Client Alert

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UPDATE: Regulators Scrutinize Contingent Commission Payments

In October, 2004, New York Attorney General Eliot Spitzer filed a civil action in the Supreme Court of the State of New York alleging that Marsh & McLennan, the nation's largest insurance broker, had engaged in bid-rigging and other fraudulent practices. The filing of this litigation stimulated insurance regulators and other state attorneys general to launch their own investigations of bid-rigging and contingent commissions. In addition, the National Association of Insurance Commissioners (the "NAIC") recently adopted model statutory wording requiring the disclosure of producer compensation from insurers. Various states are considering the adoption of statutes and/or regulations incorporating this model wording or otherwise restricting the payment of contingent commissions. This recent focus on contingent commissions may lead to sweeping changes in the way in which insurance is marketed.

This Client Alert provides a status report on the ongoing controversy regarding contingent commissions and examines the potential implications of the controversy for the insurance industry. (See prior Client Alerts regarding our firm's handling of contingent commission matters available at http://www.lordbissell.com/newsstand_search.cfm?ATY=3237.)

SPITZER'S CIVIL ACTION AGAINST MARSH

Although insurers have been paying contingent commissions to producers for decades, Spitzer's civil action alleges that the receipt of such payments, regardless of whether they are based on the volume, persistency or profitability of the business placed by a producer, creates a "patent conflict of interest" for producers who hold themselves out as representing policyholders. The complaint portrays contingent commissions as a powerful economic incentive which inevitably leads producers to steer their customers to those insurers that offer the most lucrative contingent commission arrangements, regardless of the customers' interests. The complaint alleges that Marsh had a practice of pressuring insurers to offer contingent commissions and of steering clients to the insurers that yielded to such pressure.

The complaint also alleges that the lure of greater contingent commission income led Marsh to engage in systematic bid manipulation. Marsh allegedly selected the insurer to write a particular risk at a specific rate and then instructed other insurers to provide higher quotes, regardless of whether those other insurers were prepared to write the risk at lower rates. It was understood that insurers that cooperated by providing such false quotes would be rewarded by being selected by Marsh as the "winning" bidder for other risks. Pursuant to this alleged scheme, Marsh's customers were presented with the illusion of competition, while insurers were free to charge inflated rates, reflecting contingent commissions paid to Marsh.

REGULATORY INVESTIGATIONS OF CONTINGENT COMMISSIONS

Insurance regulators and/or state attorneys general in approximately twenty-five states have reacted to the allegations in the Spitzer lawsuit by initiating their own investigations of producer compensation arrangements. These state authorities have served both insurers and producers with subpoenas or other requests seeking information regarding contingent commissions and other compensation arrangements as well as steering, bid-rigging and other alleged anti-competitive activities. The amount of information demanded by these subpoenas varies widely, even though state insurance departments generally pattern their inquiries on a template information request developed by the NAIC. Some inquiries are relatively restrained in their demands, while others require the production of massive amounts of information and documents in very short time frames.

Spitzer's own investigation remains active. One area of interest for his investigation as well as investigations that are ongoing in other states is the extent to which producers may have profited from so-called "tying arrangements" in which they allegedly refuse to place business with a particular insurer unless the insurer agrees to purchase other services (e.g., reinsurance brokerage services) from the producer or one of its affiliates. Spitzer has also indicated an interest in examining vertical relationships in the insurance industry (e.g., the ability of producers to realize "undisclosed" profits from ownership interests in wholesalers or reinsurers) and has expressed concerns regarding the extent to which the industry has "escaped" U.S. regula-

tion by the use of off-shore insurance and reinsurance companies. In addition, California Insurance Commissioner John Garamendi is investigating vertical relationships in the title insurance industry. He has characterized reinsurance premiums paid by title insurers to certain captive reinsurers as illegal "kickbacks" paid for the purpose of inducing the realtors, lenders and others who own the reinsurers to steer business to the title insurers.

Another focus of some of these state inquiries is the role that producers have played in the placement of insurance for state agencies. In order to obtain such state business, producers sometimes are required to disclose their compensation arrangements in response to a formal request for proposal. States are now examining whether any producers who placed business for state agencies received compensation in addition to what was disclosed in these responses. Connecticut Attorney General Richard Blumenthal has filed a civil action against Marsh, alleging in part that Marsh received contingent commissions in connection with a particular placement for a state agency contrary to the restrictions set forth in the request for proposal.

Some state authorities have also examined the compensation paid in connection with the placement of employee benefit coverage. These investigations have yielded allegations of the payment of undisclosed producer fees as well as bid-rigging and the steering of employee benefit insurance to insurers willing to pay large contingent commissions or "overrides" to producers.

The involvement of state attorneys general in these investigations opens up the possibility of criminal indictments for individuals participating in the alleged schemes. In fact, Spitzer's investigations have resulted in criminal charges against a number of executives from insurance companies and producers. Other fall-out from the investigations includes an avalanche of new class actions by policyholders and shareholders against both producers and insurance companies. These lawsuits have been brought on a number of different legal theories, typically including misrepresentation, breach of fiduciary duty by broker-defendants, violation of unfair trade practice laws, antitrust violations and securities law violations.

PROPOSED NEW LEGISLATION AND REGULATIONS

Aside from investigating producer compensation arrangements and practices for possible abuses, insurance regulators in various states are proposing new legislation or regulations. In an effort to provide a template for such legislation, on December 29, 2004, the NAIC adopted an amendment to its Producer Licensing Model Act that deals with compensation disclosure. Pursuant to this model legislation, a producer who represents the customer in connection with an insurance placement or who receives compensation from the customer may not receive *any* compensation from an insurer for that placement, unless the producer (a) has obtained the customer's "documented acknowledgement" of the producer's receipt of compensation from the insurer, and (b) discloses the amount of such compensation. If the amount of compensation is not known at the time of disclosure, the producer must disclose the method for calculating the compensation and, if possible, a reasonable estimate of the amount.

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Industry trade groups have criticized this model legislation for imposing the difficult burden of obtaining written acknowledgements from customers of a producer's compensation from insurers and for not expressly excluding independent agents from its disclosure requirements. These groups have indicated their intent to lobby for changes in the legislation whenever it is proposed for adoption by the various states. On the other hand, the model wording has been criticized by consumer groups for not going far enough in addressing the abuses uncovered in the Spitzer investigation. The NAIC itself has indicated that it will consider more restrictive model wording, which may define a fiduciary duty for certain producers and/or require the disclosure of all quotes received for a particular placement and certain disclosures relating to producer-owned reinsurance arrangements.

Some states are proposing legislation or regulations that go well beyond the kind of disclosure obligations contained in the NAIC model language. For example, the California Insurance Department has proposed a regulation that, in part, would require producers to provide their customers with the proposal of a "best available" insurer and prohibit them from recommending the selection of an insurer other than a "best available" insurer. Groups opposed to this proposal point out that there is no objective way of determining a "best" insurer for any particular placement and that adoption of this standard would expose producers to considerable litigation risk, if any recommended insurer falls short of the customer's expectations. (See the analysis of the California proposal in our Client Alert at http://www.lordbissell.com/newsstand_story.cfm?NSID=677.)

SPITZER'S SETTLEMENT WITH MARSH

On January 31, 2005, Spitzer announced a settlement of his civil action against Marsh. Pursuant to this settlement, Marsh made no admission of wrongdoing but agreed to pay $850 million (the estimated amount of one year's contingent commission income for Marsh), which will be used to make payments to Marsh customers nationwide whose business resulted in contingent commission payments to Marsh. (As yet, there is no agreement on the formula for allocating this $850 million among Marsh's customers.) Policyholders who accept payments from this $850 million fund will be required to release Marsh for all claims (other than shareholder claims) relating to any of the allegations, acts, or "types of conduct" that are the subject of Spitzer's complaint or of the citation issued in connection with the related investigation of Marsh by the New York Superintendent of Insurance. It appears that this broad release would bar policyholders who accept any payment from the New York settlement fund from recovering on any other claim against Marsh involving Marsh's receipt of contingent commissions (other than a shareholder claim),

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regardless of whether the claim is asserted in private litigation or against any settlement fund that another state might ask Marsh to establish. Thus, the Spitzer settlement appears to place a formidable obstacle in the way of any other state that may wish to achieve a richer settlement for its own policyholders.

The settlement agreement also imposes certain business reforms on Marsh. In particular, Marsh has agreed to make permanent the commitment it made shortly after the filing of Spitzer's lawsuit not to accept additional contingent commission payments. Marsh also agreed to limit its compensation in connection with insurance placements to (a) specific fees paid by its customers and (b) commissions in a specified percentage of premiums to be paid by insurers. Marsh must disclose such commissions to its customers in writing and obtain the customers' written consent to the payments. However, the settlement agreement, which permits the payment of a commission "set at the time of purchase, renewal, placement or servicing of the insurance policy" does not make it clear whether multiple commissions may be collected in connection with a single policy, e.g., one commission set at the time of placement and another at the time of servicing. Marsh also has agreed not to retain any interest earned on the premiums it collects, unless it provides its customers with prior notice of this practice. It will not use wholesale brokers, except with the agreement of its customers after disclosure of Marsh's compensation arrangements with such brokers, any interest Marsh has in the brokers, and alternatives to the use of the brokers. It will disclose to customers all quotes it solicits and receives, including disclosure of any interest Marsh has in the quoting insurers. In addition, Marsh will implement company-wide standards of conduct regarding compensation from insurers, establish a Compliance Committee of its Board of Directors to monitor compliance with these standards, and submit to an annual examination by the New York Department of Insurance over a five-year period.

This settlement places heavy burdens on Marsh in the form of requirements to provide extensive disclosures, obtain customer consents to its compensation arrangements, and take steps to assure compliance with the standards set forth in the agreement. It remains to be seen if any of these settlement provisions will find their way into new producer legislation and regulations in the various states. Given the high profile of the settlement, it is possible, especially if settlements with other producers are reached on similar terms, that these terms may be viewed as a "best practices" standard for the entire industry, which other producers may have to adopt in response to market pressures or which may be incorporated into new legislation or regulations. However, it can be argued that the Marsh settlement was crafted to respond to Marsh's unique circumstances, which combined extraordinary market power with extraordinarily abusive business practices, including bid-rigging. Spitzer himself has indicated that he is not yet ready to recommend any particular legislation and has not concluded that there should be an absolute ban on the use of contingent commissions.

At this time, it is impossible to predict exactly how the various states will regulate or restrict the use of contingent commissions, though it appears likely that some kind of compensation disclosure will be required in many states. A blanket prohibition of contingent commissions appears unlikely. However, it seems inevitable that whatever disclosure, customer consent or other requirements are imposed, producers are likely to find compliance burdensome and time-consuming.

AVAILABILITY OF EXTRANET

Lord Bissell has established an extranet (private website) to track developments relating to contingent commission issues. This extranet is frequently updated and includes relevant Client Alerts, copies of subpoenas and other requests for information from various states, proposed statutes and regulations, copies of complaints in class action suits regarding contingent commissions and news stories. This extranet also tracks developments regarding finite reinsurance issues. For password access to this extranet as well as to an extranet we maintain to track federal law developments of interest to the insurance industry (e.g., TRIA extension, SMART Act, and class action reform), please contact lali@lordbissell.com.

ABOUT THE AUTHORS

John Gurley is a partner with extensive experience in all areas of corporate insurance, including regulatory issues. Michael Trier is a partner with broad experience in the insurance industry, who has advised clients in dealing with contingent commission investigations. Mark Goodman is a partner who represents insurers and other financial institutions in regulatory, transactional and corporate matters, including contingent commission investigations.

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