THE TEXAS INSURANCE SCANDAL:
A STUDY OF INADEQUATE REGULATION

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THE TEXAS INSURANCE SCANDAL:
A STUDY OF INADEQUATE REGULATION

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CHAPTER I

DISCOVERY OF FRAUD IN THE TEXAS INSURANCE INDUSTRY

On February 6, 1953, Insurance Commissioners George Butler and Garland A. Smith signed a board order which informed the officers and directors of the Texas Mutual Insurance Company that after investigation the company was found to be "insolvent and unable to meet its maturing obligations." On February 10 the management and owners of Texas Mutual admitted in writing that their company was, in fact, insolvent. This exchange initiated what was to become the infamous Texas insurance scandal, during which more than fifty-two insurance companies were declared bankrupt and put into receivership.

The insolvency of Texas Mutual was not the first sign of severe problems in Texas insurance. Many insurance companies had gone bankrupt before TMIC was put into receivership in 1953; the Liquidation Division of the

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3Texas, State Board of Insurance, Data on Receiverships as Prepared from the Records of the Liquidation Division, Austin, Texas, January 18, 1965, pp. 3-5.
Insurance Commission reported that between 1940 and 1956, $15,000,000 to $20,000,000 were lost to about 1,000,000 people because of company failures. The mid-fifties was labeled the scandalous era in Texas insurance by some students of Texas government because this was the time when the public became acutely aware of fraud in the industry, primarily because of the failure of several large companies. Heretofore, the majority of failing companies had been small in size, and therefore had affected fewer people and received less attention from the news media.

Since to trace and examine all of the companies that were involved in scandal and fraud would be far too extensive a task for this study, seven companies have been chosen for examination because they best illustrate the consequences of weak insurance regulation in Texas. In studying each company major emphasis has been given to the factors which contributed directly to the eventual receivership of the company. In some cases companies failed because of poor or inexperienced management; however, most companies collapsed because promoters

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4 *Texas Observer*, April 11, 1956, p. 3.

evaded the law or took advantage of the many ambiguities in state regulatory statutes to establish unsound enterprises.

Texas Mutual Insurance Company suffered the distinction of being the first large Texas concern to go bankrupt because of questionable business practices and to receive a great deal of publicity as a result. On June 1 Attorney General John Ben Shepperd publicly charged that TMIC had been created through fraud. During court action against Texas Mutual, Justice R. G. Hughes brought attention to the gross inefficiency of the entire insurance regulatory system in Texas when he accused the company of "Ponzi-like manipulations" and declared the State Insurance Commission guilty of "fraud, if not criminal laxity." 

After various investigations the facts concerning TMIC's fraudulent business practices were presented in the Travis County District Court. The company was authorized initially to do business on July 11, 1949. The organizers were D. H. O'Fiel, Paul Lowry, and his brother Leslie Lowry, the latter a one time mayor of Houston who had been ousted by recall. The court records indicate

8Texas, State Board of Insurance, Charter File of Texas Mutual Insurance Company, Austin, Texas.
9"Insurance--Texas Frauds," op. cit.
that the brothers had personal investments of only $500, and had borrowed the remainder of the money needed to meet the minimum $20,000 state capitalization requirement, even though legally this money was to be unencumbered. Renne Allred, Jr., counsel for the State Liquidator, later testified before the state Senate Investigating Committee that the Lowrys paid back the borrowed $19,500 within a week of the day the company was approved and authorized to do business by selling insurance.

Almost as soon as Texas Mutual was licensed to do business, its owners decided that the company might sell more insurance if it appeared to have a larger amount of assets. To give the appearance of greater prosperity in TMIC’s prospectus and annual statement, the Lowrys overvalued a "shabby" one-story building in Beaumont which they bought for their home office building. They paid $100,000 in notes for the building, and no cash changed hands. The Lowrys persuaded three friends to value the building at $436,000. The law required the Insurance Commission to accept real estate appraisals on land claimed as assets by insurance companies if the appraisals.

10State of Texas v. Texas Mutual Insurance Company, et. al., "Final Judgement," 53rd District Court, Case No. 94,820, Austin, Texas, p. 3.


12"Insurance--Texas Frauds," op. cit.
were made by any two local freeholders or land owners. The Lowrys' appraisal was sent to the Insurance Commission by their attorney, William T. Moore, who not only was a state senator, but also chairman of the Senate Insurance Committee. The Insurance Commission accepted the appraisal, and TMIC was legally entitled to list their $100,000 building as an asset worth $436,000.

After many complaints from the policyholders of Texas Mutual and some indications that previous investigations into TMIC had not disclosed the truth, the Insurance Commission ordered further investigation which found the company to be insolvent, and it was subsequently put into receivership. When the Insurance Commission finally suspended Texas Mutual's license, the company was over $500,000 in debt. An examiner for the Insurance Commission, Bert Bolinger, stated that TMIC had not paid approximately $350,000 in loss claims and $40,000 in commissions and returned premiums. The company's balance was overstated by $450,000 since the money did not actually belong to TMIC because it was in unearned premiums. The company's total liabilities amounted to about $840,000, while its

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13Texas, Revised Statutes, Annotated (Vernon, 1952), Insurance Code, Article 2.10, sec. 2.

14"Insurance--Texas Frauds," op. cit. Moore received at least $13,000 over a three year period for services rendered to Texas Mutual Insurance Company.
admitted assets totaled only $265,425, leaving a deficit of approximately $574,575. 15 The company had written 38,000 policies and owed $1,200,000 on 1,600 claims when it went out of business. 16

The placing of Texas Mutual in receivership on February 13, 1953, also resulted in the receivership of five related companies: Atlantic Finance Corporation, Lone Star Casualty Company, Texas Fire Insurance Company, Texas Underwriters, and Texas Western Assurance Company. 17 It was not unusual for several companies to be operated by the same owners. This was especially common among companies found to be operating fraudulently. Investigations revealed that these related companies in the TMIC "group" borrowed and loaned money and assets among themselves for the sole reason of giving the appearance of financial stability at examination time. Texas Western Assurance, for instance, was incorporated on May 22, 1952, with stated assets of $125,000, which was the minimum state requirement for organization. The entire $125,000, however, was borrowed from the mother company, Texas Mutual. 18 The money was


17 Texas, State Board of Insurance, Data..., p. 3.

returned the next day, May 23. Another subsidiary of Texas Mutual, Texas Fire Insurance Company of Beaumont, borrowed the $100,000 capital and $50,000 surplus requirement for fire insurance companies from Texas Mutual to begin business. The money was repaid two days after the new company received its certificate in July, 1951. In May of 1952 Leslie Lowry organized the Lone Star Casualty Company in Beaumont. This company borrowed its capital and surplus requirement from Texas Fire Insurance Company.

These companies' actual assets amounted to little more than the premiums received after they commenced operations. Though each company was chartered to sell a particular kind of insurance, they were all owned and operated by the same individuals. In theory the companies were supposed to be financially independent, but in fact, the companies interchanged money and real estate.

In addition to establishing subsidiary companies by passing money from one company to the other, TMIC engaged in bribery to protect itself from exposure. Examiner Allred testified that the Insurance Commission's chief examiner, L. W. Blanchard, approved a high realty appraisal

19Ibid. See also Texas Observer, January 25, 1956, p. 7.
for Texas Mutual assets when the company did not even have the deed for the property. Allred went on to reveal that Texas Mutual had entertained Blanchard and other examiners and paid examiner Virgil C. Thompson $300 while he was auditing the company. The end result of the several instances of bribery was a favorable report to the Insurance Commission and a mere "specter of an audit."  

One of the more interesting aspects of the TMIC insolvency concerned a certain kind of policy the company had illegally sold. Texas Mutual had issued, without proper authorization, policies stamped "nonassessable," indicating that the policyholder was not liable for losses above the amount of his investment. The state attempted to assess these 38,052 policies to make up nearly $2,700,000 in company losses. The lower court approved such action, but its ruling was reversed on appeal. The question raised was whether policyholders who thought that they were buying nonassessable mutual insurance could be held liable for claims against the company. The Austin Third Court of Civil Appeals declared that the policies were, indeed, nonassessable in this situation. The three founders of Texas Mutual, Leslie Lowry, Paul Lowry, and D. H. O'Fiel

21"Insurance--Texas Frauds," op. cit.  

22"Insurance Groups Watch Texas Case," Business Week (December 12, 1953), p. 120.
were ultimately indicted in May, 1954, on charges of perjury in submitting false statements and affidavits to the Insurance Commission relating to the funds in the organization and operation of TMIC.23

The general concern over the unhealthy state of the insurance industry in Texas greatly increased when two El Paso firms, United Lloyds and its related company, United World Life Insurance Company, went into receivership. In January, 1954, the Board of Insurance Commissioners reported that their annual examination of United Lloyds had found the company to be insolvent to the extent of approximately $500,000. The bankruptcy suit revealed that the company's attorney-in-fact, Spencer S. Treharne, had borrowed $55,000 of the $60,000 minimum necessary for licensing. The license was issued in March, 1952, and United Lloyds repaid the borrowed money a few months later.24

Just as Leslie Lowry had immediately extended the admitted assets of Texas Mutual, Treharne also took over for his company a piece of real estate which his father, Franklin O. Treharne, had purchased for $30,000. The younger Treharne then marked up the value of the property


24 Texas, Attorney General, "Summary...," p. 4.
on United Lloyds' books to $322,000. An Insurance Commiss-
ion examiner testified that Lloyds also borrowed $70,000
to show a solid footing in the end of the year statement.
This loan was repaid in January, 1953.25

In September, 1953, Spencer S. Treharne ventured
further and organized another company, the United World
Life Insurance Company. Although the company received
a charter, it had actually borrowed the entire amount of
money presented to the Board of Insurance Commissioners
as unencumbered assets. Upon discovery of these manipu-
lations, the Attorney General's office suggested to the
proper District Attorneys the possibility of prosecuting
the individuals responsible for criminal violations.26
Treharne later was indicted for his misrepresentations
to the Insurance Commission.27

Another insurance investigation and subsequent trial
which caused widespread publicity involved Lloyds of North
America. In January, 1954, the Board of Insurance Commiss-
ioners completed an examination of the large Houston
company and reported to the Attorney General's office that
the company had been operating at a $427,381 deficit.28

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26Texas, Attorney General, "Summary...", p. 5.
28The State of Texas v. United Lloyds, et. al.,
"Final Judgement," 98th District Court, Case No. 97,629,
Austin, Texas, p. 6.
Further examination disclosed that this company, too, had been established on borrowed money.

In setting up Lloyds of North America, Ralph W. Hammonds, a former Olympic wrestler, fraudulently presented the minimum $80,000 guaranty fund needed to meet the Insurance Code requirement for licensing. Of the $80,000 which Hammonds presented to the Board of Insurance Commissioners, only $20,000 legally was admissible. Forty thousand dollars of the fund was inadmissible because it represented a note fraudulently secured on a deed of trust on a certain property. The note was secured from a Dent Taylor, who, it was later revealed, did not even own the property. To make up the remainder of the required $80,000 guaranty fund, Hammonds borrowed another $20,000.29 Hammonds sold more than 50,000 policies during the year following October 31, 1952, the date on which he received authority to sell insurance, and from the $1,700,000 received in premiums, he repaid the $20,000 loan.30

Further investigations into Lloyds of North America revealed additional instances of fraud. Some securities listed as assets of the company were admitted for much

29Ibid., p. 8. 30Ibid.
more than they were worth. For instance, Hammonds listed some real estate at $42,000, while its actual value was only $5,750. Some of Hammonds' claimed securities were not only over-estimated, but were ineligible securities. Also, many of the claimed securities were obtained through fraud.

The investigations into Lloyds of North America received a great deal of publicity because of various noteworthy people who were involved directly and indirectly in the court proceedings. Governor Allan Shivers and Ralph Yarborough were subpoenaed in the receivership trial against the company, though neither was called to testify.

Shivers had been summoned to testify in defense of a former campaign manager, John Van Cronkhite, who had worked for Hammonds personally and for Hammonds' companies. As the proceedings evolved, it was disclosed that Van Cronkhite was paid $1,000 a month by Lloyds for "public relations counsel" or to "keep cordial relations with the State Insurance Commission."

Hammonds stated that he had hired Van Cronkhite at the suggestion of Governor

31Texas, Attorney General, "Summary....," p. 5.
32Ibid.
33Dallas Morning News, June 11, 1954, Sec. 1, p. 4.
34"Insurance—Texas Frauds," op. cit.
Shiver's executive assistant, Maurice Acers. Hammonds claimed that the stability of his company was not questioned until Van Cronkhite asked Lloyds for a pay raise to $2,000 a month. He later testified that he denied the request and almost immediately the Insurance Commission began investigating his company. Hammonds claimed that his company was being "persecuted" by the state because three investigations into Lloyds had been conducted in a year when only one such inquiry was customary. In an attempt to stop the investigations he went to see Governor Shivers. Hammonds testified that Van Cronkhite had previously threatened him, saying that if "I [Hammonds] didn't keep him on the payroll...it would be bad for my company." Hammonds added, "I wanted to know if Shivers knew what was going on."  

Evidently Hammonds received no help from the Governor, since the investigations were continued, resulting in the discovery of insolvency in Lloyds of North America and the eventual receivership of the company. On the other hand, Shivers did defend Van Cronkhite. The Governor announced that an investigation of Van Cronkhite disclosed that he had, indeed, been "sucked in," as

36Ibid., June 11, 1954, Sec. 1, p. 4.
Van Cronkhite phrased it, and did not know that Lloyds of North America was operating insolvent and fraudulently.\footnote{37}

Ralph Yarborough’s involvement stemmed from several innuendoes he made concerning the weak nature of Lloyds of North America and other Texas insurance companies.\footnote{38} Van Cronkhite accused Yarborough of actually being the attorney for Lloyds of North America and using attorney Herman Jones as a "front." Nevertheless, Yarborough was not called to testify, did not enter into the formal proceedings, and was not implicated in the record in any way. It therefore appears that Yarborough’s chief concern was discrediting the Shivers administration, appointees, and associates.

When Lloyds of North America went into permanent receivership on June 15, 1954, three related companies, Hammonds and Company, Motor Club of North America, and Trust Company of North America also were forced out of business.\footnote{39} A Harris County grand jury later indicted Hammonds on the charge of filing false statements to the Insurance Commission.\footnote{40}

\footnote{37} “Insurance--Texas Frauds,” \textit{op. cit.}
\footnote{39} \textit{State of Texas v. Lloyds of North America, et. al.}, "Final Judgement," 98th District Court, Case No. 98,365, Austin, Texas, p. 1.
\footnote{40} \textit{Dallas Morning News}, June 7, 1954, Sec. 1, p. 12.
On July 7, 1954, a month following the receivership of Lloyds of North America, the General American Casualty Company went into permanent receivership. Like most of the companies that had failed, General American was conceived in instability. It was formed by taking over two companies, General Lloyds Fire and Casualty Company and the Alamo Casualty Company, which had already collapsed.\(^1\) C. B. Erwin, the board chairman and organizer of General American Casualty, had gained his experience in life insurance, which tends to be more stable than casualty. Many Texas insurance men thought that Erwin was out of his field in the risky casualty business. In addition, Erwin attempted to expand General American Casualty too quickly by assuming a large amount of insurance risks that other companies had avoided. General American's premium loss ratio was estimated as running as high as 70 per cent, when the normal ratio was about 40 or 50 per cent.\(^2\)

Ralph D. Stokes, the president of General American Casualty, and Erwin blamed much of their trouble on the consequences of a statement made on June 12 by Ralph Yarborough, who charged that a five million dollar insurance company was in trouble. Yarborough did not mention

\(^{1}\)Ibid., p. 1.

any company in particular, but Erwin claimed that General American was forced into receivership because agents who suspected General American to be the company in question did not turn in premium income, estimated at $843,000, after Yarborough's innuendo.43

The attorney for the State Liquidator, Renne Allred, Jr., later stated that General American Casualty Company's difficulties went far beyond any supposed loss created as a result of Yarborough's statement. He disclosed that the company owed approximately $1,500,000 in loss claims which it could not pay, and that General American's assets were tied up with a $900,000 loan from Republic National Bank in Dallas and $2,400,000 in unearned premiums.44

In spite of these overwhelming obstacles, interested parties made attempts to put the company on a sound footing before it went into receivership. Commissioner Garland Smith made one of the earliest efforts during the first week in June of 1954, when Erwin first told the commission of the company's trouble. Smith asked three other Texas companies to take over General American, but none would accept the task.45 On July 6, 1954, Ray Callahan, representing the directors of General American, suggested

43*Dallas Morning News*, June 18, 1954, Sec. 1, p. 1.
45"Insurance—More Scandal in Texas," **op. cit.**
reorganizing the company and selling enough stock to put it back in business. Frank Cain, the chairman of the board of Home Service Casualty Company of Dallas, suggested that his company take over the existing assets of General American and that stock be sold to pay off the company's debts. Charles D. Dunne, President of Dunne's International Insurance Reports, stated that he had authority to pledge $700,000 to the General American Casualty Company for controlling interest.

None of the proposals appeared sound enough to the District Court or the State Insurance Liquidator, who was temporarily operating the company. As during the three weeks given the company to find an acceptable solution to their financial deficit, none had been found, the General American Casualty Company was placed in permanent receivership on July 7, 1954.


47Ibid. Three years later it was discovered that insurance ratings could be bought from Dunne's rating organization. Dunne's International Insurance Reports was recommending Texas Mutual Insurance Company and ICT Insurance Company with an "A/" (excellent) rating immediately before they each collapsed. See Texas, Senate General Investigating Committee, A Report of the ICT Insurance Company Failure and Related Matters (Austin, 1957), pp. 16, 84.
In liquidating the company's assets for the benefit of the company's 57,000 creditors, claimants, policyholders, and stockholders, several fraudulent activities were uncovered. Jose Groce, acting for the State Liquidator, J. D. Wheeler, filed a 266-page court petition demanding $6,600,000 damages from 44 individuals and several insurance agencies, banks, and bonding companies. Four members of the Insurance Commission's staff lost their jobs because of their activities in handling the affairs of General American. The former Chief Examiner, Larry Blanchard, Supervising Examiner Robert R. Butler, and examiners William J. Noad and Lee L. Pfefferkorn were charged with "willfully and maliciously" violating their duties as examiners by showing General American solvent as of June 30, 1952, when they knew it was not. The suit stated that the examiners intentionally did not include gross policy premiums of $2,693,420 written by the company. This unrecorded amount reduced General American's unearned premium reserve liability by the amount of $987,207, which was due policyholders.

The suit accused the four examiners of accepting petty bribes in return for a favorable report to the

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48 State of Texas v. General American Casualty Company, et. al., "Plaintiff's Original Petition," 126th District Court, Case No. 98,764, Austin, Texas.

49 Ibid., p. 19.
Insurance Commission. Noad was accused of accepting from representatives of General American a $47.95 radio for his wife and $135 to pay his rent. Blanchard, Butler, and Noad were accused of having permitted Erwin, or his company, to entertain them at deer hunts, banquets, and parties. All four of the examiners were suspended. Insurance Commissioner Garland Smith stated that though he had received complaints against Blanchard in both the General American and Texas Mutual cases, there had not been enough evidence to warrant his dismissal before. In any event, if the rewards were indeed this small, the price of bribery seems amazingly low considering the stakes.

The closing of General American Insurance Company gained the Texas insurance industry national attention in the news media. General American was the nineteenth insurance company to follow Texas Mutual into permanent receivership, and at least fourteen of the nineteen companies participated in activities that required tighter regulation and closer supervision. Nevertheless, the scandal in Texas insurance deepened before it improved.

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CHAPTER II

THE U. S. TRUST AND ICT FRAUDS

The failure of two large Texas insurance companies, U. S. Trust and Guaranty Insurance Company on February 3, 1956, and ICT Insurance Company on March 5, 1957, greatly increased the public's growing awareness and concern over the existence of fraud, mismanagement, pay-offs, and lax regulation in Texas insurance. The receivership investigations uncovered enough evidence of fraud to bring charges against insurance promoters, state senators and representatives, and insurance commissioners.

U. S. Trust was organized by a Waco promoter, A. B. Shoemake, who already had a background of involvement in bankruptcy courts. In 1938 Shoemake, at that time attorney-in-fact for Republic Underwriters, had been sued along with the company for bankruptcy. The state alleged that the company had not kept the minimum state required reserve capital and was insolvent. Just before the court closed the company and froze its assets Shoemake allegedly withdrew from the company $125,850 in cash and $40,725 of Chrysler and U. S. Steel stocks.\(^{51}\) In spite of this questionable

\(^{51}\textit{Texas Observer}, \text{December 21, 1955, p. 2.}\)
background the Board of Insurance Commissioners gave Shoemake another chance in the Texas insurance industry when it granted U. S. Trust a charter on July 16, 1945.

U. S. Trust was first suspected of being insolvent in May, 1954, when Clark Diebel, a state auditor assigned to insurance investigation, discovered discrepancies in the company's books while routinely going over its accounts. The State Auditor's Department immediately informed Insurance Examiners V. F. Blanchard and Robert Butler that the company appeared to be bankrupt and that its subsidiary, in which U. S. Trust had invested most of its capital, was not paying dividends. The Auditor's office suggested to the insurance officials that they should immediately turn the case over to Attorney General John Ben Shepperd for prosecution. The Insurance Commission apparently thought the evidence unconclusive. It did notify Shoemake that some doubt existed as to U. S. Trust's solvency and began a series of meetings during June and July, 1954, with examiners and auditors to discuss the company's position.

During these sessions the Commissioners decided to examine some of the company's books and records, since "no specific admissible evidence was available" to prove the company's

52 Ibid., p. 5.

insolvency and because the Insurance Commission had not audited U. S. Trust since the end of 1952. Shoemake, fearing that an examination by the Commission might result in a run on the company's deposits, proposed the hiring of an independent examiner. At an August meeting the commissioners agreed to the proposal. Shoemake hired and paid a former assistant of the Insurance Commission, Charles K. Leslie, to examine the company and try to get Shoemake's books in shape. Leslie completed his audit and reported on October 13, 1954, that U. S. Trust was solvent on the basis of its major holding, U. S. Automotive Service, which showed a net cumulative earned surplus of $136,000. As a result of this report the Commission allowed U. S. Trust to continue operations.

In November, 1954, banks and individuals complained that U. S. Trust was not paying valid claims and had instituted an unregulated borrowing program. In this "certified draft program" Shoemake induced investors to lend money to his company by offering them a return of 5 per cent on demand. These loans were not backed by the FDIC though

54Ibid.

55Texas Observer, December 21, 1955, p. 3.
Shoemake's advertising created that impression. The complaints became so numerous that the State Banking Commission checked with the Attorney General's office to see if the Banking Commission had the same jurisdiction over U. S. Trust as it would have over a bank. The Attorney General ruled that U. S. Trust could not be regulated as a bank and regulation fell entirely to the Insurance Commission. Toward the end of February, 1955, the Insurance Commissioners responded to the complaints by authorizing P. W. Goad to audit U. S. Trust. Goad completed the report by June 24 and claimed that U. S. Trust was insolvent. He stated that the company falsified accounts, had no organized system of bookkeeping, no control over its deposits, and that the company's records overestimated the value of the company by $1,000,000. Goad explained that the "curious million dollar error" in U. S. Trust's books was the amount U. S. Trust owed its subsidiary which sold new and used cars, U. S. Automotive. The debt was never recorded on

56 "A Cleanup in Texas," Business Week (July 4, 1956), p. 4. See also Texas Observer, December 21, 1955, p. 4. When Shoemake began selling the "certified draft accounts," he advertised that the accounts were insured by the FDIC. However, he was advised to stop such advertising by Assistant Attorney General Elbert Morrow. Shoemake rephrased his advertisement so that it still created the impression that the accounts were FDIC insured. Statement by Elbert Morrow, attorney, Dallas, May 3, 1966.

57 McLennan County Grand Jury, op. cit., p. 5.

58 Texas Observer, December 21, 1955, p. 3.
the company books, and U. S. Automotive canceled the debt in order that U. S. Trust could pass as solvent. Goad also informed the Insurance Commission that on U. S. Trust's "deposit accounts" was a statement saying "insured to $10,000," when in reality, the accounts were not insured at all. Goad further found that the company's employees were not bonded, that legitimate insurance claims were not being paid, and that the company had never conducted an internal audit.

On June 24, 1955, using the findings of the investigations, the Board of Insurance Commissioners issued a summary of the irregularities discovered in U. S. Trust and its subsidiaries, which stated that the company was insolvent to the amount of at least $592,000, had kept poor accounts, and was guilty of misrepresentation by showing its subsidiary, U. S. Automotive, as a solvent firm. The summary further claimed that U. S. Trust had deliberately falsified records and misrepresented insurance policies and the certified draft accounts. The commissioners set a hearing for July 5, 1955, on the revocation of the company's license.

59 McLennan County Grand Jury, op. cit., p. 5.
60 Texas Observer, December 21, 1955, p. 3.
61 Ibid.
At that hearing Shoemake, through his attorney Bert McDaniel, denied all allegations in the summary and presented a Dallas certified public accountant, Felix Einsohn, who claimed that he could prove the company solvent by a complete audit of U. S. Trust's assets, U. S. Automotive in particular. The commissioners were compelled to accept Einsohn's claim of the subsidiary's solvency because the Insurance Commission had no authority to examine non-insurance corporations such as U. S. Automotive and therefore could not determine its worth. The hearing recessed to as late as September 15 without restraining U. S. Trust from doing business. The Commission and the Attorney General said that they "needed more evidence" before continuing the hearing. In the interim the Insurance Commission requested Shoemake to voluntarily reduce the interest rate on the "certified drafts," or take other steps, such as stopping advertisement, to limit the borrowings on the drafts. The Board thought that voluntary reduction of borrowings would result in "the maintaining of the status quo until the true financial condition of the company could be established."

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63 Texas Observer, December 21, 1955, p. 3.

64 McLennan County Grand Jury, op. cit., p. 8.
In complete disregard of the commissioners' request, Shoemake continued to sell "trust deposit accounts," which were in effect "mere receipts" for money. He continued to conduct a vigorous advertising campaign, which included Texas newspapers and Drew Pearson's television news show. As a result of this drive, Shoemake gained deposits at the approximate rate of $20,000 a day during the time when his company was being investigated for insolvency. By the time the show cause hearing resumed on September 15, the U. S. Trust certified draft program had added $5,800,000 in deposits. During the hearing a representative of the Attorney General's Department stated that since a question of over-evaluation of U. S. Trust's real estate holdings existed, the testimony of competent property appraisers would be necessary before court action could be undertaken. Admissible testimony or evidence relating to the land evaluations could not be obtained under the existing laws as the Insurance Commission was not allowed to audit books of companies that did not sell insurance. Thus the hearing again was recessed, having failed to establish either the solvency or insolvency of the company.

65 Texas Observer, December 21, 1955, p. 3.
66 Ibid., p. 4.
67 Ibid., p. 8.
68 McLennan County Grand Jury, op. cit., p. 2.
69 Ibid., p. 6.
Although the Insurance Commission apparently used every method within its power to close U. S. Trust, the law imposed limitations which severely hampered its efforts. Signs of an end to the Commission's frustration in trying to close U. S. Trust arose in the 1955 Texas Legislature. Representative Tom Joseph of Waco sponsored H. B. 240, which redefined a state bank so that Shoemake's program of selling deposit drafts would be regulated and supervised. U. S. Trust was escaping such supervision because the Insurance Code contained no regulation covering U. S. Trust's quasi-banking activities. Representative Joseph was backed in his efforts by some Waco bankers and savings and loan executives who resented Shoemake's promise of 5 per cent interest as compared to the banks' 3 per cent average. H. B. 240 passed the House of representatives, but a group of eight senators retained by Shoemake stopped the measure in the Senate Committee of Banks and Banking by sending the bill to a subcommittee whose members, William Moore, Carlos Ashley, and Gus Strauss, opposed it. The retention of the subcommittee members by Shoemake was not discovered until later investigations.

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72Ibid., December 21, 1955, p. 5.
Another reform measure, H. B. 39, called for all insurance securities to be regulated by the Insurance Commission. The bill would also regulate Shoemake's draft deposits. Senator Ashley managed to attach an exemption clause that excluded any company which had capital exceeding $500,000, a characteristic of U. S. Trust and Guaranty. The House voted against the bill with the Senate amendments, and the bill went to a conference committee, which agreed to a measure without the Ashley exemptions. This law, titled "The Insurance Securities Act," partially was responsible for toppling Shoemake's fraudulent enterprises.

Following the later receivership of U. S. Trust, a full-scale investigation of state officials retained by Shoemake was instrumental in leading to close scrutiny of the entire lobbyist situation in Austin. Shoemake spent thousands of dollars in an attempt to prevent close regulation and supervision of his companies' activities. A Waco grand jury alleged that Shoemake engaged in "a definite pattern" of hiring legislators for both legal work and influencing legislation. No legislator or member of

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73Ibid., May 2, 1955, p. 4.
76 McLennan County Grand Jury, op. cit., p. 8. See also Texas Observer, March 7, 1956, p. 4.
the Insurance Commission ever was brought to trial, which greatly disturbed Waco District Attorney Tom Moore, who said, "I felt that some of the state senators we questioned... in connection with the U. S. Trust and Guaranty case should have been indicted."77

Despite Shoemake's efforts to stave off reform, new measures subsequently gave the Insurance Commission and the Attorney General the power and jurisdiction to evaluate the records of U. S. Automotive and some other questionable assets of U. S. Trust. On September 20, 1955, in accordance with the new Texas Insurance Securities Act which became effective on September 6, Shoemake completed application for a permit to sell insurance securities. On November 23, after the careful examination of U. S. Trust's assets, Joe Moore, head of the new securities division, informed the company that the license was denied because of falsifications and over-evaluations found in Shoemake's submitted statement of company assets. The examination also found that the company's own subsidiary, Arkansas Fire and Marine Insurance Company, reinsured $1,600,000 of U. S. Trust automobile insurance. In essence, this meant that the company was insuring itself. Apparently Arkansas Fire and Marine was established for the sole purpose of

77Texas Observer, June 22, 1956, p. 5.
reinsuring U. S. Trust and thereby removing the $1,600,000 liability from U. S. Trust's books.78

The evidence against U. S. Trust was now so conclusive that the Insurance Commission acted immediately to close the company. On the morning of December 15 all of the auditors, lawyers, commissioners, and representatives from the Attorney General's office presented the allegations against U. S. Trust in petition. District Judge Charles O. Betts signed a temporary restraining order stopping all activities of the company and freezing its assets until a hearing on December 22, 1955. Although the evidence indicated that U. S. Trust was insolvent in June, 1954, because of the restraint the inadequate law demanded it took regulating officials from June, 1954, to December, 1955, to place the company into receivership. This delay cost investors in the deposit accounts over $5,800,000.79 The Insurance Board stated that the company had incurred debts of more than $7,000,000 that were still outstanding to over 48,000 persons when the company was put into receivership.80

Some parties blamed the insurance commissioners for the costly delay in prosecution. One outspoken newspaper,

78Ibid.
79McLennan County Grand Jury, op. cit., p. 2.
80Texas Observer, June 20, 1956, p. 4.
The Texas Observer, published the following insinuating remarks:

Why did it take twenty months for the Commission to put the company into receivership? Why did they let the owner talk them out of a state audit? Why did they not insist the company be closed down after they formally found it insolvent and its records falsified in June, 1955?81

The State Insurance Board might have been negligent in its duties of regulating U. S. Trust, but the investigations and subsequent receivership of the company indicate that the weak nature of the law was the prime hindrance to all efforts at closing U. S. Trust. Only when the legislature changed the outmoded law forbidding the examination of company assets was the insolvent company finally put out of business.

U. S. Trust and Guaranty Company of U. S. Automotive Service and Arkansas Fire and Marine Insurance Company went into permanent receivership on February 3, 1956. A McLennan County grand jury attributed the company's failure to a lack of proper management and control, lack of adequate trained personnel, the absence of proper books and accounting methods, and too rapid expansion.82 Shoemake was indicted on February 29, 1956, by the McLennan County grand jury for the "unlawful offer for sale of securities."83

81Ibid., December 28, 1955, p. 2.
82McLennan County Grand Jury, op. cit., p. 11.
83Letter from Don Hall, District Attorney, Waco, Texas, March 29, 1966.
A federal grand jury indicted him and six other corporate officials on charges including conspiring to defraud investors by false representations, fraudulent bookkeeping, and transferring to subsidiaries obligations too large for the subsidiaries to cover.84 Before Shoemake's case came to trial he attempted suicide, and performed what Waco District Attorney Don Hall termed "almost perfected lobotomy." Hall stated that Shoemake "has no recollection of his prior financial endeavors." The brain damage caused by the bullet Shoemake fired into his head has kept him in the U. S. Veteran's Hospital in Waco suffering from "mental incapacitation."

About the time the furor aroused by the bankruptcy of U. S. Trust began to subside, a large Dallas firm, ICT Insurance Company, announced its insolvency. During the subsequent investigations and receivership trial, the organizer of ICT, Ben Jack Cage, gained the reputation as the most notorious of all the insurance promoters of the scandal era. Texans are still provoked to anger when they think of the fiasco surrounding Ben Jack Cage, his ICT Insurance Company, and the regulatory officials Cage paid to do his bidding. The original incorporators, Jack V. Cage, Ben Jack Cage, and John G. Vaughan, formed the company by reorganizing Texas Lloyds, a concern already

84Texas Observer, August 16, 1957, p. 4.
85Don Hall, op. cit.
owned by Ben Jack Cage. Cage made the firm a stock insurance company and from this beginning built up a complex of seventy-two interrelated corporations which operated in twenty-five states.86

A key factor in Cage's scheme involved selling his insurance company to organized labor, thereby acquiring working capital from the sale of stock, and at the same time acquiring a large clientele for the sale of insurance. His plan proposed to make insurance available to the labor organization at a lower cost and return a profit to union members. In June, 1950, Cage and Nile E. Ball, a labor attorney, asked the Texas State Federation of Labor to purchase enough ICT shares to become its major stockholder. Cage stated at the TSFL convention, "Labor is the biggest thing in Texas.... God willing, we will build for you a living memorial for the working people of Texas."87 The convention approved the plan, and local unions and individuals began pouring money into the Insurance Company of Texas until 380 Texas AFL locals acquired more than 50 percent of ICT stock, enough for controlling interest.88


Ben Jack Cage and his associates then contracted with labor to manage ICT on behalf of the ill-informed board of directors. This newly formed management group was named Jack Cage and Company, later called JACCO.

Late in 1955 the labor officials representing the owners and stockholders of ICT became aware that the company's financial position bordered on insolvency. The labor leaders first rescinded the management contract with Jack Cage and Company, and then took measures to revive the firm. They reorganized the books, reinsured some policies for which the company was liable, and sold additional stock. None of their efforts succeeded, and in February, 1957, a show cause order was issued by the Insurance Commission giving officers of ICT a chance to prove the company's solvency. Since the deficit exceeded $4,000,000, the Commission placed the company in receivership on March 4, 1957. 89

The Insurance Commission originally issued ICT a permit to operate because the company appeared to meet the state requirements. One of the state's primary stipulations demanded that the company have an initial $200,000 in reserve. The attorney for the receiver, Renne Allred, disclosed that the $200,000 on deposit at the Mercantile National Bank in

Dallas had been loaned to Cage by the bank on May 22, 1950. However, the vice-president of the bank, Meyer J. Rachofsky, signed an affidavit stating that the $200,000 was "free and clear of any encumbrances and wholly and entirely at the disposal of the Insurance Company of Texas." The Insurance Commission had chartered ICT primarily on the merits of this false affidavit.

Allred further revealed that both the Mercantile and Republic National Banks in Dallas had loaned money to the ICT Insurance Company on other occasions. Allred made the point that the loans usually were obtained just before an official examination or before the publication of the ICT annual statement. ICT entered the money as assets on the company books but did not list the corresponding debt as a liability. By making these "year-end" and "examination-time" loans ICT had a veneer of financial stability. One of the organizers of ICT, J. G. Vaughan, testified that a common method of borrowing was to sell the bank premium notes with a repurchase agreement to take effect immediately after the first of the year. This arrangement temporarily built up a large cash balance, and at the same time reduced taxes since the bank converted the premium notes to government bonds.

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90 Texas, Senate, *op. cit.*, p. 7.
According to the Senate Investigating Committee several high ranking and influential leaders in the TSFL "defected to the cause of Mr. Cage because of the temptation of personal gain." As a result of this "temptation" they did not always act in the best interest of labor. One of these officials, Paul C. Sparks, was Executive Secretary of the TSFL when appointed a director of ICT Insurance Company and ICT Discount Corporation. Prior to November, 1953, Sparks received at least $4,000 from Jack Cage and Company in monthly payments of $500 for promoting insurance stock sales to labor.

When Cage and his associates set out to manage ICT for its labor owners, they drew up an agreement which allowed them management independence from the company board of directors. Cage selected company officials who had little or no experience in the insurance business. The management contract left very little for the ICT officers to do in the operation of the company, a fact openly admitted by Frank G. Newman, the lawyer who had drawn up the agreement. According to Sparks the management of JACCO decided at least on one occasion (July 19, 1956) that financial statements would not even be released at an approaching stockholders

93 Ibid., p. 102.  
94 Ibid., p. 47.  
95 Ibid., p. 54.  
96 Ibid., pp. 98-99
meeting. Sparks stated that Cage assured his associates that the Board of Directors of ICT "would not see the management picture." Cage was hiding the records that showed that JACCO mismanaged ICT funds and that the value of ICT's stocks had been inflated by at least $500,000 when purchased by labor.

From the time the TSFL bought controlling interest in ICT and contracted for JACCO to manage the company, JACCO operated as if it were the principal, even though the management contract called for JACCO to act only as agent. Since JACCO was the authorized dealer of ICT stock, the money earned by sale of stock passed first through the hands of the management company. JACCO then was to remit and credit the ICT Insurance Company for the subscriptions. JACCO did not remit to ICT money received for all the stock sold but credited these receipts, which totaled nearly $1,000,000, to the management company's separate account.

The management team also deceived ICT Insurance Company by combining the funds of all ICT's subsidiaries so that the money of one company could not be distinguished from that of another. Similarly, JACCO manipulated and transferred assets and created unauthorized contractual obligations among the companies to the point where funds and obligations were hopelessly confused.

97 Ibid., p. 43.
98 Ibid., p. 103.
100 Ibid., p. 95.
In the case of Lone Star Boat Works Cage transferred assets from three of ICT's companies to inflate the boat works company's stated value by $1,600,000. Initially, American Family Investment Company bought Lone Star Boat Works for about $700,000. Lone Star was then transferred to another ICT firm, Commercial and General of Tangiers, Africa. Commercial and General then sold the boat company back to another ICT affiliate, Continental Union Insurance Company of Alabama for $2,247,000. Cage avoided paying a federal capital gains tax by allowing the paper profit to appear on the books of a foreign corporation.

Cage boosted the value of ICT assets when he purchased an office building through United Metropolitan Corporation, a $1,000 dummy corporation wholly owned by ICT. Cage had the building appraised by the Dallas Real Estate Board of Appraisers. Jack Cage and Company then arranged for ICT to purchase the building for the new appraisal value, which was $152,500 above the original sale price. Cage thus enabled ICT to increase its stated assets value without actual cost. However, on the same day that ICT paid United Metropolitan for the building, United Metropolitan

\[101\text{Ibid.}, \text{p. 66.}\]  \[102\text{Ibid.}, \text{p. 79.}\]
"loaned" $152,500 to JACCO.\textsuperscript{103} The gain in stated value of the home office building eventually came back to Ben Jack Cage at JACCO. In an end of the year transaction, Cage arranged to purchase 102,325 shares of All States Life Insurance stock for $520,000 if B. F. Biggers, the organizer of All States, would repurchase the stock on or before December 31, 1955. Cage agreed that he would repurchase the stock after the state's year-end examination.\textsuperscript{104} Frank G. Newman, employed as legal counsel for Jack Cage and Company from July, 1953, to November, 1954, testified that the All States Life Insurance stock would have had to been declared non-admitted assets if left in the ICT portfolio at annual statement time.\textsuperscript{105}

The frequent exchange of assets between interlocking companies helped to present a picture of solvency and profit for the individual companies and hid the losses incurred due to the malpractices of JACCO. The extremely large expenses incurred by associates of Jack Cage and Company account for a great deal of ICT's losses. JACCO advanced funds to its officers and employees without


\textsuperscript{104}Texas, Senate General Investigating Committee, A Report of ICT Insurance Company..., p. 36.

\textsuperscript{105}Ibid., p. 56. See also Texas, Senate General Investigating Committee, A Report Concerning ICT, Pierce P. Brooks..., p. 21.
complete records of the amounts issued, or how the money was used.\textsuperscript{106} From June, 1952, to May, 1953, expenses for travel and entertainment totaled $192,495.91. The amount for the following year was $235,139.04. The Senate Investigating Committee found these particular expenses "excessive" for a company the size of ICT and its management.\textsuperscript{107}

More ludicrous than the amounts spent for "travel and entertainment" were the items purchased by this expense money. William S. Skiles, who audited JACCO, stated that thirty-one persons, including Mrs. Jack Cage, held company authorized airline credit cards.\textsuperscript{108} Another suspicious item was a special account which Ben Jack Cage opened at the Highland Park State Bank in Dallas on May 7, 1953. JACCO made deposits to the account even though the corporate minutes did not show authorization for such action. Disbursements of over $32,000 consisted of items such as $2,945 for printing materials for Cage's Lazy C Ranch and over $25,000 to hotels and to cash. A sum of between $4,000 and $5,000 was expended by Cage personally. A total of $55,272.30 was entered on invoices as contributions of various kinds, including some charities. The total drawn to income tax, father's doctor bills, Mrs. Cage, and

\textsuperscript{106}Ibid., p. 100. \textsuperscript{107}Ibid., pp. 30, 98. \textsuperscript{108}Ibid., p. 30.
several department stores amounted to $3,104.35. The total expenditures of this unauthorized account amounted to $120,000.109

Labor leaders placed much of the blame for the failure of ICT on Cage's unsuccessful and expensive business ventures. Cage used company funds to promote a food ingredient that supposedly would repel flies from cows. Another idea promoted the sale of an alarm for women to carry in their purses to be used against molesters. Cage also promoted a do-it-yourself pregnancy test kit. He was also charged with spending $69,000 in trying to sell two-inch square lots of a ranch for seventy-five cents each.110

Despite the fact that Cage's clever maneuvering of funds between companies made it difficult to detect the mismanagement and fraud, the state regulatory officials seemed to be particularly lax and negligent in connection with JACCO and ICT. JACCO influenced insurance examiners and commissioners by payments and gifts to allow the ICT matrix of companies "more than usual consideration."111 Nile E. Ball, who held an equal partnership with Cage in JACCO, stated at a board of directors meeting in January,

109Ibid., pp. 31-32.
110"The Tall Wanderer," op. cit., p. 102.
111Texas Observer, October 11, 1957, p. 8.
1956, that, "we have studiously cultivated the Insurance
Department."\textsuperscript{112} John Osorio, Insurance Commissioner until
the 1957 reorganization of the Insurance Commission, intro-
duced documents to the Senate Investigating Committee
establishing the fact that the three commissioners, George
Butler, Garland Smith, and Byron Saunders "used their posi-
tion and authority to assist companies such as ICT in matters
outside their regulatory duties."\textsuperscript{113} Saunders recommended
were sent to Butler and Smith asking them to recopy them
on the Insurance Commission's stationery, sign them, and
send them to other state Insurance Commissioners recommend-
ing permits for certain companies. Many such letters were
introduced as exhibits.\textsuperscript{114} Commissioners Smith and Saunders
chose to cover up and hide what was going on in JACCO in
exchange for certain considerations. Smith received a new
automobile air conditioner from Cage on March 30, 1953.
Another benefit in the form of a retainer of $700 a month
was given to Commissioner Smith's son-in-law, Max Wayne
Rychlik. Alledgedly, the money was to open an Austin ICT
office. Although the plan never materialized, Rychlik
received a total of $18,000.\textsuperscript{115}

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\textsuperscript{112}Texas, Senate General Investigating Committee,
\textit{A Report of ICT Insurance Company...}, p. 25. \\
\textsuperscript{113}Ibid., p. 90. \hspace{1cm} \textsuperscript{114}Ibid., p. 91. \\
\textsuperscript{115}Texas Observer, October 11, 1957, p. 8.
\end{flushright}
ICT Discount Corporation paid Commissioner Saunders $7,000, which Saunders later claimed was payment for an oil royalty lease executed in Tyler on January 11, 1954. Two other ICT firms, Atlas Alarm Corporation and Triangle Research and Advertising Company, paid the Commissioner $900. Saunders was charged with perjury after he stated before a Travis County Grand Jury that the money was for legal services which he had rendered during his tenure as a commissioner.\textsuperscript{116} Nile E. Ball, second only to Cage in JACCO management, admitted to investigator Otto Millinax on January 9, 1956, that payoffs of $500 monthly were being made to Saunders and Smith.\textsuperscript{117} John G. Vaughan, one of the original incorporators of ICT, testified that he had entertained insurance commissioners and state examiners lavishly with JACCO funds.\textsuperscript{118} Nine monthly checks totaling $4,500 were sent to the Alabama Insurance Commissioner L. L. Gwaltney. This payment insured a license for a very weak link of the ICT chain, Continental Union Insurance Company, a firm used to reinsure a large volume of ICT insurance.

\textsuperscript{116}Ibid., pp. 7-8.

\textsuperscript{117}Texas, Senate General Investigating Committee, A Report of ICT Insurance Company..., p. 74.

\textsuperscript{118}Ibid., p. 20.
The record of Cage's activities indicates fraud and embezzlement, yet Cage was convicted on only two counts—one of embezzlement and one of perjury. A jury sentenced him to the maximum ten years in jail, but he served no time, for while on bail he left the country for Brazil, where he still remains. Cage's fraudulent management of ICT covered a period of five years (1952-1957) before company officials discovered the firm to be insolvent and the state put the concern permanently out of business. Similar activities, however, were occurring in many other companies, primarily because the insurance laws in Texas were inadequate in the supervision and regulation of company activities and therefore invited unscrupulous individuals to enter the industry and make a personal fortune at the expense of the investing public and the repute of the insurance industry.

119 Texas Observer, November 1, 1957, pp. 1, 8.
CHAPTER III

TEXAS INSURANCE REGULATION: A STUDY OF INADEQUACY

Many companies would not have been allowed to operate had the examining staff and the laws regulating insurance been adequate and efficient. The law required a qualifying investigation for new companies and a biennial examination, but because of the shortage of examiners the Commission reviewed many records by correspondence and did not examine some companies at all.\textsuperscript{120} A heavy schedule forced examiners to do their jobs hastily, spending an average of only two or three weeks on each company. A survey of other states indicated that examiners averaged only four companies a year.\textsuperscript{121}

The examiners not only were few in number, but lacked training and experience. Because of the complicated and distinctive nature of insurance examining, a thorough knowledge of the job was vital for conducting examinations with the thoroughness necessary to uncover misrepresentation.

\textsuperscript{120}Texas, Revised Statutes, Annotated (Vernon, 1952), Insurance Code, Article 1.15. Texas, Attorney General, "Recommended Changes in the Insurance Code," Correspondence to the Texas Legislative Council, Austin, Texas, May 27, 1954, p. 2.

\textsuperscript{121}Texas Legislative Council, Insolvency in the Texas Insurance Industry, 1939-1954 (Austin, 1954), pp. 112-114.
The Insurance Commission found it difficult to keep experienced examiners; the turnover rate during a probably typical six year period (1948-1954) ran as high as 50 per cent.\textsuperscript{122} Recruiting examiners proved difficult as the salary was low and the job demanded almost constant travel. The beginning annual salary was $4,100, while the salary for senior examiners amounted to only $5,400. A survey revealed that 40 per cent of examiners in other states were paid more than the highest ranked examiner in Texas. Texas examiners estimated that they were required to spend twenty-eight days a month away from their homes.\textsuperscript{123} Since recruiting was almost impossible, Texas had no experience or educational requirements for prospective examiners.\textsuperscript{124} Under such circumstances it was not surprising that the examiners' investigations failed to expose company insolvency and fraudulent activity.

The examinations required a check of the companies' entire capital structure, including all money, stocks, notes, bonds, and mortgages claimed as assets.\textsuperscript{125} However, the Commission admitted that staff limitations resulted in many cursory examinations.\textsuperscript{126} Statement letters from banks

\textsuperscript{122}Ibid., p. 172. \hspace{1cm} \textsuperscript{123}Ibid.
\textsuperscript{124}Ibid., p. 169.
\textsuperscript{125}Texas, Revised Statutes, Annotated (Vernon, 1952), Insurance Code, Article 2.04.
\textsuperscript{126}Texas Legislative Council, \textit{op. cit.}, p. 198.
often were not verified, and later receiverships found some of these balances encumbered. Stocks not traded on security exchanges were usually taken at book value due to the time shortage. Assets in the form of real estate or mortgage loans on real estate also were taken at book value since the companies' properties often were widely scattered throughout the state. In addition, the average examiner did not feel he was in a position to judge the actual worth of real estate.\textsuperscript{127} Often these properties were greatly inflated (as much as four times their actual worth) as unscrupulous promoters took advantage of the lack of established standards or qualifications for property appraisers. The examiners only spot checked companies' stock purchases. Each type of company was limited to certain forms of investments, but the examiners simply did not have time to thoroughly check all stock purchases made by large companies. More stringent regulations were needed requiring more and better trained personnel in order that Texas insurance companies would have closer and more frequent investigations. Such a program of close scrutiny would stabilize the industry and enable the investing public to assume confidence in Texas insurance.

\textsuperscript{127}Ibid., p. 199.
In the midst of the insurance scandal it became evident that one reason the Insurance Commission was not adequately performing its functions was that the department had a poor organizational structure. The Board acted jointed only in conducting formal hearings, determining rates, and in a few other general Board actions. There were three virtually autonomous divisions known as the Life, the Fire, and the Casualty Divisions. The Life Division had the greatest responsibility since it had charge of licensing and examining of all three classes of companies. Regulation was greatly curtailed under this three-division organization because two of the three commissioners had no say on such important matters as company examinations, licensing, and investigations of complaints. Information was not interchanged between the three divisions, resulting in some complaints not being examined.128 Such a breakdown in communication made it possible for individual commissioners to engage in profitable personal transactions with representatives of companies under the commissioner's regulatory charge.

The most frequently criticized portion of the insurance laws concerned capital requirements for new companies. Many firms began operations on a "shoestring," which

prevented them from surviving the inevitable financial dips. Chapter Two of the 1951 Insurance Code stipulated a capital requirement for insurance companies of $100,000, "unless otherwise provided." This requirement was written into the Code unmodified from the statutes of 1874. Given price changes, the requirements should have become more rigid in the succeeding seventy-five years rather than the reverse. After the statement of the general rule, the following chapters provided exceptions, most of which had been written into the law before 1900. Life, health and accident companies formed under the limited capital stock plan could be formed with a beginning paid-up capital reserve of only $5,000. The same was true of a mutual life, health and accident company. Mutual assessment companies, burial associations, and local aid groups could commence operations if they had a membership of 500 and collected a membership fee from each member, which usually amounted to a total of $1,000. Chapters fifteen through twenty provided further exceptions to the $100,000 capital requirement.

129 Texas, Revised Statutes, Annotated (Vernon, 1952), Insurance Code, Article 2.02.
132 Texas, Revised Statutes, Annotated (Vernon, 1952), Insurance Code, Article 2.02.
133 Ibid., Article 3.03.
134 Ibid., Article 11.02.
Mutual fire and casualty companies had no capital requirements and could organize with a $70,000 surplus. \(^{135}\) With $250 in assets a farm mutual company could be formed. \(^{136}\) All that was needed to organize and receive a charter for a county mutual was a $10,000 surplus and a deposit equal to the largest risk. \(^{137}\) Lloyds, a Texas institution capitalizing on the famous British company's name, received a charter with a guaranty fund of only $60,000. \(^{138}\) A reciprocal exchange could be formed with a surplus fund of $50,000. \(^{139}\)

In a study of the capitalization requirements of the various states Texas required the least initial investment for almost every type of company compared. Only Mississippi had a lower requirement for ordinary stock life insurance company ($50,000). \(^{140}\) Texas' $25,000 requirement for limited capital stock companies was the lowest in the nation. Thirty-three states required a larger amount of capital for organizing a stock fire insurance company. \(^{141}\) For fidelity, guaranty, and surety and mutual insurance companies, Texas had the lowest capital requirement in

\(^{135}\)Ibid., Articles 12.05, 14.10.  
\(^{136}\)Ibid., Article 15.08.  
\(^{137}\)Ibid., Article 16.06.  
\(^{138}\)Ibid., Article 18.05.  
\(^{139}\)Ibid., Article 19.03.  
\(^{140}\)Texas Legislative Council, op. cit., pp. 112-114.  
\(^{141}\)Ibid., pp. 117-120.
the selected group of fourteen states.\textsuperscript{142} The fact that Texas has had more insurance companies since 1939 than any other state supports the conclusion that insurance companies found the law to their liking. The fact that Texas companies ranked only sixth nationally in premium income and fifth in total assets indicates that the quantity is not an accurate gauge of quality in the state.\textsuperscript{143}

Stricter capitalization regulations would have curtailed much of the industry's problem. The low qualifications attracted "unqualified and irresponsible operators" to the business of insurance.\textsuperscript{144} A study of company failures dramatically proves that such persons gravitated to the Texas insurance industry, mismanaged company affairs, and often operated outside the law. Under Texas law the Insurance Commission could not refuse a promoter a license to operate in the state even when the promoter had been responsible for placing a previous company in receivership.\textsuperscript{145} On several occasions promoters bankrupted one company and afterwards started a new firm. A legal stipulation requiring proven ability and know-how before obtaining a license would have greatly aided in eliminating fraudulent practices in the industry.

\begin{itemize}
\item \textsuperscript{142}Ibid., pp. 122, 127-128.
\item \textsuperscript{143}Ibid., p. 17.
\item \textsuperscript{144}Ibid., p. 105.
\item \textsuperscript{145}Texas, Attorney General, "Recommended Changes in the Insurance Code," p. 3.
\end{itemize}
One of the most astonishing parts of the Texas law exempted the sale of securities in insurance companies from the registration requirement.\textsuperscript{146} Insurance companies thus could manipulate stock and stock sales with little restriction and no supervision. Companies had to file annual statements, which did not have to be attested to by a certified public accountant, and the Banking Commission was required to accept the statement in lieu of an examination.\textsuperscript{147}

Under the Texas Securities Act two methods could be used to obtain the necessary capital for the formation of an insurance company. One plan called for close supervision right up until the actual incorporation of the company. The organizers presented the Secretary of State with an application to sell securities, a proposed plan of doing business, information on the background of the officials to be connected with the company, and an agreement that all of the money collected would be deposited in a certain bank until all the capital necessary to create the company had been raised. Commissions and all other expenses were limited and the bank could not disburse the money from the account without the written authorization of the Secretary

\textsuperscript{146}\textit{Texas, Revised Statutes, Annotated} (Vernon, 1948), Article 600A, secs. 5, 23g.

\textsuperscript{147}Texas, Attorney General, "Recommended Changes in the Securities Act and Laws Pertaining to the Banking Commission," Correspondence to the Texas Legislative Council, Austin, Texas, May 27, 1954, p. 2.
of State. Once an insurance company sold its subscription stock equal to the value of the minimum capital requirement, the Securities Division of the Office of the Secretary of State released the company's funds that had been on deposit. Neither the Securities Division nor the Insurance Commission had any further control over the operation of these companies in the sale of their securities. Insurance companies were then free from regulation and were allowed to issue new classes of stock and sell this stock on any plan considered desirable to the company. Insurance companies, once past the hurdle of raising the minimum capital stock, could then freely manipulate stock and stock sales with no regulation. 148

The second and most popular method of obtaining the necessary capital for the formation of an insurance company provided "absolutely no safeguard for the public." 149 The company utilized the trust powers under Article 1303b of the Texas Securities Act by issuing an original stock subscription consisting of an equal number of two classes of participating no-par value common stock with equal voting rights. 150 The incorporators and promoters would purchase all of the first class of stock for as low as ten cents each, thus obtaining ownership over one half of the corporation. The second bloc would then go on the market for a

148 Ibid.
149 Ibid., pp. 2-3.
150 Texas, Revised Statutes, Annotated (Vernon, 1948), Article 1303b.
much higher rate, maybe ten dollars. The incorporators would not publish the fact that there were two classes of stock issued, equal in value but unequal in original purchase price. The small number of promoters then would have controlling interest in the investment company for a fraction of the cost. The incorporators also received commissions as high as twenty per cent on the sale of the second bloc of stock. In addition, the organizers were the company's officers and therefore received salaries set by themselves. This scheme was workable only because the "1303b companies" were considered exempt from the Texas Securities Act as a company with trust powers claiming exemption to regulation under Section 3 (o) of Article 600A.

Section 3 (o) is read in connection with Section 5, and the combined effect is that the securities of trust companies are exempt from registration under the Securities Act. After the promoters had sold the investment or "trust" company's subscription stock and were in control of the corporation, they converted the firm into an insurance company through a "partial liquidating dividend" to the stockholders. Provision for this "partial liquidating dividend" was usually included in a clause in the "1303b's"

151Texas, Attorney General, "Recommended Changes in the Securities Act...," p. 2.

152Texas Legislative Council, op. cit., p. 151.
charters, which provided for an exchange of stock of the 1303b trust company for the stock of the newly organized insurance company, with the holders of stock in the new insurance company taking equal valued no-par shares as was required by the Insurance Code. This meant that both the promoters and the other investors got insurance company stock of equal value even though the investors paid a great deal more for theirs. The promoters thus received a substantial paper profit since their original investment was a fraction of that made by the owners of the second bloc of stock. Incorporators used this plan instead of initially forming an insurance company because the Insurance Code required stock to be of equal value.\textsuperscript{153} According to figures from the Attorney General's Office approximately 1100 of these companies were operating under Article 1303b in 1954.\textsuperscript{154} Not all of these trust companies converted to insurance companies, but had the option either to sell the pre-organizational certificates for two separate prices, or to sell all certificates of equal value.

Another type of unregulated securities was "deposit account" certificates, which were issued by an insurance company that promised five per cent interest for the

\textsuperscript{153}Texas, Revised Statutes, Annotated (Vernon, 1952), Insurance Code, Article 2.07, sec. 2.

\textsuperscript{154}Texas, Attorney General, "Recommended Changes in the Securities Act...," p. 5.
certificates. The program was actually a banking transaction, since the firm borrowed the money from investors, who could demand payment at any time. The promoter counted the funds as company assets without the corresponding liability, thereby committing fraud, since borrowed money could not lawfully be listed as assets. Those who bought these deposit account securities lost most of their investment when the company went into permanent receivership. Many other stocks and securities transacted between related companies were inflated far above their actual value. Some were advertised as being insured by the FDIC when they were not. Having no registration requirements, agents freely represented to investors securities which did not fulfill the agents' promises. Many securities had pages of fine print that only experienced security dealers could understand.

The statutes contained no provisions regulating one of the most obvious factors contributing to the eventual insolvency of many companies—excessive commissions and management allowances. According to the 1952 Spectator Insurance Yearbook, the national average paid out in commissions, management allowances, and employee salaries was, at the highest, 28 per cent of net premium income. However, the analysis of data covering both insolvent

155McLennan County Grand Jury, op. cit., p. 2.
and solvent mutual companies indicated that Texas firms tended to exceed 30 and even 50 per cent of their premium income. Insolvent companies' percentage regularly ranged from 50 to even 100 per cent. No insurance company could maintain a favorable balance sheet when management paid such large commissions and allowed themselves such extensive allowances. Some regulation was necessary to limit such spending and protect investors and policyholders.

Questionable investment practices of insolvent concerns often went unnoticed until the companies fell into receivership. Insurance promoters operating companies on the borderline of insolvency claimed unnegotiable securities, exaggerated values of mortgages held for loans, and overvalued home office buildings as assets. When the receiver attempted to make these investments liquid, he was unable to obtain the full stated value that the companies had claimed in annual statements. Promoters often made unwise investments primarily for a high personal profit and because they realized that the Insurance Code did not authorize the Insurance Commission to check into the actual value of real estate held as security for loans and questionable stocks and bonds.

157 Texas Legislative Council, op. cit., p. 185.
158 Ibid., p. 187.
Receivership cases also indicated that selling a great deal of insurance on credit was one of the common unregulated activities carried on by insolvent companies. This added bulk to annual statements and hid the true solvency picture of the company, as firms claimed insurance sold on credit, called premium balance or agency balance, as part of total assets. Most companies in the nation claimed a premium balance as part of their total assets, but the amount was usually below 8 per cent.\textsuperscript{159} Companies operating insolvently in Texas often reported premium balances of over 25 per cent of their total assets.\textsuperscript{160} Not only were insolvent companies in Texas far out of line with national practice, but such balances were usually falsely reported, overdue, or uncollectible. In one instance a company engaged in several other questionable practices, reported a general agency balance of $363,779, which amounted to 41 per cent of total assets.\textsuperscript{161}

Also unregulated were the premium receivables that companies claimed as assets in annual statements. These were, for the most part, made up of time payments due the company for insurance contracts. Receivership proceedings

\textsuperscript{159}\textit{Spectator, op. cit.}, p. X.
\textsuperscript{160}\textit{Texas Legislative Council, op. cit.}, p. 183.
\textsuperscript{161}\textit{Ibid.}, p. 184.
found that these, too, were often uncollectible or excessive amounts fraudulently entered in the annual statements in order to swell the apparent assets of the company. Deficits of some companies might have been substantially reduced had the company or receiver been able to collect such receivables or the premiums sold on credit.

It is significant that most instances of falsification, unauthorized withdrawals and misappropriation of funds, and the other fraudulent practices concerned those types of insurance organizations not covered by criminal statutes. The provisions existing in 1954 applied only to certain mutual insurance associations, with penalties ranging from $500 to ten years in prison. However, a uniform law covering all types of companies making it a felony for officers, agents, or employees of insurance companies to submit false reports or statements to the Insurance Commission or to accept loans, advances, or transferred assets from the company or its affiliates would have imposed some loyalty to the welfare of the company and at least created a positive threat for promoters. Reform was absolutely necessary; the question remained as to how much and how effective?

162Texas, Revised Statutes, Annotated (Vernon, 1952), Insurance Code, Articles 14.01, 17.25, secs. 16-19.
CHAPTER IV

INSURANCE LAW REFORM

Even after the weaknesses in insurance laws in Texas received notoriety, the strengthening of the laws did not come quickly or easily. Suggestions for changes had been advanced by the larger and well-established insurance companies even before the insurance scandal, but attempts to legislate tighter controls had evoked much criticism from the smaller companies, who claimed that the big companies desired to run them out of business or stifle competition. This criticism and effective lobbying had been strong enough to stop any reform legislation. Governor Shivers admitted that the state laws were lax, and in 1951 and 1953 endorsed reform bills, which passed the Senate but died in the House.\(^\text{163}\) As public criticism and adverse publicity grew, individuals from the entire industry became alarmed because insurance policies and company stocks became increasingly more difficult to sell. The insurance industry, second only to oil in revenues in Texas, exercised its powerful influence in Austin, and

politicians decided that it would be politically astute to initiate improved controls.

As fraud continued to be revealed the news media voiced skepticism that many legislators would work conscientiously for reform because insurance companies had retained a number of legislators, sometimes for specific legitimate legal services, but many times for the legislative influence they could wield. The Senate committee investigating the bankrupt companies was criticized for holding secret sessions when there was "widespread suspicion" that legislators themselves were involved. The disclosure of the tactics of both legislators and pressure groups in the 1955 and 1957 regular sessions pointed out, at least in part, the inadequate regulation of insurance in the state. The State Bar Association's Board of Directors recommended a $10,000 fine and a possible two year jail sentence for legislators whose employment by insurance companies was to influence the action of state officials, agencies, or legislation in the favor of promoters or companies. As a result of the criticism pertaining to the inadequate regulatory laws and their administration,
reform became a major issue in the 1954 political campaign. As a consequence, the 54th Legislature passed twenty-two acts directly affecting the insurance industry. Approximately 100 changes were made in the law, requiring an increased amount of capital and surplus reserves of new companies and more frequent and thorough examinations.

Following the 54th Legislature the Insurance Commission initiated a unique solvency call whereby all existing companies would receive a closer than usual examination to determine that they met the new requirements. As a result of this check, ninety-nine Texas-based firms were not relicensed and had to go out of business. In addition, fifty to 100 companies that had been licensed were put under close scrutiny by the Insurance Commission and checked as often as every month. The industry experienced a phenomenal drop in the number of new domestic companies organized in Texas following the reform legislation. The number of companies granted certificates of authority dropped from 149 in fiscal 1955 to only nine in 1956.

The weak insurance administration was still an issue in the 1957 Legislature. Twenty-two companies went into

169Texas Legislative Council, A Review..., p. 28.
receivership before the 55th Legislature concluded in 1957, among them the two largest companies to go bankrupt, U. S. Trust and Guaranty and ICT. In addition to the publicity these ignominious frauds received, it was evident that some of the reform laws passed in the previous session had to be revised to be effective. As a result, the 55th Legislature passed sixteen laws to further improve and strengthen insurance. The industry suffered a total net loss of 120 companies from September, 1955, when the regulations were first tightened, to June, 1958.170 Because the scandal was at its height during the 54th and 55th legislatures, most reform measures were passed during those sessions. Though numerous bills were enacted, many were technical in nature and relatively few dealt directly with strengthening regulation.

Legislative reform in the area of company examinations and examining staff should have received prime consideration as almost all other regulation hinged on the knowledge by the Insurance Commission of the activities and actual financial condition of a company. The law had required biennial examination of domestic companies, but the 54th Legislature amended the statute to require an examination every six months for the first three years of a company's existence, an annual check for the following three years,

and thereafter, biennial examinations. 171 Theoretically, this examination program carefully scrutinized the companies in the weakest period of their existence. Pragmatically, however, the law was not effective because the legislature did not give the Insurance Commission sufficient examiners (only eleven more were added to the staff) to make the increased number of examinations. 172 The new law required 1,504 examinations for 1955-1956, but because of the limited examining staff, only 587 took place. 173 A further change in the law established a minimum standard of education and experience for examiners and raised their maximum salary from $5,400 to $7,400. 174 One provision of H. B. 10 in the 54th Legislature that directly affected the validity of examinations specifically vested in the Insurance Commission the authority to assess the value of a company's real estate investments. 175

A major action of the 1955 Legislature was the passage of two Senate bills which adjusted the financial responsibility of insurance companies by making it more difficult
for a company to be established on a shoestring, and requiring those existing companies with a shaky financial status to correct that condition. S. B. 12 increased the minimum capital and surplus requirements for life, health, and accident companies, while S. B. 15 increased these requirements for fire, marine, and casualty companies.176 Except for title companies and fidelity, trust, and guaranty companies, requirements for all companies were increased. After September 6, 1955, stock life, mutual legal reserve life, Lloyds associations, and reciprocal exchanges were required to have an initial $100,000 capital and $100,000 surplus reserve.177 Previously stock life was required to have $100,000 in capital, mutual legal reserve life had to have the $100,000 plus a $25,000 surplus, Lloyds associations were required to have $60,000 minimum, while reciprocal exchanges needed only $50,000 capital. Stock fire companies and mutual fire and marine companies license requirements were increased from $100,000 and $20,000, respectively, to $100,000 capital and $50,000 surplus.178 Casualty companies' initial requirements were raised from as low as $50,000 to $150,000 capital with $75,000 surplus.179

177 Texas, Revised Statutes, Annotated (Vernon, Supplement, 1955), Insurance Code, Articles 3.03, 11.01, sec. 1, 18.05, 19.06.
178 Ibid., Articles 2.02, 15.06.
179 Ibid.
planning to sell a multiple line of insurance—fire, marine, and casualty—the new license requirement was $200,000 capital with $200,000 surplus, as opposed to an earlier requirement of only $70,000.\textsuperscript{180}

The capitalization reforms were not as strict on companies already in existence.\textsuperscript{181} Stock and mutual fire, marine, and casualty companies, Lloyds associations, and reciprocal exchanges were required to meet the new standards in capitalization, but firms were given ten years to meet them.\textsuperscript{182} Stock life companies, mutual life companies, and farm mutual companies were exempt if they were already doing business in the state before September 16, 1955.\textsuperscript{183}

If the higher capitalization demands were not enough to discourage incompetent promoters, other provisions of H. B. 10 were. This bill gave the Insurance Commission the authority to revoke a company's license where it found in question the "competence, fitness, and reputation" of officers and directors.\textsuperscript{184} The 55th Legislature took a further step in S. B. 444 and subjected insurance company officers to perjury laws if they filed false

\textsuperscript{180}Ibid.

\textsuperscript{181}Insurance companies are required to maintain the minimum capitalization reserve requirement throughout their existence.

\textsuperscript{182}Texas, Revised Statutes, Annotated (Vernon, Supplement, 1955), Insurance Code, Articles 2.20, 18.23, 19.10.

\textsuperscript{183}Ibid., Articles 3.02, sec. 2, 11.01, sec. 2a.

\textsuperscript{184}Ibid., Articles 1.14, sec. 3, 3.04, sec. 4b, 11.02, sec. 4b, 18.04, 19.03, sec. 5.
financial statements with the Insurance Commission.\textsuperscript{185} Agents, counselors, and salesmen in life insurance also had to meet stricter examination and licensing requirements under S. B. 16, H. B. 68, and H. B. 39. The licensing statutes added detailed regulations and definitions concerning the agent, the agent's written examination, penalties for violations, and authorization for the Life Insurance Commissioner "to establish as needed, reasonable rules and regulations" for the administration of these stipulations.\textsuperscript{186}

Before the 1955 reform legislation no regulation of the sale of insurance securities had existed. The use of the organizational scheme under Article 1303b and 600A of the Texas Securities Act had victimized investors of an estimated $100,000,000.\textsuperscript{187} New provisions for the regulation of the securities, dealers, agents, and salesmen were enumerated in H. B. 39, entitled "The Insurance Securities Act." The new provision repealed Article 600A, bringing those companies with trust powers formed under Article 1303b subject to regulation. A Securities Division of the Insurance Commission to administer a securities


\textsuperscript{186}Texas, Revised Statutes, Annotated (Vernon, Supplement, 1955), Insurance Code, Article 21.07-1.

\textsuperscript{187}Texas Legislative Council, \textit{A Review...}, p. 45.
check was created entirely separate from the Securities Division of the Secretary of State's Office, which regulated all other securities sold in the state. The act specified exactly what was subject to review and the qualifications for the dealers of the securities. The newly organized Securities Division was authorized to obtain any information it needed concerning the companies' advertising, and limit the total expense of marketing securities to 20 per cent of the securities' sale price. The Insurance Commission could deny a company's right to sell stock if anything was misleading or irregular in the records or actions of the company.

A short time after the 1955 Legislature the insurance industry and state authorities saw that a dual system of security regulation—the Insurance Commission administering insurance securities and the Secretary of State regulating other securities—was "awkward and unwieldy." Governor Price Daniel appointed a Securities Advisory Committee, which worked with the State Bar Association and produced what became S. B. 294 in the 55th Legislature. This act transferred the regulation of both insurance

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189 Texas, Revised Statutes, Annotated (Vernon, Supplement, 1955), Chapter 580.

securities by the Insurance Commission and the regulation of all other securities by the Secretary of State to a new State Securities Board, which was to employ a salaried securities commissioner. The new act also tightened the standards for agents and dealers and demanded that the Securities Commission approve each stock company's prospectus.

The Attorney General, Legislative Council, and Senate General Investigating Committee pointed out to legislators that the criminal provisions of the insurance laws pertained to only certain mutual companies. Nevertheless, except for S. B. 39 in the 1955 Legislature, S. B. 444 in 1957, and H. B. 464 in 1961, there was no law or group of laws passed that provided a penalty uniform to promoters in all types of insurance. The law passed by the 54th Legislature provided a penalty of two years in prison, a $1,000 fine, or both for the conviction of a violation of the Insurance Securities Act. H. B. 464 of the 57th Legislature increased this penalty to ten years, $5,000 fine, or both for such an offense. S. B. 444 of the 55th Legislature subjected insurance company officers to


the perjury laws if they filed false financial statements with the Insurance Commission. These were the only changes made in the Insurance Code as a result of the scandal. Penal provisions continued to cover only the small mutual companies. 194

The reform legislation attempted to prevent companies from entering into fraudulent and questionable investments by establishing a new schedule of investments which offered less option to insurance companies in their investment programs. The 1955 Legislature amended the requirements for investments of stock held for capital and surplus primarily to provide that only cash or negotiable securities met the capital and surplus requirements. 195 Mortgage notes on real estate held by insurance companies had to be federally insured. 196 The law limited a company's total investments in mortgage notes on Texas real estate to 50 per cent of the minimum capital and surplus held by that company. Insurance companies could not invest in securities of a corporation if a majority of its voting stock was owned by or for the benefit of any of the officers of the investing insurance company. 197

194 *Texas, Revised Statutes, Annotated (Vernon, Supplement, 1955)*, Insurance Code, Article 14.01.


196 *Ibid.*, Article 2.08, sec. 4.

197 *Ibid.*, Articles 2.08, 2.10, sec. 5c.
The 54th Legislature also enacted statutes that set limitations on direct real estate investments. The law had previously been one of the strictest in the nation, limiting insurance companies' real estate investments to the purchase of one building site and office building.\textsuperscript{198} A 1955 law limited a company's investment in its office building and site to 33 \(\frac{1}{3}\) per cent of admitted assets.\textsuperscript{199} This act further stopped companies from tying up large portions of their assets in one building (rarely ever worth its book value). No other general reforms were enacted during the 54th Legislature or since which restricted company realty investment practices. In fact, the law was liberalized as public attention to the scandal in insurance subsided. However, other states had already begun liberalizing provisions limiting insurance companies' investments in real estate.\textsuperscript{200}

Prior to the passage of the "1957 Reorganization Act," Texas was the only state which had three insurance commissioners and such a divided, "inadequate, inefficient, and uneconomical" insurance regulatory agency.\textsuperscript{201} Statutes pertaining to the agency's organization were first amended

\begin{itemize}
\item \textsuperscript{198} Texas Legislative Council, \textit{A Review...}, p. 58.
\item \textsuperscript{199} Texas, \textit{Revised Statutes, Annotated} (Vernon, Supplement, 1955), Insurance Code, Article 3.40, sec. 1b.
\item \textsuperscript{200} Texas Legislative Council, \textit{A Review...}, p. 59.
\item \textsuperscript{201} Texas Research League, \textit{op. cit.}, p. 11.
\end{itemize}
in 1955. The amended version of Chapter One of the Insurance Code intended to eliminate the close identification each commissioner had with a particular phase of insurance. The law retained a three member Board of Insurance Commissioners but without the former specified titles of Fire Commissioner, Life Commissioner, and Casualty Commissioner. The provision giving each commissioner general supervision over matters in each particular field was amended, and such supervision became the responsibility of the three member board as a whole. The legislature's failure to repeal earlier legislation providing for the old division of responsibility resulted in confusion of commissioners' duties and many department activities. Basically, the department's administration stayed the same. This being the case, the 1957 Legislature, under the direction of Governor Price Daniel, completely reorganized the Insurance Commission. The new statute, S. B. 222, established a part-time three man State Board of Insurance which was directed to act as a single unit, and individual members were prohibited from dividing or confining their activities to special fields of insurance regulation as was the case prior to the law passed in 1957. The law designates that the board appoint


203Ibid., Article 1.04.

204Texas, Attorney General, Biennial Report, p. 67.
a full-time commissioner of insurance as its chief executive or administrative office, responsible for administering, enforcing, and carrying out the provisions of the Insurance Code under the supervision of the board. A more unified effort, both in administration and policy formation, was the major reason for the reorganization. As with all regulatory agencies, effectiveness depends on the persons appointed, but with the reforms the law could no longer be blamed for corruption.
CHAPTER V

CONCLUSION

To most persons the insurance fiasco hit with appalling shock, but a few astute observers were aware of the approaching disaster in the industry. The large, well-established companies long had fought for stronger regulation. State officials such as Attorney General John Ben Shepperd and Governor Allan Shivers had the foresight to endorse and attempt to strengthen the law, but such efforts were opposed and defeated by the small insurance companies in Texas. These small firms opposed strengthening the regulatory agency and insurance laws on the grounds that the large companies were more interested in driving them out of business than they were in reform. Having much more at stake than did the large, well-established firms which could carry on business with or without the reforms, the smaller enterprises retained more legislators and established a much stronger lobby to look after their interests than did the large concerns. As company after company faced bankruptcy and receivership trials, public opinion was stunned by the degree of fraud and mismanagement.

The Texas Legislative Council and Senate and House investigating committees even revealed bribery of employees of the Insurance Commission and state legislators. The scandals finally resulted in reform of the regulatory laws in the 54th and 55th legislatures.

It is unfortunate that such a large industry and one so directly connected with the people could reach a state of major crisis without any warning to the majority of its patrons. The public legitimately expected government to prevent irregular or unsound business practices and conditions. On the surface the industry had displayed signs of growth and stability. Insurance in Texas had a history dating from before the annexation of Texas, and ranked second only to oil in gross income.\(^{206}\) Company taxes and fees alone totaled $21,599,040.05 in 1954.\(^{207}\) The public was not aware that an average of five companies a year went bankrupt in Texas between 1939 and 1953—a total of sixty-eight.\(^{208}\) It also was not generally known that Texas retired 126 companies between 1939 and 1953, more than any other state in the country.\(^{209}\) The public might


\(^{207}\) Texas State Board of Insurance, Annual Report (Austin, 1965), p. 56.

\(^{208}\) Ibid., p. 22.

\(^{209}\) Texas Legislative Council, Insolvency..., p. 31.
not have placed so much trust in the industry if it had known that the law governing and regulating insurance basically had not changed since the 19th century. Few statutes of consequence had been amended or added since the insurance regulatory agency was organized in 1923. As a result, the state's insurance laws ranked among the weakest in the nation.

The collapse of several large companies, beginning with Texas Mutual Insurance Company in February, 1953, sparked public questioning of insurance regulation. Each subsequent company failure revealed more complicated schemes of fraud, culminating with the ICT fraud fiasco disclosed in 1957 and 1958. The legislature demanded investigation of the insolvent companies to determine the cause for such frequent collapses. The Texas Legislative Council made two studies between 1954 and 1956, but House and Senate committee investigations begun in 1955 were not finished until 1959. The investigations generally concluded that insurance company organizers of the promoter type took advantage of inadequate regulations and supervision to create companies with virtually no financial basis and to mismanage company funds in unsupervised areas.

The 54th and 55th legislatures enacted remedial legislation in an attempt to stabilize the industry. The 54th Legislature enacted twenty-two laws that made approximately 100 changes providing for increases in the required amount
of capital and surplus, especially of new companies; more control over capital and surplus; and stronger examination procedure. Company failures continued, however, and the 55th Legislature noted still other areas in the law that needed strengthening and passed sixteen laws which improved regulation and completely reorganized the Insurance Commission.

Following the 54th Legislature the Insurance Commission initiated a unique solvency call whereby all existing companies would receive a close examination to ensure that existing companies met the requirements of the new law. At the conclusion of the check ninety-nine Texas-based firms were not relicensed and forced out of business. The industry experienced a net loss of 120 companies from September, 1955, when regulations were first tightened, to June, 1958. In addition, between fifty and a hundred companies that had been relicensed were placed under close scrutiny because of their weak financial condition. Some companies in question were checked as often as once a month. Following the reform legislation the number of new domestic companies organized in Texas dropped phenomenally from 149 in fiscal 1955 to only nine in 1956.

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213 Texas Legislative Council, A Review..., p. 28.
Although the reform legislation corrected many of the inadequacies in the Insurance Code, some suggestions for reform went unheeded. Many of these weaknesses still have not been corrected to date (1966). One area that received only scant attention in reform was allocations for the hiring of the Insurance Commission's examining staff. A Senate investigating committee stated in a report submitted in May, 1957, that the staff of forty-three examiners was inadequate. The study called attention to the fact that 1,504 companies were supposed to have been examined, but only 587 had received official audits. That this situation has not been corrected is reflected by the meager 537 examinations completed in 1965.

Allocations also limited examiners' salaries. The Insurance Commission complained of the situation to the Governor in the 1959 Annual Report:

> It has been difficult to maintain a proper examination schedule, as it is impossible to recruit and retain an adequate staff...at the salaries presently authorized.

The 1965 Annual Report explained that the Insurance Commission started fiscal 1965 with fifty-three examiners,

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but by the end of the year had only forty-six, the decrease reflecting resignations to accept higher salaried positions in industry, the federal government, or insurance departments of other states.\textsuperscript{217} Considering that the inadequate examining staff was one of the primary reasons many of the fraudulent or insolvent companies avoided discovery, it is condemnable that the state has not enacted remedial legislation.

The initial capitalization requirement, previously extremely low, was raised considerably in the reform legislation, but all life insurance companies and farm mutuals were exempted if they were operating at the time the statutes became effective. The legislature also failed to increase the capitalization requirements of multiple line companies to comparable levels of companies dealing in only one type of insurance. In 1955 the legislature raised beginning capital requirements of multiple line mutual companies from as low as $70,000 to $200,000 with an additional required surplus of $200,000. The legislature raised multiple line stock companies' reserve requirement from $200,000 to $300,000, still the lowest in the Texas Legislative Council's selected fourteen comparable states, which had requirements ranging from $400,000 to $3,550,000.\textsuperscript{218} As multiple line companies

\textsuperscript{217}Ibid., (1965), p. iii.

\textsuperscript{218}Texas Legislative Council, \textit{A Review...}, p. 15.
deal in several types of insurance, it seems reasonable for them to have to pay a total capitalization comparable to single line companies. For instance, life insurance companies were required to maintain a total capitalization and surplus of $200,000, fire insurance companies, $150,000, and casualty companies, $225,000. A multiple line company runs the same risks that each of the individual firms do selling only one kind of insurance. An amendment requiring multiple line companies to maintain the standard set for each type of insurance sold would make the law uniform and multiple line companies financially secure. The reserve would not necessarily need to be held separately for each type of insurance sold as long as the total amount was sufficient for protection against any financial eventuality.

Every company studied that went into receivership had an unusually large amount of uncollectable agency balances and premiums receivable, yet no remedial legislation limited the amount companies could claim in this area. The Texas Legislative Council considered these over-estimated balances a prime contributing factor in causing insolvency. On many occasions companies anticipated receipts that never were paid. In some cases agencies reported the amounts

219 Texas Legislative Council, Insolvency..., p. 134.
of insurance sold but never turned in the premiums because the agents doubted the solvency of the issuing company. In still other cases companies counted premiums receivable each month without allowing for cancellations. Companies operating on a large volume of only anticipated premiums soon found that expenditures exceeded receipts. Legislation has not been passed to limit amounts that companies may claim as anticipated income.

Before the establishment of the Securities Commission in 1957 insurance securities were unregulated. However, the laws establishing the Securities Commission provided no stipulation covering secondary securities. The initial sale was regulated by the Commission, but after the securities had been sold once the owner could resell the securities or trade them in any manner he saw fit. The 1958 State Board of Insurance Annual Report requests legislation to regulate the secondary sales of insurance securities, but no law has yet been enacted.220

The 1955 and 1957 legislative reforms left much to be desired in the area of reinsurance. The Insurance Commission still does not scrutinize small subsidiaries closely enough to prevent them from reinsuring liabilities of the mother company above the subsidiary's ability to pay in the case

of loss. The new laws also did not prohibit company officers or directors from investing company funds in a firm which they personally controlled. Additional stipulations in investments and reinsurance need to be made to prevent the possibility of additional fraud.

The most obvious failure of the legislative reform was the failure to initiate strong, uniform penal provisions for violations of the statutes. Speaking at a Texas Press Association Convention in Galveston Attorney General John Ben Shepperd said, "If you catch violators you can make them stop, but you can't punish them." A Travis County Grand Jury report on graft in public offices suggested that adequate penal provisions would "deter officers and directors from reckless and ill-advised handling of funds...."

A need for revision of the Insurance Code had existed before the scandals. In 1950 a legislative committee, headed by Will C. Thompson, began to reorganize the insurance statutes, but the Insurance Commissioner, George B. Butler, directed the legislators not to make any substantive changes in the revision. Evidently the commissioner did not want to alter the status quo and upset any insurance company. The committee followed Butler's mandate

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222 Ibid., January 10, 1958, p. 1.  
223 Statement by Will C. Thompson, Attorney, Dallas, June 30, 1966. See also William J. R. King, op. cit., p. 45.
and produced the 1951 Insurance Code, which still contained many laws dating back to 1874. As a result the Code can not help but present many "conflicting and confusing provisions," and still needs simplification, clarification, and uniformity that only a complete revision can accomplish.224

Insurance companies must be able to fulfill their contractual obligations, and in order to maintain solvency a company must be soundly financed and managed with adequate reserves which are properly invested. It is the function of the state's regulatory body, the Insurance Commission, to ensure that companies fulfill their responsibilities to the public. Sound regulation requires strong laws governing licensing and company procedures. It demands careful, competent, and thorough financial examinations of companies to ascertain that legal and ethical standards are being met. Good regulation also demands investigations of complaints of malpractice, and prompt action when needed. The absence of such safeguards and regulations from Texas law in the early 1950's formed a triumphal arch for underhanded promoters and was the cause of many company failures in the insurance industry.

The insurance scandals vividly illustrate the worst in state regulatory law. The corruption of state officials and the laxity of the law were an affront to the people of Texas. The burning question remains in insurance regulation: "Are things any better now than in the 1950's?" There is room for doubt.
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