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THE SMALL LAWS: ELIOT SPITZER AND THE WAY TO INSURANCE MARKET REFORM

Sean M. Fitzpatrick*

"For when you break the great laws, you do not get liberty; you do not even get anarchy. You get the small laws."[1]

INTRODUCTION

In 2004, the property-casualty insurance industry was roiled by a scandal unparalleled in its history, with the world's largest insurance broker, Marsh & McLennan, accused of defrauding customers by "rigging bids" to maximize its own profits. New York State Attorney General Eliot Spitzer's suit against Marsh in October 2004 was the first salvo in a continuing challenge to long-established insurance market practices,[2] and has set in motion a process of regulatory scrutiny and proposed legal reform whose ends are impossible to predict. Indeed, not since another ambitious New York governor-to-be, Charles Evans Hughes, cut a swath through the life insurance industry as chief counsel to the renowned Armstrong Committee—at almost exactly a century ago—has the insurance community faced so fundamental a challenge to its structure and ethics.[3] In a curious historical twist, that earlier scandal had its genesis in a grand party thrown

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in 1905 by the young heir to control of the Equitable Life Assurance Society, on the site of whose then headquarters—120 Broadway in New York City—now stands the office of Attorney General Spitzer. Regulatory firestorms such as Mr. Spitzer has unleashed are like Pandora's Box: Once opened, even their authors are powerless to control their ultimate effects. And those effects are likely to surprise even the most well-intentioned regulator. In this particular case, a strong argument can be made that an industry-wide ban on the contingent compensation structures targeted by Spitzer would bankrupt hundreds of small insurance agencies in communities throughout America, and lead to the further consolidation of insurance brokerage business in large global firms like Marsh. Insurance is an old-fashioned, surprisingly risk-averse industry. Its fundamental practices have changed little for generations. Indeed, the state of affairs that first drew Attorney General Spitzer's attention—large commercial insurance brokers allegedly manipulating the market for their own benefit—was the result of nothing so much as the coupling of time-honored sales incentive practices developed on Main Street, U.S.A. with an unprecedented level of market power attained by a few global megafirms following a consolidation spree in the 1990s. But it would be an expensive mistake to jump from that observation to the conclusion that all contingent compensation of all insurance producers is necessarily harmful to insurance consumers.

Part I of this Article traces the history of Attorney General Spitzer’s investigation into insurance industry practices (the “Spitzer Investigation”). Part II offers an overview of the property-casualty insurance market as it has evolved in the United States and discusses the pros and cons of traditional insurance producer compensation practices. Part III describes regulatory and legislative responses to the Spitzer Investigation, largely focused in interstate organizations such as the National Association of Insurance Commissioners and the National Conference of Insurance

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5. Among the many ironies of the current investigations—which include a substantial focus on threats to competition in the insurance market—is the fact that the consolidation of more than sixty percent of the global insurance brokerage market for large corporate risks into three megafirms occurred in the 1990s without so much as a peep from federal or state antitrust authorities. See Oversight Hearing on Insurance Brokerage Practices, Including Potential Conflicts of Interest and the Adequacy of the Current Regulatory Framework: Hearing Before the Subcomm. on Financial Management, the Budget, and International Security, Comm. on Governmental Affairs, 108th Cong. 55 (2004) (statement of Eliot Spitzer, State of New York Attorney General), available at http://www.oag.state.ny.us/press/statements/insurance_investigation_testimony.pdf [hereinafter U.S. Senate Testimony].

6. Although Attorney General Spitzer and other regulators have also launched investigations into practices in the market for health and employee benefits insurance, see, e.g., Press Release, Office of N.Y. State Attorney Gen. Eliot Spitzer, Life, Disability Broker Charged with Fraud, Antitrust Violations (Nov. 12, 2004), available at http://www.oag.state.ny.us./press/2004/nov/nov12a_04.html, this Article will focus on the property-casualty insurance market.
Legislators. Finally, Part IV sets forth the author's suggestions for a simple, voluntary reform that would increase transparency for insurance consumers while avoiding the pitfalls likely to attend more draconian solutions.

I. THE SPIZTER INVESTIGATION

The Spitzer Investigation began without fanfare on February 10, 2004, when the Washington Legal Foundation ("WLF"), a free-market-oriented advocacy organization, sent a letter to the state insurance commissioners and attorneys general of New York and California. In its letter, the WLF voiced concerns with "two potentially damaging practices engaged in by some in the insurance brokerage industry":7 namely, the use of "placement service agreements" by brokers to obtain additional compensation from insurers based on the volume of business placed with them and the alleged "leveraging" by brokers of primary insurance production "to procure an insurance company's highly lucrative reinsurance [placement] business."8 While the WLF letter focused on so-called placement service agreements ("PSAs")—a usage coined by Marsh and not widely used elsewhere in the insurance industry—the thrust of the WLF's complaint was that so-called "contingent commissions" paid by insurers to brokers based on the brokers' achievement of premium volume and profitability goals "can compromise the broker's fiduciary duty to represent the best interests of their clients, and create incentives for brokers to refer business to companies that will make them more money."9 Similarly, the WLF argued that a broker's leveraging of its ability to refer primary insurance business to obtain reinsurance brokerage engagements from insurers could lead to a similar conflict of interest.10

In their typical form, "contingent commissions" are payments made by an insurer to an insurance agency or brokerage for success in achieving stipulated levels of premium volume and profitability on its overall book of business with that carrier.11 Such payments are in addition to the "standard commissions"—typically ranging from ten to twenty percent of the total

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8. WLF Letter, supra note 7, at 2.

9. Id. at 1.

10. Id. at 2-3.

policy premium—that are paid by the carrier on each discrete insurance transaction. Marsh’s innovation, developed in the late 1990s, was a “Placement Service Agreement” that ostensibly compensated the broker based on services provided to the insurer and was calculated based on premium volume alone, without regard to the ultimate profitability of the business produced by Marsh. A few other large brokers adopted the PSA terminology, sometimes as an acronym for “Profit Sharing Agreement,” but profitability remained a component of most non-Marsh PSAs.12

Interestingly, in view of what followed, the WLF’s concern was limited to conflicts involving insurance brokers, who “are paid to advocate for their customers, not themselves, and certainly not for the insurance companies with whom they place their business.”13 The WLF did not address the more complicated issue of independent insurance agents, intermediaries who are contractually bound to represent the interests of insurance carriers that appoint them.14 As I discuss in the next section, intermediaries operating solely as true “brokers” are relatively rare in the United States, and tend to be centered in certain geographic areas, most notably New York City and San Francisco, whose insurance markets developed from maritime roots and not surprisingly borrowed their structure from the original “broker market,” Lloyd’s of London. Elsewhere in the United States, the demands of distance led to the development of an “agency system” whereby intermediaries were empowered to act on behalf of one or more insurers in performing functions not permitted to true brokers, such as binding and issuing policies.15 Independent insurance agents continue to place the bulk of property-casualty policies in this country.16

12. In 2004, as questions about contingent commissions arose, Marsh and its largest competitor, Aon Corporation, briefly adopted the term “Market Service Agreement” or “MSA” to describe their contingent commission agreements with carriers, but this nomenclature was never adopted by the industry at large.
13. WLF Letter, supra note 7, at 3. In fact, contingent compensation paid to brokers had been subjected to regulatory scrutiny by New York State as recently as 1998, when the state’s Department of Insurance issued a Circular Letter requiring brokers to disclose contingent commissions to their clients. See N.Y.S. Dept. of Ins., Circular Letter No. 22 (Aug. 25, 1998).
14. See 7 Eric Mills Holmes, Holmes’ Appleman on Insurance 2d: Law of Insurance Agents § 47.5, 326 (1998) (“Bluntly stated, an ‘insurance agent’ represents the insurance company, whereas an ‘insurance broker’ represents the insured, although the question whether one is an insurance agent or broker is a question dependent on the particular facts.” (footnotes omitted)); Int’l Risk Mgmt. Inst., Professional Liability Insurance, at XV.C.1 (2003) [hereinafter IRMI] (“Traditionally, the difference between insurance agents and brokers is that agents are considered representatives of insurance companies while brokers are thought of legally as representatives of insureds.”); Sean M. Fitzpatrick, Fear Is the Key: A Behavioral Guide to Underwriting Cycles, 10 Conn. Ins. L.J. 255, 269 n.47 (2004); see also Krumme v. Mercury Ins. Co., 20 Cal. Rptr. 3d 485, 488-90 (Cal. Ct. App. 2004) (discussing the broker-agent distinction under California law). For purposes of this Article, the terms “producer” and “intermediary” will be used to describe both brokers and agents.
15. See generally Holmes, supra note 14, §§ 44.1-.7.
Spitzer’s interest in potential abuses in the insurance industry was further whetted by an anonymous letter received by his office on March 30, 2004. The letter, postmarked from a New York suburb and signed only “Concerned,” made damning allegations about Marsh’s PSAs, asserting, “The point is to appear as if Marsh is providing a service to the insurance market rather than the reality which is that Marsh is receiving major income for directing business to preferred providers/insurance markets.”17 Spitzer’s office reportedly issued a subpoena to Marsh within three days of receiving this corroboration of the WLF’s allegations.18

The Spitzer Investigation became public on April 22, 2004, when Aon, the world’s second-largest insurance broker, reported that it had received a subpoena from Spitzer’s office inquiring about its acceptance of contingent commissions from insurers.19 Soon thereafter, Marsh and Willis Group Holdings, the world’s third largest broker, reported receiving similar subpoenas.20 Within a month, Spitzer’s office had broadened its probe to include insurance companies as well as brokers, issuing a number of subpoenas to large property-casualty insurers.21

The New York Attorney General broadened his investigation into two additional areas in mid-2004. In a second round of subpoenas issued to insurance carriers in August 2004, the Attorney General’s office first sought information regarding insurers’ compensation arrangements with independent insurance agents, as opposed to brokers.22 At the same time, documents were requested concerning the second alleged source of insurance market distortion raised by the WLF—the “tying” by an insurance intermediary of retail business production to an insurance

18. Fishman, supra note 17.
20. David K. Bradford, Advisen, Placement Service Agreements: Big Brokers Under Fire 1 (2004); see also Gretchen Morgenson, Hat Trick: A 3rd Unit of Marsh Under Fire, N.Y. Times, May 2, 2004, § 3, at 9. At least one smaller New York City broker, Kaye Associates (a subsidiary of Hub International), was also subpoenaed in this first wave. Id. California Insurance Commissioner John Garamendi was the first regulator outside New York State to follow Spitzer’s lead in announcing his own investigation. Joseph B. Treaster, An Inquiry into Insurance Payments and Conflicts, N.Y. Times, Apr. 28, 2004, at C1. Others would follow; at this writing more than twenty other states have initiated investigations of insurance market conduct.
22. A sample subpoena is on file with the author.
carrier's willingness to retain that intermediary's reinsurance brokerage affiliate to place its reinsurance.\textsuperscript{23}

Perhaps the most fateful day in determining the ultimate course of the Spitzer Investigation was September 9, 2004, when a New York University law student working as an intern in Spitzer's office unearthed an e-mail indicating that Marsh had conspired with insurance carriers to rig bids on insurance renewals: obtaining false, inflated quotes from complicit markets to enable Marsh to direct business to a chosen market with an eye toward maximizing its PSA payments.\textsuperscript{24} The quid pro quo for such cooperation from the "losing" markets would be protection by Marsh on its own renewals through similar means. This evidence of outright fraud and market manipulation provided the catalyst that enabled Spitzer's staff to crystallize a more unfocused discomfort with insurance market sales incentives (including contingent commissions, loans to producers, funding of producers' sales staffs, leveraging reinsurance broking engagements, etc.) into a broader challenge of disclosure practices in the property and casualty ("P&C") market.

This challenge manifested on October 14, 2004, when Spitzer filed suit against Marsh.\textsuperscript{25} The thrust of Spitzer's complaint was two-fold. First, he alleged that Marsh's practice of accepting contingent commissions led the broker to elevate its own interests above those of its clients, by "steering" business to carriers based more on the economics of Marsh's PSAs than on the needs of the customer.\textsuperscript{26} Second, Spitzer alleged several instances of outright bid rigging by Marsh in the Excess Casualty insurance market, with the purpose of ensuring that its own commissions were maximized at the expense of the insureds. This evidence provided the basis for Spitzer's lawsuit against Marsh, which sought to force the company to conform to ethical practices and to divest itself of its conflict of interest.


\textsuperscript{25} See Marsh Complaint, supra note 2.

\textsuperscript{26} Id. ¶¶ 7-8, 14-42. In an amusing footnote to this story, Spitzer was embarrassed in April 2005 when Reuters reported that his gubernatorial campaign had paid the Google search engine firm to direct users searching the term "AIG"—an insurance company then under intensive investigation by Spitzer's office—to a link to the "Spitzer for NY Governor" campaign website, which featured the message: "Good Guys Can Finish First. Sign up Now to Join the Fight!" NY's Spitzer Gubernatorial Campaign Goes to Google, Reuters, Apr. 6, 2005 (on file with author, together with screen capture of link as it appeared). Within hours of the Reuters report, the link had been removed and Spitzer's spokesman had publicly disavowed the "relatively low-level campaign staffer" responsible. See Spitzer Pulls Campaign Ad Off Google AIG Link, Reuters, Apr. 6, 2005 (on file with author). To his credit, Attorney General Spitzer quickly renounced this campaign device, no doubt appreciating the irony that his hapless staffer's Google gambit had in effect caused his campaign to make an undisclosed payment to an intermediary for the purpose of steering consumers of information services to its website.
involving collusion with a number of major insurers. On the same day he filed his complaint against Marsh, Spitzer underscored the seriousness of his allegations by announcing guilty pleas by two employees of insurer American International Group ("AIG"), who admitted to participating in criminal bid rigging.

It would eventually become clear that, while Spitzer had discovered a serious problem in one niche of the market, outright bid-rigging behavior appears to have been limited to the excess casualty sector, where the combination of a commoditized product and a highly concentrated brokerage market created conditions ripe for abuse. But, even if we accept that the bid rigging admittedly conspired in by a number of Marsh employees (as well as underwriters at several major insurance companies) was an aberration, how do we account for it? Why would executives at Marsh risk the professional reputation of the firm, as well as the loss of substantial clients and the long-term income stream they represented, in return for the transient benefit of achieving any one year’s PSA payment from a particular insurer? From Marsh’s standpoint, the answer lies in the unfortunate way the broker apparently structured its profit centers, and the perverse incentives that flowed from that structure. By setting up its Global Broking division so that its sole source of income was PSA payments from carriers, and by assigning internal “credit” for the normal income derived from standard commissions to a separate Client Advisory division, Marsh all but guaranteed that its employees in Global Broking would elevate the maximization of PSA payments over all other considerations, including the long-term reputation and even financial well-being of the firm. As I discussed at length in an earlier article on the insurance underwriting cycle, insurance professionals respond to the incentives provided them, and many of the “problems” the insurance industry contends with—from “boom” and “bust” market cycles to the recent bid-rigging scandals—can be traced fairly directly to ill-conceived compensation structures.

Other commentators, notably Professor John Coffee, have also observed that even a firm whose very value derives from the trust of the marketplace in its integrity can unwittingly place its franchise at risk by creating a bureaucratic culture where profit centers have powerful short-term economic interests that are inconsistent with the firm’s long-term interests,

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27. Marsh Complaint, supra note 2, ¶¶ 43-66. Excess Casualty is a type of multi-peril liability insurance that sits in excess of more specific primary liability policies; it is a highly commoditized product available from many insurance carriers.


29. See generally Fitzpatrick, supra note 14.
and where the necessary internal and external controls to manage such an institutional tension are lacking. Coffee also astutely points out that this risk is exacerbated where, as in the large broker market, a limited number of competitors reduces the risk that questionable practices will be "outed" by marketplace rivals. Marsh should, perhaps, have seen warning signs—friction between its Global Broking and Client Advisory arms was an open secret in the P&C industry—but beyond reportedly trying to adjust the incentives of its client advisors to gain their buy-in to the Global Broking business model, Marsh plainly did not do enough to safeguard against the risks of that model. Indeed, given the incentives provided and the absence of necessary countermeasures, it speaks well of Marsh’s employees outside the Excess Casualty area that they apparently did not succumb to the temptation to game Marsh’s compensation system at the expense of its clients.

But what of the underwriters who conspired with employees of Marsh Global Broking in rigging bids? Were they so driven to meet premium production goals that they became blind to the fundamental wrongness of their conduct? While this is possible, I suspect the real answer is more subtle, and lies in the way that ethical and cultural norms are communicated within the insurance industry. Insurance is an industry without an established, written set of rules governing business practices (unlike, for example, law or accounting). New initiates to the insurance business typically receive their training in an informal way, from more senior employees, and there is a tendency in the industry to accept business practices of long standing at face value, without examining their ethical implications. The structure of the insurance market—with intermediaries acting as the gatekeepers of new business opportunities—also creates some confusion among underwriters as to whom precisely their “customer” is: the producer they must please in order to sell policies or the end user of those policies. Taken together, these influences make it sadly likely that at least some of the underwriters who have pled guilty to providing fictitious quotes to Marsh never thought of their behavior as unethical, let alone criminal. Rather, they probably provided such quotes when asked after being told "this is just how it’s done,” well aware, as they no doubt were, of the importance of maintaining good relations with the world’s largest insurance producer. Again, the surprising thing may be not that bid rigging occurred among a small number of players in the excess casualty insurance industry.

30. See John C. Coffee, Jr., Understanding Enron: “It’s About the Gatekeepers, Stupid”, 57 Bus. Law. 1403, 1409-16 (2002). It is worth noting in this context that another potential check on broker misbehavior—regular customer contact with their insurers—was absent to a unique degree in the Excess Casualty market. Excess Casualty is a product involving infrequent claims, and requires neither the regular servicing of traditional insurance products like property insurance, nor the in-depth annual underwriting process (often involving face-to-face meetings with underwriters) typical of complex casualty lines such as directors’ and officers’ liability insurance.
31. Id. at 1414-15.
32. Marsh Complaint, supra note 2, ¶ 39.
market, but that similar practices did not develop in other sectors of the P&C market where limited intermediary channels, a commoditized product, and dangerous financial incentives also existed.

In any event, Spitzer’s combination of a broad-based attack on contingent commissions, long a familiar and public feature of the insurance market, with an indictment of outright fraud in the form of bid rigging, was neatly done. And, while some commentators pointed out the questionable logic of meting out equal condemnation to the two very different practices, the distinction was largely overlooked in the media barrage that followed Spitzer’s filing against Marsh. The term “kickback” was almost uniformly adopted in press accounts of the Marsh Complaint and even in regulatory pronouncements from other states, notwithstanding the New York Attorney General’s own initial reluctance to use the term.

Throughout late 2004 and early 2005, however, Spitzer sent conflicting signals as to how he viewed contingent commissions in and of themselves, untainted by association with bid rigging or other types of fraud. One could infer from the Marsh Complaint that Spitzer believed such payments were inevitably corrupting of the insurance market. At other times, however, the Attorney General has expressly stated that his concern is not with contingent commissions per se, but rather with inadequate disclosure to customers of such payments. In a speech to the National Press Club on January 31, 2005, for example, Spitzer acknowledged that, while the way contingent commissions were used by mega-brokers such as Marsh was wrong, “in other parts of the industry, they may be appropriate.”

33. Indeed, some of the most vocal critics of contingent commissions as “kickbacks” have overlooked the fact that their evidence was provided by the insurers themselves, who publicly report on contingent commissions paid in their annual statutory statements filed with each state’s insurance department. See, e.g., J. Robert Hunter, Consumer Fed’n of Am., Contingent Insurance Commissions: Implications for Consumers 2 (2005), available at http://64.233.179.104/search?q=cache:ihRWPXhe5t0J:www.consumerfed.org/.


36. Earlier in his investigation, Attorney General Spitzer had been reluctant to use the word “kickback” in describing contingent commissions. See Interview with Eliot Spitzer (WXXI-Rochester, NY radio broadcast May 28, 2004) (transcript available at http://www.wxxi.org/ntk/Transcripts/2004/0528.html). But, despite eschewing the term in the Marsh Complaint itself, Spitzer had adopted the media’s popular term by the time of his November 2004 U.S. Senate testimony. Of course, as recounted above, his office had discovered Marsh’s bid rigging in the interim.

might be other contexts," he added, "where contingent agreements might not usurp decision-making and fiduciary duty."

In any event, Spitzer's filing of the Marsh Complaint set off a nationwide wave of investigations, and regulatory and legislative initiatives to reform insurance brokerage practices. Spitzer's subsequent $850 million settlement with Marsh, announced in January 2005 on the same day as his National Press Club speech, lent credence and momentum to these investigations.

The New York Attorney General retained the initiative even as other regulators joined the fray, issuing new rounds of subpoenas focused on (1) allegations of a conspiracy among lawyers' malpractice insurers to boycott plaintiffs' class action law firms, and (2) "finite risk" and other "nontraditional" insurance products allegedly utilized by some companies to manipulate their financial results. The latter of these prompted the U.S. Securities and Exchange Commission to begin its own investigation, following up on its earlier enforcement actions against insurance industry giant AIG regarding finite risk products it had sold with a broad investigation paralleling Spitzer's. Spitzer's office also broadened its focus from contingent commission arrangements to other financial dealings between insurers and producers, including insurer funding of individual producer's salaries and incentives to limit marketing of renewals. These facets of the Spitzer investigation gained prominence when the Attorney General simultaneously sued Aon and announced a $190 million settlement.


39. At this writing, more than twenty states have initiated formal investigations into insurance market conduct. Both the National Conference of Insurance Commissioners ("NAIC") and National Conference of Insurance Legislators ("NCOIL") have promulgated model legislation directed at disclosure to consumers of insurance producer compensation. See infra Part III. Spitzer himself extended his investigation of contingent commissions and bid rigging into the health insurance market in November 2004, with a suit against a leading health and benefits broker, Universal Life Resources. See Press Release, Office of N.Y. State Attorney Gen. Eliot Spitzer, Life, Disability Broker Charged with Fraud, Antitrust Violations (Nov. 12, 2004), available at http://www.oag.state.ny.us/press/2004/nov/nov12a_04.html.


42. See Gretchen Morgenson, Next Up for Spitzer: Funny Numbers, N.Y. Times, Nov. 21, 2004, § 3, at 1. These inquiries, while raising fascinating questions in and of themselves, are beyond the scope of this Article.
with the brokerage firm in March 2005. In April 2005, Spitzer reached a similar $50 million settlement with the number three broker, Willis. Marsh, Aon, and Willis each agreed to essentially the same set of “business reforms” as part of their settlements; chief among these was a ban on their acceptance of contingent commissions and other forms of incentive compensation from insurers.

It is not yet clear whether Attorney General Spitzer intends to press this reform on smaller producers, including independent agents, although his remarks at the National Press Club indicate that he may stop short of doing so. If he does hesitate, what potential consequences of such an outright


45. The “business reforms” agreed to by Marsh, Aon, and Willis include the following: written disclosure and client acknowledgement of standard fee or commission arrangements; prohibition of contingent commissions; prohibition of any “pay to play” charges to insurers; prohibition of “bid-rigging” arrangements; prohibition of reinsurance brokerage “leveraging”; prohibition of inappropriate use of wholesalers (i.e., running placements through affiliated Wholesale brokers to generate additional commissions); mandatory disclosure to clients of all insurance quotes procured and related compensation; and implementation of written standards of conduct and ethics training. The full texts of the Marsh, Aon, and Willis settlement agreements are available on Attorney General Spitzer’s web site at http://www.oag.state.ny.us/press/agpress05.html (last visited Apr. 17, 2006).

46. David Brown, the chief of Spitzer’s investor protection bureau, has taken a more aggressive public stance, noting, “[t]hat’ll be interesting to see if the smaller operators reform themselves. If they don’t, maybe we’ll have a more extended inquiry on our hands.” Elkind, supra note 17, at 134. As recently as October 2005, some in Spitzer’s office were remarking that “we’re only in the fourth inning . . . [t]here’s been very little resolution and there’s no plan to walk away from this.” Ellen Kelleher & Andrea Felsted, A Year on, Spitzer Keeps up the Pressure, Fin. Times, Oct. 14, 2005, at 28. As this Article went to press, Attorney General Spitzer provided additional insights into his approach to the general issue of contingent commissions when, on February 9, 2006, he announced a $1.6 billion settlement with AIG that resolved, inter alia, allegations of bid rigging and abusive contingent commission practices by that firm. See Press Release, Office of N.Y. State Attorney Gen. Eliot Spitzer, AIG Settles Fraud, Bid-Rigging and Improper Accounting Charges (Feb. 9, 2006), available at http://www.oag.state.ny.us/press/2006/feb/feb09a_06.html. In the settlement agreement, Spitzer exacted AIG’s agreement to support legislation banning contingent compensation outright (an unlikely outcome, as discussed in Part III, infra) and,
ban should concern him? Recalling Chesterton’s observation, does the fact that some participants in the insurance market broke certain “great laws” (the Eighth and Tenth Commandments come to mind47) leave us no recourse but a fifty-state patchwork of new producer compensation and disclosure regulations, “small laws” that may disrupt the fundamental economics of the insurance industry? If this prospect is unappealing, what alternatives are available to curb insurance market abuses that will not threaten lasting damage to a vital sector of the economy?

But before we reach these questions, it will be helpful to describe the U.S. property and casualty insurance market as it had evolved prior to the Spitzer Investigation, and to consider the economics of that market.

II. THE INSURANCE MARKET AND CONTINGENT COMMISSIONS

To trace the origins of the modern U.S. insurance market, we must begin at Edward Lloyd’s famous coffee house in seventeenth-century London. Brokers first appeared in this market as a convenient mechanism for communication among the risk takers, or “underwriters,” who collectively insured individual ships and cargoes.48 This system of intermediaries permitted providers of capital to the insurance market to transact business with each other and with purchasers of insurance efficiently, sparing each underwriter the expense of maintaining its own staff of “office keepers.” Business at Lloyd’s was conducted, much as it is today, within the tight

more interestingly, its agreement to forswear contingent commissions in any line of insurance where the Attorney General could demonstrate based on industry data that the insurance companies collectively writing sixty-five percent or more of the premium volume either did not pay contingents or had agreed to abide by the same commitment as AIG. See Agreement Between the Attorney General of the State of New York and American International Group, Inc. and its subsidiaries (collectively, “AIG”) dated January 18, 2006, available at http://www.oag.state.ny.us/press/2006/feb/signedSettlement.pdf. Attorney General Spitzer will presumably utilize his prosecutorial leverage to encourage competitors of AIG in various insurance lines to agree to similar terms in the coming months, but it remains to be seen whether the sixty-five percent threshold stipulated will be practically attainable in any substantial segment of the widely fragmented property and casualty (“P&C”) market. In any event, this mechanism demonstrates both Attorney General Spitzer’s view that the insurance market would be a fairer playing field without contingent commissions and his recognition that no single insurer can “unilaterally disarm” in this area. Of course, it also implies that Spitzer realizes he will need to continue to seek reform through investigatory pressure on individual companies, given the low probability of sweeping legislative or regulatory reform in this area.

47. The Eighth Commandment is “Thou shalt not steal”; the Tenth Commandment is “Thou shalt not covet thy neighbor’s [goods].” See Exodus 20:15, 20:17 (King James). My fellow Roman Catholics will, of course, recognize the former as the Seventh Commandment, but—as our story is about to turn to London—I will defer to our Anglican forebears in this respect.

48. Raphael, supra note 3, at 33-36. Amusingly, in light of our current subject, Adam Raphael points out that early brokers at Lloyd’s adopted the euphemism “office keepers, broking being regarded as disreputable.” Id. at 35. Insurance itself, of course, has even older roots, dating from at least as far back as the eighteenth century B.C.E., when an early form of marine insurance known as “bottomry” was enshrined in the Code of Hammurabi in ancient Babylonia. See Peter L. Bernstein, Against the Gods: The Remarkable Story of Risk 92-95 (1996).
confines of a small physical marketplace. Initially, underwriters could personally oversee all aspects of their insurance transaction and, as the number of participants in the market grew, "syndicates" of capital providers, or "names," were formed. These syndicates would choose one among their number to serve as the "active underwriter" for the group, and these active underwriters carried on the business for centuries thereafter on much the same personal basis that their forebears had.\(^\text{49}\) In this system, brokers were accorded a distinct role within the Lloyd's constitution, as presenters of business opportunities without underwriting authority.\(^\text{50}\)

Interestingly, in this same period, the underwriters at Lloyd's employed a distinct, worldwide network of "Lloyd's agents" to provide reports from, and represent their interests in, remote locations.\(^\text{51}\) By 1880, there were more than 1000 Lloyd's agents around the world, whose authority extended to the approval of claims payments.\(^\text{52}\) The transplantation to and subsequent development of this system in the United States laid the seeds of the most challenging puzzle now facing Attorney General Spitzer.

A. Brokers and Agents in the U.S. Property-Casualty Market

The United States' property and casualty insurance market had its birth in marine underwriting, much like its London parent, and the roles and legal relations of the various players in the marketplace were similarly derivative of the London model.\(^\text{53}\) Locally based fire insurance companies were also organized on a mutual-ownership basis in several seaboard cities during the colonial period.\(^\text{54}\) When the American Revolution removed British restrictions on the formation of joint stock companies, substantial underwriting companies were organized for the first time in the new United States, beginning with two marine insurance companies in Charleston, South Carolina, chartered in 1776. With the formation of the Insurance Company of North America in Philadelphia in 1794, a uniquely American insurance marketplace—characterized by stock and mutual companies dwarfing individual Lloyd's syndicates in size—began in earnest.\(^\text{55}\)

At the same time, the United States was expanding at a rapid pace in both geography and population. The large new insurers in cities such as Philadelphia and Hartford needed a mechanism to do business across distances that dwarfed not only the City of London, but all of England. The Lloyd's agency system, modified to the American setting, provided the solution. While insurance intermediaries acting as true brokers—that is,  

49. See generally Raphael, supra note 3, at 37-46.
50. Id. at 45, 64-65.
51. Id. at 27.
52. Id. Eventually, Lloyd's extended its delegation of authority to some agents to include underwriting, or "binding," authority. See, e.g., Lloyd's Binding Authority Registration, http://www.lloyds.com/lloyds_market/market_participants/coverholders/binding_authority_registration_BAR (last visited Mar. 2, 2006).
54. Id. at 14-15.
55. Id. at 13.
representing insurance purchasers—remained the rule in traditional maritime insurance markets such as New York and San Francisco, elsewhere in the United States a new model predominated, with intermediaries contracting to represent the interests of one or more insurance companies in marketing their products. Ultimately, the two most common types of insurance intermediaries in the United States were “exclusive agents,” who were employed by and represented only one insurer, and “independent agents,” who represented multiple insurers. Because the latter distribution model required a departure from traditional principles of agency law, particularly in the area of ownership of customer information and renewal rights, the independent agency system developed a formalized set of legal rules known as the American Agency System.

Notwithstanding the historical, geographical, and conceptual distinctions between brokers and independent agents, however, the legal distinction between the two has grown imprecise in recent decades. Indeed, one can hardly locate an in-depth legal analysis of the broker-agent distinction that does not feature words such as “blurry” or “cloudy.” Some states no longer even recognize multiple species of insurance intermediaries, denoting all intermediaries simply as “agents” or “producers” (this is the case, for example, in Connecticut); other states, including major insurance markets such as New York and California, continue to recognize two separate species of intermediaries. In a similar vein, some courts and commentators have simply given up, conflating brokers and independent agents for analytical purposes. Even in jurisdictions where brokers and independent agents have largely been viewed as synonymous, however,

57. Id. at 413-19.
59. See, e.g., IRMI, supra note 14, at XV.C.1 (noting that “the distinctions between the legal duties owed by agents and brokers have, in recent years, become blurred”); Colin Sammon, Comment, Insurance Agent and Broker Liability: Crossing the Two Way Street, 29 Ohio N.U. L. Rev. 237, 238 (2002) (“In many states, the distinction between ‘agent’ and ‘broker’ is at best a cloudy one.”).
60. See Appleman, supra note 14, § 47.6, at 338.
61. See, e.g., Douglas R. Richmond, Insurance Agent and Broker Liability, 40 Tort Trial & Ins. Prac. L.J. 1, 5 (2004) (“Brokers are sometimes referred to as independent agents and are generally considered to be the insured’s agent.” (citations omitted)). Richmond later qualifies this view, observing that “brokers” (as he defines them) may enter into “agency relationships” with insurance carriers and thus become “dual agent[s] for both the insured and the insurer. Specifically, a broker may be an agent of the insured for purposes of obtaining coverage and an agent of the insurer for other purposes.” Id. at 7 (footnote omitted). Richmond’s struggle will be familiar to anyone who has tried to survey the precise contours of the broker-agent distinction.
questions remain as to the precise legal status of such producers under agency law, and to the scope of their legal duties to customers.

Legal distinctions aside, from a practical standpoint, it is generally recognized that brokers are most often used by large commercial customers, while smaller businesses and individuals purchase the bulk of their insurance through agents, either captive or independent. Thus, in economic—if not in legal—terms, the insurance market is fairly clearly stratified. In fact, the two segments of the market have substantially different characteristics, the former tending toward oligopoly since the large broker consolidations of the 1990s and the latter more resembling the "perfect competition" of economics textbooks with numerous firms contesting for relatively tiny slivers of the market. We should not be surprised to discover that compensation mechanisms that are benign in the competitive agency market might be abused in the less competitive brokerage sector.

Some state regulators have been slow in recognizing the broker-agent distinction in the wake of the Spitzer Investigation, whose focus on the largest intermediaries, which conduct the bulk of their business as brokers (and in major historical "broker markets" like New York and San Francisco), obscured that issue for a time. As regulators outside New York begin to investigate second-tier insurance intermediaries, however, their efforts are being complicated by the fact that these intermediaries carry on a substantial portion of their business as independent agents, contractually bound to pursue the interests of their appointing carriers. Indeed, in the first Spitzer Investigation-related complaint against an intermediary that explicitly addressed the broker-agent distinction, Connecticut's Attorney General, Richard Blumenthal, abandoned the breach of fiduciary duty thrust of Attorney General Spitzer's complaints (and his own) against Marsh, Aon, and Willis, presumably because the firm in question, Hilb Rogal & Hobbs, conducts the overwhelming majority of its business as an independent agent. Instead, Attorney General Blumenthal alleged that the firm had violated Connecticut's unfair trade practices statutes by claiming to represent the interests of insureds despite its agency relationships with insurers.

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63. Cummins & Doherty, supra note 11, at 6-7.
64. Id. at 9.
65. Id. at 7-13.
67. Id. ¶ 16.
68. Id. ¶¶ 16-22, 102-09.
So, while there may be some question as to the precise legal borders of the broker-agent distinction, it remains an important factor to be considered in assessing the appropriate response to the revelations of the Spitzer Investigation and its progeny.

B. The Uses and Abuses of Contingent Commissions

Insurance intermediaries are compensated in various ways for their work. In most cases, producers are compensated by the insurance carrier on a commission basis, although large corporate insurance buyers sometimes choose to compensate their brokers directly on a fee basis.69 Commission-based compensation comes in two primary forms. The first is "standard commission" which is calculated as a percentage of the policy premium (typically ranging from five percent to twenty percent) and deducted by the producer from the customer’s premium payment before it is remitted to the carrier. The second is "contingent commission," which is calculated as a percentage of a producer’s entire book of business with a particular carrier (normally ranging from one percent to two percent) and paid by the carrier at year end based on the producer’s meeting overall production and profitability goals.70 Contingent commissions have been used by insurers as an incentive mechanism for their agents for a century or more.71 Although contingent commissions have come under attack in recent months, their persistence can be attributed to substantial advantages they provide to insurers, intermediaries, and even consumers. But if, as I will argue, contingent compensation is the most efficient (e.g., low cost) means of promoting effective distribution of insurance products,72 what risks does it pose and how can they be addressed?

To begin at the beginning, the affinity of insurers for contingent commissions as a mechanism for compensating producers is easy to grasp. It should resonate with anyone familiar with distributing products through

69. See Cummins & Doherty, supra note 11, at 14-16.
70. Id. at 14-15.
72. Given that no fair observer can question that the P&C insurance market is, on the whole, a highly competitive one, it is fair to assume that compensation structures in the industry reflect perceived overall economies and a rational division of costs and benefits among the parties to insurance transactions. See, e.g., Laureen Regan & Sharon Tennyson, 
Agent Discretion and the Choice of Insurance Marketing System, 39 J. Law & Econ. 637, 638 (1996) (noting that “different insurance marketing organizations arise as a means to minimize the costs of correctly matching policyholder risks with insurance coverage”).
intermediaries, whether Oreos sold at Wal-Mart or Thin Mints sold by your friendly neighborhood Girl Scout. Simply put, distributors large and small will sell more of a particular product if they have incentives to do so, be those incentives volume bonuses or merit badges. In the case of commodities (i.e., fungible goods or services), the relative level of sales incentives may entirely dictate the focus of the distributor’s energies between one similar product and another.

Insurance is, despite the best efforts of carriers to distinguish their products in the marketplace, substantially commoditized. Standard commissions, while variable and therefore susceptible to use as a sales incentive, are a blunt instrument and have no motivating effect beyond a single transaction. Moreover, standard commissions offered by one carrier in the context of a particular transaction will commonly be matched by one or more competitors eager to write the same account. Even if all competitors do not agree to pay higher commissions on any one transaction, the net effect of this type of competition over time is to increase commissions and, ultimately, the premiums paid by consumers above an optimum level. (And, of course, differential standard commissions have the same potential to induce producers to “steer” business to higher-paying insurers as contingents—a simple point, but one that has been largely overlooked in the debate over contingent compensation.) Contingent commissions, on the other hand, allow each carrier to compensate its producers on the basis of overall sales performance, fine-tuning the incentives it provides to its business strategy. While such compensation can also be the subject of “bidding up” by competing carriers, an independent agent or broker needs to maintain multiple sources of insurance capacity so it cannot leverage the “highest bidding” insurer on a book-of-business basis as it can in the context of a single transaction.

As importantly, typical contingent commission arrangements reward the intermediary not just for the volume of business produced, but for the profitability of that business. Although profit-based commissions have been used in the industry for many years, carriers have become steadily more committed to including this factor in their contingent compensation arrangements. Profitability is an important element in an effective incentive program because it puts the producer’s “skin in the game,” enlisting the agent or broker in the effort to identify customers that are less likely to incur insured losses. Such an alignment of interests has benefits for consumers, as well as providers, of insurance, as I discuss below. At a minimum, such profit sharing provides a disincentive for the producer to attain its sales goals by loading up the carrier with substandard risks.73

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73. Given insurers’ strong interest in linking producer compensation to profitability, Marsh’s success in the late 1990s in eliminating profitability as an element in its contingent compensation through the device of the PSA speaks volumes about the relative bargaining power of that mega-broker and the many competing insurers for which it places business. J. David Cummins and Neil A. Doherty, in their recent study of the economics of insurance
Interestingly, given the financial stakes involved, there has been little independent research indicating that contingent commissions are effective in influencing producer behavior. The mere fact that this device has been so widely adopted by insurers over the past century is probably proof enough of its efficacy, however. The one academic study of the topic, by an MIT doctoral candidate named Jeffrey Wilder, found that contingent commissions do indeed influence the behavior of individual producers who are aware of them (i.e., equity owners in an insurance agency). Wilder also noted that contingent commissions can theoretically influence the behavior of nonowner producers as well, if an agency creates internal incentives for them in support of the firm's goals.

If the appeal of contingent commissions to insurance carriers is fairly clear, why has this form of compensation been embraced by the producers themselves? Why would they not simply insist on higher standard commissions on the front end and eliminate the risk that bad results on their placements would reduce their compensation? The simplest answer to this question is that insurance agents and brokers need access to insurance carriers as much as the carriers need access to customers, and the market for insurance placement services remains more than competitive enough to prevent individual intermediaries from exacting standard commissions equivalent to what carriers are willing to pay on a contingent basis to their most successful producers.

There is perhaps another, more subtle, reason that contingent commissions have developed as a compensation technique distinct from standard commissions, a reason having to do with the internal economics of insurance agencies. Most individual insurance agents or brokers are employees of their firms, with little or no equity stake in the business. They do, however, "own" their books of business to a large extent, giving successful agents considerable bargaining power vis-à-vis their employers. Insurance brokerage is an "eat what you kill" business, meaning that the bulk of an individual agent's compensation is based on a percentage of the

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74. At a more fundamental level, Laureen Regan and Sharon Tennyson have demonstrated that insurers will gravitate to independent agent and broker distribution, as opposed to direct sales or captive agent distribution, for more complex products where the intermediary's superior access to information concerning the risk will produce improvements in underwriting results outweighing any increased compensation costs involved. See Regan & Tennyson, supra note 72, at 646-47.


76. Wilder, supra note 75, at 21.

77. See generally Cummins & Doherty, supra note 11, at 10-13.
standard commission income she brings into the firm. Accordingly, an agency principal would have a strong incentive to reduce the firm’s standard commission income if such income could be replaced with revenue that was less visible to employee agents—like year-end contingent commission payments calculated as a percentage of the firm’s entire book of business. Indeed, it may be that efforts to preserve the confidentiality of contingent commission arrangements have had less to do with keeping such information from an insurance agency’s customers than they have with keeping such information from the agency’s own employees. While agency owners are understandably reluctant to concede this for the record, many will state in private that contingent commissions provide a vital pool of “house” money that funds the basic overhead of their firms. Off the record, many principals of smaller agencies question whether they could remain in business without contingent compensation reserved to the firm. Such compensation also provides an incentive for an insurance agency to guard its firm-wide reputation for ethical conduct (without which it is likely to lose agency appointments from carriers), and should therefore improve oversight of individual producer’s sales practices.

The potentially cataclysmic impact on the level of competition in the market for insurance intermediation services of an outright ban on contingent commissions has gone largely unnoted in the debate spawned by the Spitzer Investigation. It may well be, however, that Attorney General Spitzer’s concession at the National Press Club that contingent commissions can be appropriate in some circumstances indicates that he understands this risk.

But what of the customers? Are the interests of insurance consumers prejudiced by contingent compensation agreements between insurers and intermediaries? Attorney General Spitzer and others have alleged that such compensation artificially raises the price of insurance, as opposed to reflecting its true costs. It is not at all clear, however, that this is the case. To the contrary, a strong case can be made that independent intermediaries compensated in part based on the performance of their overall books of business with individual insurance carriers are the most efficient distribution mechanism for complex insurance products. Further, contingent commissions may generate benefits to insureds—in terms of the “exposure cost” (that is, the risk-based premium net of expenses) and availability of coverage—in addition to reducing the transaction costs of the insurance purchase.

From the standpoint of basic economics, the mere durability of the independent broker or agent distribution model as a feature of the market for certain kinds of insurance products argues for its efficiency.

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78. See Wilder, supra note 75, at 7-8.
79. See, e.g., Phil Zinkewicz, Agents Being Swept into the Scandal, Rough Notes, Dec. 2004, at 84, 84-86.
80. See, e.g., Cummins & Doherty, supra note 11, at 17-18; Regan & Tennyson, supra note 72, at 645-46.
Notwithstanding market distortions such as Attorney General Spitzer apparently discovered in the Excess Casualty area at Marsh, the broader P&C insurance market is unquestionably a truly competitive one, with low barriers to entry and an array of available distribution channels all but guaranteeing that consumers will in most circumstances have access to a desired mix of insurance products and services at costs free of what economists refer to as “monopoly rents.” Indeed, Laureen Regan and Sharon Tennyson have demonstrated that insurers will gravitate to lower cost distribution structures such as direct sales or captive agents in lines where underwriting is relatively generic and claims costs more predictable (e.g., personal lines coverages such as auto), that is, where they can compete for profitable business without incurring, and passing on to the consumer in whole or in part, the higher costs of an independent intermediary. And, if the P&C insurance market is fundamentally competitive, then consumers must benefit from the efforts of providers and intermediaries to achieve competitive advantage in terms of cost and other factors. At a minimum, therefore, the current independent producer marketing organization is due a presumption of economic legitimacy.

With specific regard to profit-based contingent commissions, some consumers (specifically, good risks) will also benefit from lower prices because such commissions provide an incentive for producers to provide sufficient information to the carrier to overcome its concern with the problem of “adverse selection,” which arises because an insured inevitably knows more about its true risks than the insurance carrier. As J. David Cummins and Neil A. Doherty have observed,

Insofar as the insurer is unable to differentiate risks, it may try to charge uniform premiums to good (low) risks and bad (high) risks alike. Thus, the good risks will end up subsidizing the bad. This implies that bad risk

81. See Cummins & Doherty, supra note 11, at 7-14. It may be argued that this view of the insurance market is overly simplistic, and in particular that the market for insurance intermediation services demonstrably has sectors that are less than perfectly competitive. This argument is probably strongest with respect to two sectors at the extremes of the commercial P&C market: commercial insurance for large corporations on the one hand and personal lines insurance for middle-income families on the other. The former sector sees limits on competition for brokerage business because the enormous resource requirements of large commercial can only be met by a small number of large firms. At the smaller end of the spectrum, competition may be limited in practical terms by the reluctance of consumers to “shop” their business from one agent to another for reasons of loyalty or simple aversion to change. While such arguments cannot be dismissed out of hand, I would argue that even in these sectors, aggressive competition does occur—whether in the form of Aon proposing alternative programs to Marsh clients in the Fortune 500 or a direct marketer of personal auto insurance sending an unsolicited rate quote to an individual consumer. Thus, even if buyers of insurance in some quarters, large and small, show reluctance to change intermediaries frequently, they nonetheless have access to market information enabling them to assess whether they are getting a “good deal” through their chosen intermediary.

82. See Regan & Tennyson, supra note 72, at 645-46. Cummins’s and Doherty’s research indicates that producer compensation is passed through to consumers in increased prices, but not fully, so insurers retain an economic interest in achieving the lowest priced distribution model that will produce a sustainable book of business, as of course, do consumers. See Cummins & Doherty, supra note 11, at 19-21.
policyholders will find insurance very attractive and will demand considerable insurance, but the demand for insurance by good risks will be light and might disappear altogether. Thus, asymmetric information "crowds out" the good risks, and insurance is only fairly priced for the bad risks. The insurance market ends up with an adverse selection problem, with the insured population representing primarily the higher risk clients. The costs of adverse selection fall on policyholders, particularly the good risks, who may have to pay excessive rates or accept diminished coverage. Insurers recognize the problems caused by lack of information, and this is reflected in the prices and coverage they offer. But, if adverse selection can be avoided, policyholders will be better off.  

Thus, contingent compensation arrangements that provide incentives to producers to assist in overcoming the adverse selection problem will benefit policyholders by encouraging insurers to price good risks more competitively. Transaction costs can also be lowered through this device, because the costs of an independent agent’s or broker’s vetting of a risk are in the aggregate spread among a number of carriers to which it might submit business. Finally, profit-based contingents give producers a significant incentive to provide their clients with loss control services after they have sold a policy—and help fund such services.

Contingent commissions should arguably be preferred over standard commissions by consumers for another reason: Higher up-front commissions encourage a short-term focus by producers, reducing their reluctance to place business with markets irrespective of their long-term prospects. Such a short-term focus, and the periodic market contractions it contributes to as marginal carriers fail, exacerbates the volatility of the underwriting cycle and ultimately hurts consumers.  

Contingent commissions, on the other hand, give the producer a stake in making sure that a carrier remains solvent and able to pay claims, as well as annual performance awards to its producers.

Implicit in Attorney General Spitzer’s critique of contingent commissions, however, is a belief that—whatever market-proven efficiencies they may represent and whatever benefits to consumers they may provide—such compensation is a corrupting influence on producers because of the temptations it provides to "steer" business in order to maximize benefits to the producer as opposed to the customer. This concern is not utterly unfounded, as no one would deny that producer incentives are designed by carriers to attract business, but it overlooks one fundamental fact. Insurance intermediaries are normally more concerned with the risk of losing a good customer to a competing producer than they

83. Cummins & Doherty, supra note 11, at 25. Even contingent commissions based on volume alone may have benefits for consumers, ranging from lowered costs achieved by economies of scale within insurers to increased competition from new markets using such commissions to gain market share. Id. at 17, 24.

84. Fitzpatrick, supra note 14, at 269-70.
are with any marginal inducements that may be provided by any one insurance carrier.85 A typical agent or broker is therefore extremely unlikely to act in such a way that it will risk losing a customer and the long-term income stream it represents, whatever immediate benefit it might derive in contingent compensation.86 Even less compelling is the claim made by some critics that profit-based contingent commissions will cause producers to be less than aggressive in seeking payment for their client’s claims.87 Anyone with practical experiences in the insurance business knows that customers make lasting judgments about intermediaries and insurers based on their behavior in the claims-paying context; the risk to individual customer relationships and to the intermediary’s reputation in the marketplace would both militate strongly against a contingent commission-induced effort to reduce claims collections.88

If concerns with endemic market manipulations driven by contingent commission arrangements are largely unfounded, however, a belief that the insurance market is fundamentally competitive has as its necessary corollary the acknowledgement that greater transparency in producer compensation would not alter the market’s essential structure and operations. This, in truth, is the challenge that has been thrown down by Attorney General Spitzer: If the insurance market is efficient and serves consumers well, what have its participants to fear from a little sunshine?

But before we explore the implications of this challenge, let us first examine the early legislative and regulatory responses to Spitzer’s challenge.

III. LEGISLATIVE AND REGULATORY RESPONSES: THE SMALL LAWS

By mid-2005, the focus of regulatory debate on the implications of the Spitzer Investigation had shifted from state attorneys general (“AGs”) to state legislators and insurance commissioners. This shift was not attributable to any lack of continuing prosecutorial zeal on the part of state AGs, as demonstrated by ongoing civil and criminal investigations on multiple fronts, but instead reflected the real limitations of their power to drive prospective market reform other than by consent agreements with individual defendants. One can also speculate that state prosecutors have been reluctant to attack the well-established institution of contingent

85. As noted above, I have explored the motivations of insurance producers and other insurance market participants in more detail in an earlier work. See id. at 269 (“Whatever an agent’s or broker’s legal relation to the underwriting carrier they are motivated, in practical terms, by the fear that they will lose their customer to another agent or broker who can deliver the same coverage at a lower price.”). Of course, circumstances can exist—as they appear to have existed in the Excess Casualty unit at Marsh Global Broking—where individual producers can be simultaneously insulated from the salutary effects of this fear and motivated by other incentives. Such combinations of circumstances remain rare, however.

86. See, e.g., Cummins & Doherty, supra note 11, at 23; Wilder, supra note 75, at 7.
87. See, e.g., Hunter, supra note 33.
compensation for independent agents, as opposed to brokers, either because they appreciate the risk of unintended harm to an important "Main Street" business sector or because they fear alienating a powerful political constituency.  

Legislative and administrative market reform efforts have targeted disclosure of compensation received by insurance producers, as opposed to proscribing contingent commissions themselves. Two organizations of state insurance officials, the National Association of Insurance Commissioners ("NAIC") and the National Counsel of Insurance Legislators ("NCOIL"), have promulgated model producer disclosure legislation in response to the Spitzer Investigation. The NAIC acted first, in December 2004. The initial NAIC draft addressed producer disclosure at two levels. Section A of the draft prohibited any producer that "receives any compensation from the customer...or represents the customer" in an insurance placement from accepting compensation from the carrier unless the customer has consented in writing and been informed of the amount of such compensation.  

Section B of the original NAIC draft also contained a "generic disclosure" provision, which provided that—irrespective of whether a producer was being paid by or acting on behalf of the customer—the producer must disclose to its customer that it will receive compensation from the carrier writing the customer's policy, that such compensation might vary from carrier to carrier, and that the producer might receive compensation from the carrier based on aggregate performance of its book of business with that carrier. Ultimately, however, the NAIC adopted a

89. While not as numerous as lawyers, insurance agents are a substantial bloc in state legislatures. Cf. Peverill Squire, Legislative Professionalization and Membership Diversity in State Legislatures, 17 Legis. Stud. Q. 69, 74-75 (1992).

90. In relevant part, Section A of the NAIC Model Act provides as follows:

A.(1) Where any insurance producer or any affiliate of such producer receives any compensation from the customer for the placement of insurance or represents the customer with respect to that placement, neither that producer nor the affiliate shall accept or receive any compensation from an insurer or other third party for that placement of insurance unless the customer has, prior to the customer's purchase of insurance:

(a) Obtained the customer's documented acknowledgement that such compensation will be received by the producer or affiliate; and

(b) Disclosed the amount of compensation from the insurer or other third party for that placement. If the amount of compensation is not known at the time of disclosure, the producer shall disclose the specific method for calculating such compensation and, if possible, a reasonable estimate of such amount.


91. The deferred Section B provided, in pertinent part as follows:

B. An insurance producer must disclose the following, if applicable, to a customer, prior to the purchase of insurance:

(1) That the producer will receive compensation from an insurer or other third party for the sale;

(2) That the compensation received by the producer may differ depending upon the product and insurer(s); and
model disclosure provision that contained only Section A, and deferred consideration of the broader requirement of draft Section B.

NCOIL took an even more conservative approach, adopting a model disclosure law in March 2005 that requires a producer to obtain consent from and disclose its compensation to the customer only where the producer will be paid by both parties to the transaction.\footnote{That the producer may receive additional compensation from an insurer or other third party based upon other factors, such as premium volume placed with a particular insurer and loss or claims experience.} In other words, the NCOIL model did not include the alternative basis for requiring disclosure contained in Section A of the NAIC model: that the producer "represents the customer with respect to the placement." The NCOIL model also limited its requirements to a customer's "initial" placement of insurance (as opposed to renewals) and reduced the specificity required in disclosing formula-based contingent compensation.\footnote{The NCOIL Model Act provides, in pertinent part as follows: A. Where any insurance producer or any affiliate of such producer receives any compensation from the customer for the initial placement of insurance, neither that producer nor the affiliate shall accept or receive any compensation from an insurer or other third party for that placement of insurance unless the producer has, prior to the customer's purchase of insurance: (1) Obtained the customer's documented acknowledgement that such compensation will be received by the producer or affiliate; and (2) Provided a description of the method and factors utilized for calculating the compensation to be received from the insurer or other third party for that placement.}

In the months since the NAIC and NCOIL models were issued, states that have acted in this area have shown an almost uniform preference for the NCOIL model. At this writing, a total of seven states have enacted new producer disclosure laws; none has adopted the NAIC model outright and only two have adopted requirements beyond those contained in the NCOIL model.\footnote{Significantly, neither New York nor California has yet addressed broker disclosure legislatively. New York seems unlikely to enact broad insurance market reform legislatively. Indeed, notwithstanding New York Attorney General Spitzer's attacks on contingent commissions in general, Connecticut, Georgia, Oregon, and Texas have enacted versions of the NCOIL Model. Arkansas and Rhode Island have enacted similar legislation with an additional requirement that all producers receiving compensation from the insurer disclose that fact. Nevada's Division of Insurance has issued a temporary rule imposing substantial disclosure requirements on brokers, but exempting agents, defined as those producers that are "compensated by the insurer." State of Nev., Dep't of Bus. and Indus. Div. of Ins., Temporary Regulation Concerning Broker's Duties to Client: Duty Against Self-Dealing, Duty to Disclose Compensation and Duty to Disclose All Quotes; Violations (Feb. 3, 2005), available at http://doi.state.nv.us/Laws-REG-Temp-Broker-05.pdf.}
the state's insurance superintendent has said publicly that independent agents, as opposed to large brokers, should be entitled to accept contingent commissions.95 California's insurance commissioner has taken a more aggressive stance, proposing broad-based regulations imposing new duties on insurance brokers and agents.96 There is a substantial question, however, whether Commissioner John Garamendi has the statutory power to impose such requirements under existing California law,97 and the California legislature has thus far rebuffed his attempts to obtain such authority through new legislation.98


96. See Press Release, Cal. Dep't of Ins., Insurance Commissioner John Garamendi Unveils New Regulations in Ongoing Battle to Protect Consumers from Impact of Secret Broker Commissions (Apr. 13, 2005), available at http://www.insurance.ca.gov/0400-news/0100-press-releases/0080-2005/release039-05.cfm. Commissioner Garamendi's proposals are by far the most far reaching seen to date. Specifically, Commissioner Garamendi's proposed regulations would require the following:

- Require the agent or broker to advise a client, prior to signing an agreement or receiving a fee, whether the producer will seek a quote from one insurer or more than one insurer.
- Require the agent or broker to reveal if he or she is acting on behalf of the insurer or the client in connection with the placement of insurance. A producer who accepts a fee from a client is conclusively deemed to be acting on behalf of the client.
- Require the agent or broker to reveal the amount of compensation he or she will receive if the client purchases insurance with any insurer recommended by the agent or broker. If the amount of compensation cannot reasonably be known at the time this disclosure is made, the producer may disclose the method by which any such compensation will or may be calculated.
- A broker or agent acting on behalf of the client, or who accepts a fee from the client, may not accept any compensation from a third party for the transaction done on behalf of the client without first obtaining the consent of the client.
- A broker or agent who has told a client that he or she will search for the best quote on a policy must reveal the number of quotes obtained, the name of the insurer, the premium amount, and other required information.

Id. Commissioner Garamendi's April 2005 proposed regulations were less far reaching, however, than provisions he proposed in October 2004 in the immediate aftermath of New York Attorney General Spitzer's suit against Marsh. See, e.g., Lord, Bissell & Brook, Client Alert, California Proposes Revamped Insurance Producer Disclosure Regulations (Apr. 22, 2005), http://www.lordbissell.com/Newsstand/2005-04_RevisedCABrokerRegs_Barney.pdf. As of this writing, Commissioner Garamendi has postponed issuing the regulation he proposed in April 2005, citing a move toward voluntary disclosure of agency and compensation arrangements being promoted by a leading producer trade group. See infra note 110.


98. See News Release, Nat'l Ass'n of Mutual Ins. Cos., California Legislative Committee Takes Correct Action on Producer Requirements (May 2, 2005), http://www.namic.org/newsreleases05/050502nr1.asp. On September 30, 2005, the California Department of Insurance again entered the mix, issuing an informal letter opinion to "explain its legal position on the fiduciary duties of brokers and independent agents under California law." Letter from Jon A. Tomashoff, Senior Staff Counsel, Cal. Dep't of Ins., to Stephen Young, Esq., IBA West (Sept. 30, 2005) (on file with author). Not surprisingly, the
Thus, a full year after Attorney General Spitzer shocked the insurance world with his bid-rigging allegations against Marsh, the “business reforms” settlements he has imposed on Marsh, Aon, and Willis remain the most substantial new market regulation—in practical terms—yet effected. Legislative responses thus far have been few, and those that have been enacted are quite limited in scope. These “small laws” tell us something about both the elected officials who enacted them and the public, which thus far seems satisfied with them: that both understand (intuitively, at least) that the market dysfunctions which gave rise to abuses at large global insurance brokers like Marsh, Aon, and Willis have little relevance to the independent insurance agent on Main Street, U.S.A., or to his customers.

But where does this leave us? How are we to resolve the very real issues raised by the Spitzer Investigation about the opacity of the insurance market to the consumers it serves? How are policyholders to be assured that their intermediaries are properly managing the potential conflicts of interest inherent in their function? Put in more prosaic terms, how and on what basis is the Spitzer Investigation to be resolved? What terms of armistice will be acceptable to the stakeholders in this controversy, be they prosecutors, legislators, insurance intermediaries, carriers, or consumers? In the next section, I outline one way to achieve such a concord: a simple new “social contract”99 for the P&C insurance market.

IV. A MODEST PROPOSAL: INSURANCE “IN THE SUNSHINE”

The foregoing has, I hope, demonstrated two things. First, the simplistic invocation of loaded terms like “kickback” fails to capture the complexity of the economic and legal relationships that have developed over centuries in the insurance market, and one would disturb that edifice of relationships at some risk to the interests of insurance consumers. Second, notwithstanding the above observation, Attorney General Spitzer is on to something: He has detected a reluctance in insurance practitioners to disclose the details of producer compensation that would seem to belie the industry’s assertion that its prevailing distribution represents the best of all

Department’s counsel asserts that both brokers and independent agents (when acting as “dual agents” for both the carrier and the insured) owe fiduciary duties to customers, despite California case law indicating that the producer-insured relationship is something less than a fiduciary one. See, e.g., Hydro-Mill Co. v. Hayward, Tilton & Rolapp Ins. Assocs., 10 Cal. Rptr. 3d 582 (Ct. App. 2004); Kotlar v. Hartford Fire Ins. Co., 100 Cal. Rptr. 2d 246 (Ct. App. 2000).

99. Thomas Donaldson & Thomas W. Dunfee, Précis for Ties that Bind, 105 Bus. & Soc’y Rev. 436, 442 (2000). Donaldson and Dunfee believe that the same logic that sanctifies a handshake between two individuals turns out also to sanctify the implicit understandings of economic communities woven throughout the business world. These are the informal but critical agreements—or “social contracts”—that provide the warp and woof of economic life. These are the agreements that exist within industries, national economies, trade groups, and corporations, and, further, that are the implicit “contracts” critical for understanding business ethics.

Id.
possible worlds for consumers. Given this reluctance, one could forgive the
Attorney General for thinking that the insurance industry “doth protest too
much” in reciting the economic case for contingent commissions. And,
while Spitzer has, through the medium of private settlements, largely cured
the market dysfunctions born of the excessive concentration of the
brokerage market for large corporate risks that occurred in the 1990s, he
plainly has lingering concerns about the rest of the P&C market. What,
then, would ease these concerns and bring an end to the Spitzer
Investigation and its progeny in other states?

Transparency, my friends, transparency: This is the *sine qua non* of a
peace treaty between Attorney General Spitzer and the insurance industry.
There are models aplenty of how this could be accomplished. Some U.S.
insurers have, for example, voluntarily placed information regarding their
producer compensation practices on their public web sites.100 This
approach has been endorsed by the largest organization of independent
agents, the Independent Insurance Agents & Brokers of America
(“IIABA”), better known as the Big “I.”101 But as helpful as disclosure by
insurers can be, most consumers’ primary point of contact with the
insurance market will continue to be agents and brokers. Any legal duties
of disclosure that exist also reside in that relationship, as opposed to the
more remote relationship between insured and insurer. Should insurance
producers, in addition to carriers, be encouraged to disclose the basis of
their compensation?

Real estate agents and brokers, for example, have in recent years adapted
to a system in which a consumer cannot even be shown a property without
first deciding how the intermediary will be compensated and signing an
acknowledgement that the consumer understands who will pay the
intermediary and whose interests the intermediary represents. The real
estate industry is a particularly useful analog for purposes of considering
reform in the insurance market. An intermediary-driven market like
insurance, the real estate market has been regulated similarly over the past
century—with every U.S. state maintaining a “licensing statute or
regulatory scheme addressing qualifications for obtaining the necessary real
estate salesperson’s or broker’s license, and regulations governing realtors’

100. The most comprehensive such disclosure is The Chubb Corporation’s, available at
http://www.chubb.com/marketing/chubb3887.html (last visited Apr. 17, 2006); the author
participated in the development of this disclosure. Other major carriers such as The
name=HIG/Page/Po pUp&nt_page_id=1122655319479&nt_section=1122655319479&c=Page (last visited Apr.
have also posted producer compensation disclosures.

Insurance Company Disclosure (Sept. 23, 2005), available at
http://www.iiia.org/eprise/main/CB_Website/Affiliated/NationalAssociation/IIAA/02_News
/02_PressRelease/NA20050923143814.
Like today's insurance regulations, however, traditional state realtor licensing statutes did not typically mandate particular agency, compensation, or disclosure arrangements, which instead developed primarily in response to the particular economics of the real estate purchasing process.footnote{103}

The real estate industry's wake-up call came in 1983, when a Federal Trade Commission study found that seventy-two percent of all home buyers believed, erroneously, that the “selling agent” assisting them was representing their interests.footnote{104} In fact, under long-established industry practices, such intermediaries were sub-agents of the seller of the property. In the ensuing decades, most states responded by mandating disclosure to consumers of such agency relationships.footnote{105} Many states themselves provide consumers with information on real estate agency relationships.footnote{106} One feature of virtually all such disclosure regimes is the acknowledgment of “dual agency”: That is, an intermediary may act for both sides to a real estate transaction so long as this dual agency is disclosed.footnote{107}

Such disclosures as are now mandated in the real estate industry have the benefit of being simple and not providing so much information as to be useless to consumers in practical terms.footnote{108} For example, one real estate

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footnote{103} Id. at 71 (“State licensing statutes did not, however, dictate the form of agency representation then prevalent. Instead, the entrenchment of the listing/cooperating or ‘traditional’ agency representation model was a direct result of the multiple listing systems in use nationwide.”).

footnote{104} L.A. Reg’l Off., Fed. Trade Comm’n, Residential Real Estate Brokerage Industry 1, 69 (1983). In what perhaps should stand as an object lesson to the insurance industry, the real estate industry did not immediately embrace changes to the traditional market models proposed in the wake of the 1983 Federal Trade Commission study. Indeed, it was not until 1992 that the National Association of Realtors (“NAR”), under political pressure from consumer groups and economic pressure from a new sector of “exclusive buyer’s agents,” agreed to eliminate the requirement that agents accessing its regional and local multiple listing services be subagents of sellers. Olazábal, supra note 102, at 74-75. This voluntary reform recognized, perhaps belatedly, that change in the real estate market was inevitable, and allowed the NAR to retain the initiative in guiding the evolution of real estate market practices.


footnote{107} Olazábal, supra note 102, at 79.

footnote{108} The “privacy policy” disclosures required of financial institutions by the Gramm-Leach-Bliley Act of 1999, 15 U.S.C. 6801-6809 (2000), come to mind as an example of disclosure “overkill.” Does any appreciable portion of the consuming public actually read these impenetrable missives? There are, of course, commentators who believe that current real estate disclosures are insufficient, as there would no doubt be those who make the same critique of my proposed insurance producer disclosure. Interestingly, however, the complaint lodged against current realtor disclosures is that they are too complex to be understood by unsophisticated homebuyers, not that they are too simple. See, e.g., Olazábal,
firm in my state, Connecticut, provides its customers with a simple “Consumer Information Statement of Real Estate Relationships” that outlines the various ways in which an intermediary can participate in a transaction:

1. AS A SELLER’S AGENT... I AS A LICENSEE, REPRESENT THE SELLER AND ALL MATERIAL INFORMATION SUPPLIED TO ME BY THE BUYER WILL BE TOLD TO THE SELLER.

2. AS A BUYER’S AGENT, I... REPRESENT THE BUYER AND ALL MATERIAL INFORMATION SUPPLIED TO ME BY THE SELLER WILL BE TOLD TO THE BUYER.

3. AS A DISCLOSED DUAL AGENT, I... REPRESENT BOTH PARTIES. HOWEVER, I MAY NOT, WITHOUT EXPRESS PERMISSION, DISCLOSE THAT THE SELLER WILL ACCEPT A PRICE LESS THAN THE LISTING PRICE OR THAT THE BUYER WILL PAY A PRICE GREATER THAN THE OFFERED PRICE.¹⁰⁹

This disclosure is brief, straightforward, and gives the client the option of choosing how he or she wishes to work with the intermediary. It is simple enough to be understood by an unsophisticated purchaser of real estate, while being sufficient to initiate a more far-reaching dialogue with even the most sophisticated.

I suspect that Mr. Spitzer and his colleagues in state AGs’ and insurance commissioners’ offices around the country would consider themselves to have achieved substantial market reform, perhaps to the point of resolving their broader concerns over producer compensation, if the Big “I” and other independent producers’ organizations would propose—and their members would voluntarily adopt—a disclosure form for new customers that sets out the basic facts of the intermediary’s agency relationships. Such a disclosure might look like this:

OUR FIRM HAS AGENCY CONTRACTS WITH THE FOLLOWING INSURANCE COMPANIES: _______.

IF YOU CHOOSE, OUR FIRM WILL ACT AS A “DUAL AGENT,” REPRESENTING BOTH YOU AND THE INSURERS WHO HAVE APPOINTED US, IN YOUR INSURANCE PURCHASE. IF WE ACT AS A “DUAL AGENT,” WE WILL BE COMPENSATED ON A COMMISSION BASIS, WITH OUR COMMISSION BEING INCLUDED IN YOUR POLICY PREMIUM AND PAID BY THE INSURER YOU SELECT. WE MAY ALSO BE ELIGIBLE TO RECEIVE ADDITIONAL COMPENSATION FROM THAT INSURER BASED ON THE OVERALL VOLUME AND PROFITABILITY OF THE POLICIES WE WRITE WITH THAT INSURER.

 supra note 102, at 123-24. This criticism in itself would seem to support the idea that a simple, high-level approach to disclosure will benefit the greatest number of consumers.

INFORMATION ABOUT SUCH ADDITIONAL COMPENSATION FOR WHICH OUR FIRM MAY BE ELIGIBLE CAN BE FOUND ON OUR WEB SITE, AND IS ALSO PROVIDED BY THE INSURERS WE REPRESENT ON THEIR WEB SITES.

IF YOU CHOOSE, WE WILL REPRESENT YOUR INTERESTS EXCLUSIVELY AS A "BROKER" IN YOUR INSURANCE PURCHASE. IF WE ACT AS YOUR "BROKER," WE WILL BE COMPENSATED BY YOU, WITH OUR FEE TO BE DETERMINED ACCORDING TO THE ATTACHED SCHEDULE, AND WE WILL ACCEPT NO COMMISSION OR ADDITIONAL COMPENSATION FROM AN INSURER IN CONNECTION WITH YOUR PURCHASE.

Adoption of a disclosure form along these lines would probably change few consumers' approach to purchasing insurance; most would presumably prefer to trade on a commission basis, just as most home buyers continue to purchase real estate through agents compensated by the seller. Such an approach would add little extra time or inconvenience to the insurance purchasing process, and any new costs imposed would be de minimis. No complex calculations would be necessary; no estimates of contingent payments due, if at all, only after a review of an entire year's performance, would be required. Most importantly, this reform would preserve important mechanisms by which insurance carriers and their appointed agents have sought for a century or more to align their interests and control their costs, while respecting the consumer's right to understand the fundamental legal and economic relationships underlying his or her insurance purchase. 110

Clearly, a voluntary solution along these lines would be preferable to the ongoing costs in time, resources, and distraction of the ongoing insurance market investigations. It would recognize the time-honored economic value of the independent agency system, preserve its efficiencies, and remove the cloud of suspicion raised by Attorney General Spitzer's discovery of real abuses involving large brokerage firms whose control of a few niches of the

insurance market grew to the point where normal checks (primarily fear of competition) on an otherwise benign system of producer compensation ceased to operate effectively. If adopted, the independent agency system, and the insurers and consumers who rely upon it, could return to the business of efficiently spreading society's risks for the benefit of all. Sunshine, as Louis Brandeis observed, is the best disinfectant.  

111. Louis D. Brandeis, Other People’s Money and How the Bankers Use It 62 (National Home Library Foundation ed. 1933).