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Contingent Commissions in Insurance: A Legal and Economic Analysis

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This paper gives a brief analysis of the role of contingent commissions in insurance markets. These contracts have received a great deal of attention in recent years because they were the focal point of major criminal enforcement actions that New York's then-Attorney General, now Governor, Eliot Spitzer, brought against prominent insurance brokers, including the largest three brokers: Marsh & McLennan, Aon, and Willis. Those prosecutions resulted in fines and other sanctions being lodged against these brokerage houses, as well as continuing criminal prosecution against employees who were engaged in some bid-rigging schemes. On balance, a strong case can be made out for requiring disclosure of contingent commissions and for banning any form of bid-rigging. The adverse consequences of nondisclosures are more difficult to track than those for collusion, given the difficulty of showing in individual cases a connection between the nondisclosure and any pecuniary loss sustained by the insured. The case for banning all contingent commissions in the absence of concealment or bid-rigging, still remains "not proven." It is not easy to come up with a powerful efficiency explanation for the use of contingent commission agreements, but if these agreements continue to be adopted with full disclosure in the absence of collusion, then it seems premature to ban them just because our incomplete knowledge of how brokerage markets work does not supply a compelling efficiency justification for their use.

The author is the James Parker Hall Distinguished Service Professor of Law, University of Chicago, and the Peter and Kirsten Bedford Senior Fellow, The Hoover Institution. In developing his own views, the author had the benefit of an informative and comprehensive paper, *The Economics of Insurance Intermediaries*, by Professors J. David Cummins and Neil A. Down. He is also most appreciative of the excellent research assistance he received from Chad Clamage, Stanford Law School, Class of 2008 and of funding support from the Barbon Institute.

I. Introduction

The purpose of this short paper is to give a brief analysis of the role of contingent commissions in insurance markets. These contracts have received much attention in recent years because they were the focal point of major criminal enforcement actions that New York's former Attorney General, Eliot Spitzer, brought against prominent insurance brokers, including the largest three: Marsh & McLennan, Aon, and Willis. Those prosecutions resulted in fines and other sanctions being lodged against these brokerage houses, as well as continuing criminal prosecutions of employees who were allegedly engaged in some bid-rigging schemes.

The gist of these settlements is captured in the terms that Marsh & McLennan entered into with Spitzer's office: in addition to paying US$850 million over four years into a client compensation fund, Marsh agreed that:

> "the company will adopt dramatic new reforms, including an agreement to limit its insurance brokerage compensation to a single fee or commission at the time of placement, a ban on contingent commissions, and a requirement that all forms of compensation will be disclosed to and approved by Marsh's clients."[1]

The merits of these settlement provisions require a great deal of attention, but before addressing those issues, it is best to begin with an account of what these contracts are, and the role they play in the overall insurance industry.

This paper is organized as follows. The first section relies on the general theory of insurance to give a definition of contingent insurance contracts and to offer a tentative efficiency explanation for their selective use in some insurance market segments. The second section then analyzes the two main objections that have been made against the use of these contracts based on the laws of fiduciary duties regarding disclosure on the one hand, and the antitrust laws on the other. The third section then evaluates whether it is wise to ban or regulate these contracts in the absence of either nondisclosure or collusion, and concludes that, as of yet, the case for any further regulatory initiative is as yet unproved. In this regard the blanket ban found in the New York settlement appears to go beyond the exigencies of the situation.

1 Press Release, New York State Attorney General & New Your State Insurance Department, Insurance Broker Agrees to Sweeping Reforms (Jan. 31, 2005), *available at* http://www.oag.state.ny.us/press/2005/jan/marshsettlement_pr.pdf.

II. Contingent Commissions

The essential function of a contract of insurance is to shift the risk of certain specified losses in whole or in part, from the insured to the insurer. The insurance company receives a premium from an insured that obliges it to compensate the insured for losses that arise on the occurrence of certain designated events. As with all useful contracts, the reassignment of risk cannot be a sterile transaction, from which neither side receives any gain. The transaction costs of finding a suitable insurer and negotiating terms and premiums are positive, so that entering into an insurance contract only makes sense if each side expects to receive some net benefit from the contract. As with all transactions, from the ex ante perspective, each side must think itself better off from the transaction to enter into it.

More formally, two conditions must be satisfied. On the one side of the market, the gain to the insured must exceed in expectation the sum of the premium paid and the transaction costs incurred in setting up the transaction. On the other side of the market, the premium received from the insured (plus any subsequent investment income from said premium) must exceed the present value of the insurer's future payoffs plus the transaction costs it incurs to put the deal together. Taken together, these two conditions suggest that the transaction will go forward only if the sum of the gains to both sides exceed their combined transactions costs. The question is what factors must be taken into account to explain why this outcome will result.

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The first point to note is the source of the gain from the shifting of risk between the two parties. On the insured's side, this gain usually comes from smoothing the flow of income and expenses over time in different states of the world. For individuals, where it is hard to diversify risk, the need for insurance is often quite great. In the corporate setting, the shareholders may well have diversified portfolios, so that insurance becomes a less pressing issue. But even here, firm managers are often not fully diversified, and they may pressure the firm to take out insurance, knowing that an adverse event which produces sharp fluctuations in income could hurt their individual prospects by exposing the firm to a risk of bankruptcy or the loss of working capital. Many businesses therefore take out insurance in order to stabilize their future revenues and, through that, their profit position and the position of their key managers. That practice can be found in businesses both large and small, in both partnerships and corporations.

In addition, in some markets the insurer does more than smooth the insured's loss function. It also takes steps that help the insured organize its business to reduce and manage the risk of loss, and the insurer backs its promise of assistance

by assuming responsibility for these losses in the event that these (reduced-risk) events come to pass. That outcome is quite common with liability insurance, where the twin obligations to provide indemnification and defense are best understood as a way to make credible the commitment to engage in extensive accident prevention activities. The inspection firm that fails in its fundamental obligation now has to face the consequences. But if it has done its job well, then payouts on these losses could easily be a tiny fraction of the total premium dollar.

The insurance company achieves its own protection against loss in several ways. First, it diversifies some kinds of risk by taking on many insureds, always taking care to see that their risks are independent, so that payment on one policy will not correlate with payment on many or all such policies. This is one reason why insurance policies, especially in the property and casualty area, often sensibly exclude coverage of certain catastrophic losses—e.g., flood damages—that tend to occur in large bunches. Second, the company can pass on some portion of the risk through reinsurance contracts with a range of other carriers, so as to further diversify its risks across geographical regions and loss type. Finally, as noted above, the insurer can provide incentives (such as renewals at favorable rates) to insureds to take greater care and to avoid risky behaviors in order to reduce the probability of a claim.

In order to achieve these gains, it is necessary to find some way to pair insurers with insureds at reasonable cost. There is no single business strategy for discharging this critical search function. Many insurers hire in-house agents to sell their products. These agents often work extensively in the personal lines (home, auto, disability) in which the coverages offered are relatively standardized, and the competition in question usually comes down to the premium, the policy deductible, and the limits in light of the history of the insured (e.g., driving record). In other markets, however, the need for more specific or tailored forms of coverage is greater. Enter the independent brokers, who act as matchmakers between the insurers and the insureds. Brokers are typically hired by the insured as their agents, often taking on the task of finding suitable coverage from a full range of insurers with whom they have ongoing business relations.

The logic of the brokerage contract mirrors that of the basic insurance arrangement. The deal will go through only if both parties gain. On the one side, the insured must be satisfied that the broker's services in finding coverage and securing favorable terms cost less than the incremental gains the broker delivers from getting superior coverage, or a lower price, or some combination of the two. The relevant comparison does not ask whether the insured is better off with insurance than without it. Rather, it is whether the incremental costs of hiring a broker produce an insurance policy that is better than the insured could have acquired on its own, taking into account his own costs of search and negotiation. On the other side, the broker's expenses in finding a client suitable coverage must be lower than the expenses it incurs in rendering the services.

There is no one contractual formula for insurance brokerage, just as there is no one way to compensate employees for their labor. The most prevalent contract formula, however, calls for the brokerage commissions to be paid in one lump sum, set as a fixed percentage of the policy premium. The fee is generally high for the initial booking of the contract, usually in the neighborhood of 10 percent, but lower for repeat business, reflecting the benefits of stability in the business relationship. The broker who needs to perform fewer services receives a lower commission for his efforts. In many niche commercial markets, however, the information needed to provide for stable insurance markets is not available, so it is not all that surprising that in general about 4 to 5 percent of brokers' revenues come from contingent commissions.[2] As the name implies, these commissions are contingent on factors such as the profitability of the account to the insurer, or the duration or volume of the business that the broker has placed with the insured. They are typically paid by the insurer, rather than by the insured, as a reward for landing good accounts.

Choosing optimal insurance brokerage contract terms often turns on the complexity of the underlying business transaction. In many cases, particularly in personal insurance lines, the markets are relatively thick and sufficiently abundant, and reliable data on risk is available both for large populations and for the individual insurance applicant. Oftentimes individuals with little knowledge of the overall market turn to brokers who find it relatively easy to bring the two sides together. The effectiveness of this matching system is evidenced by the strong market position held by independent brokers. A.M. Best estimates that independent agents and brokers handled 67 percent of commercial lines property-casualty business and 33 percent of personal lines business in 2003. Estimates of the independent agent trade association put those numbers at 79.8 and 36.6 percent, respectively.[3]

These relatively routine transactions are frequently handled by standardized contracts, which are one way to provide assurance to inexperienced clients that they are not receiving less favorable treatment than other clients. But these transactions hardly tell the whole story. Most large commercial clients have unique risks that are hard to evaluate.[4] The terms of commercial contracts often vary by explicit agreement, as well as by the use of so-called manuscript policies, whereby standard print policies are altered, sometimes by hand, to take into account the specific circumstances of individual cases. The choice of policy limits and deductibles, the purchase of excess layers of coverage from other insurers,

2 J. David Cummins & Neil A. Doherty, *The Economics of Insurance Intermediaries* (May 20, 2005) (working paper), *available at* http://www.huebnergeneva.org/documents/cumminsdohertybrokers%205-20-05d.pdf.

3 *Id.* at 8, n. 4.

4 *Id.* at 7.

and the need to retain risks at certain levels all make it highly unlikely that a single standard form of insurance will work for all first and third party lines.[5] For different kinds of risks, different forms of coverage have to be devised.

One common feature of many of these complex deals is that it may be difficult to estimate the profit or loss that the insurer will receive from the transaction over the life of the policy. The usual public forms of information may be insufficient to allow the insurer to make an accurate estimation of the potential risk. This problem is pervasive in many complex commercial insurance transactions, regardless of whether contingent commissions are used, because the distinctive information about the nature and extent of any given risk is often chiefly, if not exclusively, in the hands of the insured, not the insurer. Accordingly, the law has imposed on the insured a duty to disclose all material circumstances that relate to the anticipated frequency and severity of losses.

The great risk in these cases is that of adverse selection, and it falls on the insurer, not the insured. Consider two parties that appear to present the same risk. The party with private information that his expected losses will be greater than the norm is more likely to purchase the insurance because he gets the standard rate even though he presents the higher risk. Yet any party with private information that his expected losses will be less than the norm is more likely to find that the insurance is not worth the cost. The low-risk customers exit the market, while the high risk customers stay.

THE GREAT RISK IN THESE CASES IS THAT OF ADVERSE SELECTION, AND IT FALLS ON THE INSURER, NOT THE INSURED.

The problem of adverse selection is endemic to all insurance markets. In certain difficult markets, insurers have to go to great lengths and considerable cost in order to counter the risk of adverse selection. One way to do this is to ask the broker, who has a closer relationship with its client, to vouch for the suitability of the insured as a risk. One way for the broker to demonstrate its belief that the insured is an appropriate risk is to bind itself to the transaction in such a way that the profit that it receives from the transaction will be reduced if the insured turns out to be of higher-than-expected risk.

The simplest way to achieve this result is to adopt the profit-based contingent commission, whereby some fraction of the profit that the broker hopes to receive from the transaction is held back and is conditional on the insurer making a profit out of the transaction. That scheme may have some use, but it is far from perfect as a sorting device because there are still likely to be many cases in which the original risk is, in fact, low, but the loss experience is nevertheless high. Yet the adverse financial outcomes do not mean that the broker has understated the

5 The former cover losses such as property damage or business interruption insurance. The latter cover various risks of liability to third persons.

relevant risks. The poor outcome (for the broker) could stem from a random roll of the dice.

The profit-based contingent type of payment is not unique to the insurance industry, and it can occur in any cases where two conditions are satisfied:

(1) there is a high variance in the potential payoffs to one party to the contract, and

(2) it is difficult for the party at risk to observe the underlying effort or risk associated with its trading partner.

Contingent payment systems in common use in other areas also reflect these dual concerns by pegging commissions not to completed transactions, as with ordinary brokerage fees, but to the profits generated by the deal. The most familiar version of this is the lawyer's contingency fee, which ties the service payment to the level of the recovery in the underlying case. Although this may look, in form, like the fee that a broker collects on selling a home, the underlying risk is surely much greater, given the possibility that the defendant prevails in a case so that the lawyer receives nothing at all. This is one reason why contingency fee lawyers work to obtain settlements which reduce the variance for both their clients and themselves. Viewed in this light, a contingent commission that is closely tied to the profitability of the transaction is likely to make sense in cases where the potential insureds have little or no previous track record.

It is possible to adopt similar fee arrangements in other markets, but their inherent complexity may well lead to a competitive disadvantage. Such appears to be the case with mortgage brokers who work, in the first instance, for consumers. These brokers are also compensated by a premium rate when they supply lenders loans that yield an interest rate in excess of par. This is called yield-spread premium. In order for brokers to collect that yield-spread premium, they should, in principle, have to reduce proportionally their upfront charges to clients. But the complexity of the market may prevent smooth adjustments, so that this payment scheme could harm consumers by giving mortgage brokers an added incentive to offer above-par loans to increase their compensation, without reducing their upfront charges.

This market failure may well have happened with mortgage brokers. In 2004, the U.S. Federal Trade Commission published its study on the effect of the disclosure of brokers' compensation agreements on consumer's choice. The study found that

> "[i]f consumers notice and read the compensation disclosure, the resulting consumer confusion and mistaken loan choices will lead a significant pro-

> portion of borrowers to pay more for their loans than they would otherwise. The bias against mortgage brokers will put brokers at a competitive disadvantage relative to direct lenders and possibly lead to less competition and higher costs for all mortgage customers."[6]

That study was directed toward consumer markets where these risks are likely to be greater, even in cases of disclosure, which supports the conclusion that customers will shy away from products that they do not fully understand. But the persistence of the contingent commission in the commercial insurance context suggests that repeat players are more likely to surmount these information obstacles. So while it is sensible to predict the demise of these contracts in one market, it hardly follows that they will necessarily fall into disuse in other markets.

In those cases where some contingent commission survives, however, it should not be supposed that its use eliminates all conflict of interest between the parties. In both the brokerage and the lawyer situation, one risk that remains is that the agent will quit work too soon because the agent has to bear all the cost of additional work to land the contract or to recover a verdict, even if the agent only receives a fraction of the additional gain. Nonetheless, these conflicts are endured as a cost of doing business for at least two reasons. First, the parties who get paid under these arrangements tend, as repeat players, to develop strong reputations in their markets, and hence can be counted on to put out some extra effort today in order to improve their odds of getting additional business from the insurers tomorrow. Second, the alternative compensation systems could be worse because, in removing one set of conflicts, they create a second set that is more acute: the use of hourly fees could easily result in brokers and lawyers running up bills while doing little or no labor of any value. Additional factors may be operative in various individual cases.

In the end, therefore, contingent commissions in insurance, like other forms of contingent payments, may prove to be the best solution in certain critical segments of the market. The persistence of their use among commercial parties over long periods of time should be treated as some evidence of their economic value, especially when they take place between sophisticated parties who have the ready option to return to fixed commissions payable in full when the transaction is completed.

The arguments above help explain the use of commissions that are contingent on the level of profit the insurer achieves from the account. But there are still some unresolved issues. In some substantial fraction of cases, the contingent fees

6 James M. Lacko & Janis K. Pappalardo, *The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment*, FED. TRADE COMM'N BUREAU OF ECON. STAFF REPORT (Feb. 2004), at ES-1, *available at* http://www.ftc.gov/os/2004/01/030123mortgagefullrpt.pdf.

are tied not to profit, but to volume or to renewals from a particular client. The use of volume measures is somewhat puzzling because it is not clear just what contingency is represented in volume transactions; that is, it is not clear why any subsequently acquired information is needed to determine the payout to the broker. A simple response might be to use, instead, a standard form of volume discount that just lowers the fixed commission at the front end, which may well be done in some cases.[7] To be sure, any institutional practice would have to account for both the advantages and disadvantages of placing large-volume accounts with a single insurer. On the plus side of the ledger, there are lower transactions costs to service the account, which could justify the higher payment based on the total amount of business generated by an individual client. But on the other side, writing extensive coverage for a single firm could expose the insurer to certain forms of correlated risk that are difficult in the abstract to calculate. If volume is achieved through multiple clients as opposed to a few large ones, then the insurer achieves greater diversification of his portfolio. Moreover, if insurers offer volume-based commissions, they must believe that it is profitable to insure large companies, all costs and benefits considered. If so, then contingent commissions based on volume might operate as a surrogate for contingent commissions on profits. And if they do not, then we should not expect their use to survive over time.

By the same token, the use of contingent commissions based on future renewals seems less difficult to understand. The renewal decision of the insurer represents its judgment that the account continues to be worth holding. The payment of a commission at this time is simply a statement that the initial account was more profitable than the insurer could have obtained by using only its own underwriting skills, and thus resembles a contingent commission based on profits. It is also worth noting that the size of that commission could be effectively limited because the insured, which knows its own payout history, could also insist on a reduction in the premiums that it pays.

There are some real business questions as to why and how these commissions are used. But whatever the uncertainties as to their effectiveness, it seems inappropriate to conclude that these commissions are simply and solely illicit covert devices to pay off brokers for steering business in a certain direction.

In sum, there are some real business questions as to why and how these commissions are used. But whatever the uncertainties as to their effectiveness, it seems inappropriate to conclude, as did Eliot Spitzer, that these commissions are simply and solely illicit covert devices to pay off brokers for steering business in a certain direction, which is thought to justify their ban even in the absence of collusion or nondisclosure. Any secret payment

7 For more discussion of the economic rationale of volume-based commissions, see Cummins & Doherty, *supra* note 2, at 17.

could have that effect, even if no contingencies are involved. More concretely, the fraud risk with contingent commissions looks to be no greater than that associated with ordinary brokerage commissions. There is trouble any time brokers receive secret payments for steering clients to higher-priced insurers for comparable coverage.

III. Twin Pitfalls of Contingent Commissions: Nondisclosure and Bid-Rigging

In light of the above arguments, it is not surprising that the recent litigation over contingent commissions generally does not rest on the assumption that these contracts were improper in any and all cases. Instead, the perceived risks are nondisclosure and bid-rigging. Each requires a few more words.

A. NONDISCLOSURE

The duty of disclosure is a pervasive norm in many commercial contexts as a source of protection to the uninformed party against conflicts of interest. Even if it is accepted that strangers deal with each other at arm's length, it is widely agreed that agents owe a fiduciary duty to their clients. As a matter of basic legal principle, contingent commissions should be subject to the standard duty to disclose. Normally, the agent is paid only by his principal. Yet now, in the absence of such disclosure, the broker would also receive a secret payment from the insurer with whom he is doing business. The obvious fear is that the agent's loyalty will follow the secret commission, thereby saddling the principal with an inferior insurance contract from which the agent makes a larger profit.

The case for requiring disclosure with contingent commissions is, to give one useful comparison, even stronger than it is in securities cases. Securities regimes require disclosure to the general market, and the information involved could concern all the risks and potentials of the proposed venture, which could easily prove valuable to the competitors of the firm. Moreover, deciding which disclosures are material and which are not is a delicate task which often results in massive litigation over what are often only trivial omissions in the disclosure process. But in the case of contingent insurance commissions, any disclosure is private and is made only to a single party. There is little to no risk of communicating vital information to the competitors of the firm.

Furthermore, it is possible to put sensible limits on what should be disclosed. In this regard, it would be unwise to insist that the entire contingent commission arrangement should be disclosed by the broker to the insured. A simple disclosure that the broker has received some contingent commission from the insurer should trigger the interest of any commercial insured, who can then ask for further information if that is desired for its own protection. According to Cummins and Doherty in their 2005 paper, the typical basic commission today covers part

of the fee to the broker, who still receives about 2 percent contingent commission directly from the seller.[8] That rate is an obvious subject of negotiation. At the same time, it must be remembered that disclosure of the contingent commission does not preclude the agent from insisting on the original deal.

It is also worth remembering that no disclosure obligation prevents a broker from seeking at any time to modify or terminate an agreement that no longer works to its advantage. To be sure, in the initial position, the duty of loyalty obligates the agent to take steps to improve the position of the client, even if these obligations work to his own disadvantage. His sole benefit comes from the compensation that the agreement supplies against these contingencies. If carrying out these duties generates losses to the agent that exceed any contract gains to the principal, it may make sense for both sides to terminate the relationship going forward because it reduces the net worth of the pair. Because no readjustment in fees can generate a net profit, the parties are better off without any arrangement at all. The precise distribution of the loss will turn on the specific contractual provisions and the relative bargaining skills of the parties. Where conflicts arise that are less acute, to the extent that the relationship is worth preserving, the two parties could agree to modify the agreement so as to keep it alive. The principal could ask the agent to alter his compensation schedule, to look for new trading or additional partners, or to explore a different set of contractual terms. Given the disclosure, the performance, termination, or renegotiation of any contingent commission contract follows ordinary contractual principles. Whether the terms of the policy changes after disclosure, however, is a business and not a legal concern.

The creation of any general disclosure obligation also must be put in context. That obligation is not the only source of protection available to potential insureds. In light of the general industry knowledge surrounding their use, any firm concerned with these lurking commissions is entitled, and surely prudent, to announce requests for proposals (RFPs) for competitive bids that raise the question front and center. These proposals routinely "request the complete disclosure of all compensation to be earned on the account. That compensation package will be expressed in terms of direct commission and/or fee, reinsurance, wholesale commission, contingent commission, etc."[9] Once a client asks point blank whether the broker has received contingent commissions from insurers, any refusal to answer that direct question honestly is a garden-variety version of fraud. An ambiguity from the common law disclosure obligation is effectively removed.

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8 *Id.* at 20.

9 William J. Kelly, *Whom Do You Trust? The Selection, Evaluation and Compensation of Insurance Brokers*, RISK MGMT. MAG. (Apr. 2006), *available at* http://www.rmmagazine.com/Magazine/PrintTemplate.cfm?AID=3077. Kelly is a risk manager and Chairman of the International Federation of Risk and Insurance Management Associations, and he attests to such practices.

Empirically, there is some evidence that buyers have started submitting RFPs in recent years.[10] But it is difficult to know for sure how much benefit these disclosure requests generate for insureds. One study conducted by Advisen, Ltd., in May of 2004 concludes that "less than 20 percent of the buyers at the 330 surveyed companies felt the level of disclosure they received from their insurance brokers about contingent commissions was entirely adequate."[11] But the response rate to this survey was not mentioned, nor do we know the fraction of premium volume covered by the fully satisfied clients. Nor, for that matter, do we know the baseline disclosure rates for other sorts of brokerage payment systems. A second study in November of 2004 also found, with a low response rate of 16 percent, that "57 percent of the 684 respondents believe their brokerage firms do not fully disclose all sources of income related to insurance transactions."[12] The same survey also found that "nearly two-thirds of the respondents said they were not yet considering changing brokerage firms," which could be evidence that the perceived shortfalls in disclosure are less harmful than might be supposed. The acid test on this matter is how, with risk exposure held constant, insurance premiums in transactions with disclosure stack up in dollar and cent terms against identical transactions in which either no disclosures or inadequate disclosures have been made. Is there in fact a price differential that hurts the insured? How often, and in what cases? On this point there is, to my knowledge, little or no systematic research.

The unsettled market situation clearly is capable of improvement especially in light of the recent litigation. One possibility is for major players in the brokerage industry to issue general statements of policy as to whether they do or do not accept contingent commissions from insurers. Given that the economic case for using contingent commissions is uncertain, many firms might choose to clear the air by announcing that they will not resort to them at all. Just that result was undertaken, for example, by Willis in the aftermath of the New York investigation. The *Willis Client Bill of Rights* states categorically that "Willis will not accept contingency compensation from insurers."[13]

But what about those cases in which this explicit disclaimer has not been made. Suppose, for example, that for some reason an insured remains ignorant

10 *Id.*

11 *See* Press Release, Advisen, Majority of Commercial Insurance Buyers Say Contingent Commission Practice Is Conflict of Interest (May 24, 2004), *available at* https://www.advisen.com/HTTPBroker?action=jsp_request&id=articleDetailsNotLogged&resource_id=28386431.

12 Press Release, Advisen, Advisen Survey Finds Corporate Insurance Buyers Seek Transparency on Broker Compensation, Transaction Terms and Prices (Nov. 16, 2004), *available at* https://www.advisen.com/HTTPBroker?action=jsp_request&id=articleDetailsNotLogged&resource_id=36216473.

13 Willis Client Bill of Rights, *at* http://www.willis.com/The%20Way%20We%20Do%20Business/extras/ClientBillofRights_letter.pdf.

about the use of contingent commission in its contracts. Nonetheless, the extent of its ensuing harm is hard to determine, given the fact that other institutional safeguards also help to protect the uninformed insured. The most obvious such safeguard is competition itself. That competition expresses itself in many ways. Although systematic evidence is scant, some large insureds may choose to work through more than one broker—some national and some regional—for different portions of their insurance portfolio.[14] This strategy of segmentation means that a firm does not turn all of its business over to one large brokerage house, but can instead parcel its accounts by size and complexity to multiple brokers.[15] The constant input from many brokers provides observable bases for price comparisons, as each current broker seeks to expand its fraction of the overall business from an established client. Nor is potential competition limited to the stable of established brokers. Other brokers, anxious to gain new business, are also able to review the prices the insured pays, and would be able to let a prospective client know, if such is the case, how poorly it is being treated.

The ability to shift accounts between insurers could thus take place even if the insured has no knowledge of an undisclosed secret commission. In equilibrium, these competitive forces are not likely to lead to perfect pricing, for the costs of search are positive, even for experienced businesses. But except in the highly unlikely circumstance that every competitive firm (remember collusion has been put to one side for the moment) engages in the same practice of nondisclosure, the actions of these competitors still remain an important protection against abuse.

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14 Quoting Kelly:

> I have, on rare occasions, moved discreet pieces of business to niche brokers that have developed a particular specialty. For example, a previous employer had a relocation subsidiary, a firm that facilitates executive moves for third party corporations. As part of the business, we had a portfolio of approximately 9,000 residential homes throughout the country. A representative of a very small Connecticut brokerage offered to bid on the portfolio. As the property and liability coverages were placed by a top brokerage firm, I did not expect the niche company to be successful. However, he returned with a three year, non cancelable program, from a top rated insurer with absolutely compelling cost savings.

See William J. Kelly, Everything I Ever Wanted to Say to an Insurance Broker, Address to Willis Exceptional Producers' Meeting (Apr. 14, 2000), *available at* http://www.ifrima.org/DOWNLOAD/WILLISINSURERBROKERAGE.PDF.

15 Quoting Kelly, *supra* note 9:

> . . . Larger corporations that have significant insurance needs in each of the major coverage areas of property, casualty, and management liability may, and often do, elect to utilize the services of multiple brokers. As these insurance programs are usually discreet from each other and led by different specialist insurance companies, they can be separately managed through different insurance brokerage firms.

This approach allows the insured to remain both a client and a prospect, with each broker continuing to vie for that portion of the risk they do not have and with no one provider becoming overly comfortable in the relationship.

It is also important to ask about the importance of the disclosure option in the ordinary course of business. It is surely of great moment when the insured, as principal, pays commissions to the broker at the normal rate, for then he has no reason to suspect that this broker has received a commission from the party on the other side of the transaction. But if the insured sees an unusually low stated commission, then, based on past experience, he might be able to infer that the broker has received some compensation from the insurer, for otherwise the transaction does not offer enough gain for the broker to accept it.

The size of the direct commission could prove relevant in the event of litigation for damages once an insured learns of a previous nondisclosure. A disappointed insured could sue, for example, the broker, to turn over the contingent commission, or perhaps to obtain a reduction in rates to the level that they might have been if the full disclosure had been made, so that the client could have tested the market with other brokers. As in all such cases, the disclosure serves as the basis of a successful claim only if the insured can prove that the nondisclosure caused some economic loss. The broker could, therefore, be free to argue that an unusually low commission provided sufficient information of the contingent commission to constitute effective notice to the principal, thereby implying tacit acquiescence. In some cases, it seems at least an arguable question of fact whether sophisticated purchasers would believe that a highly complex and delicate brokerage transaction would generate only a below-normal payoff to the successful broker. These uncertainties about causation, however, are something that both sides would do best to avoid. The strong case for routine disclosure of contingent commissions makes sense precisely in that it eliminates the need to resolve the messy problems of proof that inevitably arise in the event of nondisclosure.

THE STRONG CASE FOR ROUTINE DISCLOSURE OF CONTINGENT COMMISSIONS MAKES SENSE PRECISELY IN THAT IT ELIMINATES THE NEED TO RESOLVE THE MESSY PROBLEMS OF PROOF THAT INEVITABLY ARISE IN THE EVENT OF NONDISCLOSURE.

B. ANTITRUST RISK

The second risk associated with the use of contingent commissions involves collusion or bid-rigging, of which there was incontrovertible evidence in the New York cases against the leading brokerage houses. Here the illegality of the practice is unquestioned under the antitrust law, which imposes strong sanctions against these forms of collusion. But in this setting, the objection to outright collusion also rests on principles of ordinary contract law. No insured would ever consent to a transaction whereby a broker presents it with phony high bids from nominal competitors just to create the illusion of competitive bidding. At the very least the industry collusion is aggravated by fraud. To be sure, even if the market for using contingent commissions is complex, the antitrust issues are not: these cases are simple instances of price fixing and market division. They do not

offer any difficult attack on the standard vertical arrangement between a broker and an insurer. As a first approximation, the horizontal restraint of trade looks every bit as illegal in these two-sided insurance markets as they do anywhere else.

But once the illegality is established, other questions still remain. What kind of remedy, either civil or criminal should be imposed in these cases? In this situation, it is useful to distinguish between imposing sanctions against the individuals who knowingly engaged in the wrongful transactions, and imposing sanctions against the brokerage house or insurer at which they worked. The former question is straightforward because the actual participants to the scheme do not appear to have any substantive defense against either civil or criminal sanctions, although it is always wise to examine the full record to be sure.

The liability of the brokerage houses is more complicated. On the civil side, the actions in question were surely within the scope of employment, so damage awards or other civil sanctions are surely appropriate. But the criminal side is much more difficult. If the bid-rigging were authorized by persons higher up in the firm, the criminal sanctions would properly reach up through the firm hierarchy. But, even if that were the case, the question of criminal responsibility of the firm, as an entity, for the actions of its employees is a separate matter. It is highly debatable whether any firm—which necessarily means the innocent shareholders in public corporations—should be asked to pay the price for wrongs in which they did not participate.

Even under current law, which uses broad definitions of vicarious liability to rope in corporate defendants, the question of prosecutorial discretion looms large. In principle, any decision to launch a criminal investigation against the firm is likely to depend in large measure on the frequency and pattern of the bid-rigging incidents, which is, for example, the situation in the New York cases. If these incidents were confined to a small number of key people on only a few occasions, the corporate criminal sanction (which could lead to a firm dissolution Arthur Andersen-style) seems to be massive overkill. It is far better to stick with the individual sanctions that do not pose that risk. But if the bid-rigging practices were endemic, the balance starts to shift. Exactly where the balance should tip in any case is hard to say.

The evidence on the frequency and distribution of wrongs within the brokerage houses is, however, important for an additional reason. It gives some guidance as to the level of appropriate fines. The remedy of choice in the New York settlements was restitution of the revenues received by the firms in all their contingent fee transactions.[16] The argument made in favor of dollar for dollar resti-

16 Press Release, New York State Attorney General & New Your State Insurance Department, Insurance Broker Agrees to Sweeping Reforms (Jan. 31, 2005), *available at* http://www.oag.state.ny.us/press/2005/jan/marshsettlement_pr.pdf.

tution of all contingent commissions paid was that these were "almost pure profit" derived from wholly corrupt transactions, which were used solely to steer business to the insurance company that paid the largest contingent commissions.[17]

It is unlikely that this system of rough justice hit on the right remedy, because the proper calculations are more difficult to make than this simple restitution formula suggests. The first step is to figure out the extent to which the bid-rigging increased the cost of premiums to the insured or, in the alternative, lowered the level of coverage for any given level of premium. Clearly, there should be no restitution for contingent commissions paid without taint of bid-rigging, at least in cases of full disclosure. Even in those cases where the bids were rigged, the proper measure of damages is not the amount paid under the contract. Rather, it is solely the price increment from the conspiracy in restraint of trade that should be trebled, not the full amount of the commissions paid. That calculation could prove difficult if there were some partial offset in the direct premiums or commissions paid by the insurer. It is possible that these supracompetitive profits, once trebled, were large enough to wipe out the revenues from these transactions. But any grand assertion that the entire contingent premiums counted as "almost pure profit"[18] could be correct only if there would have been no reduction in the base premiums paid on this policy in the absence of the contingent commission. Yet that contention seems highly questionable. Cummins and Doherty report that "[p]remium-based commissions account typically for about 10-11% of premiums, compared with an average of 1-2% of premiums for contingent commissions."[19] The elimination of contingent commissions in these contexts is likely to produce at least some adaptive response from brokers, who in all likelihood would charge at least the same flat rate as before, and perhaps more. In fact, our knowledge of these various practices does nothing to rule out the possibility that eliminating contingent commissions in competitive markets could lead to higher brokerage fees for businesses, if there are any losses of efficiency advantages. How this plays out, given the available state of knowledge, is uncertain.

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17 *Hearing on Insurance Brokerage Practices Before the Subcomm. on Financial Management, the Budget and International Security of the S. Comm. on Governmental Affairs, 108th Cong. 7* (2004) (statement of Eliot Spitzer, Attorney General, New York State), *available at* http://www.oag.state.ny.us/press/statements/insurance_investigation_testimony.pdf.

18 *Id.*

19 Cummins & Doherty, *supra* note 2, at 2.

In light of these complexities, the correspondence between the wrong and the remedy should be proved, and not presumed. The risk here is that the threat of criminal prosecution leads to the imposition of remedies beyond those needed to promote market efficiency. The subject of prosecutorial discretion is beyond the scope of this essay, but the dangers of overdeterrence should never be overlooked, especially in the prosecutor's hour of triumph. The major risk is that the consequences of any decision to prosecute are necessarily amplified because prosecution triggers a broad range of collateral regulatory responses. Insurance commissioners in every state have to investigate whether to impose additional sanctions—loss of licenses and tighter reporting requirements, for example—once the indictment has been filed. In some jurisdictions the licenses could be pulled immediately. These sanctions impose severe penalties even if the charges are dismissed as unfounded down the road. The irony is that a defendant has stronger protections against the conviction than against the indictment, even though the indictment poses far greater risk. Given this giant lever, private brokers could easily make settlements that overstate the extent of any social loss (even if trebled) attributable to its bidding practices. The social losses from over-enforcement, moreover, cannot be lightly ignored if it leads a brokerage firm to avoid business practices that might have a high expected social value. How to control prosecutorial discretion is beyond the scope of this paper, but the problem will not quietly disappear in the near future. Its systematic risks extend far beyond the risks in contingent commission cases.

IV. Legislative Reform

As noted, legislative reform on the matter of contingent commissions warrants careful attention. As so often happens, the impulse for legal reform often takes place even when the existing laws have imposed heavy sanctions on the parties. And all too often the inquiry is not whether any shortfall in current enforcement should be fixed by the more effective use of existing institutions and sanctions against wrongdoers. Instead the usual public reaction is to ask what new sanctions could be added to the arsenal to nip various forms of misconduct in the bud—without asking, however, whether tougher sanctions will stifle beneficial conduct as well. As befits this situation, the pressure is placed on both the disclosure and the antitrust fronts, and each requires somewhat different treatment.

On the question of disclosure, it is unclear how often contingent commissions have been disclosed. For these purposes, suppose that no disclosures have been made, but that no bid-rigging has taken place as well. In these cases, the magnitude of the problem is uncertain given that competitive forces have remained operative. It is always hard to know whether any consistent lack of disclosure should be treated as strong evidence of a long-term problem, or whether it just means that the level of market distortion is relatively small. Indeed one reason to require the disclosures is that once they are made, it removes any need to spec-

ulate over this difficult counterfactual. Nor need any broker wait for outside parties to impose a duty to disclose. Their first line of defense could always be voluntary disclosures that make the legislative or administrative intervention largely unnecessary. In this regard, note that the settlements with New York preclude the use of undisclosed commission by the signatories. If non-signatories follow suit, then the problem has taken care of itself. The only possible efficiency loss here arises if these undisclosed commissions have positive economic value, at which point the legislative ban results in unnecessary efficiency losses. On the antitrust side, there is no need for any change in the appropriate legal rule because the bid-rigging was already illegal under tough laws in effect at the time it was practiced.

ON THE ANTITRUST SIDE, THERE IS NO NEED FOR ANY CHANGE IN THE APPROPRIATE LEGAL RULE BECAUSE THE BID-RIGGING WAS ALREADY ILLEGAL UNDER TOUGH LAWS IN EFFECT AT THE TIME IT WAS PRACTICED.

The hard question that remains is whether Congress or the states should ban the use of all contingent commissions, even when the broker has complied with all disclosure and antitrust regulations. That objective has been touted in New York, so much so that the ban on contingent commissions in all contexts is now regarded as a major legislative objective. The case for the legislation is not made out by the demonstration of either nondisclosure or bid-rigging, because the use of contingent commissions requires neither. Surely, we would not ban standard commissions in their entirety because of nondisclosure or bid-rigging, so why do it in the case of contingent commissions? The preferable strategy looks therefore to avoid such an overbroad prohibition. To that position there are possible objections. The first of these is that the risk of overbreadth is minor because contingent commissions turn out to play little role in a competitive market with full disclosure. At this point the ease of enforcement might in principle justify the broader restraint on conduct. Why not ban these commissions if their only use is to distort insurance markets by the illicit steering of business? Yet the result represents some measure of regulatory excess if any efficiencies do follow from the use of contingent commissions in their familiar historical niches. It is a taller order to explain why routine business practices should be banned across the board than it is to require their disclosure to clients. Unfortunately, the New York initiative does not discuss why these contingent commission contracts might prove valuable in some contexts. If there is any evidence that the practice long predates the recent abuses in New York, then the best that can be said is that the case for the total ban is "not proven". ◀