he said, I hate to say that. I was misquoted because I wrote to them and they did later revise their statement to say

that we want to see that there's a market-conduct program in place, that you have a plan, you follow through the plan, you have a means to identify and correct the problem, that you have a track record of doing so, and you're doing so on a going-forward basis. This was a major reversal by A.M. Best, after we advised them that the small companies, first of all, are going to have a great deal of problems complying with this. It is not cost-effective. There are not only agency issues, there are worker's compensation issues, direction and control. There are now ERISA issues as a result of the Microsoft decision.

So, there are a great number of problems that we felt needed to be addressed by someone other than A.M. Best, and as a result, if anybody in this room has been told by their management team that because of A.M. Best they should join IMSA, they need to look at the statement again because IMSA is no longer a requirement. They will look favorably upon these issues that I just spoke about, but they will not measure you up against any particular program. The NALC, for those of you who don't know, is the successor—I guess you could say an interest, although not really—of the National Association of Life Companies that merged with the ACLI in 1992. The NALC was founded by presidents, CEOs, and associate members of the former organization who decided not to merge with the ACLI.

So, the NALC, while a small-company organization, just like the old NALC, has a number of large company members. Many of the large companies, though, run their companies like smaller companies. But, let me tell you, as far as market conduct is concerned, I guess you could say it reminds me of the story about the bear in the woods. The bear's chasing this man, and the man trips, and falls. He's going to die, so he starts saying the Lord's prayer. Well, the bear kneels down next to him and starts to pray. The man says, "Wait a second here. I'm saved, I have myself a bear that believes in God," until he hears the bear saying, "Give us this day our daily bread."

Now, this is a problem. If you're going to look to the regulators, or any outside organization to save you from market conduct then, well let me just say, market conduct can be fun if you're a plaintiff's attorney. Because they're the only ones who are going to have fun here. And there are many reasons out there to comply. There's absolutely no reason, and there's no way to stay in business, unless you follow the basic guidelines.

The good news is you still have to comply with market conduct at the state level. You have to care and feed three sets of examiners. How long will a small company stay in business with the taxation problems we deal with from DAC, with the 809 problems? For a small mutual company with compliance problems on top of the additional regulatory costs and taxes, if the company can't defend its niche and its

forced out of business, then that's life. But you shouldn't be forced out of business because of the cost of regulation and taxes. That's what's happening here.

So as a result, when there are companies out there that are saying, this is not cost effective, they are right. It is not cost-effective. But you're going to have to put something in place. The real concern here is, how many layers of new procedures are you going to have to have in place?

With regard to the NAIC, there have been numerous presentations by IMSA, by the ACLI, to have the NAIC adopt or endorse IMSA. There was a presentation before the National Conference of Insurance Legislators. Basically, our answer is contained in the letter to Stan Bainter from the National Conference of Insurance Legislators. We have worked with the regulators, legislators, and the rating agencies to assure that, while market-conduct compliance and self-regulation are important, self-regulation means you regulate yourself. The issues of confidentiality are a time bomb.

You do not have any assurances that anything you do won't be discoverable. And the other thing is, make no mistake about it, if you're an attorney, or an actuary, if you're an assessor you can be subpoenaed to testify. Therefore, one of the questions is, will you be taking notes? Your notes are discoverable. There is absolutely no confidentiality. If you're an attorney, you are not an agent. You are not an attorney acting in that capacity. As a result, you are an independent person, and you can be subpoenaed as any other. So, there are a great number of issues. That issue in the *National Underwriter* is something that we have brought up in our letter as well.

Other issues on market conduct that you have to be aware of include niche products, small policies, senior life, senior annuities. We used to have a preneed committee, which was composed of preneed insurers. Then we got final expense insurers. Then we got people who did things through the mail, and the Internet. Finally, we said, all right, home service, small policy. This is a horse built by committee, a camel. Small policy-slash, we fought over the slash, small policy/specialty markets committee, dealing with niche products, small policies, senior life, senior annuities.

Guess what? Plaintiff's attorneys out there, senior annuities, it's the next wave you know. Do you know about a straw plaintiff? Plaintiff's attorneys are modern-day Rumpelstiltskins. They take the straw plaintiff and they spin them into gold. That's the next area. You now see the issue of small policies and annuities are coming back to the fore because you have folks at the NAIC who don't know what

happened three years ago, when the Life Committee, said we've been there, done that, and received the T-shirt.

Here's the proof. We don't need to do this again, but we keep having the same things come up again. We have a problem at the NAIC. It's called self-perpetuation. Regulators enjoy regulating. What they enjoy more is going to nice climates to regulate. As a result, we have a working group on annuities. Well, the working group on annuities had to come up with something. They decided ask, what is an annuity? What's a definition? So, one of the reasons that there's the full employment act for actuaries well into the next millennium was due to the role of the Academy. The Academy was asked by the Life and Health Actuarial Task Force to draft it, so they drafted these guidelines. The guidelines got sent from the task force to the Life (A) Committee, and just sent out to the states. Well, of course, if you're a regulator you say, look at this. This is an annuity. If it's not an annuity, what is it?

If it doesn't fall within the definition of annuities, then you decide it's not an annuity. What if you're an annuitant? What happens to you? What happens to your tax liability? What happens to everything that goes along with that? Therefore, if it's not soup yet, don't send it out to the states, folks. That was our message. They keep doing it. We have this thing called Due Process, capital D, capital P. Sorry, it's the lawyer in me, I apologize, but it's a problem when you start sending these things out. Now, here's a problem. The Academy is being asked to put these things that aren't soup yet into the pot. And then they're being sent out to the states. Now you have the Academy, which is not only a quasi-super-regulator, but you also have things that are going out to people that are Academy work. They scratch out Academy and they say "NAIC (not adopted)" or "work in progress" or "we like this." And then it gets sent to other states. We've had a problem with these kinds of things.

Now, what happens to you or your clients, in the states? Your client gets a phone call from your friendly neighborhood regulator and says, guess what? We've got this thing, it's not a model, it's not adopted, we've got this thing from the NAIC. And your company violates this thing. Once the company violates this thing and the plaintiff's attorneys get a hold of it, you can fill in the blanks. The NALC is trying through the Industry Liaison Committee, which is this high-level group of regulators, the executive committee, and the chairs of the zones, to get together and discuss things with the trade association representatives and their members about policy-level issues.

One of the things that we brought up to them is this Due Process problem, which is huge, and it's continuing. What you're seeing here are the kinds of things that your

companies are going to be measured against. Therefore, it's very important for you to be able to rely on those who attend the meetings, either your representatives or the trade associations, to point these things out in big, bold letters, so that when you get the phone call, you can call the regulator and say, no, it's not adopted by your state. It's not a guideline. It's a thing. We don't have to comply with a thing. Look at your administrative procedures act, which is very important.

One of the issues that is going to be coming up, and it's a big one, is suitability. It is going to be the watchword of the next several months, several years, several lifetimes. This thing is going to be like plutonium—it will never go away. Now, take plutonium, put it on velcro, and stick it on your suit. It's going to follow you everywhere. The great thing about plutonium is, once you have it, it's the gift that keeps on giving. You will have this thing because the annuities working group has this glossary of annuities. It turned from a definition into a glossary, by the way. The glossary goes out, as an attachment. We write to the NAIC hierarchy. We write to the President, Jo Musser, who is from Wisconsin, who will be resigning right after the meeting and running for Congress, so she's trying to be very presidential about these things. And we wrote to Terry Vaughn, the chair of the Life (A) Committee, from Iowa, and said look, we have a Due Process problem. They said, thank you; these things aren't that important because they just got attached to the minutes.

This suitability problem occurred again with the annuity group. The annuity working group, after it sends out this wonderful glossary that shouldn't have gone out anyway, says, we're just about out of issues. We probably don't have anything to talk about. And someone says, "Senior annuities. Suitability." You should have seen it, it was like the sunrise on this working group. Do you know what? We've spent the last 90 minutes listening to a presentation from IMSA and a presentation on senior annuities and suitability. I think we can work for another year, so let's talk to the committee about it. Self-perpetuation.

Now, the NAIC is asking for a sunset. At one point there was talk that if there was an issue that was going to be worked on at the NAIC, you have to have a certain number of commissioners sponsor that issue. Issues are wonderful. They're talking about trying to take the working groups and combining them so that you don't have 17,000 working groups, tasks force, subcommittees, committees; you name it, they got it. So they're talking about doing this and they don't know how. Our suggestion is fine, get three commissioners, five commissioners, two commissioners, get any number of commissioners to sponsor the continuation of the working group.

Here's what's going to be coming out of that other wonderful thing called replacements. Replacements—the word is suitability. Annuities—the word is

suitability. On suitability I think what they're going to do is push this thing back up to the Life (A) Committee, and then the Life (A) Committee is going to just parcel it out. Everyone gets a chance with suitability, unless they create a suitability working group.

How many people here sell traditional small policies? Senior life? Preneed? Final expense? Do any of you do telemarketing? Do any of you do direct mail? These things are just the tip of the iceberg. I take it most of you are actuaries, and if anybody is going to be able to look at this, remember that suitability is subjective. We went through this in our replacements working group. Suitability is subjective. The only thing objective about suitability is that you can look at the benefit-to-premiums ratio, and it takes actuaries to do that because lawyers can't count. So there may be some role there for you.

We had this wonderful replacements working group call a couple of days ago, and it was wonderful. I had the mute button on and I was in my office screaming. My assistant thought I was insane. Thank goodness the mute button worked. We had this wonderful conversation, it basically went like this. We need to have a 60-day free look on any replacement. Then, we have to have a 60-day period where the original insurance company, mind you, who had nothing to do with this, has to automatically reinstate the policy, irrespective of health, for 60 days.

Now, I'm not an actuary, but I think there has to be some actuarial implications there, first of all. Then they said, the company that was being replaced is required to a) write a letter, b) make a phone call, c) make a personal visit, d) bring an updated policy illustration or depiction of the policy, even if one can't be generated, or e) all of the above.

Well, they chose e) all of the above for a little while, until Paul D'Angelo, who was the chair of the working group, who spearheaded the Prudential investigation, got involved. Again, that's another one of those things; it's the gift that keeps on giving because Paul looks at the world through Prudential-colored glasses. Everywhere he sees a violation, it's a problem. So Paul, during this conversation, which was more or less a monologue, went through this whole litany of, we really need to make companies do this, and by the time he got done, he'd completely talked himself out of it.

We ended up with, there's still going to be a 60-day requirement. And by the way, New York's regulation, which is in draft—and here's another one of those wonderful things—the 60 days will begin to run, in the authorizing statute, from the date of issuance of the policy. However, the National Association of Life Underwriters (NALU) seems to agree that the department can do this. The

difference is that a regulation would say, 60 days from the date of delivery. There's no legislative authority to do that. It can be challenged, and the department will lose, but the NALU, they have an interesting perspective, and I'll give you that in a minute, will say that, no, the 60 days can run from the date of delivery, even if the statute doesn't say that. The NALU have been very interesting in all of this.

When it comes to the issue of their input into this, they have one stock response. It's the agents' fault. The agents. The agents say, it's their fault. It's the insurance company's fault—they made us do this, they made us do that. As a result, anything that they propose always does one thing—point the finger back at the insurance company. In these meetings, they always point their fingers back at the insurance company; it's not their fault.

If anybody out there thinks that the agents' associations are there with you, they're against you. And they're talking to the regulators about you. And you should not be paranoid only if it isn't true. Believe me, be paranoid because they're not your friends in these negotiations. They have never once stepped up to the plate. What you have here is the regulators, the consumer advocates, when they show up, and the agents, and they're all saying it's your fault. The replacement issue is something that's on a very fast track.

Another issue is hierarchy of licensing. How many do business in multiple states? You're in Nevada, you have a general agent in Nevada, and you have a subagent in another state. Nevada looks at the company and says, guess what? You need to have that general agent, who only touches the paperwork and takes an override, licensed and bonded, and fulfill continuing education requirements in every state in which they have an agent—even if they have no contact with the state, they don't visit there, and all they do is ministerially relicense. We, the NALC, have brought this issue to the market conduct committee. There will be a subgroup that's going to be working on this.

Another issue that's going to be coming up is banks. You know the great thing about plaintiff's attorneys is they look at insurance companies as those that make money. They look at banks as money. Deep-pocket insurance companies won't be the deep pockets anymore. Are little companies getting sued for market-conduct violations? Absolutely.

Don't kid yourself because you are a company that they can own, they will take you apart. We lost a member because they got sued for market- conduct violation, something very similar, and basically everything is tied up in litigation. They can't even pay a couple $100 for a membership because everything is in limbo, and they were a small company, another one of those technical violations. Life illustrations,

it's also known as the full employment act for actuaries well into the next millennium. The good news is there's an illustration actuary and a valuation actuary—how many hats do you have?

The bad news is they're all the same person. Norma used to be seven feet tall. The problem is that you have all these people and all these roles that have to be filled, and they're not going to hire anybody to help you out. But let me tell you a couple of things, very quickly, that are very important, as far as illustration regulation is concerned.

Section 9 of the Life Insurance Illustrators Model Regulation—if any of you are being told that your company has to provide each producer with a laptop or each producer must have their own laptop—read section 9B, because you're wrong. I had a member that said, we have been telling our people they have to have laptops and printers.

Here's the argument. My dad is 74. He was 72 when we enacted the regulation. He's an agent. He has no laptop and no printer. He's not going to buy one either. The issue was, do you have to have one? The answer is no. If your printer doesn't work, can you not make the sale? No. And one of the reasons was, in the old days, before companies got smart, there were many times when you wrote the policy—my dad wrote two policies—and the person died before the policies were issued. Both had the accidental death benefit. He delivered a death benefit check. They were clean applications.

The point is there are some companies that still do that; not many, but there are some that do. If they do, is it proconsumer to say that because, for whatever reason, my illustration wasn't exactly what I had planned? Or my printer didn't work, and as a result, I can't write the policy? Absolutely positively not. You have to have the proper illustration by the time of delivery. Get ready folks, here it comes; mutual holding companies are a big problem. Why? Because there is an ever-increasing volume of people who have been sitting on the sidelines saying, this is illegal, it's immoral, and it's fattening.

Lawsuits will happen. Insurance departments will be sued for poor draftsmanship. All kinds of questions are arising now. There are a number of states that have enacted these. Demutualization is something that's going to happen anyway. There are companies that are going to demutualize. You will have companies called De-Mutual of New York, I suppose. That's what's coming up next.

I guess the one important thing that we have to think about, and I'm sorry, but I'll finish with this, is the role of the regulator. How many of you attended the banks

and insurance session? A number of years ago, when I was with Consumer Credit Insurance Association (CCIA), we sat down and talked to the comptroller of currency about debt cancellation contracts, which is credit insurance that is written, but not called credit insurance (reserving requirements that resulted from a 1964 ruling from the comptroller). Now, the controller said, we will approve anything for sale by a bank that will not impair solvency and will make the bank money. And my challenge to the Life (A) Committee a number of years back was, I've never heard an insurance regulator ever say that about insurance.

Bob Wilcox, at the time, was the chair of the life exposure working group, and I said, "I care." Well, that's real nice. No one believes you. The problem is, once again, as I stated, the regulatory pressures are very important, and they're what's going to force many small companies out of business. One of the consumerists who some of you know was talking about this a number of years ago.

Jim Hunt said, with the work that the NAIC is doing right now, it's going to force a lot of mom and pop insurance companies out of business. Perhaps that's not such a bad idea. There are many regulators out there who don't like small companies. It's like chasing mercury. You don't want to do it. As a result, if we can get all the mercury together into one big group, let's do it. The regulators are not going to try and keep you in business; it's going to be very difficult for you to remain in business. One of the things you're going to have to do is be very diligent about market conduct, but you're also going to have to do it on a cost-benefit analysis. But make no bones about it, you have to do it.