

Presentation to The Surplus Line Association of California

Spitzer's Crusade and Its Effect on the Insurance Industry



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A LIMITED LIABILITY PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

Spitzer's Crusade

- **History**

- **February 2004 – Washington Legal Foundation sends letter calling on regulators to investigate alleged conflicts of interest caused by placement service agreements**
- **April 2004 – Spitzer begins investigation into contingent commissions among allegations of “kickbacks”**
- **September 9, 2004 – First email describing alleged bid rigging schemes discovered**
- **September 17, 2004 – First major wave of subpoenas issued under the Donnelly Act**
- **October 14, 2004 – Complaint against Marsh filed**

Targeted Practices

- **Contingent Commissions**

- **Typically require the insurer to pay the broker based on one or more of:**
 - **How much business the broker's clients place with the insurer**
 - **How many of the broker's clients renew policies with the insurer**
 - **The profitability of the business placed by the broker**

Targeted Practices...con't

- **Fictitious Quotes or Bid-Rigging**
 - **Solicitation of fictitious high quotes from insurers in order to create the appearance of true competition for insureds**
 - **A, B, or C quotes**
 - **Drive-bys**

Targeted Practices...con't

- **Reinsurance Tying**
 - **Allegations that certain brokers require an insurer to purchase reinsurance through the broker or an affiliate of the broker as a condition of that insurer being selected to provide insurance coverage or awarded placement of a policy**
- **Financial Engineering Products**
 - **“Nontraditional insurance” or “income smoothing” products that enable customers to best engineer their income statements and balance sheets**
- **The Practice of “Float”**
 - **Practice whereby a broker would receive a cash premium and hold it for as long as nine months before remitting the premium to the insurer**

State Investigations

- **33 State Insurance Departments and 11 State Attorneys General have taken action**
 - **In total, 71 insurance companies and 23 brokerages have been publicly named as targets for investigation**
- **Attorneys General**
 - **California AG Bill Lockyer has commenced a formal investigation of antitrust, unfair competition and bid-rigging violations, which has lead to at least one formal suit being filed (and subsequently settled)**
 - **Florida AG Charlie Crist has also issued subpoenas to a variety of insurance brokerages, as “part of a larger effort to ascertain whether insurance practices are being conducted lawfully...with insured citizens’ best interests at the forefront.”**
 - **Connecticut AG Richard Blumenthal has announced a similar investigation, issuing at least 42 subpoenas, and has filed suit against Marsh and ACE alleging that ACE paid Marsh a secret \$50,000 commission to steer an \$80 million state contract to the company**

State Investigations...con't

Insurance Departments

- **California Department of Insurance has:**
 - **Drafted a proposed regulation requiring the full disclosure of all broker compensation**
 - **Proposed Section 2184.3 – Misrepresentation**
 - **“A broker who fails to disclose to a client all material facts surrounding the broker’s receipt or potential receipt of income from a third party, which income derives in whole or in part from a transaction on behalf of the client, violates Insurance Code section 790.03(b)”**
 - **Proposed Section 2184.4 – Fiduciary Duty**
 - **“(a) A broker who places his or her own financial or other interest above that of his or her client violates Insurance Code section 790.02.**
 - **(b) A broker violates Insurance Code section 790.02 if, with either new or renewal business, he or she:**
 - (1) Fails to provide the client with the proposal of a best available insurer;**
 - (2) Advises a client to select an insurer other than a best available insurer;**
 - (3) Advises a client not to select a best available insurer from among multiple insurers suggested to the client;**
 - (4) Fails to take reasonable measures to obtain a quote from an insurer that might be a best available insurer.”**

State Investigations...con't

- **Surplus Line-Specific Issues related to the Proposed Regulation:**
 - **Section 1763 vs. “best available insurer”**
 - **Wholesale intermediary exemption**
- **California Department of Insurance has also:**
 - **Issued Formal Letters of Inquiry requiring the production of documents pertaining to broker compensation arrangements**
 - **Retained a plaintiff’s law firm**
- **North Carolina Insurance Department has issued over 5,000 requests seeking letters of certification, signed by CEOs, regarding big-rigging and there are indications that it is seeking criminal indictments of insurers and brokers**
- **New Jersey Department of Banking & Insurance has requested information regarding commissions, bid-rigging and reinsurance tying from over 40 P&C and L&H producers and has issued Order requiring 18 of New Jersey’s largest insurers to submit detailed information and documents regarding their producer compensation arrangements**

Federal Involvement

- **Senate Hearing – November 16, 2004**
- **Antitrust Modernization Commission**
 - **McCarran-Ferguson Act**
- **Securities and Exchange Commission**
 - **Reporting Issues**
- **Department of Labor**
- **Department of Justice**
- **Internal Revenue Service (?)**

Other Developments

- **National Association of Insurance Commissioners**
 - **Executive Task Force on Insurance Broker Activities**
 - **Proposed Amendment to the Producer Licensing Model Act**
- **National Conference of Insurance Legislators**
 - **Proposed Insurance Broker Fiduciary Duty and Conflict of Interest Model Act**
- **Europe**
 - **Head of European Commission's insurance unit has said he is watching developments in the U.S. closely**
 - **UK Financial Services Administration has taken over regulatory responsibility from the General Insurance Standards Council and plans to focus on conflicts of interest**

Likely Impact on Industry

- **Replacement of Key Management**
- **Fines, Settlements, Class Actions and/or Guilty Pleas**
 - Effect on employees (e.g., termination/layoffs, retirement accounts)
- **Industry Reshuffling – M&A Activity**
 - *Wall Street Journal* (1/20/05) reports that Marsh is considering the sale or closing of its investment subsidiary, MMC Capital
 - Business model challenges
- **Federal Oversight**
 - Antitrust Modernization Commission, SMART Act, etc.
- **Disclosure/Elimination of Contingent Commissions**
 - According to A.M. Best, insurers in the U.S. property/casualty market paid out nearly \$3.7 billion in contingent commissions in 2003
 - Engagement Letters

Tit. 10 CCR § 2189 App. B

STANDARD BROKER FEE AGREEMENT

1. The parties to this agreement are _____ ("CLIENT") and _____ California Department of Insurance license #XXXXXXX, ("BROKER").
2. CLIENT appoints BROKER as CLIENT'S insurance broker of record.
3. This agreement shall become operative on _____ (date), and shall continue in full force until terminated by either party.
4. BROKER agrees to represent CLIENT honestly and competently.
5. CLIENT agrees to pay BROKER a broker fee for BROKER'S services. The broker fee is \$ _____. The broker fee IS/IS NOT refundable (circle one).
6. BROKER may charge CLIENT, and CLIENT agrees to pay, additional fee(s) for the services listed below. The additional fees and services are:

Service Amount

7. Following are the nature and amount of all fees known to BROKER that will be charged by persons other than BROKER or the insurance company in connection with current placement of CLIENT'S insurance. These fees are not retained by BROKER.

_____ Client signature Date

_____ Broker signature Date

In case of any questions or problems concerning broker fees or insurance, contact the Department of Insurance at 1-(800) 927-HELP.

Practical Implications

- **Document Retention**
 - Underwriter Files
 - “Dead Submissions”
 - EMAILS!!
- **Training and Corporate Procedures**
- **Transparency**

Important Questions

General

- Have you conducted business with any of the brokers targeted by Spitzer?
- Have you received a letter of inquiry, written request for information or subpoena from an insurance regulator or law enforcement official regarding your business practices?
- Are you, or any of your employees or producers, the subject of an investigation or named as a defendant in any civil litigation, or the subject of any other regulatory inquiry or action involving the alleged use of or involvement with improper broker compensation arrangements, bid-rigging, tying or inappropriate steering activities?

Contingent Commissions

- Have you entered into “placement service agreements” or “market services agreements?”
- Have you paid or received contingent commissions under service agreements?
- Have you properly disclosed the payment or receipt of such contingent commissions?

Important Questions...con't

Fictitious Quotes

- Have you ever submitted or requested a bid that you knew would not be a competitive bid (e.g., a “B quote,” “protective quote,” or “alternate quote”)?
- Have you ever attended a meeting with a potential insured and had no intention of competitively bidding to bind the insurance sought by that potential insured?

Reinsurance Tying

- Do commissions or other contingent payments play any role in the manner in which reinsurance is obtained when binding a policy?
- Have you properly disclosed the manner in which reinsurance is tied?
- Are your existing business arrangements among insurers, brokers, and affiliated reinsurers appropriately transparent to prospective insureds?

Important Questions...con't

Corporate Governance

- Do you have an ethics officer entrusted with reviewing and monitoring your business practices?
- Have you terminated employees who have participated or engaged in questionable acts or conduct?
- Have you established any sort of independent monitor of your business practices?
- Do you have in place internal controls intended to prohibit bid-rigging, tying arrangements or other inappropriate steering activities, and have those internal controls been reviewed to ensure that they properly detect such inappropriate behavior?
- Have you taken any specific steps to investigate whether your company, or any of its employees or producers, directly or indirectly participated in improper broker compensation arrangements, bid-rigging, tying or inappropriate steering activities?
- Have you preserved all documents in your possession or control that may relate to contingent commissions or fictitious quotes?

Government Reporting

- Have you properly disclosed the potential impact of Spitzer's investigation in your financial reports filed with applicable government agencies (e.g., addressing the potential impact of Spitzer's investigation in SEC filings within the risk factor section, the forward-looking statement disclaimer, or estimates of whether the investigation's impact upon business operations will be material)?

Investigation Buzzwords

- **A, B, C quote**
- **Additional Compensation Agreement**
- **Additional Incentive Program**
- **Advance Commission**
- **Advance of Payment**
- **Alternate Quote**
- **Alternative Quote**
- **Artificial Bid**
- **Artificial Quote**
- **Bid Rigging**
- **Block Quote**
- **Blocking Quote**
- **Bonus Agreement**
- **Bonus Kicker**
- **Broker Incentive Agreement**
- **B quote**
- **CCA**
- **Co-marketing Agreement**
- **Commission Alternative Plan**
- **Compensation in addition to commissions**
- **Conditioning**
- **Contingency Fees**
- **Contingent Arrangement**
- **Contingent Commission**
- **Contingent Compensation**
- **Contingent Payment**
- **Contingent Point Program**
- **Contingent Profit**
- **C Quote**
- **Fiction Quote**
- **Fictional Quote**
- **Fictitious Quote**
- **Float**
- **Future Business**
- **Future Placement**
- **Group Insurance Management Agreement**
- **Growth and Profit Arrangement**
- **Growth Bonus**
- **Incentive Agreement**
- **Incentive-Based Commission**
- **Incentive-Based Compensation**
- **Incentive Commission**
- **Incentive Compensation**
- **Incentive Payment**
- **Incentive Plan**
- **Incentive Program**
- **Incentives Commission**
- **Market Service**
- **Marketing Contract**

Investigation Buzzwords...con't

- **Marketing Service Fees**
- **Maximum Compensation**
- **Minimum Compensation**
- **MSA**
- **National Market Management Fee Agreement**
- **Overriders**
- **Overrides**
- **Performance Plus Agreement**
- **Performance Plus Payment**
- **Placement Service**
- **Preferential Treatment**
- **Preferred Agency Agreement**
- **Preferred Agency Contract**
- **Preferred Marketing Agreement**
- **Premium Service Revenue**
- **Producer Incentive Plan**
- **Production Service Agreement**
- **Professional Service Agreement**
- **Profit and Growth Bonus Arrangement**
- **Profit-Sharing**
- **Protect Lead**
- **Protecting Lead**
- **Protect Quote**
- **Protective Quote**
- **PSA**
- **Rigged Bid**
- **Rigging Bid**
- **Throwaway Quote**
- **Throw Away Quote**
- **VBCA**
- **Volume Based Commission Agreement**
- **Volume Incentive**

California Reinsurance Regulations

- **Background**

- **Cal. Ins. Code section 922.8(a)**
- **CDI Bulletin 97-5**
- **September 28, 2004 – “Proposals Concerning Reinsurance Accounting Agreements and Oversight”**
 - **Unprecedented breadth and substance**

Scope

- **Codification of “Underground Regulations”**
- **Extraterritoriality**
 - **Domestic Insurers**
 - **Foreign Licensed Insurers & Foreign “Volume” Insurers**
- **Retroactivity**
 - **15 months advance notice of Proposal’s application to new and renewal reinsurance contracts**
 - **27 months advance notice of Proposal’s application to existing reinsurance contracts and those entered into over these interim 15 months**

<u>Proposed Regulation</u>	<u>Applicable to Domestic Insurers</u>	<u>Applicable to Foreign Licensed Insurers</u>	<u>Applicable to Foreign “Volume” Insurers</u>	<u>Applicable To Non-Licensed Insurers</u>
Affirmation of Compliance	✓	✓	✓	
Collateral Funding Requirements	✓	✓	✓	
LOC Evergreen Clauses	✓			
Reinsurance Intermediaries	✓		✓	
90-Day Execution Rule	✓	✓	✓	
90-Day Overdue Reinsurance Recoverables Rule	✓	✓	✓	
Insolvency Clauses	✓	✓	✓	
Setoff Provisions	✓			
Arbitration Clauses	✓		✓	
ECO Clauses	✓			
Bulk Reinsurance	✓	✓	✓	
Prospective Bulk or Affiliate Reinsurance	✓	✓	✓	
New P/C Transfer of Risk	✓	✓	✓	

Significant Provisions

- **Collateral Funding Requirements**

- **Disallows credit for reinsurance ceded to a licensed or accredited reinsurer that is the subject of a “regulatory order” or “regulatory oversight” on the grounds of “financial hazard” by any state in which it is licensed**

- **Letter of Credit Issues**

- **Requires 60 days notice of non-renewal for the letter of credit under the mandated evergreen clause, as opposed to commonly-required 30 days notice**
- **Requires the prior written consent of the Commissioner to make any amendment to the LOC other than an amendment modifying the amount of the credit**

Significant Provisions...con't

- **Reinsurance Intermediary Issues**
 - **Subject to limited exceptions and the Commissioner's approval, prohibits the use of reinsurance intermediaries and requires any payments due between a ceding insurer and the reinsurer to be made directly to the other party**
 - **Commissioner's approval process is basically an annual licensing requirement imposed upon intermediaries dealing with ceding insurers**
- **“Ninety-Day” Issues**
 - **90-Day Execution Rule**
 - **90-Day Overdue Reinsurance Recoverables Rule**

Significant Provisions...con't

- **Insolvency and Set-off Issues**

- **All references to insolvency in a reinsurance contract to which a California domestic insurer is a party must be contained within the insolvency clause**
- **Prohibits use of setoffs in liquidation proceedings entirely**

- **Arbitration Issues**

- **Restricts the content of an arbitration clause, including requiring that such arbitration be held in California and, in the case of a receiver, allows the Commissioner to waive arbitration**

Significant Provisions...con't

- **Affirmation of Compliance**
 - **Affirmation must be verified under penalty of perjury by an officer of the insurer based upon his or her personal knowledge of the insurer's reinsurance program**
 - **If insurer cannot provide one verified affirmation for all of its reinsurance agreements, it may submit several verified affirmations each listing the reinsurance agreements it covers**

Reinsurance Requirements for LESLI List Applicants

- **California Department of Insurance has been imposing certain reinsurance collateralization requirements upon LESLI list applicants**
 - **High RBC thresholds**
 - **RBC ratios as trigger for automatic collateralization**
 - **Confidentiality of RBC information**
 - **Regulatory authority**
- **NAIC Reinsurance Task Force ad hoc group**
 - **100% Collateralization Rule for Alien Reinsurers**

Prospects For Federal Insurance Legislation – B.S.*

- **House –**
 - **Three years and 16 hearings by House Financial Services culminating in Oxley/Baker “roadmap”**
- **Senate –**
 - **Banking Committee – 2 hearings so far in 2004:**
 - **Commerce Committee – Hollings Bill**
 - **Government Affairs Committee – 11/16/04 Hearing**

* **Before Spitzer**

Optional Federal Charter –

- **Similar to National Bank/State Bank Model**
- **But no FDIC – Reliance on State Guaranty Funds**
- **Senate – Several Potential Sponsors**
- **Lack of Consensus Among Industry Players**

Oxley-Baker “Roadmap” Proposal – Now Called SMART Act

- **National Uniformity Standards for State-Based Regulation**
- **No Federal Charter or License**
- **Enforcement through Courts and “Partnership” Mediation**

SMART Roadmap . . . continued

**Designed to Address Perceived Weaknesses of State System through
Preemptive Imposition of State-Developed Standards**

- **Product Speed-to-Market**
- **Multi-State Licensing**
- **Market Conduct**
- **Price Controls**
- **Surplus Lines Simplification**

Specific Goals

- **Surplus Lines (Title VIII)**
 - **One-Stop Eligibility (IID Listing for Aliens)**
 - **Automatic Export**
 - **Multi-State Tax Allocation (“Home State” Rule)**
 - **Broker License Data Base**

Most Contentious Issues – Besides Absence of OFC

- **Enforcement Mechanism**
- **Price Deregulation**
- **Consumer Protection Claims**
- **And now ... Producer Conduct**

Enforcement Under SMART Act – The Partnership

- **Entity consisting of**
 - **3 Federal Officials (Treasury, Fed Reserve, SEC)**
 - **3 State Commissioners (NAIC nominates list, President selects)**
 - **1 Chairperson – votes only if tie (industry experience)**

Enforcement Under SMART Act – The Partnership . . . Continued

- **Roles**
 - **Monitor compliance with Act's mandates**
 - **Mediate Disputes**
 - **Issue Advisory Opinions**
 - **Seek Court Enforcement/Intervention**

Enforcement Under SMART Act – The Partnership . . . Continued

- **Two “Liaison” Officers**
 - **Tax/Financial Policy**
 - **International Insurance Issues**

Outlook For Reform in 2005-2006

- **SMART Act (Standards) more probable than OFC**
- **Negative Impact of Spitzer Allegations on Insurance Agenda (TRIA, SMART/OFC, etc.)**

Senate Government Affairs Subcommittee Hearing (11/16/04)

- **State Witnesses -- Spitzer (NY-AG), Blumenthal (CT-AG), Serio (NY-Supt), and Garamendi (CA-Comm.)**
- **Industry/Consumers --**
 - **CIAB, IIABA, PCI, RIMS, Consumer Federation of America**

Chairman – Sen. Peter Fitzgerald (R-IL) – Posed Four Questions Related to Broker Activities/Compensation:

- **What Form of Compensation Disclosure?**
- **Is Disclosure Enough?**
- **Increase Federal Anti-Trust Enforcement?**
- **What Do Revelations Mean for Congress’
Consideration of SMART Act or OFC?**

Witness Responses

- **Government Witnesses and CFA/RIMS criticized both OFC and SMART as “deregulation” inappropriate in light of revelations**
- **These witnesses seemed to favor beefed-up SMART Act (i.e., leave State authority intact)**

- **Spitzer called for Federal Investigation in Four Areas:**
 - 1. “Massive capital flows offshore” by brokers and insurers (e.g. Bermuda)**
 - 2. “Interlocking relationships” among brokers, insurers, and reinsurers**
 - 3. Premium rate-setting**
 - 4. “Fundamental inquiry into ethics of the industry”**
- **Serio also called for authority over broker parents/affiliates**

Impact

- **Will industry be on the defensive or turn the call for action to its advantage?**
- **Is TRIA extension in jeopardy as well?**
- **Will the effect spill over to tort reform or asbestos deal?**
- **Will the NAIC response reassure Congress?**

Miscellaneous Legislative Issues

- **California Unfair Competition Law (§ 17200)**
 - *Donabedian v. Mercury Insurance Company*
 - California Court of Appeal held that the UCL could be used to enforce Proposition 103 and possibly other provisions of the Insurance Code
 - **Proposition 64**
 - Passed in November 2004 with 59% of the vote
 - Limits the use of the UCL to private individuals who can demonstrate that they have been harmed financially by an alleged unfair business practice
 - Restricts consumer groups' ability to bring 17200 actions against insurers
 - *Californians for Disability Rights vs. Mervyns LLC* (Feb. 2005)
 - California Court of Appeal held that Proposition 64 does not apply retroactively to lawsuits filed before November 3, 2004

Miscellaneous Legislative Issues

- **Privacy Issues**

- **SB 27 – effective January 1, 2005**

- **Requires that, in response to customer requests, businesses must provide details about the type of personal information they share with other businesses, along with the names and addresses of companies with whom the information is being shared**

- **AB 1950 – effective January 1, 2005**

- **Requires business that own or license personal information about a California resident to “implement and maintain reasonable security procedures and practices appropriate to the nature of the information, to protect the personal information from unauthorized access, destruction, use, modification, or disclosure”**

- **SB 1436 – effective January 1, 2005**

- **Consumer Protection Against Computer Spyware Act**

Miscellaneous Legislative Issues

- **2004 Legislation**
 - **AB 2490 (Maddox)**
 - **Permits surplus brokers placing personal lines insurance products, such as homeowners' insurance and associated excess or umbrella coverages, immediately to bind coverage with an applicant in the same manner as non-admitted insurers and surplus brokers are currently authorized for commercial lines insurance products.**
 - **AB 2557 (Koretz)**
 - **Increases penalties on unlicensed insurers, augments background information reporting requirements for insurance license applicants and licensees, and allows the Commissioner to penalize providers of continuing education that fails to meet CDI standards**
 - **AB2962 (Pavley), SB 64 (Speier), SB 1855 (Alpert)**
 - **Homeowner's Bill of Rights**

Miscellaneous Legislative Issues

- **2005 Legislative Agenda**
 - **Surplus Line Premium Tax Penalties**
 - **E&O Coverage**

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