Royal Drug and McCarran Act Protection: The Exception or the Rule? - Group Life & Health Insurance Co. v. Royal Drug Co.

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ROYAL DRUG AND McCARRAN ACT PROTECTION: THE EXCEPTION OR THE RULE? —
GROUP LIFE & HEALTH INSURANCE CO. V. ROYAL DRUG CO.

The legislative protection of the McCarran-Ferguson Insurance Regulation Act of 1945 (McCarran Act)\(^1\) has provided the insurance industry with an immunity from federal antitrust laws that is not enjoyed by other national industries.\(^2\) The Act protects traditional state regulation of the insurance industry by allowing it to preempt federal control, while it leaves the door open to federal antitrust regulation in the event that a state fails to exercise such control.\(^3\) The Supreme Court, however, has handed down a number of decisions reflecting a strong reluctance to recognize judicially the preemption of federal law by state regulation.\(^4\) By narrowly construing the term

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   § 1011 Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest. . . .

   § 1012(b) No 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: Provided, 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.

   § 1013(b) Nothing contained in this chapter shall render the said Sherman Act inapplicable to any agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation.


3. Section 2(b) of the Act provides that basic federal antitrust statutes 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) (1976).

4. See SEC v. National Sec., Inc., 393 U.S. 453 (1969) (the approval by the Arizona Director of Insurance did not exempt an insurance company merger from federal regulation); FTC v. Travelers Health Ass'n, 362 U.S. 293 (1960) (state regulation sufficient to preempt federal regulation must govern an activity which both occurs and has its primary impact within that state); SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959) (issuance of variable annuity contracts failed to qualify for exemption under the language of the McCarran Act requiring exempted activities to be part of the "business of insurance"—a phrase which must be defined by federal courts as a matter of federal law). See note 60 infra.
“business of insurance”\(^5\) in the recent case of \textit{Group Life \& Health Insurance Co. v. Royal Drug Co.},\(^6\) the Court again succeeded in effectively curtailing state dominance over the insurance industry while serving notice that state sovereignty in the area of insurance regulation may be the exception rather than the rule.

The purpose of this Note is to examine \textit{Royal Drug} in light of historic changes in the Court’s interpretive approach to the McCarran Act exemption and to establish the case as representative of the Court’s current pro-antitrust position. The Note will criticize the Court’s reasoning and discuss the impact of the decision in regard to its precedential value as well as its economic repercussion upon the health insurance industry—its products and its premiums.

**FACTS AND REASONING**

Group Life \& Health Insurance Company, also known as Blue Shield of Texas (Blue Shield), offers the public a prepaid prescription drug policy which is approved and regulated by the Texas State Board of Insurance.\(^7\) The policy entitles the insured to purchase prescriptions from any pharmacy. If the pharmacy selected has entered into a provider agreement\(^8\) with Blue Shield (Pharmacy Agreement),\(^9\) the insured pays only a two dollar policy deductible, while the pharmacy’s remaining acquisition costs are directly reimbursed by Blue Shield. Should the policyholder purchase drugs from a “non-participating” pharmacy, however, the individual must pay the full price at the time of purchase and subsequently apply to Blue Shield for reimbursement. Under these circumstances, the policyholder receives only seventy-five percent of the customary charge for the drug, less the two dollar deductible.

Independent, “non-participating” pharmacists brought a civil antitrust action against Blue Shield, alleging that the Pharmacy Agreements fixed the

\(^5\) The phrase “business of insurance” is a direct quote from the text of the McCarran Act, 15 U.S.C. \$ 1011 (1976). The Act exempts from federal regulation only those activities which are both governed by state regulation and which may be categorized as part of the “business of insurance.”


\(^7\) Pursuant to the authority invested in the State Board of Insurance and its Commissioner under Article 3.42 of the Insurance Code, TEX. INS. CODE ANN. art. 3.42 (Supp. 1977), issuance of the policy involved was duly approved in Oct., 1974, and was subsequently regulated by the State Board as provided under Article 21.21, TEX. INS. CODE ANN. art. 21.21 (1963). Prior to this, Blue Shield provided identical coverage under a policy which the Commissioner had exempted from the approval requirements of the Code in Sept., 1969. Brief for Petitioner at 32-34.

\(^8\) A provider agreement is the contract between a purchaser and a supplier of either goods or services.

\(^9\) Blue Shield offered to enter into this provider contract with each licensed pharmacy in Texas. The Agreement established a ceiling on the mark-up available to participating pharmacies in the amount of the policy’s two dollar deductible. 440 U.S. at 209. Additional reimbursement for the pharmacy’s acquisition costs was limited to the actual billed and paid costs of the products dispensed. *Amicus Curiae Brief of The Blue Shield Assoc.*, App. C at 9a.
retail price of drugs and pharmaceuticals\textsuperscript{10} in violation of section 1 of the Sherman Act.\textsuperscript{11} Additionally, plaintiffs asserted that provisional conditions within the insurance contract establishing economic incentives for policyholders to deal exclusively with participating pharmacies served to coerce an unlawful group boycott.\textsuperscript{12} The District Court for the Western District of Texas granted Blue Shield’s motion to dismiss based upon the provisions of the McCarran Act.\textsuperscript{13} On appeal, the Fifth Circuit reversed.\textsuperscript{14} In a decision from which four justices dissented, the Supreme Court affirmed the judgment and reasoning of the court of appeals.\textsuperscript{15}

The Court focused its reasoning on interpretation of the statutory phrase “business of insurance” and concluded that the contractual arrangements between Blue Shield and “participating” pharmacies were not within the scope of that phrase.\textsuperscript{16} The Court began its analysis by quoting an earlier opinion which distinguished the “business of insurers” from the “business of insurance.”\textsuperscript{17} After establishing that mere activity by an insurance company was not a sufficient basis for application of the McCarran exemption, the Court

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\item Insofar as the two dollar policy deductible established a comparable ceiling on the drug mark-up available to “participating” pharmacists, the Pharmacy Agreements were charged with fixing prices on these items. 440 U.S. at 209.
\item 15 U.S.C. § 1 (1976). This Section provides:
Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding one million dollars if a corporation or, if any other person, one hundred thousand dollars, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.
\item 440 U.S. at 207.
\item Royal Drug Co. v. Group Life & Health Ins. Co., 415 F. Supp. 343 (W.D. Tex. 1976). After extensive discovery, dismissal was based upon the following findings: 1) the activities specified in the complaint and the Pharmacy Agreement itself constitute the “business of insurance,” \textit{Id.} at 347; 2) the State of Texas was effectively regulating such business, \textit{Id.} at 348; and, therefore, 3) according to the McCarran Act, the federal antitrust laws were preempted by the state’s regulation, \textit{Id.} at 349.
\item Royal Drug Co. v. Group Life & Health Ins. Co., 556 F.2d 1375 (5th Cir. 1977). The reversal was based upon the appellate court’s conclusion that the provider agreements between Blue Shield and participating pharmacies were not part of the “business of insurance.” \textit{Id.} at 1382. The appellate court did not reach the other questions decided by the trial court.
\item 440 U.S. at 233. Justice Brennan dissented and filed an opinion in which Chief Justice Burger, and Justices Marshall and Powell joined.
\item \textit{Id.}
\item \textit{Id.} at 211. The Court quoted the following from one of its earlier decisions:
The statute did not purport to make the States supreme in regulating all the activities of insurance companies; its language refers not to the persons or companies who are subject to state regulation, but to laws ‘regulating the business of insurance.’ Insurance companies do many things which are subject to paramount federal regulations; only when they are engaged in the ‘business of insurance’ does the statute apply.
\item \textit{Id., quoting SEC v. National Sec., Inc., 393 U.S. 453, 459-60 (1969).}
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evaluated Blue Shield’s Pharmacy Agreement in terms of its ability to satisfy two essential characteristics of the “business of insurance” that were delineated in previous decisions.

The first of these characteristics, recognized in SEC v. Variable Annuity Life Insurance Co., was the significance of underwriting or spreading of risk as an indicium of insurance. In applying this standard, the Royal Drug Court concluded that the Pharmacy Agreement itself spread no risk but was simply the means whereby the insurer provided the benefits for which the policyholder had contracted. Blue Shield argued that the underwriting of risk was a combination of selecting the best customers (risk assessment), reducing the risk (risk reduction), and increasing the predictability of that reduced risk. The Court rejected Blue Shield’s contention that the Pharmacy Agreements spread the risk assumed by the insurance company because they reduced the risk and provided more certainty as to the potential magnitude of that risk.

The second factor considered in the Court’s analysis was the contractual relationship between the insurer and the policyholder. The landmark decision of SEC v. National Securities, Inc., set forth several guidelines for determining the “business of insurance.” These guidelines included: (1) the type of policy issued; (2) the reliability, interpretation, and enforcement of that policy; and (3) the relationship between the insurer and the insured. The Royal Drug Court narrowly construed the

19. Id. at 71. In Variable Annuity, the Court held that insurers could not rely on the McCarran Act to exempt them from complying with federal securities registration requirements. A variable annuity was held to be a security rather than insurance because of the lack of an assumption of risk. Id. This decision reflected the classic definitions and concepts of insurance. See 1 G. COUCH, COUCH ON INSURANCE § 1:3 (1931 & Supp. 1966); R. KEETON, INSURANCE § 1.2(a) (1971).
20. 440 U.S. at 214-15. Relying heavily on a distinction made by the government in its amicus brief, the Court concluded that risk reduction is a separate concept rather than a necessary ingredient in risk underwriting as asserted by petitioner. Brief for the United States as Amicus Curiae at 15-19. See notes 21-22 and accompanying text infra.
22. 440 U.S. at 213-14.
23. Id. at 215.
25. Id. at 460. In National Securities, a merger between two insurance firms which previously had been approved by the Arizona Director of Insurance was successfully enjoined for violation of the Securities Exchange Act of 1934 and rule 10b-5. In refusing to allow the McCarran Act to exempt the merger from federal regulation, the Court promulgated a restrictive new standard. In what remains to date as the most extensive attempt to define the scope of the exemption, the Court stated:

The relationship between insurer and insured, the type of policy which could be issued, its reliability, interpretation, and enforcement—these were the core of the ‘business of insurance.’ Undoubtedly, other activities of insurance companies relate so closely to their status as reliable insurers that they too must be placed in the same class. But whatever the exact scope of the statutory term, it is clear where the focus was—it was on the relationship between the insurance company and the
National Securities’ phrase “relationship between insurer and insured” to mean “between insurer and insured.” By deleting the word “relationship,” the Court was required to address simply the question of whether the parties to the contract were in fact the insurer and the insured. This restrictive application of National Securities allowed the Court to conclude narrowly that separate contractual arrangements between a provider and an insurance company failed to meet the standard of being “between insurer and insured.” The Court rejected Blue Shield’s assertion that the Pharmacy Agreement fell within the National Securities guidelines because of its intimate relationship with “the type of policy which could be issued, its reliability, interpretation and enforcement.” Without ever directly addressing the obvious interdependence between the Pharmacy Agreements and the “relationship between insurer and insured,” the Court asserted that, at best, Blue Shield succeeded in establishing probable interaction between the agreements and the policyholders’ premiums.

In concluding its case law analysis, the Court rejected a previous line of cases which held that ramification upon rate-schedule structures was a suffi-

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policyholder. Statutes aimed at protecting or regulating this relationship, directly or indirectly, are laws regulating the ‘business of insurance.’

Id.

Relying on the standard set forth in National Securities, subsequent decisions have held a variety of activities to be within the “business of insurance.” See, e.g., American Family Life Assurance Co. v. Blue Cross, 486 F.2d 225 (5th Cir. 1973), aff’d, 346 F. Supp. 267 (S.D. Fla. 1972) (insurance services provided under another name); Commander Leasing Co. v. Transamerica Title Ins. Co., 477 F.2d 77 (10th Cir. 1973) (title search services included within the “business of insurance”), Schwartz v. Commonwealth Land Title Ins. Co., 374 F. Supp. 564, supplemental opinion, 384 F. Supp. 302 (E.D. Pa. 1974) (same); Sanborn v. Palm, 336 F. Supp. 222 (S.D. Tex. 1971) (the appropriation by one insurance company of another’s name was held to be within the “business of insurance”).


26. 440 U.S. at 216.
27. Id.
29. Id.
30. Id.
cient qualification for granting an exemption under the McCarran Act. The Court categorized these ramifications as merely the products of business decisions. It reasoned that to allow these “business decisions” to qualify as the “business of insurance” because they affected rates would necessitate recognizing almost every business decision made by an insurance company as exempt from federal regulation.

As secondary support for its decision, the majority presented a synopsis of the legislative history of the McCarran Act. The Court noted that Congress originally declined to pass legislation providing the insurance industry with a blanket exemption from federal antitrust laws. Therefore, the Court concluded that the Act’s legislative history provided support for the judicial reduction of the exemption’s applicability. In further support of its interpretation of the legislature’s intent, the Court pointed out that at the time the McCarran Act was passed, the courts did not recognize arrangements like Blue Cross and Blue Shield as insurance. The Court, there-


32. 440 U.S. at 217.

33. Id. at 217-30. The Act was passed in response to the Supreme Court’s decision in United States v. South Eastern Underwriters Ass’n, 322 U.S. 533 (1944). This case held for the first time that the insurance industry was a part of interstate commerce and therefore subject to federal regulation under the commerce clause. The McCarran Act represented the legislature’s attempt to retain state regulation and taxation of the business of insurance in the wake of uncertainties created by the decision in South Eastern Underwriters. S. REP. No. 20, 79th Cong., 1st Sess. 2 (1945); H.R. REP. No. 143, 79th Cong., 1st Sess. 2-3 (1945).

34. 90 CONG. REC. 6565 (1944). This bill failed in the Conference Committee after having passed in the House of Representatives. It was opposed by the National Association of Insurance Commissioners. 90 CONG. REC. 8462 (1944). The Act, as ultimately passed, was largely the opposition bill proposed by that organization. 91 CONG. REC. 453 (1945) (remarks of Sen. O’Mahoney).

35. 440 U.S. at 225-26. See Jordan v. Group Health Ass’n, 107 F.2d 239 (D.C. Cir. 1939) (a group health association incorporated as a non-profit organization furnishing medical services and supplies was held not to be insurance); California Physicians’ Serv. v. Garrison, 155 P.2d 885 (Cal. App. 1945), aff’d, 28 Cal. 2d 790, 172 P.2d 4 (1946) (a non-profit physicians’ service corporation was held not to be insurance); Commissioner of Banking & Ins. v. Community Health Serv., 129 N.J.S. 427, 30 A.2d 44 (1943) (same). As the Court points out, the only case to the contrary was Cleveland Hosp. Serv. Ass’n v. Ebright, 142 Ohio St. 51, 49 N.E.2d 929 (1943) (contracts sold by a non-profit hospital service corporation were held as "substantially
fore, deduced that it would be impossible to conclude that Congress had any intention of including prepaid medical provider plans within the "business of insurance." 36

As a final reason for affirming the appellate court's decision, the Court reconfirmed and applied two general principles stated in previous antitrust decisions. First, the Court reiterated its policy of narrowly construing all exemptions, both implied and express, from federal antitrust regulation. 37 Second, the Court cited the judicial policy that an exemption is forfeited when one of the parties involved is a non-exempt entity. 38 The Court held

amounting to insurance"). In addition, two cases decided after the McCarran Act also held that these plans were not insurance. Michigan Hosp. Serv. v. Sharpe, 339 Mich. 357, 63 N.W.2d 638 (1954) (a contract merely entitling certificate holders to medical services or supplies at reduced rates was not held to be insurance); Hospital Serv. Corp. v. Pennsylvania Ins. Co., 101 R.I. 708, 227 A.2d 105 (1967) (a corporation which provided hospital care to its subscribers was not part of the insurance industry).

36. 440 U.S. at 227. As pointed out by the dissent, however, this conclusion appears to be in direct conflict with the Court's earlier interpretation of the McCarran Act in SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959). The Royal Drug dissent quoted the following: "We realize that . . . insurance is an evolving institution. Common knowledge tells us that the forms have greatly changed even in a generation. And we would not undertake to freeze the concept 'insurance' . . . into the mold it fitted when these Federal Acts were passed." 440 U.S. at 238 (Brennan, J., dissenting), quoting SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 71 (1959).

37. 440 U.S. at 231. See Abbott Labs v. Portland Retail Druggists Ass'n, Inc., 425 U.S. 1 (1976) (drugs purchased by a non-profit hospital but not put to its exclusive use failed to qualify for exemption under the Nonprofit Institutions Act); Connell Construction Co. v. Plumbers & Steamfitters Local Union No. 100, 421 U.S. 616 (1975) (the first proviso in § 8(e) of the National Labor Relations Act was held not to authorize subcontracting agreements that were neither within the context of a collective-bargaining relationship nor limited to any particular jobsite); FMC v. Seatrain Lines, Inc., 411 U.S. 726 (1973) (§ 15 of the Shipping Act does not exempt one-time acquisition-of-assets agreements that result in one of the contracting parties ceasing to exist); United States v. McKesson & Robbins, 351 U.S. 305 (1956) (exemptions of the Miller-Tydings and the McGuire Acts were expressly made inapplicable to agreements "between wholesalers").

38. 440 U.S. at 231. See Ramsey v. United Mine Workers, 401 U.S. 302 (1971) (a union was held to have forfeited its antitrust exemption when it agreed with an employer group to impose a certain wage scale on other bargaining units, thus joining a conspiracy to limit competition); Case-Swayne Co. v. Sunkist Growers, Inc., 359 U.S. 384 (1967) (it was not the intention of Congress to allow an organization with non-producer interests to avail itself of the exemption provided by the Capper-Volstead Act by contracting with one so protected); United Mine Workers v. Pennington, 351 U.S. 657 (1956) (a union was held to have forfeited its antitrust exemption when it entered into agreement with non-exempt large coal operators); United States v. Borden Co., 308 U.S. 188 (1939) (dairymen's agreements with non-exempt distributors failed to qualify under the Capper-Volstead Act); Foremost Int'l Tours, Inc. v. Quantas Airways Ltd, 525 F.2d 281 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976) (the scope of an antitrust immunity was held to be no broader than the industry so regulated).

In other contexts, the Court has insisted on focusing on the industry affected by anticompetitive activities while refusing to allow exemptions in one area to be extended to other businesses. See, e.g., International Salt Co. v. United States, 332 U.S. 392 (1947) (protection under patent laws did not exempt agreements requiring lessees of patented machines to use only inventor's unpatented products in their operation); McCullough v. Kramerreir Corp., 166 F.2d 759 (9th Cir. 1948) (the purpose of the patent laws was to encourage invention; therefore, agreements not to exercise inventive powers in creating competing devices failed to qualify for exemption).
that when these two policies were considered together, each not only supported application of the other, but also sustained the holding that Pharmacy Agreements between an insurer and an entity outside the insurance industry should not be considered within the "business of insurance." 39

THE TREND IN MCCARRAN ANALYSIS AND APPLICATION

For more than twenty years after passage of the McCarran Act, judicial decisions generally relied on the assumption that the term "business of insurance" included virtually all activities engaged in by both insurance companies and their agents. 40 The courts determined qualification under the exemption by focusing on the existence of state regulation. 41

FTC v. National Casualty Co. 42 accurately illustrates the early judicial emphasis on the mere existence of state regulation. In National Casualty, the Federal Trade Commission enjoined certain advertising practices it alleged were false, misleading, and deceptive. 43 Setting aside the Commis-

This principle was expressed by the Court in the context of the insurance industry when it stated in Hill v. National Auto Glass Co., 1971 Trade Cas (CCH) ¶ 73,594, 90,459 (N.D. Cal. 1971), that "[c]ongress at no time indicated an intent to give insurance companies carte blanche to operate in concert with noninsurance companies. The McCarran Act will be narrowly construed by this Court to extend only so far as the problem it sought to solve." See also Battle v. Liberty Nat'l Life Ins. Co., 493 F.2d 39 (5th Cir. 1974), cert. denied, 419 U.S. 110 (1975) (an insurer's wholly owned subsidiary providing merchandise and services required by its policies was not exempt under the McCarran Act); Center Ins. Agency, Inc. v. Beyers, 1976-1 Trade Cas (CCH) ¶ 60,940 (N.D. Ill. 1976) (conduct of the advertising agency employed by an insurer was not exempt under the McCarran Act). Contra, Lowe v. AARCO-American, Inc., 536 F.2d 1160 (7th Cir. 1976). In Lowe, the Seventh Circuit, interpreting the National Securities decision, granted exemptive status under the McCarran Act despite the fact that neither the insurance broker nor the premium finance company who made credit sales of insurance policies were insurance companies. The court of appeals held:

Moreover, the fact that neither appellee is an insurance company does not take the disputed transaction outside the scope of the 'business of insurance.' There is nothing in the McCarran Act which limits the 'business of insurance' to the business of insurance companies, for as the Supreme Court has stated, "the Act's language refers not to the persons or companies who are subject to state regulation, but to laws regulating the 'business of insurance.'"

Id. at 1162.

39. 440 U.S. at 231.
42. Id.
43. Id. at 561-62.
sion's orders, the Court reasoned that under the McCarran Act the Commission lacked authority to issue such orders in states having laws forbidding the specified practices. The Court further held that the legislative history of the Act failed to support the Commission's argument that a general statutory prohibition alone failed to qualify as regulation. Finally, the Court found that the state regulation requirement of the McCarran exemption was satisfied. The Court never considered, however, whether the advertising of policies fell within the "business of insurance." In addition to exemplifying the original approach taken by the courts in applying the McCarran exemption, National Casualty was also the progenitor of a separate line of cases which hold that the extent of active regulation is not a crucial determinant of exemptive status. The failure of the Court in National Casualty to draw a distinct delineation between legislation and regulation has resulted in a series of decisions which rely on National

44. Id. at 562-63. The Court stated, "An examination of that statute and its legislative history establishes that the Act withdrew from the Federal Trade Commission the authority to regulate respondents' advertising practices in those States which are regulating those practices under their own laws." In relying on the Act's legislative history for support, the Court cited to the following: 91 CONG. REC. 1481 (remarks of Sen. Ferguson); 91 CONG. REC. 1443 (remarks of Sen. McCarran); 91 CONG. REC. 1087, 1089-1090 (remarks of Reps. Hancock and Gwynne); 91 CONG. REC. 482-483 (remarks of Sens. Ferguson, Murdock, and Radcliffe); S. REP. NO. 20, 79th Cong., 1st Sess.; H.R. REP. NO. 143, 79th Cong., 1st Sess. FTC v. National Casualty Co., 357 U.S. 560, 563 (1958).

45. FTC v. National Casualty Co., 357 U.S. 560, 564 (1958). The Court failed, however, to go beyond its assertion and explain why the exemption requirements were satisfied. It also failed to provide guidelines for future determinations or to indicate what factors were required for a state system to qualify as regulation.

46. Accord, Transnational Ins. Co. v. Roselund, 261 F. Supp. 12 (D. Ore. 1966). In Transnational, by liberally construing the state of Washington's anticompact law, the district court exempted the alleged conspiracy from federal regulation without ever addressing the issue of whether such a conspiracy was part of the "business of insurance." 47. See, e.g., Ohio AFL-CIO v. Insurance Rating Bd., 451 F.2d 1178 (6th Cir. 1971), cert. denied, 409 U.S. 917 (1972) (the mere existence of a statutory scheme of state regulation was alone sufficient to preempt federal law); Allstate Ins. Co. v. Lanier, 361 F.2d 870 (4th Cir.), cert. denied, 385 U.S. 930 (1966) (state regulation did not have to require that auto insurers adhere to rates fixed by a rating bureau in order to qualify for exemption under the McCarran Act); Miley v. John Hancock Mut. Life Ins. Co., 242 F.2d 758 (1st Cir.), cert. denied. 355 U.S. 828 (1957); Gerlach v. Allstate Ins. Co., 338 F. Supp. 642 (S.D. Fla. 1972) (regulatory legislation concerning disclosure in premium financing agreements precluded applicability of the Truth in Lending Act); Sanborn v. Palm, 336 F. Supp. 222 (S.D. Tex. 1971); Holly Springs Funeral Home, Inc. v. United Funeral Serv., Inc., 303 F. Supp. 128 (N.D. Miss. 1969) (a provision in a burial insurance policy which had been approved by the state legislature and the insurance commissioner was exempt although it provided that claims for services performed by unauthorized funeral homes need not be honored); California League of Independent Ins. Producers v. Aetna Casualty & Surety Co., 175 F. Supp. 857 (N.D. Cal. 1959) (state regulation merely permitting or authorizing specific conduct was sufficient to qualify for exemption under the McCarran Act); Professional & Business Men's Life Ins. Co. v. Bankers Life Co., 163 F. Supp. 274 (D. Mont. 1958).

48. FTC v. National Casualty Co., 357 U.S. 560, 564-5 (1958). The Court, having first negated the necessity of an administrative system reflective of federal regulation, proceeded to state, "However, assuming there is some difference in the McCarran-Ferguson Act between
as precedent that a state's legislation might satisfy the requirement of the McCarran Act even if it failed to actually result in effective regulation. 49

The first of these decisions, the landmark case of California League of Independent Insurance Producers v. Aetna Casualty & Insurance Co., 50 held that a state regulation was required to meet only minimal standards of effectiveness. Relying on National Casualty as primary support, the district court in California League held that a state was regulating the "business of insurance" when it merely legislated generally to proscribe, permit, or authorize specific conduct of the insurance companies. 51 The California League decision reinforced the judicial deference to state regulation already prevalent in McCarran exemptions, 52 while at the same time discouraging any in-depth examination of those regulations. 53 Under California League, essentially any insurance company can obtain exempted status if a state statute exists dealing with the activity in question. 54

The most recent case adopting this reasoning is Ohio AFL-CIO v. Insurance Rating Board. 55 Citing to both National Casualty and California League as support for its holding, 56 the Sixth Circuit stretched this rationale to an attenuated conclusion. The court held that existence of the state regulatory agency was sufficient to preempt federal law 57 even though the

49. See note 38 supra. This holding also represents the intention of the Act's sponsor, Senator McCarran. He wrote: "Thus, for purposes of enforcement of federal laws, the question is one strictly of legal construction. The inquiry will be: 'Is this practice regulated by State law?'—not 'Is it effectively regulated?' or 'Is it wisely regulated?', but simply: 'Is it regulated?" McCarran, Federal Control of Insurance: Moratorium Under Public Law 15 Expired July 1, 34 A.B.A.J. 539, 542 (1948).


51. Id. at 860. Plaintiffs charged the defendants with conspiring to restrain trade by acting in concert to decrease the rate of commission paid to automobile insurance agents. The court, however, ruled that plaintiffs failed to state a claim based upon the McCarran Act and so dismissed the action. Justifying the ruling on its interpretation of National Casualty, the opinion stated: "In F.T.C. v. National Cas. Co., . . . the Court held that there was State regulation within the meaning of § 1012 (b) when a State act generally prohibited 'certain standards of conduct'." Id.

52. See note 38 supra.

53. The prevalent emphasis upon the mere existence of a state regulation made it appear unnecessary to go beyond a cursory examination of a state statute. Therefore, the emphasis upon existence discouraged serious analysis of state regulations.


56. Id. at 1180-81.

57. Id. Quoting from the district court's opinion, the appellate court approved the following: "A court is not empowered to make a policy judgment as to the type of regulation which is desirable. The Ohio legislature has adopted a statutory scheme which sets standards for insurance rates. This court is not concerned with the wisdom of the
statutorily authorized Ohio Insurance Rating Board never denied a request for a rate increase.58

In an effort to counteract the liberal application of the McCarran exemption created by focusing on only the issue of state regulation,59 a second approach was promulgated which narrowed the scope of the exemption. Courts began to interpret the McCarran Act via a circumspect analysis of the phrase "business of insurance."60 Departing from their earlier assumption that the "business of insurance" could be equated with the business of insurance companies,61 the judiciary did not rely solely on the fact that a defend-

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58. In addition, the Ohio regulatory agency never even employed an actuary to review the rates established by the industry. See Ohio AFL-CIO v. Insurance Rating Bd, 409 U.S. 917, 917-18 (1972) (Douglas, J., dissenting).


61. See notes 40-41 supra. The courts’ reliance on this assumption mirrored a similar assumptive position taken by Congress. The legislative record contains many statements made at
Reflecting this analysis of the McCarran exemption, the Supreme Court's recent decisions have further restricted the construction of "business of insurance." 63

Royal Drug, the Court's most recent and restrictive decision, extends this pattern. In applying only the Variable Annuity test of risk underwriting 64 and that part of the National Securities standard dealing with the relationship between the insurer and the insured, 65 Royal Drug has further restricted the application of immunity. 66 By confining itself to these two tests, the Court has significantly reduced the possibility that an insurance company will achieve exemptive status. Consequently, the Court has disavowed the validity of the following factors previously considered by courts in determining whether conduct was within the "business of insurance":

the time the McCarran Act was passed in which congressional leaders freely interchanged the two phrases. For example, Senator Pepper stated, "[W]e should not give the insurance companies immunity. . . ." 91 CONG. REC. 1444 (1945). Senator Murdock argued, "Certainly the very purpose of the bill . . . is to provide that state legislatures . . . may relieve insurance companies from contracts in restraint of trade." 91 CONG. REC. 490 (1945). Senator Barkley expressed concern that an effort might be made by the states "[t]o put insurance companies within the State on an island of safety from congressional regulation." 91 CONG. REC. 1488 (1945).

62. SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 71-72 (1959), illustrates the Court's originally shallow acceptance of insurance company status as satisfaction of the "business of insurance" requirement of the McCarran Act. In Variable Annuity, subjection to the federal securities laws was based upon the defendant's inability to qualify as an insurance company. Id.

63. The following decisions support this contention: Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. 205 (1979); St. Paul Fire & Marine Ins. Co. v. Barry, 438 U.S. 531, 548 (1978) (the "boycott" clause of § 3(b) of the McCarran Act shall include but not be limited to "blacklisting and other exclusionary devices directed at independent insurance companies or agents"); SEC v. National Sec., Inc., 393 U.S. 453 (1969); State Bd. of Ins. v. Todd Shipyards Corp., 370 U.S. 451 (1962) (a Texas tax on out-of-state insurance transactions was held invalid); FTC v. Travelers Health Ass'n, 362 U.S. 293 (1960); SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959); FTC v. National Casualty Co., 357 U.S. 560 (1958); Wilburn Boat Co. v. Fireman's Fund Ins. Co., 348 U.S. 310 (1955) (a marine insurance policy was held subject to federal laws under the admiralty clause of the constitution); Prudential Ins. Co. v. Benjamin, 328 U.S. 408 (1946) (state tax on foreign insurance companies was held valid under the protection of the McCarran Act).


64. See notes 19-22 and accompanying text supra.

65. See notes 26-27 and accompanying text supra.

66. The Court failed to establish guidelines for applying that part of the National Securities standard dealing with reliability as an insurer, interpretation and enforcement of policies, and types of policies which qualify for exemption. This failure has the effect of emasculating that portion of the National Securities standard capable of providing a broad basis for allowing exemptive status.
whether the insurer's purpose is only to control costs,\textsuperscript{67} whether the insurer's conduct is regulated by statute,\textsuperscript{68} whether the insurer's conduct is regarded by applicable state laws as the "business of insurance,"\textsuperscript{69} and whether the conduct is peculiar to the "business of insurance."\textsuperscript{70}

That the \textit{Royal Drug} decision was intended by the Court to provide a definitive clarification of the scope of exemptive status under the McCarran Act is revealed by its initial declaration that, "[w]e granted certiorari because of intercircuit conflicts as to the meaning of the phrase 'business of insurance in § 2(b) of the Act."\textsuperscript{71} The Court's willingness to hold contrary to every other circuit deciding the identical issue appears to substantiate the Court's serious intention to promulgate a more restrictive application of the exemption.\textsuperscript{72} Therefore, insofar as the \textit{Royal Drug} decision sets forth the narrowest standard yet promulgated by the Court, it stands as the culmination

\begin{itemize}
\item \textsuperscript{68} See, e.g., \textit{Royal Drug} v. Group Life & Health Ins. Co., 556 F.2d 1375, 1381 (5th Cir. 1977).
\item \textsuperscript{69} See, e.g., Pastor v. Hartford Fire Ins. Co., 1976-1 Trade Cas (CCH) ¶ 60,783, 63,397 (C.D. Cal. 1976) (physician's suit against a California county medical association dismissed).
\item \textsuperscript{71} 440 U.S. at 208.
\end{itemize}

This intention is further substantiated by the Court's interpretations of other exemptions from federal regulation so as to reduce their applicability and hence their effectiveness. \textit{See} City of Lafayette v. Louisiana Power & Light Co., 435 U.S. 389 (1978) (established a presumption against any implied exclusion of municipalities from coverage under the federal antitrust laws); Goldfarb v. Virginia State Bar, 421 U.S. 775 (1975) (restricted the application of the "learned profession" exemption).

Congress is currently considering an antitrust bill prepared by Senator Edward Kennedy (D-Mass). Senator Kennedy's bill has the potential impact of increasing the number of plaintiffs in antitrust litigation. Under the Supreme Court's decision in Illinois Brick Co. v. Illinois, 431 U.S. 720 (1977), only direct purchasers may sue for treble damages in price-fixing cases. Senator Kennedy's bill, however, would allow consumers, as well as state and local governments, who qualified as direct or indirect purchasers, to sue manufacturers for price-fixing. Lawscope, 65 A.B.A.J. 896 (1979). In addition, Senator Howard Metzenbaum (D-Ohio) is considering the proposal of legislation to end the insurance industry's antitrust exemptions under the McCarran-Ferguson Act. Lawscope, 65 A.B.A.J. 1154 (1979).
of a judicial trend which has reduced the exemptive status congressionally bestowed upon the insurance industry.

**ROYAL DRUG—A CRITICAL ANALYSIS**

The *Royal Drug* decision first can be criticized for its one-sided interpretation of previous case law. Its application of the *National Securities* holding failed to reflect or acknowledge all of the guidelines established in that decision.\(^{73}\) The *Royal Drug* analysis appears to rest on an extensively inbred rationale because the Court chose to apply only those tests from *Variable Annuity* and *National Securities* which could not be met by the Pharmacy Agreement. Additionally, the Court refused to acknowledge or explain why satisfaction of other established criteria was of no consequence.\(^{74}\)

The Court's selective approach to interpreting the guidelines promulgated in *National Securities* does not provide an accurate representation of that opinion. For the last ten years, *National Securities* has been repeatedly recognized as judicial authority for the premise that ratemaking is included in the term "business of insurance."\(^{75}\) It also has been cited as support for the proposition that the "business of insurance" includes those activities which affect both the reliability and the enforcement of a policy as well as the very type of policy which is issued.\(^{76}\) By failing to apply these guidelines, the *Royal Drug* Court ignored the critical fact that in a prepaid drug policy a provider arrangement must exist as the means by which an insurer "obtains the very benefits promised in the policy; it does not simply relate to the general operation of the company."\(^{77}\) The Court's refusal to recognize and address this reality illustrates its failure to adjust to the expansion and development of new insurance products. In this respect, the decision curtailed the protection originally provided by the legislature to foster the growth of an industry in order to meet the needs of our society.\(^{78}\)

A second criticism is the *Royal Drug* Court's narrow interpretive approach in applying the guideline excerpted from the *Variable Annuity* decision. In maintaining that underwriting, or spreading of risk, is an "indispensable

\(^{73}\) See note 25 *supra*.

\(^{74}\) It was as if the Court had employed selective recall in supporting its contentions. By ignoring its own precedential statements which do not support its conclusion, the Court appeared to have reached its decision first and then searched about for substantiation, rather than reasoning its decision on the basis of a comprehensive analysis of the propositions which support its conclusion as well as those which do not.

\(^{75}\) See note 31 *supra*.


\(^{77}\) 440 U.S. at 246-47 (Brennan, J., dissenting).

characteristic of insurance," the Court ignored the legislative history of the McCarran Act as well as its own prior assertions that unilateral acts which do not involve underwriting are within the scope of the exemption. In fact, by asserting that the fixing of rates which itself does not underwrite or spread risk is within the "business of insurance," the Royal Drug Court conceded that some arrangements exist which qualify for exemptive status although they fail to possess this "indispensable characteristic." Having made this conceptual concession, the Court appeared less than intellectually forthright in failing to discuss why a provider agreement which is essential to the ratemaking process does not qualify as such an exception.

As a final criticism, the Royal Drug decision may constitute too narrow an attack upon too broad a problem. In light of the potentially vast impact the decision may have upon future insurance products and their availability to the public, the Court's narrow antitrust perspective on the issues may contravene laudable government policies regarding the containment of health-care costs. The Court may be legitimately criticized for judicially legislating in an area in which it lacks the administrative resources necessary properly to evaluate interrelated issues and economic ramifications.

THE IMPACT OF THE ROYAL DRUG DECISION

The Royal Drug decision will reduce the National Securities standards and will decrease significantly the potential number of provider arrangements which will qualify for exemption under the McCarran Act. If future decisions apply the National Securities test of "relationship between insurer and insured" as is narrowly applied in Royal Drug, it would appear impossible for any provider arrangements to qualify for exemption because by definition provider arrangements do not exist between the insured and the insurer. Certainly the decision established a reasonable doubt as to whether provider arrangements previously qualifying on the basis of factors ignored by the

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79. 440 U.S. at 211.
80. See 90 CONG. REC. 6538 (remarks of Cong. Celler).
82. 440 U.S. at 223.
83. Id. at 224-25, n.32.
84. See notes 91-92 infra.
85. See note 93 infra.

With respect to these areas in which costs have increased significantly, Congress has enacted or is considering legislation. See, e.g., Social Security Act and Amendments, 42 U.S.C. § 1320 (1975); Hospital Cost Containment Act of 1977, H.R. 6575 and S. 1391, 95th Cong., 1st Sess. (1977). In addition, the Department of Health, Education and Welfare is considering the following: 45 C.F.R. § 19; Department of Health, Education and Welfare, Proposed Regulation, 43 Fed. Reg. 20,516 (1978) (to be codified in 42 C.F.R. § 450). But perhaps the greatest attestation of federal involvement in controlling the costs of health care is represented by the federal health insurance programs, i.e., Medicare and Medicaid.

87. If future decisions apply the National Securities test of "relationship between insurer and insured" as is narrowly applied in Royal Drug, it would appear impossible for any provider arrangements to qualify for exemption because by definition provider arrangements do not exist between the insured and the insurer. Certainly the decision established a reasonable doubt as to whether provider arrangements previously qualifying on the basis of factors ignored by the
ruling, however, is not fully dispositive of the scope to be given the term "business of insurance." In this respect the decision leaves several important questions unanswered. First, the decision does not resolve the issue of inter-industry versus intra-industry agreements. The ideological conflict still exists between permitting intra-industry agreements to fix premium rates based upon shared actuarial data\(^8\) and denying inter-industry provider agreements which also operate to fix premium rates. Second, although the Court failed to evaluate the Pharmacy Agreement in regard to factors previously considered relevant to the procuring of exemptive status,\(^9\) the Royal Drug decision fell short of actually denying the continued applicability of these factors.\(^10\) Therefore, until future decisions test the viability of these factors, the rigidity of the Royal Drug guidelines will remain questionable.

As alluded to previously, the ramifications of the Royal Drug decision upon the insurance industry in general, and particularly upon pre-paid drug protection policies, are potentially of vast importance. There can be little dispute that provider arrangements such as the Pharmacy Agreement are essential in lowering costs to insurers.\(^1\) Without the benefit of such arrangements, the insurer's cost increases in providing prepaid drug protection...
appear destined to be reflected in an increase in consumer premiums.\textsuperscript{92} The possibility that such policies will be priced out of the marketplace is not an irrational conjecture.\textsuperscript{93} In addition, similar consequences may occur in other insurance contexts which utilize the concept of third party payors.\textsuperscript{94} Finally, because prepaid drug protection is often an important part of negotiated settlements between labor and industry,\textsuperscript{95} the potential effects upon the economy as a whole cannot be overlooked.

Additionally, the \textit{Royal Drug} decision significantly increases the probability that plaintiffs will be successful in bringing action against insurance companies under federal law. The Court has increased the applicability of federal antitrust statutes to the insurance industry by reducing the scope of the McCarran exemption. As the dominance of state regulation is reduced, the consumer may be expected to benefit. First, the consumer will have greater access to the treble-damage remedies provided by federal legislation.\textsuperscript{96} Second, increased federal regulation of the insurance industry may provide the consumer with more uniform treatment than is currently available due to the variance in both the extent and effectiveness of existing state regulations.\textsuperscript{97}

\textbf{CONCLUSION}

\textit{Royal Drug} is the Court's latest decision in a series of holdings aimed at reducing the potential for exemption from federal antitrust regulation under the McCarran Act. The judiciary has given notice that a competitive market within the insurance industry shall not be deterred by the promulgation of broad statutory interpretations. The consequences of the Court's decision, however, may go beyond the mere encouragement of competition. In fact, this decision may function as an influential consideration in the continuance

\textsuperscript{92} Because the provider agreement improves the predictability of health-care service costs it provides the insurer with some control over these costs so that he may calculate and minimize premium rates. Without such an arrangement an unpredictable and substantial increase in premium rates would be inevitable. Klarman, \textit{The Economics of Hospital Service}, 29 \textit{Harv. Bus. Rev.} 71, 79-80 (Sept. 1951). \textit{See also note 75 supra.}

\textsuperscript{93} The attraction of such policies is that they establish a ceiling upon drug purchases made by the policyholder. If the insurer is unable to control costs through provider arrangements and is therefore forced to adopt premiums which conform with the actual acquisition and overhead expenses of the pharmacies, the higher premiums thereby necessitated could conceivably so reduce the number of policyholders as to result in the product's removal from the marketplace.

\textsuperscript{94} For example, pre-paid legal service plans also may feel the reverberation of the \textit{Royal Drug} decision. See generally Kallstrom, \textit{Health Care Cost Control by Third Party Payers; Fee Schedules and The Sherman Act}, 1978 \textit{Duke L.J.} 645.


and creation of the actual insurance products themselves. At a time when insurance companies should be aggressively involved in containing skyrocketing health-care costs, *Royal Drug* may necessitate a redirection on the part of the industry. It appears that under the auspices of the judiciary, federal antitrust laws finally have succeeded in emasculating state regulations and invading areas once regarded as sacrosanct under the McCarran Act.

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