"TOO BIG TO FAIL" IS TOO BIG: WHY THE MCCARRAN-FERGUSON EXEMPTION TO FEDERAL ANTITRUST ENFORCEMENT OF INSURANCE IS PAST ITS PRIME

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"People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public or in some contrivance to raise prices."
– Adam Smith, 1776[1]

I. INTRODUCTION

Though one of the major financial institutions in the United States, the insurance industry has largely escaped federal regulation.[2] An industry with net premiums totaling $1.1 trillion in 2008,[3] insurance firms are largely subject only to state regulation.[4] The federal government has affirmatively advocated a policy of respecting state regulation and using a limited regulatory approach.[5]

The policy of minimally regulating insurance traces back to the McCarran-Ferguson Act of 1945,[6] which provides, in pertinent part, "[t]he business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business."[7] It further provides that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance."[8]

Two such acts of Congress are the Sherman Antitrust Act[9] and the Clayton Antitrust Act.[10] The Sherman and Clayton Antitrust Acts outlaw certain practices that may hurt businesses or consumers.[11] By making certain practices illegal, the antitrust laws

1. ADAM SMITH, THE WEALTH OF NATIONS 128 (Edwin Cannan ed., Random House 1937) (1776).

2. *See generally* KENNETH J. MEIER, THE POLITICAL ECONOMY OF REGULATION: THE CASE OF INSURANCE 33-48 (1988).

3. *Industry Overview: Insurance Industry at a Glance*, INSURANCE INFORMATION INSTITUTE, http://www.iii.org/media/facts/statsbyissue/industry/ (last visited Nov. 12, 2010).

4. *See* MEIER, *supra* note 2, at 43.

5. *See id.* at 33-48 (discussing the different roles of federal and state governments in the regulation of insurance).

6. 15 U.S.C. § 1012 (2006).

7. *Id.* § 1012(a).

8. *Id.* § 1012(b).

9. 15 U.S.C. §§ 1-7 (2006).

10. 15 U.S.C. §§ 12-27 (2006); 29 U.S.C. §§ 52-53 (2006).

11. ARTHUR SULLIVAN & STEVEN M. SHEFFRIN, ECONOMICS: PRINCIPLES IN ACTION 173 (2007).

aim to promote competition.[12] For example, the Sherman Act outlaws contracts that unreasonably restrain interstate commerce and makes it illegal for a company to monopolize;[13] and the Clayton Act forbids any merger or acquisition which "lessen[s] competition, or . . . tend[s] to create a monopoly."[14] The language of the McCarran-Ferguson Act essentially exempts insurance firms from application of federal antitrust laws, except in certain instances.[15]

One such insurance firm whose insurance business largely escaped scrutiny by the federal government is American International Group ("AIG"). According to the Forbes Global 2000, in 2008 AIG was the eighteenth largest public company in the world,[16] and was listed on the Dow Jones Industrial Average ("DJIA") from April 8, 2004 to September 22, 2008.[17]

AIG was removed from the DJIA following its near implosion the second week of September 2008.[18] The insurance industry giant that was hailed as "too big to fail" was on the brink of collapse due to a lack of liquidity needed to recover from the downgrade in its credit rating.[19] Despite this liquidity crisis, news reports, as well as AIG itself, claimed that AIG remained a "solid company"[20] and its insurance subsidiaries were "financially sound."[21]

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12. *Id.*

13. 15 U.S.C. §§ 1-2 (2006).

14. 15 U.S.C. § 18 (2006).

15. *See* MEIER, *supra* note 2, at 69 ("The McCarran-Ferguson Act" . . . provides that . . . the Sherman Act, the Clayton Act, and the Federal Trade Commission Act shall be applicable to the business of insurance 'to the extent that such business is not regulated by State law.'").

16. *The Global 2000*, FORBES (Apr. 2, 2008), http://www.forbes.com/lists/2008/18/biz_2000global08_The-Global-2000_Rank.html. The Forbes Global 2000 is an annual ranking of the top 2000 public companies based on four metrics: sales, profit, assets, and market value. *Id.*

17. The Dow Jones Industrial Average is an index that shows how thirty large, publicly-owned companies based in the United States have traded during a standard trading session in the stock market. *Ins and Outs of the Dow:* 2000-2009, DOW JONES INDUSTRIAL AVERAGE LEARNING CENTER, http://www.djaverages.com/?view=ilc (last visited Nov. 12, 2010).

18. *Id.* On September 15, 2008, the credit rating of AIG was downgraded by the major ratings agencies, resulting in a liquidity crisis. Mary Williams Walsh & Michael J. de la Merced, *A Race For Cash at A.I.G.*, N.Y. TIMES, Sept. 16, 2008, at C1.

19. Walsh & Merced, *supra* note 18. Downgrading A.I.G.'s credit rating "could allow counterparties to A.I.G.'s swap contracts to require A.I.G. to post collateral of up to $13.3 billion." A.I.G. was "unable to tap the liquid assets in its subsidiaries because of regulatory constraints." *Id.*

20. Press Release, AIG Statement on Announcement by Federal Reserve Board of $85 Billion Secured Revolving Credit Facility (Sept. 16, 2008), *available at* http://media.corporate-ir.net/media_files/irol/76/76115/releases/091708a.pdf.

21. Peter Whoriskey, *AIG Bailout Revives Calls for a Federal Regulator*, WASH. POST, Sept. 30, 2008, at D03.

On September 16, 2008, the United States Federal Reserve Bank ("the Fed") announced the creation of a secured line of credit totaling $85 billion to prevent the collapse of AIG and to protect its business partners.[22] The federal bailout of AIG has created much controversy, raising questions regarding the effect of the McCarran-Ferguson antitrust exemption on AIG's downfall and the resultant global economic crisis of 2007-2009.[23]

This Note will examine whether the McCarran-Ferguson exemption of insurance businesses from federal antitrust regulation has outlived its usefulness. Part II includes a brief discussion of the Sherman and Clayton Antitrust Acts. Part III discusses the history of the McCarran-Ferguson Act and its subsequent jurisprudence. Part IV discusses the role of the insurance industry, AIG in particular, in the current economic crisis. Part V will examine the suitability of applying the current federal regulatory schemes, including the Sherman Act[24] and the Clayton Act,[25] to the insurance business. Finally, this Note will discuss the creation of an independent, centralized federal regulator to oversee the insurance business, in addition to the elimination of the antitrust immunity provided to insurers.

The analysis concludes that, given the insurance industry's role in the current financial crisis, the McCarran-Ferguson exemption of insurance companies from federal antitrust regulation has outlived its usefulness. Federal oversight is needed, both through the application of the Sherman and Clayton Acts and the creation of a federal regulatory body.

II. ANTITRUST 101: THE SHERMAN AND CLAYTON ANTITRUST ACTS

A need for antitrust legislation first surfaced in the 1800s when big businesses, known as "trusts," controlled major sections of the economy, such as railroads, oil, and steel.[26] The first such antitrust

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22. Edmund L. Andrews, Michael J. de la Merced & Mary Williams Walsh, *Fed in an $85 Billion Rescue of an Insurer Near Failure,* N.Y. TIMES, Sept. 17, 2008, at A1. The available credit was increased to $182.5 billion by March 2009. Joint Press Release, Board of Governors of the Federal Reserve and the U.S. Department of the Treasury, U.S. Treasury and Federal Reserve Board Announce Participation in AIG Restructuring Plan (Mar. 2, 2009), *available at* http://www.federalreserve.gov/news events/press/other/20090302a.htm

23. *See, e.g.*, John Bury, *Say the Words Geithner: REPEAL MCCARRAN-FERGUSON*, NJ.COM (Mar. 24, 2009), http://blog.nj.com/njv_johnbury/2009/03-say_the_words_geithner_repeal.html; *The McCarran-Ferguson Act: A History of Insurance*, DAILY KOS (May 23, 2009), http://www.dailykos.com/story/2009/5/23/734267/-The-McCarran-Ferguson-Act:-A-History-of-Insurance.

24. 15 U.S.C. §§ 1-7 (2006).

25. 15 U.S.C. §§ 12-27; 29 U.S.C. §§ 52-53 (2006).

26. *See* FTC Fact Sheet: Antitrust Laws: A Brief History, FED. TRADE

statute was the Sherman Antitrust Act.[27]

The Sherman Act was passed, in part, because one such "trust,"[28] Standard Oil of Ohio, sought to control the entire oil industry by creating a special form of trust agreement to overcome a state prohibition against one company owning stock in another company.[29] The Sherman Act made it illegal for competitors to make agreements with each other that would limit competition.[30] The Sherman Act aimed to keep competition alive, and prevent the raising of prices by restricting trade or supply.[31]

However, the Sherman Act was not sufficient to control potential monopolies. With the growth of business, some companies sought to merge with other companies "as a way to control prices and production."[32] The Clayton Act was signed into law in 1914 to stop mergers or acquisitions that are likely to threaten competition.[33]

Section 7 of the Clayton Act states, in pertinent part: "No person engaged in commerce . . . shall acquire . . . the whole or any part of . . . another person engaged also in commerce . . . where in . . . the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."[34] However, most mergers are inherently seen as being legal and generally are considered a benefit to the economy by increasing efficiency.[35]

In addition to the Sherman and Clayton Antitrust Acts, all fifty states and the District of Columbia have some type of state antitrust statute.[36] However, the states are not uniform in their antitrust scrutiny. Some states follow federal law explicitly, while others provide exemptions for certain industries (or certain operations

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COMMISSION, http://www.ftc.gov/bcp/edu/microsites/youarehere/pages/pdf/FTC-Competition_Antitrust-Laws.pdf (hereinafter "FTC Factsheet").

27. *Id.*

28. The terms trust and antitrust are a bit outdated, as the laws deal more with anti-competition. When the laws were first passed the word "trust" was synonymous with monopolistic practice. *See* William L. Letwin, *Congress and the Sherman Antitrust Law: 1887-1890* 23 U. CHI. L. REV. 221 (1955).

29. FTC Fact Sheet, *supra* note 26.

30. *See* 15 U.S.C. §§ 1-7 (2006).

31. *Id.*

32. *See* FTC Fact Sheet, *supra* note 26.

33. 15 U.S.C. §§ 12-27, 29 U.S.C. §§ 52-53 (2006), *amended by* the Robinson-Patman Act of 1936, 15 U.S.C. § 13 (2009).

34. 15 U.S.C. § 18 (2006).

35. *See* Peter Passell, *Economic Scene: Do Mergers Really Yield Big Benefits?*, N.Y. TIMES, May 14, 1998, at D1.

36. *See, e.g.*, CAL. BUS. & PROF. CODE §§ 16700-70 (West 2005); FLA. STAT. §§ 542.15-.36 (2005); MASS. GEN. LAWS ch. 93, §§ 1-14A (2005); MICH. COMP. LAWS ANN. §§ 445.771-.788 (West 2005); N.Y. GEN. BUS. LAW § 340 (2005); TEX. BUS. & COM. CODE ANN. §§ 15.01-.52 (West 2005).

within certain industries), including insurance.[37]

When the antitrust laws were first enacted, federal antitrust laws were not applicable to the insurance industry because insurance was not "considered to be within the flow of interstate commerce" and, therefore, was not under federal oversight.[38]

III. THE HISTORY OF STATE-BASED INSURANCE REGULATION: FROM *SOUTH-EASTERN UNDERWRITERS* TO THE MCCARRAN-FERGUSON ACT

Going back to the nineteenth century, the insurance business was regulated exclusively by individual states.[39] However, at that time, the insurance companies were not amenable to the idea of state regulation; the insurance companies would have preferred to be regulated at the federal level.[40] Because discontinuing business within the states was not an option for many insurers, a court case made its way to the Supreme Court challenging the legitimacy of state regulation.[41] Samuel Paul, an agent of the New York insurance companies, argued on behalf of insurance that insurance is interstate commerce, and under the Federal Constitution only the federal government has the authority to regulate interstate commerce.[42] The insurers' argument was rejected, and the Supreme Court held that "[i]ssuing a policy of insurance is not a transaction of commerce."[43]

In the wake of *Paul v. Virginia*, the Supreme Court repeatedly

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37. *See, e.g.*, CAL. INS. CODE § 790 (West 2008); 740 ILL. COMP. STAT. 10/5(5) (2005).

38. SECTION OF ANTITRUST LAW, AMERICAN BAR ASS'N, THE INSURANCE ANTITRUST HANDBOOK 1 (1995) (hereinafter "ABA ANTITRUST").

39. MEIER, *supra* note 2, at 51-52. In response to fire insurance insolvencies that plagued many states, states created administrative organizations to regulate insurance, given that "[d]irect legislative regulation of insurance companies was clearly not effective." *Id.* at 52.

40. *Id.* at 53. At that time, insurance companies found it difficult to effectively operate their business when regulations varied drastically across state lines. In addition, some states would provide special treatment to those insurance companies headquartered within the state. *See id.*

41. Paul v. Virginia, 75 U.S. 168 (1869). Samuel Paul, an insurance agent in Virginia working on behalf of New York insurance companies, issued insurance policies without formerly complying with a Virginia statute requiring foreign insurance companies to obtain licensing before doing business in the state. *Id.* at 169.

42. *Id.* at 172-74.

43. *Id.* at 183. In dicta, Justice Field wrote that insurance contracts:

> are not subjects of trade and barter offered in the market as something having an existence and value independent of the parties to them. They are not commodities to be shipped or forwarded from one State to another, and then put up for sale. They are like other personal contracts between parties . . . [and] [s]uch contracts are not inter-state transactions. . . .

Id.

held that the business of insurance was not commerce and was not subject to federal regulation.[44] Meanwhile, states began to establish oversight boards and administrative agencies to regulate insurance.[45]

In order to achieve a sense of uniformity among the states, a coalition of insurance commissioners was formed, which ultimately became known as the National Association of Insurance Commissioners ("NAIC").[46] The states looked to NAIC to maintain uniformity among their practices and laws, and the states continued to regulate insurance without federal intervention.[47]

A. *United States v. South-Eastern Underwriters Association: Insurance Is Commerce*

The concept that insurance was not commerce protected insurance companies from federal regulation until 1944 when another case made its way to the Supreme Court.[48] What started as an investigation into bribery and a price-fixing conspiracy in the state of Missouri by insurance companies led to a grand jury indictment by Attorney General Nicholas Biddle against South-Eastern Underwriters Association ("South-Eastern") of Atlanta.[49]

After his own investigation, Attorney General Biddle brought suit against South-Eastern alleging violations of the Sherman Antitrust Act.[50] The insurers moved to dismiss the case on the grounds that the federal court had no jurisdiction, as "insurance was not commerce."[51] The district court, following *Paul v. Virginia* and its progeny, dismissed the indictment and held "the business of

44. *See* Hooper v. California, 155 U.S. 648, 655 (1895) ("The business of insurance is not commerce."); *see also* New York Life Ins. Co. v. Deer Lodge Cnty., 231 U.S. 495, 510 (1913) ("contracts of insurance are not commerce at all, neither state nor interstate").

45. MEIER, *supra* note 2, at 60.

46. *Id.*

47. *Id.*

48. *Id.* at 53.

49. *Id.* at 65. Missouri Attorney General Roy McKittrick brought suit against Missouri insurers after a bribery conspiracy was uncovered, which was linked to a price-fixing conspiracy. *Id.* Noting the interstate nature of insurance, McKittrick brought the issue to Attorney General Biddle's attention, who selected South-Eastern Underwriters Association as the target, based on "its reputation as one of the more flagrant monopolists." *Id.*

50. United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533, 534 (1944). Attorney General McKittrick had written to the head of the antitrust division of the Department of Justice alleging that he had uncovered evidence that insurance companies were "parties to the most vicious and powerful trust ever devised." *See* Memorandum from Frank H. Elmore, Jr., Special Assistant to Attorney General, to Thurman Arnold, Assistant Attorney General, Dept. of Justice (Jan. 21, 1942) (on file with Author).

51. MEIER, *supra* note 2, at 66.

insurance is . . . not commerce," either intrastate or interstate.[52]

The case was immediately appealed to the United States Supreme Court which reversed the dismissal.[53] The Court also rejected the insurers' arguments that, since previous judicial decisions had repeatedly held that insurance was not commerce, and the Sherman Act did not expressly mention insurance, Congress did not intend for the Sherman Act to cover insurance.[54]

Justice Black, writing for the majority, stated "[n]o commercial enterprise of any kind which conducts its activities across state lines has been held to be wholly beyond the regulatory power of Congress under the Commerce Clause. We can not make an exception of the business of insurance."[55] In addition, the Court in *South-Eastern* rejected the argument that Congress did not intend to have the Sherman Act apply to insurance companies.[56] The Court noted, "Whether competition is a good thing for the insurance business is not for us to consider. Having power to enact the Sherman Act, Congress did so; if exceptions are to be written into the Act, they must come from the Congress, not this Court."[57] In addition, Justice Black dismissed the claim that the "Sherman Act necessarily invalidates many state laws . . . as exaggerated."[58] "[T]he fact that particular phases of an interstate business or activity have long been regulated or taxed by states has been recognized as a strong reason why, in the continued absence of conflicting Congressional action, the state regulatory and tax laws should be declared valid."[59]

Dissenting in part, Justice Jackson noted that state regulation of insurance can and should continue; antitrust laws could reach the

52. United States v. South-Eastern Underwriters Ass'n, 51 F. Supp. 712, 714 (N.D. Ga. 1943), *rev'd*, 322 U.S. 533 (1944) ("[I]nsurance is not interstate commerce or interstate trade, though it might be considered a trade subject to local laws, either State or Federal, where the commerce clause is not the authority relied upon.").

53. Appeal was taken pursuant to the Criminal Appeals Act, ch. 2564, 34 Stat. 1246 (1907) (current version at 18 U.S.C. § 3731 (2006)); *see* MEIER, *supra* note 2, at 66-67.

54. *South-Eastern Underwriters Ass'n*, 322 U.S. at 560-61. ("[The evidence does not] show that the Congress of 1890 specifically intended to exempt insurance companies from the all-inclusive scope of the Sherman Act. . . . From the beginning Congress has used language broad enough to include all businesses, and never has amended the Act to define these businesses with particularity. And the fact that several Congresses since 1890 have failed to enact proposed legislation providing for more or less comprehensive federal regulation of insurance does not even remotely suggest that any Congress has held the view that insurance alone [is exempt from antitrust laws.]").

55. *Id.* at 553.

56. *Id.* at 560-61.

57. *Id.* at 561.

58. *Id.* at 562.

59. *Id.* at 548-49.

business of insurance without changing the "doctrinal status" that insurance has attained as not being interstate commerce.[60] Writing his own dissent, Justice Stone pointed out that "[c]ertainly there cannot but be serious doubt as to the validity of state taxes which may now be thought to discriminate against the interstate commerce."[61] Justice Stone also questioned "the extent to which conditions may be imposed on the right of insurance companies to do business within a state; or in general the extent to which the state may regulate whatever aspects of the business are now for the first time to be regarded as interstate commerce."[62]

B. *The McCarran-Ferguson Act: From a Temporary to a Permanent Immunity to Federal Antitrust Enforcement*

The Court's ruling generated a flood of commentary on the role of the state and federal governments in regulating insurance.[63] Justice Stone's insinuation in his dissent that the majority ruling could make state regulations and taxes unconstitutional spurred an immediate reaction in insurance companies and lobbyists.[64] Insurance firms, which at one point had preferred federal over state regulation, were urging Congress to enact proper exemption legislation.[65] The companies feared that price-fixing and other anti-competitive conduct in which they had engaged in since *Paul* would be prohibited under the Sherman Act.[66]

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60. *Id.* at 588 (Jackson, J., dissenting). Justice Jackson further noted:

> Any enactment by Congress either of partial or of comprehensive regulations of the insurance business would come to us with the most forceful presumption of constitutional validity. The fiction that insurance is not commerce could not be sustained against such a presumption . . . . The fiction therefore must yield to congressional action . . . .

Id.

61. *Id.* at 581 (Stone, J., dissenting).

62. *Id.* at 581-82 (Stone, J., dissenting).

63. *See* Charles D. Weller, *The McCarran-Ferguson Act's Antitrust Exemption for Insurance: Language, History and Policy*, 1978 DUKE L.J. 587, 590-92 (1978). As one observer noted: "the decision precipitated widespread controversy and dismay. Chaos was freely predicated." *Id.* at 590 (quoting NEW YORK INSURANCE DEPARTMENT REPORT 71 (1969)). The discussion on the McCarran-Ferguson Act within this Note focuses primarily on the issue of the antitrust exemption; however, the McCarran-Ferguson Act is another example of the political safeguards of federalism. For further discussion on insurance regulation and the political safeguards of federalism, see Katherine M. Jones, *Law, Politics, and the Political Safeguards of Federalism: The Case of Insurance Regulation and the Commerce Clause, 1938-1948*, 11 CONN. INS. L.J. 345 (2005).

64. MEIER, *supra* note 2, at 67.

65. *Id.* at 69.

66. Larry D. Carlson, *The Insurance Exemption from the Antitrust Laws*, 57 TEX. L. REV. 1127, 1133 (1979); *see also J. Hearing Before the Subcomm. of the Comm. on*

The Court's decision also troubled the states because they feared that state taxation of insurance might be considered "an undue burden on [interstate] commerce."[67] To that end, several bills were introduced to exempt insurance companies from the antitrust laws.[68]

One such bill was proposed by NAIC. The NAIC bill sought to: 1) declare state regulation and taxation acceptable under the Commerce Clause; 2) exempt insurance from the Federal Trade Commission Act; 3) exempt "insurance from the Robinson-Patman Act;" and 4) limit the insurance exemption from the Sherman and Clayton Acts to cooperative procedures relating to statistics, rates, and similar matters.[69] Of the seven sections included in the NAIC bill, section 2 is the most important to the discussion at hand. "Section 2(a) made the business of insurance subject to state tax and regulatory laws, and section 2(b) provided generally that federal law should not 'invalidate, impair, or supersede' state insurance laws."[70]

At the time, there were some who felt that section 2(b) should include the federal antitrust laws.[71] However, there were some politicians and lobbyists who felt that the insurance industry should enjoy a permanent exemption from federal antitrust scrutiny.[72]

The NAIC Bill was ultimately amended and introduced by Senators Pat McCarran and Homer Ferguson.[73] Initially, the McCarran-Ferguson bill advanced a policy that was a compromise between those who were in favor of application of the antitrust laws immediately, and those who preferred an absolute exemption.[74]

To appease both sides of the argument, the bill provided that no federal law would be construed to "invalidate, impair, or supersede"

the Judiciary on S. 1362, H.R. 3270, 78th Cong., 1st Sess. 29-30, 61-62 (1943).

67. Spencer L. Kimball & Ronald N. Boyce, *The Adequacy of State Insurance Rate Regulation: The McCarran-Ferguson Act in Historical Perspective*, 56 MICH. L. REV. 545, 554 (1958); *see* 91 CONG. REC. 1087 (1945) (statement of Rep. Hancock) ("[T]he taxes imposed on insurance companies in many States may be regarded as burdens on interstate commerce, and therefore, unlawful."); *see also id.* at 1090 (statement of Rep. Gwynne) ("I am afraid some of the taxing policies of some of the States will have to be revamped, because they are probably unreasonably impeding interstate commerce.").

68. MEIER, *supra* note 2, at 68. The Walter-Hancock bill was even introduced before the Supreme Court had decided the *South-Eastern* case in order "to eliminate the Supreme Court's jurisdiction." *Id.* Introduced at the request of fire insurance companies, it passed both the House and the Senate before it was reconsidered and defeated. *Id.* at 68-69.

69. Weller, *supra* note 63, at 594.

70. *Id.*

71. MEIER, *supra* note 2, at 72.

72. *Id.*

73. *Id* at 69; *see* 91 CONG. REC. 330 (1945).

74. S. 340, 79th Cong., 1st Sess. § 2(b); 91 CONG. REC. 478 (1945).

any state laws regulating the business of insurance.[75] In addition, section 4 of the bill made the Sherman and Clayton Acts inapplicable until 1947 and 1948, respectively.[76] The moratorium period under section 4 was intended to give the states sufficient time to pass laws authorizing insurance companies to engage in practices otherwise in contravention of antitrust laws which would be in compliance with the *South-Eastern* decision.[77]

However, the McCarran-Ferguson Bill as it was originally introduced underwent several changes before it was finally enacted.[78] After discussion in the Senate and notice of an ambiguity between sections 2(b) and 4 of the proposed bill, Senator Ferguson introduced an amendment that affirmatively restored application of the Sherman and Clayton antitrust laws after the moratorium period.[79] Senator Ferguson explained that although the *South-Eastern* decision sprung from an antitrust issue: "[w]e wanted to have the Clayton Act and the Sherman Act apply to insurance, but we did not want to go back into all the laws which had been enacted respecting interstate commerce and apply them to the business of insurance."[80]

When the Senate approved the bill, the Sherman and Clayton Acts would apply after expiration of the moratorium period.[81] However, when the bill moved out of committee to the full House, the Ferguson amendment was deleted without explanation.[82] This restored permanent antitrust immunity to the business of insurance, as long as insurance was regulated by the states.[83]

Moreover, records of the debates show that the House understood that the bill still only allowed for a limited moratorium

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75. S. 340, 79th Cong., 1st Sess. § 2(b).

76. S. 340, 79th Cong., 1st Sess. §§ 3(a) & 4.

77. *See* MEIER, *supra* note 2, at 68; *see also* 91 CONG. REC. 488 (1945) (statement of Sen. Joseph O'Mahoney) ("The purpose is to enable the states and the Congress to have time to adjust a very complicated business . . . .").

78. *See, e.g.*, MEIER, *supra* note 2, at 67-69.

79. 91 CONG. REC. 486-88 (1945). The boycott exception in the original bill provided that "[n]othing contained in this section [4] shall render the said Sherman Act inapplicable to any agreement or act of boycott, coercion, or intimidation." 91 CONG. REC. 478 (1945). Section 4 of the proposed bill created the limited moratorium from application of the Sherman and Clayton Acts. The Senate agreed to amend § 4(b) to provide the language, "Nothing contained in this act . . . ." 91 CONG. REC. 488 (1945). When the Senate amended § 2(b) to have the Sherman Act apply to the business of insurance after 1948, the previous change to § 4(b) no longer applied. The bill, as it was sent to the House contained the phrase, "Nothing contained in this section." *Id.*

80. 91 CONG. REC. 486 (1945).

81. S. 340, 79th Cong., 1st Sess. §§ 3(a) & 4.

82. 91 CONG. REC. 1085 (1945).

83. *See id.*

during which federal antitrust legislation would not be enforced against insurance.[84] The House passed the bill,[85] but the Senate disagreed with the amendment and requested that the bill go back to committee.[86]

The Conference Committee again recognized the ambiguity in the language of section 4, which granted a limited moratorium from the antitrust laws, and section 2(b), which provided that acts of Congress should not be construed to "invalidate, impair, or supersede" state regulatory laws.[87] However, instead of excepting the Sherman and Clayton Acts from section 2(b), the committee instead added language that the Sherman, Clayton, and Federal Trade Commission Acts "shall be applicable to the business of insurance to the extent that such business is not regulated by state law" after January 1, 1948.[88] Therefore, if state law regulated the business of insurance, the federal antitrust laws could not be construed to "invalidate, impair, or supersede" the regulatory law; what had been a limited moratorium became a permanent exception to the extent the states regulated the business of insurance.[89]

Furthermore, even though the Ferguson amendment language did not appear in its entirety in the final version of the bill, it was clear that the Sherman and Clayton exemption was intended to be a temporary measure. In signing the bill into law on March 9, 1945, President Roosevelt issued a public statement noting: "After the moratorium period the anti-trust laws and certain related statutes

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84. *See* 91 CONG. REC. 1090 (1945).

> Mr. GWYNNE of Iowa. What the bill does is to grant a moratorium. It provides that until January 1, 1948, there will be no prosecutions under the Sherman Act except [for boycott, coercion, or intimidation].
>
> Mr. JENKINS. As I understand [it] the bill we are considering amounts to a moratorium until 1948?
>
> Mr. GWYNNE of Iowa. That is correct, except as to acts of boycott, coercion, and intimidation.

Id.

85. 91 CONG. REC. 1093 (1945).

86. 91 CONG. REC. 1208 (1945).

87. S. 340, 79th Cong., 1st Sess. § 2(b); *see* 91 CONG. REC. 488 (1945).

88. *See* S. 340, 79th Cong., 1st Sess. § 2(b); H.R. REP. No. 213, 79th Cong., 1st Sess. 1-2 (1945).

89. The version of the McCarran-Ferguson bill that was passed states, in pertinent part:

> No Act of Congress shall be construed to invalidate, impair or supersede any law enacted by any State . . . unless such Act specifically relates to the business of insurance: Provided, That after June 30, 1948 . . . the Sherman Act, . . . the Clayton Act, and . . . the Federal Trade Commission Act, . . . shall be applicable to the business of insurance to the extent that such business is not regulated by State Law.

15 U.S.C. § 1012(b) (2006).

will be applicable in full force and effect to the business of insurance . . . ."[90]

The legislative history of the Act shows that the McCarran-Ferguson Act was intended to be a temporary moratorium on federal antitrust regulation of the insurance industry.[91] However, court holdings and actual operation of the insurance business have followed the practice that federal antitrust regulation will not apply to the insurance industry.

C. Judicial Interpretations—What is the Business of Insurance?

Under the McCarran-Ferguson Act, the antitrust laws are inapplicable to activities constituting the "business of insurance," but only "to the extent that such business is regulated by State Law," and provided that the challenged activity is not "boycott, coercion, or intimidation."[92] When an insurance company invokes the protections afforded by the McCarran-Ferguson exemption, the courts must determine that the federal statute involved "specifically relates to the business of insurance."[93] If it does not, the court then considers whether the activity in question is within the "business of insurance," and if so, whether application of federal statute would "invalidate, impair, or supersede" state law.[94]

The McCarran-Ferguson Act, however, does not define the "business of insurance." The courts have analyzed three factors when determining whether a particular practice constitutes the "business of insurance." In *Union Labor Life Insurance Co. v. Pireno*, the Supreme Court laid out the factors: "*first*, whether the practice has the effect of transferring or spreading a policyholder's risk; *second*, whether the practice is an integral part of the policy relationship between the insurer and the insured; and *third*, whether the practice is limited to entities within the insurance industry."[95]

Moreover, interpretation of what constitutes "the business of insurance" is not limited to judicial opinions. According to a report from the Government Accountability Office ("GAO"), the business of insurance entails: jointly setting agent commission rates; fixing rates pursuant to joint agreements and ratings boards; classifying and re-classifying risks; agreeing to pay damage claims based on agreed-

90. Press Release, President Roosevelt, Mar. 10, 1945, *as reprinted in President Signs Insurance Bill: Moratorium From Anti-Trust Laws Gives States 3 Years to Regulate the Industry*, N.Y. TIMES, Mar. 11, 1945, § 5, at 45.

91. *See supra* text accompanying footnotes 76-86.

92. *See* 15 U.S.C. §§ 1011-1015 (2006).

93. ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW 56, 62 (1987).

94. *Id.*

95. 458 U.S. 119, 129 (1982); *see also* Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. 205, 215-21 (1979).

upon labor rates; limiting or refusing to offer certain types of coverage; and, jointly undertaking activities to limit risks—including by revising policy language.[96]

The McCarran-Ferguson exemption has been judicially narrowed over the past sixty years.[97] Courts have distinguished the general federal regulatory exemption of the McCarran-Ferguson Act from the specific antitrust exemption provided in the McCarran-Ferguson Act.[98] Cases involving the applicability of the Sherman Act to insurance practices regulated by the states take a narrower approach to the phrase "business of insurance" and apply the three criteria laid out in the *Pireno* case.[99]

However, it is important to note the Court has held that even if a challenged practice constitutes the business of insurance and is regulated by the states, qualifying the practice as exempt from antitrust liability, the exemption is forfeited if the practice involves a third party outside the insurance industry.[100] The Court in *Royal Drug* held that "an exempt entity forfeits [its] antitrust exemption by acting in concert with nonexempt parties."[101]

D. *Judicial Interpretations—What Does it Mean to be Regulated by the States?*

Section 2(b) of the McCarran Act makes the Sherman, Clayton, and Federal Trade Commission Acts applicable to the business of insurance "to the extent that such business is not regulated by State Law."[102] However, the McCarran-Ferguson Act does not require a degree of state regulation necessary to exempt insurance from federal antitrust oversight.[103]

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96. U.S. GOV'T ACCOUNTABILITY OFFICE, B-304474, LEGAL PRINCIPLES DEFINING THE SCOPE OF THE FEDERAL ANTITRUST EXEMPTION FOR INSURANCE (2005), *available at* http://www.gao.gov/decisions/other/304474.htm.

97. *See Royal Drug Co.*, 440 U.S. at 215-21.

98. *Compare* Union Labor Life Ins. Co. v. Pireno, 458 U.S. 119, 129 (1982) (noting that Congress did not intend for agreements unrelated to the business of insurance to be subject to the McCarran-Ferguson Act), *with* Hartford Fire Ins. Co. v. California, 509 U.S. 764, 781 (1993) ("By its terms, the antitrust exemption of § 2(b) of the McCarran-Ferguson Act applies to 'the business of insurance' to the extent that such business is regulated by state law.").

99. *See, e.g.*, Hartford Fire Ins. Co. v. California, 509 U.S. 764, 781 (1993).

100. *See Royal Drug Co.*, 440 U.S. at 230-31 (1979); *see also* Homestead Mobile Homes, Inc. v. Foremost Corp. of America, 603 F. Supp. 767, 772 (N.D. Tex. 1985).

101. *Royal Drug Co.*, 440 U.S. at 231 (1979) (finding that agreements between HMOs and pharmacies that enabled the HMOs to lower costs were not the business of insurance and therefore not exempt from antitrust laws).

102. 15 U.S.C. § 1012(b) (2006).

103. *E.g.* Kimball & Boyce, *supra* note 67, at 570-73 ("The court did not inquire beyond the fact that there was legislation, but apparently the argument that

The federal courts, however, have repeatedly allowed the exemption to apply upon a showing that "a State statute generally proscribes or permits or authorizes certain conduct on the part of the insurance companies."[104] Moreover, the Supreme Court has declined to decide whether the quality of state regulation should be relevant under section 2(b).[105]

In addition to the state legislation regulating insurance companies, all fifty states have some type of state antitrust statute.[106] The states are not uniform in their antitrust scrutiny; some states adhere to the standards enumerated under Federal law, others exempt some practices within insurance from State antitrust oversight, and still others have no exemption at all.[107]

There are some questions whether the states are effective at regulating insurance companies through their antitrust statutes. A 2005 New York-led investigation of several large national insurance firms, including AIG, uncovered extensive bid-rigging, collusion, and other anticompetitive practices.[108]

However, "[t]his is not just New York State's problem, it is a pervasive national problem."[109] In many states, the insurance commission does not have the capacity to regulate or prosecute any anticompetitive behavior by insurance companies. A 2009 Center for American Progress survey of actions by state insurance

inadequacy of regulation might bring the Sherman Act into operation was not made to the court.").

104. California League of Indep. Ins. Providers v. Aetna Cas. & Sur. Co., 175 F. Supp. 857, 860 (N.D. Cal. 1959) (internal citations omitted); *see also* Crawford v. American Title Ins. Co., 518 F.2d 217 (5th Cir. 1975); Ohio AFL-CIO v. Ins. Rating Bd., 451 F.2d 1178 (6th Cir. 1971), *cert. denied,* 409 U.S. 917 (1972).

105. *See* SEC v. Nat'l Secs., Inc. 393 U.S. 453 (1969).

106. *See, e.g.*, CAL. BUS. & PROF. CODE §§ 16700-16770 (West 2005); FLA. STAT. §§ 542.15-.36 (2005); MASS. GEN. LAWS ch. 93, §§ 1-14A (2005); MICH. COMP. LAWS ANN. §§ 445.771-.788 (West 2005); N.Y. GEN. BUS. LAW §§ 340, et. seq. (McKinney 2005); TEX. BUS. & COM. CODE ANN. §§ 15.01-.26 (West 2005).

107. *Compare, e.g.,* CAL. INS. CODE § 790 (West 2008) (regulates trade practices in the business of insurance "in accordance with the intent of Congress"), *and* 740 ILL. COMP. STAT. § 10/5(4) (2005) (insurance-related activities are exempted from the Illinois Antitrust Act to the extent insurance activities are subject to the Insurance Code or any other law of Illinois), *with* Ohio v. Ohio Med. Indemnity, Inc., No. C 275-473, 1976 WL 1333 at *3 (S. D. Ohio 1976) ("The question really is whether the State of Ohio has preempted the regulation of the business of insurance by its statutory scheme. The Court holds that the State has done so, albeit by a system of non-regulation.").

108. Julie Satow, *AIG Six-Year Saga of Alleged Fraud,* HUFFINGTON POST (Mar. 24 2009), http://www.huffingtonpost.com/2009/03/24/aig-fraud-history_n_178545.html.

109. *The McCarran-Ferguson Act - Implications of Repealing the Insurers' Antitrust Exemption: Hearing Before the S. Comm. on the Judiciary,* 109th Cong. 5 (2006) (statement of Elinor R. Hoffman, Asst. Att'y Gen., Antitrust Bureau, Office of the Att'y Gen for the State of New York).

commissioners found that enforcement by state insurance commissioners was limited and sporadic at best.[110] In addition, the survey uncovered that state insurance commissioners did not bring any antitrust actions against any insurance companies.[111]

Furthermore, the states' limited jurisdiction makes it difficult to effectively regulate an international insurance company. One such insurance company that may not have been as effectively regulated as possible is AIG.

IV. THE AIG CRISIS: TOO BIG TO FAIL?

AIG is a large, complex insurance and financial services conglomerate with business lines spanning from general and life insurance to complex financial transactions.[112] AIG's roots can be traced back to 1919 when Cornelius Vander (CV) Starr founded an insurance agency, American Asiatic Underwriters ("AAU") in Shanghai, China.[113] What started as a primarily international-based company eventually came to the United States when American International Underwriters ("AIU") was opened in New York in 1926, and the AAU headquarters were moved there in 1939.[114] Through a series of acquisitions, AIU eventually became American Home, M.R. "Hank" Greenberg was appointed president, and AIG was officially formed in 1967.[115]

A. *AIG Mergers and Acquisitions: From Insurance Giant to Multinational Financial King*

Under Hank Greenberg, AIG continued to make various acquisitions, expanding its presence both nationally and internationally.[116] Since 1960, AIG has participated in "nine big [mergers]."[117] Because AIG is an insurer, and as discussed above is exempt from federal antitrust oversight, their numerous large mergers and acquisitions were not subject to "serious merger review,"

110. *See* David Balto & Stephanie Gross, *Don't Leave it to the States: Leaving Health Insurance Oversight to State Regulators is a Dangerous Idea,* CENTER FOR AMERICAN PROGRESS (Oct. 22, 2009), http://www.americanprogress.org/issues/2009/10/health_oversight.html.

111. *Id.*

112. *Pre-September 2008: The AIG Crisis,* AM. INT'L GROUP, http://www.aigcorporate.com/aboutaig/pre_september_2008.html (last visited Nov. 12, 2010).

113. RONALD SHELP WITH AL EHRBAR, FALLEN GIANT: THE AMAZING STORY OF HANK GREENBERG AND THE HISTORY OF AIG 22-23 (2d ed. 2006).

114. *Id.* at 39, 47.

115. *Id.* at 100-03.

116. *See generally id.* (describing the rise and fall of Hank Greenberg and AIG).

117. *'Too Big to Fail?': The Role of Antitrust Law in Government-Funded Consolidation in the Banking Industry: Hearing Before the Subcomm. on Courts and Competition Policy of the Comm. on the Judiciary,* 111th Cong. 77 (2009).

which is undertaken to stop anticompetitive monopolies from being formed.[118]

Section 7 of the Clayton Act aims to curb anticompetitive mergers.[119] As discussed above, insurance companies are not subject to federal oversight when there is a state law that would regulate the business of insurance. While there is no clear guidance on whether the Sherman and Clayton Antitrust Acts apply to insurance, the "safest assumption is that insurance mergers are subject to . . . the substantive prohibitions of the antitrust laws."[120]

However, at one time it was believed that even in the absence of the antitrust exemption, "[m]ost insurance mergers should survive scrutiny . . . because most insurance markets are unconcentrated."[121] This principle seems to only apply, however, to horizontal mergers, or mergers between direct competitors.

During this time of expansion, and for nearly eighty years, AIG was solely involved in the insurance business. However, two of AIG's major mergers and acquisitions moved AIG from being a "successful, rock-solid commercial property and casualty insurer" to a large financial conglomerate.[122] In the case of the AIG mergers and acquisitions, they would be considered vertical mergers, which tend to not draw the attention of the antitrust enforcers, despite changing the inherent nature of the business.[123]

In 1998, AIG acquired SunAmerica, a large financial firm that specialized in retirement savings.[124] In December 1999, AIG ventured further into financial services and became a thrift holding company when the Office of Thrift Supervision ("OTS") approved its application to charter AIG Bank.[125] In 2001, AIG purchased

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118. Gary L. Reback, *Trust Busting: How the Atrophying of Antitrust Helped Set the Stage for the Collapse of the Banking Industry*, FORBES (Apr. 15, 2009), http://www.forbes.com/2009/04/15/antitrust-aig-reback-technology-internet-antitrust.html. "Stringent antitrust enforcement might well have mitigated the AIG disaster by preventing some of the company's ill-conceived acquisitions." *Id.*

119. 15 U.S.C. § 18 (2006) ("No person engaged in commerce . . . shall acquire . . . the whole or any part of . . . another person engaged also in commerce . . . where in any a line of commerce or in . . . any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.").

120. ABA ANTITRUST, *supra* note 38, at 126-27.

121. *Id.* at 132.

122. Reback, *supra* note 118.

123. Vertical mergers are between companies that offer complimentary products. Such mergers "merit not a moment's worth of attention because an acquisition in a related market rarely augments a company's ability to charge higher prices." Reback, *supra* note 118.

124. *Id.*

125. *See* Press Release, Office of Thrift Supervision, OTS Grants AIG Federal Charter (Dec. 10, 1999), *available at* http://files.ots.treas.gov/77985.html; *see also*

American General, a life insurance and consumer loan company.[126]

AIG was no longer solely an insurance company; it was a global financial giant that offered products outside the traditional definition of the business of insurance.[127] These two acquisitions and entry into banking greatly changed the structure and operations of AIG.

One such structural change was that AIG now owned a thrift holding company, AIG Bank, and it could elect to have OTS as its regulator.[128] Under the Gramm-Leach-Bliley Act of 1999,[129] certain companies could elect to be regulated by the OTS, provided they owned at least one thrift or savings-and-loan.[130] With the creation of AIG Bank, AIG was using a loop-hole in the Gramm-Leach-Bliley Act to further expand its business lines, but under the supervision of OTS.[131] OTS's oversight duties "expanded when European regulators in January 2007 conferred on the OTS the authority to supervise AIG's overseas operations," including AIG Financial Products (AIGFP), a London-based subsidiary.[132]

B. *AIGFP: Investing in Credit Default Swaps and the Beginning of the Collapse*

AIGFP was founded as a joint venture in 1987 by three former

Press Release, Office of Thrift Supervision, OTS Approves AIG Acquisition of American General Bank (Aug. 1, 2001), *available at* http://files.ots.treas.gov/77152.html.

126. *AIG Wins American General,* CNN MONEY (May 11, 2001), http://money.cnn.com/2001/05/11/europe/pru/index.htm.

127. See *supra* text accompanying notes 124-26.

128. Ed Leefeldt, *Did AIG Find the Dumbest Regulator in Town?,* BNET (Mar. 29, 2009), http://industry.bnet.com/financial-services/1000644/did-aig-find-the-dumbest-regulator-in-town/.

129. Pub. L. No. 106-102, 15 U.S.C. §§6801-09 (2006).

> This bill . . . was designed to gut regulatory practice by letting all financial services companies into all financial businesses. Regulation was to be done by function, so if a bank decided to get into selling securities, its securities business would be subject to regulation by SEC, while its banking business remained under its primary regulator. Each financial company would get a primary federal regulator, and the Fed acts as the consolidated or umbrella regulator.

Masaccio, *The AIG Scandal, Brought to You by Light Touch Regulation,* FIREDOGLAKE (Mar. 29, 2009), http://firedoglake.com/2009/03/29/the-aig-scandal-brought-to-you-by-light-touch-regulation/.

130. Matt Taibbi, *The Big Takeover: The Global Economic Crisis Isn't About Money – It's About Power. How Wall Street Insiders are Using the Bailout to Stage a Revolution,* ROLLING STONE, Mar. 19, 2009, at 27. "Because the OTS was viewed as more compliant than the Fed or the SEC, companies rushed to reclassify themselves as thrifts." *Id.*

131. *See id.*

132. Jeff Gerth, *Was AIG Watchdog Not Up to the Job?,* PROPUBLICA (Nov. 10, 2008), http://www.propublica.org/feature/was-aig-watchdog-not-up-to-the-job.

Wall Street traders who had experience in derivative trades.[133] In 1993, the joint venture ended, and AIG operated AIGFP as a fully owned subsidiary.[134] What AIGFP aimed to do was assist investment banks, governments, municipalities and corporations in devising "methods to free up cash, get rid of debt, and guard against rising interest rates or currency fluctuations."[135]

AIGFP used the AAA credit rating[136] of AIG to enter into these derivative transactions.[137] Because AIG was rated AAA, it did not have to post as much collateral on the derivative contracts it wrote, which made them much more profitable.[138] By 1998, AIGFP had annual revenue of $323 million.[139]

That same year, JP Morgan approached AIG and proposed that they insure JP Morgan's complex corporate debt.[140] With this, AIGFP first began to engage in credit default swaps.[141] AIG believed that they would never have to pay out on the deals, as the company never expected that JP Morgan would default, unless there was a full-blown depression.[142] And even in that instance, it was believed that all counterparties would be eliminated as well, and no one would be

133. Robert O'Harrow, Jr. & Brady Dennis, *What Went Wrong: The Beautiful Machine*, WASH. POST, Dec. 29, 2008, at A01. A derivative is "[a] financial instrument whose value depends on or is derived from the performance of a secondary source such as an underlying bond, currency, or commodity." BLACK'S LAW DICTIONARY 475 (8th ed. 1999). What this essentially means is that an investment in a derivative instrument will either gain or lose value (and money) based on certain underlying events. Derivatives are usually used to hedge risk and operate as a type of insurance. *Derivative*, INVESTOPEDIA, http://www.investopedia.com/terms/d/derivative.asp (last visited Sept. 15, 2010).

134. O'Harrow, Jr. & Dennis, *supra* note 133.

135. *Id.*

136. A credit rating is assigned by an independent ratings company to provide an "independent objective assessment[ ] of the credit worthiness of [a] compan[y]." Ream Heakal, *What is a Corporate Credit Rating?*, INVESTOPEDIA, http://www.investopedia.com/articles/03/102203.asp. (last visited Nov. 12, 2010). An AAA rating is the highest rating available and signals the "highest investment grade and means that there is very low credit risk." *Id.*

137. O'Harrow, Jr. & Dennis, *supra* note 133.

138. *Id.*

139. *Id.*

140. Robert O'Harrow, Jr. & Brady Dennis, *A Crack in the System*, WASH. POST, Dec. 30, 2008, at A01.

141. A credit default swap is an insurance contract between a protection buyer and a protection seller covering a corporation's specific bond or loan. A protection buyer pays an upfront amount and yearly premiums to the protection seller to cover any loss on the face amount of the referenced bond or loan. Richard J. Zabel, *Credit Default Swaps: From Protection to Speculation*, PRATT'S J. OF BANK. L., Sept. 2008, *available at* http://www.rkmc.com/Credit-Defualt-Swaps-From-Protection-To-Speculation.htm.

142. O'Harrow, Jr. & Dennis, *supra* note 133.

demanding payment.[143]

However, in 2005, following an investigation by the New York Attorney General, CEO Hank Greenberg departed AIG.[144] In response to Greenberg's departure, as well as the New York State investigation into AIG's questionable business practices, the credit rating agencies downgraded AIG's rating from AAA to AA.[145] This downgrade triggered provisions in some of the credit default swaps AIGFP had entered into, causing AIGFP to owe more than $1 billion in collateral payments.[146]

After this, AIGFP realized that the majority of its $80 billion of debt obligations were tied to sub-prime mortgage; the risk of default would be high if the housing market were to collapse.[147] By summer 2007, the housing market had begun to do just that, and certain counter-parties began to demand collateral to cover the securities that the credit default swaps insured.[148]

On September 16, 2008, AIG's credit rating was going to be downgraded again.[149] At this point, AIG was required to post additional collateral, which resulted in a lack of liquidity.[150] As a result, AIG was unable to cover the calls for collateral made by its counterparties.

The insurance industry giant that was hailed as "too big to fail" was on the brink of a collapse that could have caused a ripple effect on its counterparties.[151] The next day, the United States Federal Reserve Bank announced the creation of a secured credit line of $85 billion to prevent the collapse of AIG.[152]

At the time of AIG's near collapse, many were saying that the housing collapse was the cause of the crisis.[153] However, had it not

143. *Id.*

144. SHELP, *supra* note 113, at 166.

145. Robert O'Harrow, Jr. & Brady Dennis, *Downgrades and Downfall*, WASH. POST, Dec. 31, 2008, at A01.

146. *Id.*

147. *See id.*

148. *See id.* Under the terms of the contracts, AIGFP was required to post more collateral than had it maintained its AAA credit rating.

149. *Id.*

150. *Id.*

151. Mary Williams Walsh & Michael J. de la Merced, *A Race for Cash at A.I.G.*, N.Y. TIMES, Sept. 16, 2008, at C1; *see also Did We Need to Bail Out AIG?*, ECONOMIST (Apr. 14. 2009), http://www.economist.com/blogs/freeexchange/2009/04/did_we_need_to_bail_out_aig.cfm, ("The justification has been that if AIG defaulted on its CDS contracts it would cause a ripple effect, bringing everyone who bought them into serious peril.").

152. Andrews et al., *supra* note 22.

153. Gretchen Morgenson, *Behind Biggest Insurer's Crisis, A Blind Eye to a Web of Risk*, N.Y. TIMES, Sept. 28, 2008, at A1.

been for the "intricate financial contracts" known as credit default swaps, the system may not have been as vulnerable.[154] As the primary regulator of AIGFP, OTS was responsible for regulating the high-risk credit default swaps.[155] However, in the days and weeks that followed the near collapse and subsequent bailout, most news outlets did not mention the failure of OTS to properly oversee AIG's use of credit default swaps.[156]

It was not until a congressional hearing in March 2009 that OTS finally stepped up and accepted blame for the meltdown. In testimony, Scott Polakoff, interim director of OTS, stated that "[i]t is time for OTS to raise their hand and say we have some responsibility and accountability here. . . . We were deemed an accepted regulator for both U.S. domestic and international operations."[157] However, it is clear that even though OTS was deemed an acceptable regulator, its oversight was lacking.

C. AIGI: The Other Side of the Coin: Securities Lending

While AIGFP was dealing in risky derivatives under the apparent oversight of OTS, the insurance units of AIG were involved in securities lending by AIG Investments ("AIGI").[158] AIG's securities lending practice was "the program whereby AIG lent securities held by its life insurance subsidiaries to hedge funds which in turn shorted the stock."[159] AIG invested the money it received from those

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154. *Id.*

155. *See* Eric Dinallo, *What I Learned at the AIG Meltdown: State Insurance Regulation Wasn't the Problem,* WALL ST. J., Feb. 2, 2010, at A17.

156. *See AIG and the Trouble with 'Credit Default Swaps',* NPR (Sept. 18, 2008), http://www.npr.org/templates/story/story.php?storyId=94748529; *see also*, Adam Davidson, *How AIG Fell Apart,* REUTERS (Sept. 18, 2008), http://www.reuters.com/article/idUSMAR85972720080918. Incidentally, while the subprime crisis was beginning to unravel in 2007, the U.S. Government Accountability Office ("GAO") openly criticized the OTS, noting "a disparity between the size of the agency and the diverse firms it oversees." U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-154, FINANCIAL MARKET REGULATION: AGENCIES ENGAGED IN CONSOLIDATED SUPERVISION CAN STRENGTHEN PERFORMANCE MEASUREMENT AND COLLABORATION 54 (2007). The GAO report also noted that among its staff, the OTS only had one insurance specialist. *Id.*

157. *American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation: Hearing Before the Comm. on Banking, Hous., and Urban Affairs,* 111th Cong. 19 (2009) [hereinafter "AIG Hearing"] (statement of Scott M. Polakoff, Acting Director, Senior Deputy Director, and Chief Operating Officer of the Office of Thrift Supervision).

158. Serena Ng & Liam Pleven, *An AIG Unit's Quest to Juice Profit: Securities Lending Business Made Risky Bets. They Backfired on Insurer,* WALL ST. J., Feb. 5, 2009, at C1.

159. Ann Kramer, *State Insurance Regulation: The Lessons of History (AIG Edition),* REED SMITH LLP (May 27, 2009) http://www.policyholderperspectives.com/tags/securities-lending/.

securities and invested in high-risk, mortgage-backed derivative instruments.[160]

The Federal Reserve and other regulators typically see securities lending as a "business with few risks."[161] However, like AIGFP, AIGI's securities lending practice had a large exposure to subprime mortgage related assets. As evidenced in state regulatory filings, the "securities-lending unit used almost two thirds of its $78 billion in cash collateral to buy mortgage-backed securities."[162]

In September 2008, at the same time as AIGFP was suffering its own problems, borrowers in the securities lending program wanted a return of their cash collateral.[163] "[Be]cause of the illiquidity in the market for [mortgage-backed securities], they could not be sold at acceptable prices, and AIG was forced to find alternative sources of cash to meet these requests."[164] The Federal Reserve Bank of New York made available $44 billion to help resolve the securities lending program.[165]

Unlike the AIGFP credit default swaps which were regulated by OTS, the AIG securities lending program was regulated by the state insurance regulators.[166] Even after AIG had almost imploded but for the injection of cash from the Fed and from the Federal Reserve Bank of New York, the state regulators still did not agree that the securities lending practice needed to be better regulated.[167] In addition, the state regulators insisted that it was only AIGFP which

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> The idea behind securities lending is to take advantage of large numbers. Insurers like AIG accumulate large quantities of long-term corporate bonds and other securities, earmarked to pay claims down the road. They can goose that return by lending out the securities to banks and brokers in exchange for cash collateral. The insurers then invest that cash to squeeze out a bit more yield for themselves and the securities borrowers. They usually achieve this by parking the cash in other fixed-income investments, such as Treasury bonds or short-term corporate debt.

Ng & Pleven, *supra* note 158.

160. Ng & Pleven, *supra* note 158.

161. Miles Weiss, *AIG to Absorb $5 Billion Loss on Securities Lending*, BLOOMBERG (June 27, 2008), http://www.bloomberg.com/apps/news?pid=20601103&sid=aoGjre8ctFFk&refer=us.

162. *Id.*

163. *What AIG Owes the Government*, AM. INT'L GROUP (June 30. 2010), http://www.aigcorporate.com/GIinAIG/owedtoUS_gov_details.html.

164. *Id.*

165. *How Much Does AIG Owe the Government?*, CPI FINANCIAL (Oct. 13, 2009), http://www.cpifinancial.net/v2/fa.aspx?v=0&aid=369&sec=insurance.

166. O'Harrow, Jr. & Dennis, *supra* note 133; *see also* Dr. Manhattan, *Convenient Fictions About AIG*, THE ATLANTIC (May 22, 2009), http://www.theatlantic.com/business/archive/2009/05/convenient-fictions-about-aig/18072/.

167. *See* AIG Hearing, *supra* note 157, at 9-10.

attributed to the near-collapse of AIG.[168]

Even in a March 15, 2009, release detailing the payments AIG made to its counterparties, $66 billion went to AIGFP (about $54 billion of which is related to the credit default swaps); but the state regulated insurance businesses lost about $43.7 billion on securities-lending transactions.[169] That same month, Joel Ario, the Insurance Commissioner of Pennsylvania, wanted to "clarify the difference between the financial products which are regulated – to the extent it was regulated at all, by the federal government – and the insurance companies which are regulated by, we think, a very effective state-based regulatory system."[170] Further, Eric Dinallo, Insurance Commissioner for the State of New York, stated, "AIG securities' lending was consolidated by the holding company at a special unit it set up and controlled. This special unit was not a licensed insurance company. As with some other holding company activities, it was pursued aggressively rather than prudently."[171]

Incidentally, the Texas Department of Insurance acknowledged the securities lending practice and the investments in risky mortgage-related securities.[172] According to an analyst, the Texas Department of Insurance was "'aware of this portfolio, but . . . didn't have transparency on what was in it because it was off-balance sheet' in the company's statutory accounting reports."[173]

State regulators were quickly realizing that the extent of AIG's liquidity crisis was beyond state regulators' ability to handle appropriately.[174] Both the states and the federal government were limited in their ability to effectively regulate AIG.[175]

V. SOLUTIONS TO THE PROBLEM: REPEAL MCCARRAN FERGUSON AND/OR FEDERAL REGULATION

Throughout the years, there have been many attempts to amend or repeal the McCarran-Ferguson Act. However, past proposals to have the federal government responsible for regulation of insurance have been successfully opposed by the states and the insurance

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168. *See id.*

169. Dr. Manhattan, *supra* note 166.

170. Tom Macguire, *Who Broke AIG,* JUST ONE MINUTE (March 18, 2009), at http://justoneminute.typepad.com/main/2009/03/who-broke-aig-.html.

171. *See* AIG Hearing, *supra* note 157, at 58 (prepared statement of Eric Dinallo, Superintendent, New York State Insurance Department).

172. Weiss, *supra* note 161.

173. *Id.*

174. *See* Sean P. Carr, *The AIG Effect: AIG Aftermath Spurs State Regulators to Modernize,* TRADING MARKETS (Sept. 8, 2009), http://www.tradingmarkets.com/.site/news/Stock%20News/2516217/.

175. *Id.*

industry.[176]

These past proposals were directed at correcting "perceived deficiencies in state regulation."[177] However, they failed due to "pledges from state regulators to work for more uniformity and efficiency" in the state regulatory process.[178]

A. *Repeal McCarran-Ferguson—Application of Sherman & Clayton Acts*

An important effort towards overhauling the regulatory structure of insurance companies began in the mid-1980s.[179] Several hearings were held and proposals were made to create a federal regulatory body modeled after the Securities and Exchange Commission ("SEC").[180] Again, the states and the insurance industry instituted reforms for new standards, and federal regulation was defeated.[181]

After the state attention to instituting reforms, Congress's general attention on insurance regulatory matters decreased during the second half of the 1990s.[182] However, in more recent sessions, Congress has begun to pay more attention to evaluating the regulatory structure of insurance.[183] From the 107th through the 110th Congresses, the House Financial Services Committee held several hearings "at both the subcommittee and full committee levels on insurance matters," several of these dealing with amending or repealing the McCarran-Ferguson Act.[184]

In 2005, the Insurance Competitive Pricing Act ("ICPA") was introduced.[185] The ICPA did not advance a total repeal of McCarran-Ferguson; it would maintain an exemption from federal antitrust laws for the business of insurance, as regulated by the States, except for price fixing, market allocation, tying arrangements or

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176. BAIRD WEBEL, CONG. RESEARCH SERV., INSURANCE REGULATION: ISSUES, BACKGROUND, AND LEGISLATION IN THE 111TH CONGRESS 1 (2009) (hereinafter: "CRS REPORT"). Some narrow exceptions to the state-based structure of insurance regulation have been enacted such as that for some types of liability insurance in the Liability Risk Retention Act. 15 U.S.C. § 3901 (2006).

177. CRS REPORT, *supra* note 176.

178. *Id.*

179. *Id.* "[C]ongressional scrutiny was largely driven by the increasing complexities of the insurance business and concern over whether the states were up to the task of ensuring consumer protections, particularly insurer solvency." *Id.* at summary page.

180. *Id.* at 1-2.

181. *Id.*

182. *Id.* at 2.

183. *Id.*

184. *Id.* at 2, 4, 10.

185. H.R. 2401, 109th Cong. (2005).

monopolization.[186]

The National Insurance Act of 2006[187] ("NIA"), introduced by Senators John Sununu and Timothy Johnson, provided for a full repeal of McCarran-Ferguson antitrust immunity, as well as transferring insurance regulation from the states to the federal government.[188] The approach taken under the NIA is that insurance is an interstate, as well as international, enterprise and state regulation is inefficient and ineffective.[189]

National insurance companies would no longer be exempt from antitrust enforcement under the McCarran-Ferguson Act except for an important safe harbor. The new exemption would protect "the development, dissemination, or use of standard insurance policy forms (including standard endorsements, addendums, and policy language), or to activities incidental thereto, by National Insurers, National Agencies, and federally licensed insurance producers."[190]

In 2009, the Insurance Industry Competition Act (IICA) was also introduced to fully repeal the McCarran-Ferguson Act.[191] The IICA "would repeal the exemption and give the Department of Justice and the Federal Trade Commission the authority to apply the antitrust laws to anticompetitive behavior by insurance companies."[192] However, the IICA would not affect the ability of each state to regulate insurance.[193] However, like NICPA and NIA, IICA never made it out of committee hearings and a full vote was not held.[194]

As of this writing, there are three pending measures to modify the antitrust exemption under the McCarran-Ferguson Act.[195]

186. *Id.*

187. S. 2509, 109th Cong. (2006). The NIA was re-introduced in 2007 as S. 40, 110th Cong. (2007).

188. *Id.*

189. *See* John Sununu, Tim Johnson, Melissa Bean & Ed Royce, Op-Ed., *Insurance Companies Need a Federal Regulator*, WALL ST. J., Sept. 23, 2008, at A27. "Letting this 19th-century regulatory model govern a 21st-century global marketplace poses obvious and increasing risks to the health of the insurance industry, American taxpayers and our capital markets." *Id.*

190. S. 2509 § 1702(a)(1), 109th Cong. (2006).

191. H.R. 1583, 111th Cong. (2009).

192. Press Release, Congressman Gene Taylor, Reps. Taylor, Defazio Defend Taxpayers from Further AIG and Insurance Industry Greed: Introduce Legislation to Repeal Insurance Industry's Antitrust Exemption (Mar. 18, 2009), *available at* http://www.taylor.house.gov/index.php?view=article&catid=1%3Apress-releases&id=467.

193. *Id.*

194. *See H.R. 1583: Insurance Industry Competition Act of 2009*, GOVTRACK.US, http://www.govtrack.us/congress/bill.xpd?bill=h111-1583 (last visited Sept. 16, 2010).

195. *See* H.R. 3596, S. 1681, 111th Cong. (2009); H.R. 4626, 111th Cong. (2009); H.R. 1583, 111th Cong. (2009).

However, unlike past attempts to repeal or modify McCarran-Ferguson, this legislation is targeted only to health and medical malpractice insurance.[196]

A full repeal of the McCarran-Ferguson Act is not supported by many, with opponents of a repeal predictably claiming that state law already adequately regulates insurance. As the Iowa Insurance Commissioner, Susan Voss, testified: "Repeal [of McCarran-Ferguson] risks transforming certain insurance practices that help consumers, promote competitiveness, and strengthen markets, into actionable violations of federal antitrust law."[197]

In addition, many claim that the McCarran-Ferguson exemption allows insurers to share data needed by small insurers, who would otherwise be unable to effectively compete.[198] However, the Antitrust Modernization Commission, which specifically looked into the McCarran-Ferguson Act's exemption, stated that in the event of a repeal of the immunity, "such data sharing would be assessed by antitrust enforcers."[199]

B. Federal Regulation: Creation of National Federal Charter

In addition to eliminating or modifying federal antitrust immunity, a number of broad proposals for some form of national federal charter or other federal regulatory oversight in insurance were introduced in both houses of Congress, but none made it to Committee for further discussion. For example, the NIA, introduced in 2006 and 2007, provided for an optional federal charter for insurance, and those insurance companies opting to fall under the federal charter would be regulated by a newly created federal insurance regulatory authority from within the Treasury

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196. *See id.*

197. *The McCarran-Ferguson Act and Antitrust Immunity: Good for Consumers?: Hearing Before the Comm. on the Judiciary,* 110th Cong. 128-29 (2007) (testimony of the National Association of Insurance Commissioners, Susan E. Voss, Commissioner of Insurance, State of Iowa).

198. ANTITRUST MODERNIZATION COMMISSION, ANTITRUST MODERNIZATION COMMISSION: REPORT AND RECOMMENDATIONS 351 (April 2007) [hereinafter "AMC REPORT"]. The Antitrust Modernization Commission (the "Commission") was created pursuant to the Antitrust Modernization Commission Act of 2002, Pub. L. No. 107-273, §§ 11051-60, 116 Stat. 1856. The Commission is charged by statute:

> (1) to examine whether the need exists to modernize the antitrust laws and to identify and study related issues; (2) to solicit views of all parties concerned with the operation of the antitrust laws; (3) to evaluate the advisability of proposals and current arrangements with respect to any issues so identified; and (4) to prepare and submit to Congress and the President a report in accordance with [the authorizing statute].

Id. § 11053.

199. AMC REPORT, *supra* note 198, at 351.

Department, instead of by the States.[200]

In addition, the National Insurance Consumer Protection Act (NICPA) was re-introduced in 2009 by Representatives Royce and Bean.[201] NICPA would establish an Office of National Insurance within the Treasury Department which would be headed by a National Insurance Commissioner.[202] While NICPA did not directly address the repeal of the McCarran-Ferguson Act and the re-application of the federal antitrust laws, it required that an insurer provide prior notice to the National Insurance Commissioner to establish or acquire a subsidiary.[203] However, NICPA also never made it out of committee.[204]

As proposed in NICPA, among other bills, Congress has considered legislation that would authorize an "optional" federal charter ("OFC"), instead of repealing the McCarran-Ferguson exemption. In addition, in 2008 the Treasury Department issued a Blueprint for a Modernized Financial Regulatory Structure, wherein the Treasury recommended the establishment of a federal insurance regulatory structure to provide for the creation of an OFC.[205] This OFC would allow insurance companies to choose between the current system, where insurance companies are regulated on the state level, and a single federal regulatory structure.[206]

The basic design of the OFC that has been proposed is similar to that of the regulatory system that has governed the banking industry.[207] The benefits of the proposed OFC include efficiency and competitive pricing.[208] In addition, "creating an OFC would place the insurance industry on the same regulatory footing as other financial industries modernized under the 1999 Gramm-Leach-Bliley Act."[209]

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200. S. 40, 110th Cong. (2007).

201. H.R. 1880, 111th Cong. (2009).

202. *Id.* § 101.

203. *Id.* § 304(c). NICPA also required approval for a national insurer to "engage in mutual to stock conversions, stock to mutual conversions, mergers, acquisitions, asset transfers and other similar corporate transactions." *Id.* § 304(d).

204. *H.R. 1880: National Insurance Consumer Protection Act of 2009*, GOVTRACK.US, http://www.govtrack.us/congress/bill.xpd?bill=h111-1880 (last visited Sept. 16, 2010).

205. Press Release, U.S. Department of Treasury, *Treasury Releases Blueprint for Stronger Regulatory Structure* (Mar. 31, 2008), *available at* http://www.us.treas.gov/press/releases/hp896.htm.

206. U.S. DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 10 (Mar. 2008).

207. *See id.*; *see also* H.R. 1880, 111th Cong. (2009).

208. *See Optional Federal Insurance Charter*, AM. BANKERS ASS'N, http://www.aba.com/Issues/Issues_OptionalFederal.htm (last visited Sept. 16, 2010).

209. *Id.* In addition, an "OFC insurance regulatory structure should enhance competition among insurers in national and international markets . . . increase efficiency . . . promote more rapid, technological change. It should encourage product

However, not all parties involved think that federal insurance regulation is appropriate. Therese Vaughan, CEO of the National Association of Insurance Commissioners, has stated, "[t]he state-based insurance regulatory system is one of critical checks and balances," where the perils of a single point of failure and omnipotent decision making are eliminated.[210] Michael McRaith, the Illinois Director of Insurance believes the optional federal charter is "a solution in search of a problem."[211]

Moreover, the recent financial turmoil among major insurers such as AIG is evidence that perhaps the time has come to reevaluate the creation of a single federal insurance regulator. The proposals advanced thus far have only recommended an *optional* federal charter.[212] Given that so many insurance firms, such as AIG, have moved beyond just being insurance companies that they are now considered "systemically important financial institutions," federal regulatory oversight is necessary.[213]

VI. CONCLUSION

When a U.S. corporation is "too big to fail" something is terribly wrong. By the end of 2007, AIG had approximately $1 trillion in consolidated assets and operated in over 130 countries.[214] The industry giant has more than 71 insurance companies and over "176 other financial services companies."[215] Each of the 71 insurance

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innovation . . . reduce regulatory costs and, most importantly, it should provide a high quality of consumer protection." *Examining Proposals on Insurance Regulatory Reform: Hearing before the Subcomm. on Capital Markets, Insurance and Gov't Sponsored Enterprises of the Comm. on Financial Servs.*, 110th Cong. 11 (2008) (statement of the Hon. David G. Nason, Assistant Secretary for Financial Institutions, U.S. Department of Treasury).

210. *Perspectives on Systemic Risk: Hearing before the Subcomm. on Capital Markets, Insurance and Gov't Sponsored Enterprises of the Comm. on Financial Serv.*, 111th Cong. 115 (2009) (statement of Therese Vaughan, CEO of the National Association of Insurance Commissioners).

211. *Perspectives on Modernizing Insurance Regulation: Hearing before the Comm. on Banking, Housing and Urban Affairs*, 111th Cong. 46 (2009) (prepared statement of Michael T. McRaith, Director of Insurance, Illinois Department of Finance and Professional Regulation, on behalf of the National Association of Insurance Commisioners).

212. *See supra* text accompanying footnotes 200-09.

213. *See* James B. Thomson, *What to Do About Systemically Important Financial Institutions*, FED. RES. BANK OF CLEV. (August 2009), at http://www.clevelandfed.org/research/policydis/pdp27.cfm.

214. AM. INT'L GRP., 2007 ANNUAL REPORT 3, 30, *available at* http://www.asiaing.com/aig-2007-annual-report.html.

215. *American International Group's Impact on the Global Economy: Before, During, and After Federal Intervention: Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the Comm. on Financial Serv.*, 111th Cong. 137 (2009) (statement of Hon. Joel Ario, Insurance Commissioner,

companies is monitored by the insurance regulators of the state in which it is licensed to operate.[216]

As such, there is no one insurance regulator or federal regulatory agency responsible for AIG's insurance activities. Despite its immense global presence, AIG's financial products units were solely regulated by OTS.[217] As a result of the subprime housing crisis, attention was drawn to both the state and federal regulators and their apparent lack of knowledge of the extent of AIG's involvement.

As discussed in detail above, the exemption from antitrust enforcement within the McCarran-Ferguson Act permitted insurance companies to engage in some anti-competitive behavior.[218] However, it is clear that times have changed since the law was first enacted in 1945.

At that time, the biggest threat to our nation's economy was monopolies.[219] In 1945 when the McCarran-Ferguson Act was enacted, the threat of "boycott, coercion and intimidation" by insurance companies warranted sufficient attention that these three acts were still governed by federal antitrust laws.[220]

Today, however, the biggest concern should be the effect of the failure of any "systemically important financial institutions" on our nation's economy, and how to keep companies from getting so "systemically important" to begin with.[221] One such "systemically important financial institution" was able to bypass federal antitrust review with its many mergers and acquisitions, by virtue of the McCarran-Ferguson antitrust exemption, combined with insufficient state and federal regulatory oversight.

Moreover, for those insurance companies, such as AIG, that have become "too big to fail," a regulatory system that advances a compulsory regulator, or national federal charter, to ensure that any potential failure is eliminated, is imperative. The states have proven ill-equipped to deal with an international enterprise.

When we are told that any corporation is "too big to fail" or that it "cannot go through bankruptcy proceedings because it would devastate our national economy," something needs to change.[222] As Representative Peter DeFazio stated, "AIG was gambling with

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Pennsylvania Insurance Department).

216. *Id.*

217. Taibbi, *supra* note 130.

218. *See supra* Part III.

219. *See supra* Part II.

220. *See* 15 U.S.C. § 1013(b) (2006).

221. *See* Thomson, *supra* note 213.

222. Bradley A. Blakeman, *No Trust in Anti-Trust Laws*, POLITICO (Mar. 25, 2009, 4:53 AM), http://dyn.politico.com/members/forums/thread.cfm?catid=1&subcatid=4&threadid=2221260.

people's life savings and lost it all to speculative and shady transactions and contributed to the current crisis. We must insure this never happens again."[223] To do so, it is time for the McCarran-Ferguson Act to be repealed, for insurance companies to be under full federal antitrust scrutiny, and for a more uniform regulatory system, starting with a national federal charter.

223. Press Release, *supra* note 192.