House
Legislative
Analysis
Section

House Office Building, 9 South
Lansing, Michigan 48909
Phone: 517/373-6466

SELF-EVALUATIVE INSURANCE AUDIT PRIVILEGE

Senate Bill 674 (Substitute H-1)
First Analysis (12-11-01)

Sponsor: Sen. Bill Bullard, Jr.
House Committee: Insurance and Financial Services
Senate Committee: Financial Services

THE APPARENT PROBLEM:

Although insurers are subject to examination by state regulators, some companies also are interested in undergoing an independent audit to determine whether they are in compliance with state and federal regulations. Insurers apparently are reluctant to do so, however, due to fear that an audit report will become a public document. For example, an audit might reveal that an insurer was not complying with a statute that had been amended, because the insurer was not aware of the amendment. Although the insurer would need to correct its practice in order to meet governmental standards, it would not want information about the noncompliance to be publicized. To encourage insurers to engage in self-evaluations and ensure their compliance with current laws, it has been suggested that these audits and audit reports be granted a statutory privilege that would keep them confidential.

THE CONTENT OF THE BILL:

The bill would amend the Insurance Code to create an "insurance compliance self-evaluative audit document" privilege, which would mean that the document could not be admitted as evidence in a civil, criminal, or administrative proceeding and a person who prepared the audit could not be compelled to testify about it. The bill also would do the following:

- Provide for the confidentiality and privilege of a document submitted to the commissioner of the Office of Financial and Insurance Services (OFIS).

- Specify that the privilege would not apply if a court required disclosure after a private hearing.

- Establish the burden of proof for asserting a privilege or grounds for disclosure.

- Exempt specific information from the privilege.

"Insurance compliance self-evaluative audit document" would mean a document prepared as a result of or in connection with an insurance compliance audit, and could include a written response to the findings of such an audit. (This term is described more fully below.) "Insurance compliance audit" would mean a voluntary, internal evaluation, review, assessment, audit, or investigation for the purpose of identifying or preventing noncompliance with or promoting compliance with laws, regulations, orders, or industry or professional standards, conducted by or on behalf of an insurer licensed or regulated under the code or involving an activity regulated under the code.

Creation of Privilege. Except as otherwise provided in the bill, an insurance compliance self-evaluative audit document would be privileged information and would not be discoverable or admissible as evidence in any civil, criminal, or administrative proceeding. Also, except as otherwise provided in the bill, a person involved in preparing such an audit or audit document would not be subject to examination concerning the audit or audit document in any civil, criminal, or administrative proceeding. If the audit or audit document or any portion of it were not privileged, however, the individual involved in its preparation could be examined concerning the portion that was not privileged.

If the document were disclosed to a governmental agency, whether voluntarily or as compelled by law, the disclosure would not constitute a waiver of the privileges with respect to any other person or governmental agency.

Neither of the proposed privileges would apply to the extent that it was expressly waived by the insurer that prepared the document or caused it to be prepared.

The bill states that it would not limit, waive, or abrogate the scope or nature of any other statutory or common law privilege.

Submission to Commissioner. If an insurance compliance self-evaluative audit document were furnished to the commissioner voluntarily or as a result of a request of the commissioner under a claim of authority to compel disclosure under the bill, the commissioner could not provide the document to any other person, and it would have to be given the same confidentiality and protections as provided in Section 222(7) of the code, without waiver of the privileges described above. Any use of the document would be limited to determining whether any disclosed defects in an insurer's policies and procedures or inappropriate treatment of customers had been remedied or that an appropriate plan for remedy was in place. (Section 222(7) requires an examination report to be withheld from public inspection until it is finalized and filed with the commissioner; allows the commissioner to withhold any examination report from the public as long as he or she considers proper; and provides that all information furnished to the OFIS and related to an examination report or investigation is confidential.)

An insurance compliance self-evaluative audit document submitted to the commissioner would remain subject to all applicable statutory or common law privileges, including the work product doctrine, the attorney-client privilege, and the subsequent remedial measures exclusion. A document submitted to the commissioner would remain the property of the insurer and would not be subject to disclosure under the Freedom of Information Act.

Court-Required Disclosure. The privileges proposed by the bill would not apply if a court, after an in camera (private) review, required disclosure in a civil, administrative, or criminal proceeding after determining that the privilege was asserted for a fraudulent purpose and/or that the material was not subject to the privilege as provided in the bill.

The privileges also would not apply in a criminal proceeding if the court determined, after an in camera review, that the material contained evidence relevant to the commission of a criminal offense under the code.

Within 14 days after the commissioner or the attorney general made a written request by certified mail for disclosure of an insurance compliance self-evaluative audit document, the insurer that prepared the document or had it prepared could file with the Ingham County Circuit Court a petition requesting an in camera hearing on whether the document or portions of it were subject to disclosure. An insurer's failure to file a petition would waive the privilege for that request. An insurer asserting the privilege in response to a request for disclosure would have to include all of the following information:

- The date of the document.

- The identity of the entity or individual conducting the audit.

- The general nature of the activities covered by the audit.

- An identification of the portions of the document for which the privilege was being asserted.

Within 30 days after the petition was filed, the court would have to issue an order scheduling an in camera hearing.

If a court required disclosure as described above, it could compel the disclosure of only those portions of a document relevant to issues in dispute in the underlying proceeding. Information required to be disclosed would not be considered a public document or a waiver of the privilege for any other civil, criminal, or administrative proceeding.

Assertion of Privilege. An insurer asserting the proposed privilege in response to a request for disclosure by the commissioner or the attorney general, would have to give the commissioner or the attorney general, at the time of filing any objection to the disclosure, the same the information that would have to be included if an insurer filed a petition for an in camera hearing.

The insurer would have the burden of demonstrating that the privilege applied. Once the insurer had met that burden, a party seeking disclosure in a civil or administrative proceeding on the ground that the privilege was asserted for a fraudulent purpose, would have the burden of proving that. If the commissioner or attorney general were seeking disclosure in a criminal proceeding on the ground that the material contained relevant evidence that was not otherwise available, the commissioner or attorney general would have the burden of proving the elements of that ground for disclosure.

In proceedings under the bill, the parties could stipulate at any time to entry of an order directing that specific information contained in an insurance

compliance self-evaluative audit document was or was not subject to the proposed privilege. Any such stipulation could be limited to that particular proceeding and, absent specific language to the contrary, would not apply to any other proceeding.

Exceptions. The privileges proposed by the bill would not extend to any of the following:

- Documents, communications, data, reports, or other information expressly required to be collected, developed, maintained, or reported to a regulatory agency under the code or other federal or state law.

- Information obtained by observation or monitoring by any regulatory agency.

- Information obtained from a source independent of the insurance compliance audit.

Definition. An insurance compliance self-evaluative audit document could include field notes and records of observations, findings, opinions, suggestions, conclusions, drafts, memoranda, drawings, photographs, exhibits, computer-generated or electronically recorded information, phone records, maps, charts, graphs, and surveys, if this supporting information were collected or developed for the primary purpose and in the course of an insurance compliance audit. An insurance compliance self-evaluative audit document also would include any of the following:

- An insurance compliance audit report prepared by an auditor, who could be an employee of the insurer or an independent contractor. The report could include the scope of the audit, the information gained in it, and conclusions and recommendations, with exhibits and appendices.

- Memoranda and documents analyzing portions or all of the insurance compliance audit report and discussing potential implementation issues.

- An implementation plan that addressed correcting past noncompliance, improving current compliance, and preventing future noncompliance.

- Analytic data generated in the course of conducting the insurance compliance audit.

MCL 500.221

HOUSE COMMITTEE ACTION:

The committee substitute removed a provision specifying that privilege would not extend to a document if the commissioner or attorney general had a compelling need for the information, the information was not otherwise available, and the commissioner or attorney general was unable to obtain the substantial equivalent of the information by any means without incurring unreasonable cost and delay.

FISCAL IMPLICATIONS:

According to the House Fiscal Agency, the bill would have no fiscal impact on state or local government. (12-7-01)

ARGUMENTS:

For:

The bill would encourage insurance companies to undergo self-evaluations to identify noncompliance with the law and promote compliance. Since insurance regulations are complex and constantly changing, it is entirely possible that an insurer might inadvertently fail to comply with current law. For example, a statute governing the computation of interest on an annuity might be amended to require a different actuarial standard. If an insurer is not aware that the law was changed, it will continue to calculate interest based on the original standard. Then, if an independent audit uncovers this practice, the insurer will have a chance to correct it and, if necessary, repay policyholders. If the audit became public, however, the insurer could be exposed to litigation and sanctions. To avoid these consequences, therefore, the insurer might simply not undergo the audit, which means that its noncompliance would remain undiscovered and uncorrected. Insurers should not be penalized for taking steps to improve their performance and ultimately benefit their policyholders.

According to a representative of the Life Insurance Association of Michigan, Illinois enacted similar legislation that has worked well for five years, and New Jersey, North Dakota, and Oregon have enacted other versions of the confidentiality protections for insurers.

For:

Michigan law already allows other industries to perform self-evaluations that are confidential. In particular, the Banking Code of 1999 permits banks

to appoint compliance review committees to evaluate their compliance with federal and state requirements. The code specifies that material gathered or prepared for a compliance review committee is confidential and not discoverable or admissible in evidence in any civil action, unless otherwise required by law (MCL 487.13902). Also, the Natural Resources and Environmental Protection Act provides for the confidentiality of environmental audits, which are voluntary, internal evaluations of facilities subject to state, federal, or local controls (MCL 324.14801 et seq.). Under the act, environmental audit reports are not subject to discovery or admissible as evidence in any civil, criminal, or administrative proceeding. Like financial institutions and businesses subject to environmental laws, insurance companies see the value of self-initiated audits but fear that the audit information could be used by regulatory agencies to identify areas of violation for enforcement action.

In addition, statutes and common law provide for a number of privileges, such as the attorney-client privilege and the physician-patient privilege, which permit the parties to communicate without fear of disclosure. The bill would create a similar protection for the communication between an insurer and an auditor.

Response:

As noted above, the confidentiality allowed for banks applies only to civil proceedings. The documents subject to this privilege also are more narrowly defined than the material under the bill. Perhaps the proposed privilege for insurers should be similarly limited.

For:

The Insurance Marketing Standards Association (IMSA) was created several years ago to function as an independent certification body for insurers that sell individual life insurance and annuity policies and long-term care insurance. To become an IMSA member, an insurer must undergo both a self-assessment and an assessment by an outside, independent examiner; to remain a member, the insurer must repeat this process every three years. An insurer also is required to have a monitoring system (which may include internal auditing) to ensure its compliance with the association's code of conduct and with applicable laws and regulations. If an insurer meets the association's high ethical standards, IMSA will award its "seal of approval". Although the insurance industry appears to be enthusiastic about the association and the concept of third-party certification, insurers are reluctant to participate because they do not want the audit report to become public. By creating a privilege for self-evaluation audits, the bill would encourage insurers to join an organization that promotes honesty, integrity, and sound marketing practices.

Against:

There is concern that the bill could preempt the commissioner's examination authority found in Section 222 of the Insurance Code. This section authorizes the commissioner or his or her representatives to examine any or all of the books, records, and documents of an insurer at any time after it has been incorporated or authorized to do business in this state. Section 222 also requires the commissioner or his or her representatives to examine the books, records, and documents of each authorized insurer at least once every five years. In addition, the business affairs, assets, and contingent liabilities of insurers are subject to examination by the commissioner at any time.

According to supporters of the bill, the proposed privilege would apply only to a self-audit "document", and would not interfere with the commissioner's existing access to information. Under the bill's definition, however, the document could include virtually any item collected or developed for the purpose of the audit. This could leave the commissioner in the position of having to prove that the information sought was not subject to the definition or produced specifically for the audit. Although the privilege would not apply to documents or information "expressly required to be collected, developed, maintained, or reported to a regulatory agency", the commissioner still would have to go though the hearing process and wait for a court to determine that the exception applied. In practical terms, the commissioner's access to information would be seriously compromised.

Against:

Some, including the Office of Financial and Insurance Services, have raised the issue of an unscrupulous insurance company utilizing the privilege granted to internal audits under the bill to hide criminal actions or insulate employees and others who were part of the audit from the scrutiny of regulators. Still others are concerned that HMOs and health insurance carriers' treatment decisions could be kept secret and privileged, thereby increasing the difficulty for patients, who may have been harmed by a decision made by an HMO to deny or delay medical treatment. Perhaps the bill should be looked at more closely to eliminate or further decrease the chances for an unintended, negative outcome.

Against:

Reportedly, the National Association of Insurance Commissioners (NAIC) has formed a workgroup to study the issue of self-evaluative audits. The legislation should be slowed down to give a chance for NAIC to look at the issue and to receive NAIC feedback, either in the form of model legislation or, at the very least, a list of guidelines for states to consider when writing laws pertaining to granting privilege for these audits.

POSITIONS:

The Life Insurance Association of Michigan supports the bill. (12-5-01)

The American Council of Life Insurers supports the bill. (12-5-01)

The Office of Financial and Insurance Services (OFIS) is not opposed to the bill. (12-5-01)

The Michigan Trial Lawyers Association opposes the bill. (12-5-01)

Analyst: S. Stutzky

■This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.