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The 2004 Insurance Broker Investigations: An Overview

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Summary

On October 14, 2004, the Attorney General of the State of New York, Eliot Spitzer, filed civil suit for violations of various state laws against Marsh & McClennan Companies and Marsh, Inc.,[1] the largest insurance broker in the United States. The principal allegations revolve around compensation arrangements between Marsh and several insurance companies, and bidding manipulation by Marsh to increase its profits from these compensation arrangements. Attorney General Spitzer also brought criminal charges against individuals involved and several guilty pleas have been announced. Since the initial suit, several other states have indicated interest in examining the conduct of insurers and brokers in their states and numerous individual and class action lawsuits have been filed. Market reaction to this was swift with Marsh & McClennan's share price falling nearly 50% in a few days and other insurance companies and brokers also seeing significant declines.

While the initial complaint has been brought under New York law, the situation may raise issues for Congress as well. One concern is the applicability of federal antitrust law. Among the laws used in the New York complaint was the state antitrust law (The Donnelly Act). Insurers, however, have enjoyed at least limited federal exemptions going back to a Supreme Court decision in 1868 and the McCarran-Ferguson Act of 1945. Another issue might be whether this situation sheds light on the overall efficacy of state regulation of insurance, which continues largely because Congress has specifically allowed it under McCarran-Ferguson. This report briefly summarizes the events that occurred and the issues they raised. It will not be updated. For current information on insurance issues, see CRS Report RL32789: *Modernizing Insurance Regulation*, by Baird Webel.

[1] Marsh, Inc. is a wholly-owned subsidiary of Marsh & McClennan Companies, Inc. In this report, "Marsh" will refer to the insurance broker Marsh, Inc., while the parent company will be referred to as "Marsh & McClennan." Other subsidiaries include Putnam Investments and Mercer Consulting, both of whom have been the subject of earlier investigations by Mr. Spitzer.

The Role of Insurance Brokers

Recent charges by the New York State Attorney General have highlighted possible wrongdoing by both insurance brokers and insurance companies, but the complaints focus largely on insurance brokers and their actions. Insurance brokers are similar to the insurance agents who are likely familiar to most people from purchase of individual insurance, but brokers generally service commercial clients rather than individuals. While insurance agents can be either "exclusive" or "captive" agents who represent one particular company or "independent" agents who may place a person's policies with any of several different companies, brokers are almost always independent. They are typically expected to search the marketplace on behalf of a client for whatever insurance company offers the best policy and to act as a knowledgeable advisor to that client. They can be particularly important for insurance needs that may be complicated or somewhat non-standard. Brokers have typically been compensated through some form of commission on the insurance policies that they arrange. Listed below are the top five global insurance brokers listed by total revenue from insurance brokerage, consulting, and related services:

Table 1. Global Insurance Brokers, by Revenue
($ in millions)

Rank	Company	Global Revenue	Revenue from Contingent Commissions
1	Marsh & McLennan Cos. Inc. (U.S.)	$9,376	$845
2	Aon Corp. (U.S.)	6,734	200
3	Willis Group Holdings Ltd. (U.K.)	2,004	80
4	Arthur J. Gallagher & Co. (U.S.)	1,202	45-50
5	Wells Fargo & Co. (U.S.)	801	Unknown

Source: Insurance Information Institute/*BestWire*.[2]

People of the State of New York vs. Marsh & McClennan Companies, Inc.[3]

This civil suit was filed on October 14, 2004, by Attorney General Eliot Spitzer. It enumerates six different causes of action, but the complaint can be seen as having two primary facets. One is relatively narrow, namely that an insurance broker, Marsh Inc.,

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[2] For global revenue, see [http://www.iii.org/international/rankings] original source *Business Insurance*. Contingent commission revenue attributed to Jay Gelb of Prudential Equity Group in "Aon Becomes Third Major Broker to Cease Contingent Commissions," *BestWire*, Oct. 25, 2004.

[3] See [http://www.oag.state.ny.us/press/2004/oct/oct14a_04_attach1.pdf] for the text of the complaint.

along with a number of insurance companies, AIG, ACE, Hartford, and Munich-American Risk Partners, rigged the bidding on a number of insurance placements for clients being represented by Marsh. The complaint alleges that Marsh would predetermine the insurance company that should be chosen by a client and asked other companies to provide higher bids than that preferred company, with this extending to "fake" presentations by these other companies to give the appearance of competition. In one instance, it is even alleged that Marsh went so far as to completely falsify a bid when an insurance company, CNA, refused to offer a bid. Such bid-rigging is clearly a violation of law and three insurance executives have already entered guilty pleas in response to criminal complaints that were filed along with this civil complaint.

The other primary aspect of Mr. Spitzer's complaint is a much broader indictment of the relationship and payment structures between insurance brokers and insurance companies. In addition to the buyer's commission, usually a percentage of the insurance premiums paid, insurance brokers have also received commissions directly from the insurance companies. These commissions have allegedly been based on more than just a percentage of the premium, with brokers receiving higher commissions if certain volume or dollar targets are met. Known generically as "contingent commissions," they apparently were also known as "placement services agreements" (PSAs) or "market services agreement" (MSAs) at Marsh. The complaint indicates that Marsh was aggressive in soliciting such agreements from insurance companies. Such contingent commissions could provide a major motivation for the bid-rigging that was described above since, unlike with a straight percentage commission, an insurance broker could possibly gain a higher commission if a particular insurance company were chosen by their client. These commissions, however, were reportedly widespread in the industry, and their propriety has been a topic of much more debate than the clear wrongdoing seen in bid-rigging.[4] Whatever the ultimate legality of these commissions, as shown in **Table 1**, they appear to have been a large revenue generator at Marsh, but not as large at the other insurance brokers.

Market and Regulatory Response

Particularly in light of the fallout from previous investigations by Mr. Spitzer into financial companies, the market reaction to the latest lawsuit was very swift. Marsh & McLennan shares fell nearly 50% in the aftermath of the allegations, while other insurance brokers' shares fell as well with Aon, Inc. and Arthur J. Gallagher down as much as 30%. The fall in broker shares is likely due both to the large uncertainty created in such a scandal as well as the market recognition that the contingent commissions are both a large part of broker earnings and are likely to be curtailed or eliminated in the future. Marsh and Aon have reportedly already indicated that they will no longer charge contingent commissions and several insurance companies have also announced that they will no longer pay them. Although the ending of contingent commissions may mean that they have to pay less fees, the share prices of insurers also reacted generally negatively

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[4] See, for example, Alan Reynolds, "Not Spitzer's Job," *Wall Street Journal*, Oct. 22, 2004, p. A16. Online at [http://www.cato.org/research/articles/reynolds-041022.html], for a view opposing that in Mr. Spitzer's complaint.

to the uncertainty following the lawsuit. AIG and ACE shares saw drops in the 20% range and mutual funds based on insurance stocks saw lesser declines.

Following the initial complaint, the legal investigations into possible insurance broker and company wrongdoing have expanded in both geographic area and scope. Attorneys General and insurance regulators in other states, including Connecticut, New Jersey, Massachusetts, Illinois, Florida, and Minnesota are reportedly looking into questions similar to those raised by Mr. Spitzer. California's Insurance Commissioner announced on October 20, 2004, a new set of regulations designed to ensure that broker or agent income from other sources be fully disclosed and to clarify the duty of agents and brokers to serve their clients' best interests.[5] The National Association of Insurance Commissioners (NAIC) has set up a 13-state task force to coordinate investigations and draft a model law address the issues. Numerous private lawsuits have been filed across the country. Other types of insurance, such as group life, disability, and health policies that are often purchased as employee benefits are apparently being scrutinized, as is other broker activity, such as the possibility of "tying" of primary insurance business together with reinsurance business from the same firm.

Issues for Congress

The primary federal statute addressing insurance regulation is the McCarran-Ferguson Act of 1945.[6] This act affirmed the primacy of the states as regulators of insurance, including a limited exemption from the federal antitrust laws. Since its passage, almost all congressional or other federal action on insurance begins with questions revolving around McCarran-Ferguson. Any federal action on the latest insurance scandals would be no exception.

McCarran-Ferguson's Antitrust Exemption

One of the state laws cited by Mr. Spitzer in the complaint was New York's antitrust law.[7] If there were to be any federal legal action, federal antitrust law would almost certainly be invoked as well. Federal antitrust actions against the insurance industry, however, are complicated to some degree by the language of McCarran-Ferguson, which provides that the Sherman Act, the Clayton Act, and the Federal Trade Commission Act will be applicable to "the business of insurance to the extent that such business is not regulated by State Law."[8] The law also states, however, that the previous preemption of the Sherman Act does not apply to "any agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation."[9] Thus, rather than simply establishing a violation of the federal antitrust laws, a federal claim against someone in the insurance

[5] See the California Department of Insurance website, at [http://www.insurance.ca.gov/docs/FS-PRS084-04.htm], for specific information.

[6] 15 U.S.C. §§ 1011-1015.

[7] Donnelly Act (N.Y. General Business Law, §§ 340 *et seq.*).

[8] 15 U.S.C. § 1012(b).

[9] 15 U.S.C. § 1013(b).

industry must also establish that the acts in question were either not the business of insurance or that they constitute boycott, coercion, or intimidation.

Until a specific case is filed and brought to conclusion; it would be impossible to predict a conclusion with certainty, however, it does not appear that the courts would be breaking with precedent in allowing a federal antitrust case along similar lines to that brought by the State of New York. Over the past few decades, courts have generally been seen as narrowing the scope of preemption provided by McCarran-Ferguson.[10] Of particular importance in such a federal antitrust case would be the definition of "business of insurance" which the courts have addressed a number of times.[11] Depending on how the courts might interpret the language of McCarran-Ferguson in such an antitrust case, Congress might wish to clarify this antitrust exemption.

Quality of State Regulation

For the past 60 years or more, the insurance regulatory world has existed in a state of varying tension between those who favor the existing state-based system and those who argue for federal involvement, or even a federal insurance charter. Whenever Congress examines insurance regulation, and thus raises the possibility of increased federal

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[10] See CRS Report RL31982, *Insurance Regulation: History, Background, and Recent Congressional Oversight*, by Carolyn Cobb, for a discussion of the history of McCarran-Ferguson and the following court decisions.

[11] While it was originally assumed that McCarran's use of the term, "business of insurance," was virtually interchangeable with the term, "insurance companies," the Supreme Court made clear first in 1969 and again in 1979, that this assumption was erroneous. In Securities and Exchange Commission v. National Securities, Inc. (393 U.S. 453 (1969)), the Court held that a state statute directed at protecting the stockholders of insurance companies was not a statute regulating the business of insurance, and that the merger of an insurance company and another company was not entitled to McCarran's "business of insurance" protection: "[Only s]tatutes aimed at protecting or regulating [*the relationship between the insurer and the insured*], directly or indirectly, are laws regulating the 'business of insurance.'" 393 U.S. at 460, emphasis added. In Group Life & Health Insurance Co. v. Royal Drug Co. (440 U.S. 205, 211 (1979)), the Court stated emphatically that the McCarran exemption "is for the 'business of insurance,' not the 'business of insurers.'" Relying on those cases, the Supreme Court and the lower federal courts have, in a variety of circumstances, steadily narrowed the McCarran antitrust exemption; it now generally excludes activities carried on by insurance companies that may be deemed "ancillary" to the underwriting or risk-spreading function of writing insurance policies, whether or not those activities ultimately redound to the benefit of policyholders. In Union Labor Life Ins. Co. v. Pireno (458 U.S. 119 (1982)), for example, the Court summarized its holding in *Royal Drug:* "In sum, Royal Drug identified three criteria relevant in determining whether a particular practice is part of the "business of insurance" exempted from the antitrust laws ...: *first*, whether the practice has the effect of transferring or spreading a policyholder's risk; *second*, whether the practice is an integral part of the policy relationship between the insurer and the insured; and *third*, whether the practice is limited to entities within the insurance industry" (458 U.S. at 129, emphasis in original). See also, e.g., U.S. Dept. of Treasury v. Fabe, 508 U.S. 491 (11993); Hartford Fire Ins. Co. v. California, 509 U.S. 764 (1993); Podiatrist Ass'n, Inc. v. La Cruz Asul De Puerto Rico, Inc., 302 F.3d 6 (1st Cir. 2003); McKnight v. Chicago Title Ins. Co., Inc., 358 F.3d 854 (11th Cir. 2004); AmSouth Bank v. Dale, 2004 WL 2092997 (6th Cir. 2004); and similar cases that discuss the factors to be considered in determining whether a practice constitutes the "business of insurance."

involvement, one of the primary arguments of the supporters of the state regulatory system is that the individual states are essentially better regulators than an envisioned federal system would be. This argument, however, raises the stakes for any problems in the insurance marketplace as some might use them as counterexamples against the claimed superiority of the state-based system.

In the late 1980s, there were a number of large insurer insolvencies, which were followed by congressional reports and hearings led by Representative Dingell that were highly critical of the regulatory system and discussed federal solutions to the problems. These insolvencies were an embarrassment to the state regulatory system and regulators were galvanized to show progress combating the problems. To some degree they were successful, and suggestions for federal intervention abated through the middle and latter part of the 1990s. Following this lull Congress is now again examining the insurance regulatory system, due primarily to the changes made to the financial regulatory system by the Gramm-Leach-Bliley Act of 1999 which freed banks and security firms from many Depression-era restrictions but left insurance regulation largely unchanged. The focus in the past few years has focused on uniformity of insurance regulation, and to some degree on deregulation, particularly of insurance rates.

The question for Congress is how to interpret this new insurance scandal. Is it an example of the state system working since it was a state Attorney General who has uncovered and prosecuted the wrongdoing? Or is it a failure of the system since the problems were allowed to manifest themselves for as long as they did? It has been argued that contingent commissions were widely used in the industry over the past decade. If these commissions are indeed a source of conflict of interest, why did the regulators not impose rules sooner? Commercial insurance is one of the more lightly regulated parts of insurance on the presumption that large enterprises are able to fend for themselves in insurance market. What does this scandal say about this presumption? Does it shed any light on the suggestion that other insurance regulation, such as rate regulation, might be reduced? Or is the question of tightening market conduct regulation essentially separate from the question of loosening rate regulation?

Outlook

While the investigations are continuing, it seems likely at this point that the ultimate scope of the scandals may center on two issues. First, is an answer to the question of the propriety of contingent commissions. If it is judged that these commissions are not improper, then the initial complaint essentially reduces to specific illegal rigging of bids, which is certainly serious, but is much narrower than an indictment of a widespread industry practice. Second, is whether further damaging evidence is found, particularly on the question of "tying" with reinsurance activity, which reportedly is a focus of ongoing investigation.

The Senate Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security has announced a hearing planned for November 16, 2004, that would focus on insurance broker issues. It is unclear whether and when the other committees that have held insurance regulatory hearings during this Congress, namely the House Committee on Financial Services, the Senate Committees on Commerce and on Banking, may take action on this issue. To this date, no legislation specifically addressing this issue has been introduced or announced.