

INCENTIVE-BASED COMPENSATION, CONTINGENT COMMISSIONS AND REQUIRED BROKER DISCLOSURES: IS THERE A MEETING OF THE MINDS?

(FORC Journal: Vol. 19 Edition 4 - Winter 2008)

Cynthia J. Borrelli, Esq.
(973) 514-1200

Although incentive-based compensation and contingent commissions are not prohibited across the entire insurance marketplace,¹ in most states, since 2004, they have been the subject of controversial debate at various state levels, as well as at the National Association of Insurance Commissioners (the "NAIC"). The concerns raised primarily relate to the disclosure of such compensation and so-called "contingent fee arrangement[s]" to insureds, as such disclosures tend to limit the possibility of insureds falling prey to deceptive practices that raise insurance prices above competitive levels.

Legal actions were launched by former New York Attorney General Eliot Spitzer and others addressing allegations of kickbacks and bid-rigging involving national brokerages and multiple insurance companies. American International Group ("AIG") ultimately paid \$125 million to settle with nine states and the District of Columbia over bid-rigging, price-fixing, and allegations regarding undisclosed contingent commissions.² While the NAIC formed an Executive Task Force on Broker Activities and ultimately adopted model legislation on disclosure requirements, relatively few states have adopted this model in its exact form.³ What guidance, therefore, can be provided to brokers and agents on compliance?

I. What Are Contingent Commissions and Other Incentive-Based Commissions?

Independent insurance producers (as opposed to captive agents for carriers who write business exclusively for that single insurer) generally receive two types of compensation. The first is a flat percentage commission based on premium volume paid at the time of sale. There may be different flat rates paid for new and renewal business. A second form of compensation considered common in the marketplace is a "contingent commission."

A. Contingent Commissions.

Contingent commissions may be paid in addition to flat percentage commissions and typically are based on profit, volume, retention and/or business growth. Contingent commissions, often loosely referred to as "bonus commissions," are not payable on a per-risk basis, but are allocated based on the performance of the entire portfolio of business placed with a particular insurer by a specific producer. Contingent compensation is derived from premium dollars, after being combined or pooled with the premium dollars of other insureds that have purchased similar types of coverage. The contingent commission schedule is often known to producers at the beginning of a given period of time (usually one year), but contingent commissions actually earned are calculated some time after business is placed and loss experience is observed and measured.

B. Supplemental Commissions.

Some insurers also pay so-called "supplemental commissions." These commissions are similar to contingent commissions in that an incentive structure based on profit, volume, retention and/or business growth is generally put in place at the beginning of a given year. However, under a supplemental system, rather than paying additional cash commissions at the end of the year, the incentive structure is used to reflect the flat percentage commission for the following year.

II. The Nature of the Disclosure Required and the NAIC Model Act 218, § 18.

With regard to contingent commissions, the nature of the disclosure required by the producer to his client and whether it needs to be documented as acknowledged by the insured depends on the particular law of the state in which the business will be placed. In order to develop a national compliance effort with regard to compensation arrangements, broker disclosures should be a thorough disclosure of the terms of the compensation arrangement in order to comply with the laws in a small number of states which strictly adhere to Producer Licensing Model Act 218, § 18 (*NAIC Model Regulation Service* (Jan. 2005 at 218-1, *et seq.*)), or, in the alternative, the most stringent state in which the producer does business.

Section 18 of the NAIC Model Act provides that where an insurance producer or an affiliate of the 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 producer has, prior to the customer's purchase of insurance:

- (a) obtained the customer's documented acknowledgment 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 the disclosure, the producer shall disclose the specific method for calculating the compensation and, if possible, a reasonable estimate of the amount.

Although far less than one-third of the states appear to have adopted the NAIC Model Act in the precise form as set forth in existing Model Act 218, § 18, there are other states that may, through bulletin, regulation or other statutory provision beyond the Producer Licensing Act, impose similar restrictions. Some states, like New Jersey⁴ and Alaska, contain these detailed restrictions only with respect to "fees" as opposed to "commissions." *See, e.g. N.J.A.C. 11:17B-1.1 et seq.* and *N.J.A.C. 11:17B-3.3*. States which have adopted the restrictions substantially similar to the Model Act include:

Arkansas, Arizona, California, Connecticut, Georgia, Illinois, Indiana, Oregon, Pennsylvania, Rhode Island, Texas, Washington and Wisconsin.

III. New York.

A. The New York Investigations.

Not surprisingly, the City of New York seems to be at the core of the broker compensation controversy. The New York State Attorney General and the Superintendent of Insurance conducted investigations of a number of insurance brokers and insurers, including AIG, Marsh & McLennan, AON and Willis North America. The investigations focused upon whether the arrangements between the broker and his client contemplate adequate disclosure of compensation from the insurers who ultimately pay the brokerage commission. New York State authorities alleged that, at many companies, payment of contingent compensation led insurance producers to steer their clients to insurers paying the producers the most compensation, either in terms of volume or percentage of premium. New York's former Attorney General Eliot Spitzer and former Superintendent of Insurance Howard Mills also alleged that the 2004 then-current level of disclosure failed to properly inform insureds of the compensation to be received.

As a result of the New York investigations, the Attorney General and Superintendent entered into a number of agreements and stipulations with some, but not all, producers doing business in New York that prohibited the receipt of contingent commissions by certain insurance brokers, prohibited the payment of contingent

compensation by certain insurers for certain lines of business, provided a mechanism for expansion of the prohibition to additional lines, and required substantial improvements in disclosures to clients.⁵

In 2004, Willis North America was the first national brokerage to voluntarily enter into an agreement with New York and several other state regulators and enforcement authorities to stop using contingent commissions as a means of boosting business. This decision and the so-called "Spitzer Investigation" ultimately led to Marsh & McLennan and AON also agreeing to discontinue contingent commission arrangements.

B. The 2008 New York Public Hearings.⁶

In July and August 2008, the Superintendent of Insurance, Eric Dinallo, and the Attorney General of the State of New York, Andrew M. Cuomo, conducted joint public hearings in Buffalo, Albany, and New York City, respectively, to obtain the views of interested persons about the proposed addition of a new regulation to address permissible forms of insurance producer compensation and disclosure by insurance producers of all forms of compensation, not just contingent commissions. Specifically, these public hearings were intended to consider producer compensation for the market as a whole as the prior agreements and stipulations were not entered into by the New York Attorney General and the Superintendent with all of the producers doing business in New York. As a result of these long-awaited hearings, it was anticipated that proposed regulations would be developed, proposed and presumably promulgated into law so that brokers, insurers, and their clients would have clarity on these serious issues.

At the hearings, the Superintendent and the Attorney General expressly sought the views of interested parties on whether insurance producers in New York should be required to make full disclosure to the insured, and to obtain the insured's consent in writing, of any compensation from an insurer or other entity relating to the issuance, renewal or servicing of the insured's insurance policy or contract. The Superintendent and Attorney General also sought views about contingent commissions, and whether such compensation created an irreconcilable conflict of interest for producers, as is suggested by Willis. Having led the charge in 2004, it is likely that New York's direction will be followed by other states who, to date, have not yet established clear mandates for the insurance industry.

C. New York Law.

1. Existing Law.

New York currently provides clear legal guidance only with regard to broker disclosures to its clients in the context of fixed commissions. In at least three Opinions of the New York Office of the General Counsel (OGC Opinion # 08-01-10 (Jan. 30, 2008), OGC Opinion # 05-08-18 (Aug. 30, 2005), and OGC Opinion # 06-11-19 (Nov. 20, 2006)), the General Counsel concluded that neither the insurance law nor regulations promulgated thereunder require that a broker disclose to its clients the fixed commission it earns on the policies it places. However, in the January 30, 2008 Opinion, the General Counsel acknowledged that the Department intended to adopt a new part to 11 NYCRR to establish requirements regarding disclosure of all sources and amounts of compensation received by licensed insurance brokers and certain agents. This Opinion also interpreted a 1998 Circular Letter, Number 22 (Aug. 25, 1998), to provide guidance requiring broker disclosure of compensation to producers over and above fixed commission payments. Such compensation was stated in the 2008 Opinion to include "contingent commissions, which may be based upon business volume, profitability, new business generated, existing business retained, or loss experience of business placed with the insurer by the producer." OGC Opinion # 08-01-10.⁷ The New York draft regulations and the Superintendent of Insurance and Attorney General investigations, suits and settlements are more fully addressed below.

On January 29, 2009, Superintendent Dinallo circulated draft regulations to be codified at 11 NYCRR 30 to address the transparency of compensation paid to insurance producers and their role in insurance transactions. The regulations apply to the entire marketplace, including to the practices of insurers, insurance producers and other Insurance Department licensees. The rules are intended to establish the so-called "minimum disclosure requirements," which include:

- 1. the nature and amount of compensation to be received by the producer in connection with a sale of insurance;
- 2. a description of any material ownership interest the insurance producer has in the insurer issuing the insurance contract;
- 3. a description of any material ownership the insurer issuing the insurance contract has in the insurance producer; and
- 4. a prescribed notice as follows:

You are purchasing an [insurance policy, annuity contract, guaranty contract, surety bond] from an insurance producer.

An insurance producer is often paid by the insurance company based on the [insurance policies, annuity contracts, guaranty contracts, surety bonds] the producer sells.

The compensation that insurance companies pay to insurance producers varies from company to company and from [insurance policy to insurance policy, annuity contract to annuity contract, guaranty contract to guaranty contract, surety bond to surety bond]. Therefore, an insurance producer may have incentives to recommend a particular [insurance policy, annuity contract, guaranty contract, surety bond] to you based on the amount of compensation paid in connection with that [policy, contract, bond].

The insurance producer is required to provide you with information about his or her compensation in connection with the [insurance policy, annuity contract, guaranty contract, surety bond] you are purchasing. You may also have a right to receive information from the insurance producer about any quotes or alternative [policies, contracts, bonds] the insurance producer considered and the relative amounts of compensation the insurance producer would have received in connection with those quotes or alternatives.

If you would like such information about quotes and alternatives, just ask the insurance producer. If you are not satisfied with the information you receive, you may contact the New York State Insurance Department.

See §30.3(a), entitled "Disclosure of Producer Compensation, Ownership Interest and Role in Insurance Transaction."

If the amount or value of any compensation to be received by the producer is not known at the time of sale, then the producer is required to describe to the purchaser in writing the method of calculating the compensation, including factors on which compensation is based, such as volume, profitability and retention, and a reasonable estimate of the amount or value. The insurance producer may state the amount as a percentage of premium. *See* §30.3(b). At the purchaser's request, the new rules specifically require the producer to provide comprehensive information about quotes solicited and received and alternative insurance contracts considered, including, but not limited to, a description of coverage, the premium and the compensation the producer would have received in connection with those quotes or alternatives. If, at the initial issuance of an insurance contract, the disclosure provided pursuant to §30.3(a) expressly applies to future renewals of the insurance contract, then no additional disclosures are required upon renewal except if

there has been a material change in the information required to be disclosed pursuant to subsection (a) at the time of renewal.

Section 30.4 of the New York draft rules requires an insurance producer to retain copies of the disclosures for not less than three years after the disclosure is given. There are a few notable exceptions to application of the disclosure rules, including: (a) the placement of reinsurance, (b) the placement of insurance with a captive insurance company, or (c) a producer that has no contacts with the purchaser, which may include wholesale brokers or managing general agents.

Violations of the regulations once they are promulgated into law will be deemed to be an unfair method of competition or an unfair or deceptive act and practice in the conduct of the business of insurance in New York, and shall be deemed to be a trade practice constituting a determined violation under Insurance Law § 2402(c), in violation of § 2403 of that law.⁸

IV. Other State Activity.

A. New Jersey.

Other state regulators have also investigated the practice of contingent commissions. For example, the New Jersey Department of Banking and Insurance ("NJDOBI") issued a bulletin, various press releases and two orders (one to insurance producers and one to carriers) reminding insurance producers and other interested parties of producer conduct requirements and regulatory sanctions for noncompliance. The orders requested copies of certain compensation plans from insurers and producers. Marsh & McLennan Companies, Inc. and its risk and industry subsidiary, Marsh, Inc., implemented significant reforms to its own business model in the wake of this controversy. The NJDOBI bulletin at issue, Bulletin No. 04-20, addressed producer conduct requirements and expressly referenced the producer's fiduciary obligations to its insured as follows:

- An insurance producer acts in a fiduciary capacity in the conduct of his or her business. *N.J.A.C.* 11:17A-4.10;
- Any insurance producer charging a fee to an insured or a prospective insured must first obtain from the insured or prospective insured a written agreement, which contains a clear statement in the amount of the fee and the nature of the service to be provided related to such fee and a statement whether the commission will be received from the insurer upon the purchase of insurance. *N.J.A.C.* 11:17B-3.1.

The unique fiduciary obligations that brokers have to their insureds is cited in support of the requirement that brokers disclose any potential conflicts in their fee arrangements to the consumers that hire them in the first place. See Oct. 22, 2004 press release from NJDOBI, quoting Director of Insurance Donald C. Bryan. It is this fiduciary capacity upon which regulators justify the need for disclosure of contingent fee arrangements to insureds.

Contingent fee arrangements routinely incentivized the producer to produce more business on behalf of an insurer or group of insurers to the benefit of the producer and the insurers. As currently defined under New Jersey law, a "commission" is:

Any payment from an insurer that is contingent upon the sale of a policy, contract or certificate of insurance, or is based on the total premium produced by the producer or written by the insurer. See *N.J.A.C.* 11:17B-1.3.

Other states' statutes including those in states adopting NAIC model legislation (like Arkansas, Georgia, Texas, and Rhode Island), have expressly defined the term "commission" to include "contingent commissions." See, e.g., *Ark. Ins. Code* § 23-64-520(a)2(A); *Ga. Ins. Code* § 33-23-46(a)(2); *Tex. Ins. Code* §

4005.004(a)(3); and *R.I. Ins. Code* § 27-2.4-15.1(c)(2). New Jersey, New York and other states view compensation arrangements on a case-by-case basis and, depending upon the arrangement, have viewed them in the context of state Unfair Trade Practice Acts, as well as in the context of a broker's fiduciary obligation. *See, e.g.*, January 29, 2009 draft 11 NYCRR § 30.5.

Effective January 4, 2009, New Jersey law requires disclosure of compensation earned by a licensed producer to the purchaser of health insurance (the "Health Disclosure Law").⁹ This includes all commissions, fees, service fees and consulting fees. Among other things, § 25 of the Health Disclosure Law amends the New Jersey Producer Licensing Act of 2001¹⁰ by requiring licensed insurance producers to disclose to health insurance purchasers any compensation received from the sale of such policies or contracts.

Section 25 of the Health Disclosure Law provides as follows:

- a. An insurance producer licensed pursuant to P.L. 2001, c.210 (C. 17:22A-26, *et seq.*) who sells, solicits or negotiates health insurance policies or contracts to residents of this State shall notify the purchaser of the insurance, in writing, of the amount of any commission, service fee, brokerage, or other valuable consideration that the producer will receive as a result of the sale, solicitation, or negotiation of the health insurance policy or contract. If the commission, fee, brokerage, or other valuable consideration is based on a percentage of premium, the insurance producer shall include that information in the notification to the purchaser.
- b. The commissioner may specify, by regulation, the information that shall be provided by an insurance producer in the notification to a purchaser of health insurance and the procedure for providing the notification.

N.J.S.A. 17:22A-28 defines an "insurance producer" as the person required to be licensed under the laws of this State to sell, solicit or negotiate insurance. The term includes insurance brokers, agents and consultants, and general agents. The scope of disclosure, on the face of the Health Disclosure Law, is quite broad, and disclosure is required for any insurance contract that meets the definition of "health insurance" at *N.J.S.A. 17B:17-4*, and for any contract sold by non-insurance health carriers, such as hospital, medical, health and dental service corporations, dental plan organizations, pre-paid prescription plans and health maintenance organizations. Disclosure, however, is expressly not required for health coverage that is an incidental part of a life or annuity contract.

What must be disclosed under the New Jersey law is any valuable consideration, including, but not limited to, commissions, consulting fees or service fees. Consideration must be disclosed even if its amount cannot be calculated or estimated. However, the nature of the compensation (*e.g.*, commission versus service fee) does not need to be disclosed. In the case of standard commission rates, the commission percentage or the per-employee amount of commission in connection with the rate proposal, binder or bill may be disclosed.

While the Health Disclosure Law requires that the producer provide the disclosure to the purchaser of insurance, in many cases, it may be more efficient for the carrier to provide the disclosure. However, producers should be aware that the obligation is theirs, not the carrier's. While the Law does imply that disclosure must be made at the time of proposal or prior to a contract becoming effective, certainly disclosure at the effective date is mandatory. Generally, disclosure at the earliest possible date is optimal.

In view of pending legislation to clarify the legislative intent regarding the scope of the producer compensation disclosure requirements described in Bulletin No. 08-16 and the Health Disclosure Law, for at least the first quarter of 2009, the NJDOBI reportedly will not take enforcement action against producers for failure to make the referenced disclosures for policies that do not constitute a "health benefit plan," *i.e.*, pre-paid prescription drug, accident only, and dental plans, among others. If it appears that new legislation may be enacted during this period, the NJDOBI will continue to wait before taking enforcement action. If the

new Bill appears not to be moving, however, the NJDOBI expects to provide a short but reasonable time for the industry to come into compliance with the newly adopted law. The NJDOBI has provided this advice to impacted insurers and producers. To avoid confusion, the NJDOBI does not intend, at this time, to issue additional bulletins on this matter until the legislative process is complete.

There is also a regulatory proposal in New Jersey addressing "service fees" that may be charged to insureds. *See* 40 N.J.R. 6736.11 This proposal applies only in the case of commercial lines insurance where the products and issues involved in the provision of such coverage are more complex. The proposal clarifies that a producer should not be prohibited from providing additional services (such as analysis of a client's risk profile and development of a comprehensive insurance program, preparation of annual coverage reviews, enhanced customer services standards and claims services, appraisals and inspection, and loss control consulting and education) and charging appropriate fees for such services, provided the insured agrees to such additional fees and they otherwise comply with *N.J.A.C. 11:17B-3.1(b)* through (g).

B. Texas.

1. Texas Law.

As noted above, Texas has adopted a compensation disclosure law quite similar to the NAIC Model. In December 2005, at the time of the NAIC approval of the Model legislation for disclosure of agent and broker compensation, then Texas Insurance Commissioner Jose Montemayor and Texas Representative Craig Eland (D-Galveston), who was serving at the time as President of the National Conference of Insurance Legislatures ("NCOIL"), were instrumental in crafting the legislation. The Commissioner was on the NAIC Task Force, and Representative Eland filed the Bill in Texas as House Bill No. 2941. While the Model was not intended to apply to the placement of business in a secondary or residual market, such as the Automobile Assigned Risk Plan, and allowed exemption of nominal fees as defined in statutes in Texas, that provision might apply to fees that reimburse the agent for expenses and special charges. The Model legislation also included a drafting note suggesting the need for statutory standards that clarify the fiduciary duty of an agent or broker to a customer where the State's laws do not adequately address such duties. Texas, instead, relied upon common law which established a fiduciary duty for agents in special circumstances, and initially deemed no statutory obligation necessary.

Texas requires that a "documented acknowledgment: be obtained before the customer's purchase of an insurance product, as demonstrated by the customer's written or electronic signature or recorded voice," or by "other additional methods that the Commissioner may authorize by rule." *Tex. Ins. Code Ann. § 4005.004(a)1*. The written disclosure must include a description of the method and factors used by the insurer to compute the compensation to be received by the producer or other third party for that placement. *Tex. Ins. Code Ann. § 4005.004(a)2*.

2. Texas Investigations and Suits/Settlements.

Both the Commissioner of Insurance and the Attorney General sent requests for information to insurance companies in the State. Texas Attorney General Craig Abbott was also active in bringing suits against insurers for bid-rigging. In December 2006, the Texas Attorney General announced that Texas and ten other states had reached agreed final judgments with one of the world's largest insurers, Zurich American Insurance Co., requiring that company to implement a variety of business reforms and refund \$9 million to Texas commercial policyholders as a result of an anti-trust settlement which it had reached in March 2006. The settlement was the culmination of a multi-state investigation alleging that the company had participated in widespread, deceptive bid-rigging, price-fixing and other schemes in the commercial marketplace, also orchestrated by Marsh & McLennan and other large brokers. In the process, large and small companies, nonprofit organizations and government offices that purchased lines of insurance from Zurich were misled

into believing that they were receiving the most competitive commercial premiums available.

Texas led the 15-month investigation, which revealed that Zurich had conspired with brokers at the center of the conspiracy in a "pay-to-play" scheme to overcharge policyholders for their commercial insurance policies. The scheme devised by Marsh & McLennan gave commercial policyholders the illusion of a legitimate competitive bidding process on policies, when in fact Marsh had pre-designated certain insurers to win bids. The results for the policyholders were actually inflated rates, not competitive bids. The scheme was successful because insurers such as Zurich failed to disclose to policyholders that they had paid these so-called secret "contingency commissions" to insurance brokers. Both Zurich and the brokers were deemed to have engaged in anticompetitive conduct. The brokers were steering contracts away from insurance companies that refused to participate in the scheme, and Zurich allegedly submitted fake quotes and was rewarded with protection from competition so it could set artificially high premiums and profits on other lucrative accounts.

The Texas Attorney General settlement eliminated the schemes, required the disclosure of all compensation paid to brokers and agents, and thereby assisted policyholders in making decisions on obtaining or renewing insurance with Zurich. The multi-state coalition supporting Texas included California, Florida, Hawaii, Maryland, Massachusetts, Oregon, Pennsylvania, Virginia and West Virginia.

In a companion settlement of a class action law suit in New Jersey, Zurich was required to distribute approximately \$122 million in refunds to commercial policyholders, including an estimated \$9.3 million to Texans. Texas, like Florida and a number of other states, has long since required the disclosure of broker's compensation in connection with a viatical settlement. **12**

C. Florida.

1. Florida Attorney General Settlements.

In 2007 and 2008, Florida's Attorney General Bill McCollum, Chief Financial Officer Alex Sink, and Insurance Commissioner Kevin McCarty, announced that Florida had reached settlement with AON Corp., a large insurance broker that received undisclosed compensation in connection with the placement of insurance coverage on behalf of Florida policyholders. As part of the agreement, AON paid \$2.6 million to Florida to reimburse affected policyholders. The Florida settlement was particularly highly publicized, as some of the insurance consumers impacted were Florida public entities, such as the Hillsborough County School District and five other Tampa-area public entities, who received a total of \$1.48 million in refund checks.

In July 2007, the Attorney General's Office, the Florida Department of Financial Services, and the Office of Insurance Regulation obtained a \$2 million settlement with Willis, resolving allegations that the company improperly collected undisclosed fees or commissions from various public entity clients. The company's clients included more than a dozen public entities in Florida, including Economic Development Councils, city and county governments and school boards. A similar \$2.6 million settlement was reached with AON in May 2008. AON reportedly had over 45 public entities as clients.¹³ Under the terms of the 2007 agreements, AON and Willis agreed to make full written disclosure of commissions and to pay the costs of the investigation.

Florida, Hawaii, Maryland, Massachusetts, Michigan, Oregon, Texas, West Virginia, Pennsylvania, and the District of Columbia also joined in a settlement in December 2007 against The Travelers Companies. Travelers signed a consent agreement with the nine states and the District of Columbia, agreeing to pay \$6 million to settle charges linked to its role in a nationwide bid-rigging scheme devised by insurance broker Marsh & McLennan. The purpose of the settlement was intended to ensure that brokers fairly represented their clients' interest by requiring greater transparency and disclosure of the types and ranges of compensation

paid to insurance brokers on Travelers' policies.

According to the complaint, Travelers allegedly participated in an intricate bid-rigging scheme in which Marsh & McLennan pre-designated which company's bid would "win" a particular account. To create the appearance of a competitive bidding process, Marsh instructed certain insurers to submit inflated, intentionally uncompetitive bids. The schemes gave commercial policyholders, which included large and small companies, nonprofit organizations, and public entities the impression that they were receiving the most competitive commercial premiums available, when they were actually being overcharged.

Additionally, Travelers was involved with a "pay-to-play" arrangement centered on its payment of contingent commissions, in addition to standard commissions and fees, to insurance brokers. These contingent commission arrangements were often undisclosed to consumers, and provided an incentive for brokers to steer business to the insurer who offered the most lucrative contingent commissions, often in violation of their clients' best interest.

V. Should Contingent Commissions Be Prohibited?

As states are inconsistent with respect to when disclosure of contingent commission and broker compensation arrangements is required, insurance brokerages such as Willis, who voluntarily stopped using contingent commissions early in the investigatory stages, have encouraged regulators to end contingent commissions for all brokerages, stating that advising clients about contingent commissions as part of a transaction does not necessarily go far enough to protect consumers. "As important as transparency is, it still isn't enough. We do not believe that it is enough to just reveal a practice that you know is not in your clients' best interests. That's not honoring the spirit of making your clients' interests paramount . . ."14

Senior management at Willis has suggested that creating "a fair system" without contingent commissions could take place in several ways. First, at public hearings held by New York during the summer of 2008, Willis CEO Don Baley testified that New York regulators could force any broker renewing a license in the state to end the practice of accepting contingent commissions. Another option proposed was to challenge the insurance industry to resolve the issue. While Baley did not want contingent commissions terminated immediately, he suggested that they should be phased out over a reasonable period of time to allow brokers to adjust their business models.

Other critics of contingent commissions contend it creates a conflict for ostensibly independent producers because the size and structure of the contingent commissions that insurers offer to intermediaries and producers can vary significantly and lead to abuses, such as improper "steering" of clients to insurers that allegedly fail to provide coverage as beneficial as that covered by competitors. The defenders of contingent commissions, on the other hand, assert that competition in the marketplace can adequately address any such conflicts. They also argue that the conflicts of interest created by contingent commissions are also inherent in the payment of supplemental and flat percentage commissions.

While an absolute prohibition on contingent commissions may well be too draconian, full and complete disclosure of all compensation arrangements is advisable to assure transparency given recent developments and the trend in regulatory authority. Producers with a national scope are particularly advised to consider disclosure of all compensation (not just contingent compensation), as some states may well impose a broad requirement. *See e.g.*, the New York draft regulation. To ensure compliance in these more broadly regulated markets, a full and complete disclosure is prudent.

VI. Recommendations For Compliance Procedures.

- 1. Include disclosure of contingent or bonus commissions on any website, and generally address compensation bases. If a state has a required written disclosure (such as the New York draft regulation), tailor the website disclosure accordingly.
- 2. Adopt a form Disclosure Statement that caters to the most restrictive state requirement.
- 3. Provide written disclosures to each insured or prospective insured. Such disclosure should include commissions, whether contingent or otherwise, fees and the source of payment, as well as that the contingent commission provides an incentive to the producers to produce more business on behalf of an insurer or group of insurers to the benefit of the producer and the insurers. Disclose the amount of fees and all commissions and clarify whether the producer will receive both fees from the insured and commissions from the insurer upon the purchase of insurance. If a precise fee is not known, include the calculation methodology in the disclosure.
- 4. The Disclosure Statement should advise the insured of his right to request and receive copies of all quotes or alternative policies, contracts and bonds the producer considered and relative amounts of the compensation the insurance producer would have received with those arrangements.
- 5. Have all written disclosures and all fee agreements signed and dated by the insured **before** the application for insurance is signed, at the onset of the business relationship.
- 6. The Disclosure Statement and all sales material should state that the individual or entity is an insurance producer, is paid commissions by the insurer, and should reference the producer's state insurance license number.
- 7. If an insured requests a more detailed disclosure of the precise fee structure on a particular contemplated transaction, make every effort to provide it.
- 8. Provide copies of all quotes or alternative policy, contract or bond forms to the insured, unless he states he does not want them.
- 9. Train all licensed personnel who interface with insureds and prospective insureds with regard to the producer's internal disclosure guidelines and each state's statutory and regulatory requirements.
- 10. If an insured requests that contingent commissions not be taken, unless they cannot be calculated on a given transaction, agree, or at the very least agree to request that the carrier not include the specific transaction in the contingent commission calculation.
- 11. Update internal guidelines and written disclosures periodically to keep up with changes in the law.

Endnotes

1. California law prohibits an admitted life insurer from paying contingent commissions on life or disability business. *See Cal. Ins. Code* § 10434.
2. States involved included: Florida, Hawaii, Maryland, Michigan, Oregon, Texas, West Virginia, and the Commonwealths of Massachusetts and Pennsylvania.
3. The NAIC model was publicly criticized as being insufficient. Then Connecticut Attorney General Richard Blumenthal called the NAIC Model "a shadow of what it should be," according to an article by Dan Haar, "Model Broker Rules Drafted," *Hartford Courant*, Business Section, page 1 (Nov. 17, 2004). Blumenthal, Eliot Spitzer and others testified on November 16, 2004 before a U.S. Senate panel, and also said that "this model simply fails to address the key defects in the current system," according to the *Courant*. *Id.*
4. New Jersey does have express disclosures regarding health insurance commissions.

FEDERATION OF REGULATORY COUNSEL, INC.

5. Marsh, Inc. entered into a similar agreement in January 2005. Yet on August 17, 2006, Marsh reportedly entered into an agreement with then New York Attorney General Spitzer and then New York Superintendent of Insurance Howard Mills to modify the 2005 agreement that banned all contingent commissions or profit sharing deals involving payments based on the volume of business Marsh placed with various insurers. The August 2006 agreement reportedly clarified that Marsh could be compensated as a Managing General Agent ("MGA") or underwriting manager, defining such activities as those where Marsh has been appointed by an insurer to be the insurer's representative in connection with the management of its book of business. See National Association of Professional Insurance Agents, *Insurance News* (Aug. 30, 2006).
6. The public hearings were held by the New York Attorney General and Superintendent of Insurance on July 14, 2008 in Buffalo, July 23, 2008 in Albany, and on July 25, 2008 in New York City. Representatives from Willis, United Insurance Agency, Inc., Plan Futures Financial Group, Henry Kay, as past President of the Professional Insurance Agents of New York, the Independent Insurance Agents and Brokers of New York, New York Insurance Association, New York Health Plan Association, Mercer Health and Benefits, LLP, Rutherford, Inc. and Russell Bonds, Inc., Marsh, Inc., Marsh & McClennan Companies, AON, American Risk and Insurance Management Society, Inc., Independent Insurance Agents and Brokers of America, the Insurance Information Institute, the Center for Economic Justice, the American Insurance Association, ACE, Fireman's Fund Insurance Company, Life Insurance Council of New York, the Excess Lines Association of New York, Allstate Insurance Company, CVS Coverage Group, Inc. and the Council of Insurance Brokers of Greater New York, all testified at one or more of these three public hearings.
7. The draft regulations recently prepared by the New York Superintendent of Insurance will, if adopted in their draft form, bring New York closer to the NAIC Model, but appear to be more comprehensive.
8. Compensation is defined quite broadly, consistent with the terms of the Model Act, to include anything of value, including money, credits, loans, interest on premium, forgiveness of principal or interest, vacations, prizes, gifts or the payment of employee salaries, benefits or expenses whether paid as commission or otherwise. See proposed §30.2(a). "Purchaser" is also broadly defined to include the person or entity to be charged under an insurance contract or a group policy and may include the named insured, policyholder, owner of a life insurance policy or annuity contract, principal under a bond, or other person to be charged, including any applicant for an insurance bond or annuity, but expressly does not include a certificateholder or member under a group or blanket insurance contract unless the certificateholder or member has direct contact with the insurance producer, or the certificateholder or member pays the entire premium. See §30.2(b).
9. See N.J.S.A. 17:22A-41.1 (P.L. 2008, c.38 (eff. January 4, 2009) and NJDOBI Bulletin No. 08-16 (October 1, 2008).
10. See N.J.S.A. 17:22A-26, et seq.
11. N.J.A.C. 11:17B-3.1 (now applicable to all permissible services fees) requires a written fee agreement containing a clear statement of the amount of the fee charged; the nature of the service provided; a statement that the fees are not part of the premium charged by the insurer; that such fees can only be charged if the insured or prospective insured consents in writing; a clear statement as to whether a commission will be received from the purchase of insurance; and the signature of the insured or prospective insured and the licensed insurance producer, as well as the date of execution of the agreement. Any fee charged by a producer shall bear a reasonable relationship to the services provided and shall not be discriminatory. A new written agreement shall be entered into for each fee charged and each time a fee is charged. An initial agreement shall not be used as the sole basis to charge a fee on a renewal policy. No insurance producer may pay or return, or offer to pay or return, all or a part of a fee charged as an inducement to purchase a specific policy, or coverage within a policy, or coverage from a particular insurer. No insurance producer may charge a service fee for services not actually performed, and finally, no insurance producer, except a duly authorized producer

FEDERATION OF REGULATORY COUNSEL, INC.

employed by and acting on behalf of his or her employer, may execute a written fee agreement on behalf of any other insurance producer or premium finance company.

12. See, e.g., 28 Tex. Admin. Code § 3.1711 and Fla. Admin. Code § 626.99181.

13. WMBB News-TV, February 9, 2009.

14. Insurance and Financial Advisor (powered by IFA Webnews.com, July 14, 2008), quoting Donald Baley, CEO of Willis North America.