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April 10, 2006

Via Express Mail and E-mail

Antitrust Modernization Commission
Attention: Public Comments
1120 G Street, N.W.
Suite 810
Washington, DC 20005

Re: Comments Regarding the McCarran-Ferguson Act

Ladies and Gentlemen:

On behalf of the Section of Antitrust Law of the American Bar Association, I am pleased to submit the enclosed comments to the Antitrust Modernization Commission in response its request for public comments relating to the McCarran-Ferguson Act.

Please note that these views are being presented only on behalf of the Section of Antitrust Law and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

If you have any questions after reviewing this report, we would be happy to provide further comments.

Sincerely,

Donald C. Klawiter

Donald C. Klawiter
Chair, Section of Antitrust Law

Comments to the Antitrust Modernization Commission Regarding the McCarran-Ferguson Act

Section of Antitrust Law
American Bar Association
April 2006

The Section of Antitrust Law ("Antitrust Section") of the American Bar Association ("ABA") is pleased to submit to the Antitrust Modernization Commission (the "Commission") the current ABA policy, adopted in 1989, recommending that the McCarran-Ferguson Act ("MFA") exemption (15 U.S.C. § 1011 *et seq.*) be repealed and replaced with certain "safe harbor" exemptions from the antitrust laws. The views expressed herein are being presented on behalf of the Antitrust Section only. With the exception of the attached ABA policy regarding the MFA (the "Policy"), these views have not been approved by the House of Delegates or the Board of Governors and, accordingly, should not be construed as representing the policy of the ABA.

Summary

This submission is intended to present the current ABA Policy and to respond to the specific questions that the Commission has selected for study relating to the MFA. To that end, the submission is presented in three parts. First, to put the issues in context, the submission begins with a brief overview of the MFA's history and scope. Next, the submission summarizes the current ABA Policy on the MFA, which is being submitted concurrently with these comments. As explained below, the current ABA Policy states that the MFA should be repealed and replaced with legislation that would subject the insurance industry to federal antitrust enforcement, with the exception of certain limited "safe-harbor" exemptions. Finally, to respond to the questions posed by the Commission in its consideration of the issues being studied, the submission concludes with a review of the economic and legal literature regarding the MFA. The submission summarizes the policy arguments that have been advanced in the literature supporting the current ABA Policy favoring repeal of the MFA and replacement with a limited number of safe harbors for joint insurer conduct. The submission also explains briefly why the Policy is preferable to the other arguments in the literature advocating the outright repeal of the MFA or favoring maintenance of the status quo regarding the MFA. The Antitrust Section hopes that the comments are of assistance to the Commission in analyzing the MFA questions selected for study.

Comments

I. The History and Scope of the MFA

In the latter half of the 19th century, dramatic growth in the fire insurance industry led to increased interest by the states in the regulation and taxation of insurance companies. In response, insurance companies, seeking to avoid such regulation, challenged the states' authority to regulate the insurance industry, contending that such regulation constituted a violation of the Commerce Clause. However, in *Paul v. Virginia*, 75 U.S. (8 Wall.) 168 (1868), the United States Supreme Court rejected the insurers' position, holding that the Commerce Clause did not preclude the states from regulating insurers.

In the wake of the *Paul* decision, state regulation of insurance increased significantly until 1944, when the United States Supreme Court, in *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944), effectively overruled *Paul*, holding that insurance was interstate commerce and therefore could be regulated under the Commerce Clause. In response, the very next year, Congress concluded that it would be beneficial, as a matter of public policy,

to permit the states to continue regulating the insurance industry, and therefore enacted the MFA, 15 U.S.C. § 1011 *et seq.*

Among other things, the MFA provides the insurance industry with a limited exemption from the federal antitrust laws. Specifically, the MFA exempts conduct (1) that constitutes "the business of insurance," (2) to the extent that such conduct is "regulated by State Law," provided that (3) it does not amount to an "agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation." All three prongs of the MFA must be satisfied in order for the exemption to attach to an insurer's conduct.

In determining whether conduct qualifies as "the business of insurance" under the MFA's first prong, the courts have considered the following factors: (1) whether the activity has the effect of transferring or spreading a policyholder's risk; (2) whether the activity is an integral part of the policy relationship between insurer and insured; and (3) whether the activity is limited to entities within the insurance industry. *See Union Labor Life Ins. Co. v. Pireno*, 458 U.S. 119 (1982); *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205 (1979). Notably, no single factor is determinative on this issue.

As to the MFA's second prong, courts have held that an activity is regulated by state law if the insurer is subject to general regulatory standards. In addition, the quality of the regulatory scheme or its enforcement do not influence the availability of the exemption. *Hartford Fire Ins. Co. v. California*, 509 U.S. 794 (1993).

Finally, with respect to the MFA's third prong, the Supreme Court in *Hartford Fire* held that a boycott occurs, thus subjecting insurer conduct to the federal antitrust laws, when a refusal to deal is designed to pursue an objective "collateral" to the terms of the transaction in which the refusal to deal occurs.

II. The Current ABA Policy on the MFA

In 1989, as part of an ABA Policy Statement on Tort Reform (Report No. 107), the ABA adopted a formal Policy on the MFA. The Policy, which continues to be the ABA position on the MFA, is attached to this comment and summarized below.

The Antitrust Section has frequently noted its opposition to industry-specific exemptions from the antitrust laws, finding them to be rarely justified. *See. e.g.*, Antitrust Section Comments Regarding the Federal Trade Commission's Workshop on Health Care and Competition Law and Policy; Report of the Antitrust Section on the Major League Baseball Antitrust Reform Act of 1997 and the Curt Flood Act of 1997 (available at http://www.abanet.org/antitrust). Such exemptions often are not necessary to eliminate the risk of antitrust liability for procompetitive conduct, and the goals of such protection often can be achieved in a manner consistent with established antitrust principles and enforcement policy. Accordingly, the ABA Policy on the MFA advocates a repeal of the exemption, rendering the federal antitrust laws applicable to the insurance industry. However, to deter unwarranted private litigation testing the limits of permissible insurer conduct absent an exemption, the current ABA Policy further recommends that a limited number of "safe harbor" exemptions be created for certain demonstrably procompetitive forms of conduct.

Specifically, the Policy recommends that insurers be authorized to engage in specified cooperative activity that is shown not to restrain competition, including the following:

- Insurers should be authorized to cooperate in the collection and dissemination of past loss-experience data so long as those activities do not unreasonably restrain competition but should not be authorized to cooperate in the construction of advisory rates or the projection of loss experience into the future in such a manner as to interfere with competitive pricing.

- Insurers should be authorized to cooperate to develop standardized policy forms in order to simplify consumer understanding, enhance price competition and support data collection efforts, but state regulators should be given authority to guard against the use of standardized forms to unreasonably limit choices available in the market.

- Insurers should be authorized to participate in voluntary joint-underwriting agreements and in connection with such agreements to cooperate with each other in making rates, policy forms, and other essential insurance functions, so long as these activities do not unreasonably restrain competition.

- Insurers participating in residual market mechanisms should be authorized in connection with such activity to cooperate in making rates, policy forms, and other essential insurance functions so long as the residual market mechanism is approved by and subject to the active supervision of a state regulatory agency.

- Insurers should be authorized to engage in any other collective activities that Congress specifically finds do not unreasonably restrain competition in insurance markets.

In addition, the ABA Policy further recommends that the "safe-harbor" provisions make clear that:

- State regulation of insurance rates should not exempt insurers from the antitrust laws under the state-action doctrine, except as specified above.

- Other non-rate regulation by a state should not exempt insurers from the antitrust laws unless that regulation satisfies the requirements of the state-action doctrine and the regulation is shown not to unreasonably restrain competition.

- States should retain the authority to regulate the business of insurance.

- The federal government should defer to state regulation except in those unusual circumstances where the regulatory objective can only be effectively accomplished through federal involvement.[1]

[1] The Insurance Competitive Pricing Act of 2005 was introduced in Congress in May of 2005 (H.R. 2401) that, consistent with the ABA Policy on the MFA, would repeal the MFA except for a limited number of "safe harbors." That legislation is currently pending before the House Judiciary Committee.

III. Policy Arguments Regarding the MFA Questions Before the Antitrust Modernization Commission

The Antitrust Section recognizes that the ABA Policy has not been universally embraced by the legal, economic, and insurance communities, and that others have advocated maintenance of the status quo or repeal of the MFA. Thus, to assist the Commission with its analysis of the MFA, the Antitrust Section has compiled a bibliography of the economic and legal literature on the issue, which is presented at the end of this Comment. To further respond to the Commission's questions regarding the MFA, the arguments advanced in the literature are summarized below.

A. Arguments Supporting the ABA Policy Favoring Modification of the MFA to Include Specific Safe-Harbor Provisions

As summarized in Section II, the current ABA Policy is not to advocate a complete repeal of the MFA, but to instead modify the MFA by eliminating the exemption for all conduct other than that which is plainly procompetitive. H.R. 2401, which is currently pending before the House Judiciary Committee, adopts this same approach. *See* Insurance Competitive Pricing Act of 2005, H.R. 2401, 109th Cong. (2005).

The Antitrust Section identifies with the following arguments frequently advanced in support of this "middle ground" position:

1. Safe Harbors Would End the Exemption for Anticompetitive Conduct, but Permit Procompetitive Behavior

Proponents of modification recognize that the MFA's blanket exemption creates anti-competitive concerns. They acknowledge that the exemption is overbroad, but they assert that it should be narrowed by enacting specific safe harbors. Safe harbors would protect the procompetitive behavior such as collection and dissemination of loss data. However, the safe harbors would not protect anticompetitive behavior such as price fixing and market allocations.

2. Repeal Without Safe Harbors Would Create Too Much Uncertainty

The "safe harbor" proponents also recognize that without safe-harbor provisions, repeal would create too much uncertainty in the insurance industry. Because there is no case law on the insurance-related issues that would arise, it is not entirely clear what forms of collective action would be allowed if the MFA was repealed in all respects. Faced with such uncertainty, many companies might avoid collective action that could be procompetitive for fear of criminal or civil penalties. Uncertainty will only be removed after expensive litigation and the reconciliation of potentially conflicting judicial interpretations.

B. Arguments Presented in Favor of Repealing the MFA

The principal argument presented in the economic and legal literature in support of repeal of the MFA is that no justification exists for providing the insurance industry with an industry-specific exemption from the federal antitrust laws; the same competition rules that apply to other industries should be applied to insurance. Other industries are subject to federal antitrust laws

and the insurance industry has not shown, and cannot show, a compelling reason for either a total or a partial exception. Other arguments advanced in support of repeal include the following:

1. The MFA Permits Anticompetitive Behavior

Proponents of repeal maintain that the exemption allows insurers to engage in anticompetitive behavior such as price fixing, illegal tying, resale price maintenance, and market allocations. Specifically, they maintain that

- Rate service organizations facilitate collusion on prices.

- Consumers are often forced to purchase coverage they do not want in order to obtain the coverage they desire. These tying arrangements can be anticompetitive because they force consumers to pay for less desirable products to get high-demand products, especially when the tying is pervasive on a market-wide basis.

- Insurance companies are permitted to control the price at which insurance is offered to consumers, which reduces competition among agents.

- Insurance companies are permitted to engage in market allocations, which control the number of competitors in a market and reduces competition.

The Antitrust Section believes that the ABA Policy addresses these concerns by making the aforementioned conduct subject to the antitrust laws and establishing safe-harbor exemptions for only procompetitive conduct.

2. MFA Complicates Efforts to Challenge Conduct that is Not Exempt

Proponents of repeal also contend that the exemption makes it harder to challenge anticompetitive conduct. State regulators and private parties must engage in costly litigation to overcome an unfounded MFA defense. That may lead to under-enforcement of the antitrust laws.

The Antitrust Section believes that the Policy addresses this concern by striking a better balance between procompetitive and anticompetitive conduct. Additionally, by establishing only a limited number of narrow safe harbors, the Policy minimizes the risk of underenforcement of the antitrust laws.

3. Not All Pooling of Information is Procompetitive

Proponents of repeal also point out that not all pooling of information is procompetitive. Pooling of expense data is not necessary to obtain procompetitive benefits. Estimates of expenses are often high, and when the estimated expenses are incorporated into rates, more efficient companies are actually charging higher rates than they would in the absence of data pooling. The existence of pooled data makes it unnecessary for companies to monitor their own costs, which leads to inefficiencies that would not otherwise exist.

The Antitrust Section believes that the Policy addresses this concern by establishing only a limited number of safe harbors that protect only procompetitive conduct.

4. Procompetitive Collective Action Would Still be Permissible

Proponents of repeal further argue that repeal would end anticompetitive collective action without affecting insurers' ability to engage in procompetitive behavior. General antitrust principles would protect the collective action that is procompetitive, such as pooling of loss information and the use of standard forms. *See generally United States v. United States Gypsum Co.*, 438 U.S. 422 (1978).

Additionally, exemptions and immunities often apply to conduct that is already permissible under general antitrust principles. If the MFA is repealed, general antitrust principles would stop anticompetitive collective action such as price-fixing, illegal tying, market allocation, and resale price maintenance. And the state action doctrine would protect certain activities governed by state regulation.

The Antitrust Section believes that these same arguments apply with equal force to the Policy, which would still allow insurers to engage in procompetitive behavior and provide the added benefit of confirming the existence of certain limited safe harbors to minimize uncertainty.

5. Federal Regulation is Preferable for an Industry with National Scope

Proponents of repeal often also assert that federal regulation of the insurance industry would be preferable. Federal regulation may be able to draw on greater resources than state regulation. State regulation varies widely, and some states have done a poor job of regulating insurance. Because the insurance industry is increasingly national in scope, national regulation may be preferable to state-by-state regulation.

C. Arguments in Favor of Preservation of the Status Quo

Finally, the proponents of maintaining the MFA in its current form frequently raise the following arguments in support of their position:

1. Limited Exemption and Procompetitive Impact

MFA proponents assert that the MFA is only a limited exception from the federal antitrust laws, and that it has been narrowed over the years through judicial interpretations of the definitions of the "business of insurance," "regulated by state law," and "boycott, coercion or intimidation."

MFA proponents argue that the exemption thus permits collective action that is actually procompetitive for the following reasons:

- Because the business of insurance is the business of spreading risk, pooling of data allows insurers to benefit from a broader base of information to spread risk and set rates.

- Liability insurance companies must deal with high variance, high correlation, and imprecise estimates because of dependence on tort regimes that differ among the states and over time. Those factors mean that pooling information will move transactional prices closer to market-clearing prices, allowing insurers to benefit from other insurers' experiences.

- Small insurers benefit greatly from data pooling, because they lack the resources and breadth to assess risks based only on their own data. Data pooling allows smaller insurers to continue to compete with larger insurers.

- Large insurers also benefit from data pooling on unpredictable lines or in states where a large insurer has limited experience. That enhances competition because a large insurer can then offer nationwide coverage to an insured.

- Standard forms allow insurance consumers to accurately and more easily compare products from different companies.

- The exemption in the MFA permits cost-containment activities such as auto safety programs and medical cost containment.

The Antitrust Section believes that the ABA Policy properly recognizes the insurance industry's characteristics, but strikes a better balance than the status quo. The Policy prohibits anticompetitive conduct, while still permitting procompetitive behavior.

2. MFA Does Not Encourage Collusion

Moreover, MFA proponents contend that there is no basis for claims that the MFA facilitates anticompetitive collusive behavior. Claims of collusion are unproven. In fact, the insurance industry's large number of competitors and competitive structure undermine the possibility of cartel behavior. First, there are low barriers to entry and exit, except in states that limit an insurer's ability to exit the industry. Second, price dispersion—the rate of deviation from "benchmark" rates—is inconsistent with cartel behavior. Finally, rate setting organizations do not have an effective mechanism for enforcing prices.

Likewise, the Antitrust Section believes that the ABA Policy does not encourage or facilitate collusion; rather, the Policy prevents anticompetitive conduct while still preserving a limited number of specific safe harbors for procompetitive conduct.

3. Repeal Would be Counterproductive and Lead to Uncertainty

MFA proponents further contend that even if the MFA is repealed and the express exemption for collective action among insurers is eliminated, smaller companies will merely "peg" their rates to rates of larger companies. This parallel action will offset any alleged benefits of repealing the MFA.

In addition, proponents point out that repeal would create uncertainty and reduce competition. The state-action doctrine would likely not exempt the full scope of conduct

currently exempted under the MFA. The MFA has been around for decades and has been subject to numerous court interpretations. Repeal would lead to costly litigation to eliminate the uncertainty of what is and is not permissible conduct. This litigation would lead to uncertainty and potentially conflicting judicial interpretations.

Because of uncertainty regarding propriety of data pooling, companies will be less willing to pool data or rely on pooled data. As a result, availability of high-risk lines will be reduced. In addition, without data pooling, smaller companies might be unable or unwilling to enter particular markets or offer particular products, which would reduce competition.

The Antitrust Section believes that any uncertainty arising from the ABA Policy would be only temporary and that the Policy strikes a better balance than the status quo when it comes to prohibiting anticompetitive conduct and confirming that certain activities are procompetitive and permissible under the safe harbors.

4. Inadequacy of Proposed Safe-Harbor Legislation

Proponents of maintaining the MFA in its current form also contend that the proposed safe harbors would not go far enough to protect competition. It is impossible to create a comprehensive list of all necessary safe harbors for current and future industry activities. Establishing safe harbors would lead to costly and uncertain litigation and potentially conflicting judicial interpretations. Finally, safe harbors are an inefficient way to regulate current industry operation.

The Antitrust Section believes that the ABA Policy seeks a middle ground between those in favor total repeal of the MFA and those in favor of the status quo.

Conclusion

The current policy of the ABA is that the MFA should be repealed and replaced with limited safe-harbor provisions. This Policy is submitted for the Commission's review and consideration. Additionally, to respond to the Commission's questions regarding the MFA, the Antitrust Section has summarized the legal and economic literature, and why it believes that the literature is consistent with the current ABA Policy. The Antitrust Section appreciates the opportunity to provide the Commission with these comments.

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