

# The War On Contingent Commissions: A Regulatory Attack On A Procompetitive Business Practice

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Insurance companies have been paying brokers "contingent commissions" for bringing them customers for at least the last half-century. Until recently, no one challenged, or even seriously questioned, this practice. Yet in the last six months, it has become an article of faith that contingent commissions are inherently harmful to the consumer.

Highly publicized lawsuits and investigations in several states have targeted companies that pay, or receive, contingent commissions. Each of these state probes has a strong focus on traditional, recognized wrongdoing such as bid rigging or fraud. Each also takes direct aim at contingent commissions, however, suggesting that these payments create conflicts of interest for brokers and increase the price of insurance.

As a result, brokers and insurers are abandoning the use of contingent commissions. But contingent commissions can, and do, serve legitimate procompetitive purposes in the insurance marketplace. While attacking truly anticompetitive conduct – such as bid-rigging – is appropriate, the challenge for regulators in doing so is to avoid eliminating efficient market practices.

## The New Conventional Wisdom About Contingent Commissions

Contingent commissions – sometimes referred to as override commissions – have long been a part of the insurance industry landscape. In essence, contingent commissions are an additional commission that an insurance company will pay to a broker – over and above the standard commission – in return for the broker reaching certain volumes of business with the insurance company. In substance, it is similar to a volume discount, only here it is a volume bonus to the broker who generates business for the insurer.

Things changed for contingent commissions in October 2004, when New York Attorney General Eliot Spitzer sued brokerage giant Marsh & McLennan for its aggressive pursuit of contingent commissions. Spitzer's attack on contingent commissions had three basic prongs: (1) he alleged that Marsh was using its contingent commission agreements to facilitate a bid-rigging scheme among insurers; (2) he suggested that contingent commissions were inherently problematic because they place the broker in a position where his duty to seek the best deal for the consumer is in conflict with his incentive to obtain the greatest compensation for himself, and (3) he claimed that contingent commis-

sions raise the cost of insurance for all consumers.

Spitzer's condemnation of contingent commissions quickly gained momentum and soon was entrenched as the new conventional wisdom. Major broker defendants in the lawsuits hastened to settle the claims against them and to agree that contingent commissions are inherently destructive to consumer interests.

## The New Wisdom About Conventional Contingent Commissions Is Wrong

The new wisdom is that contingent commissions, in and of themselves, are damaging to consumers, because:

- (1) They can be, and have been, used for improper purposes;
- (2) They create divided loyalties and improper incentives for brokers; and
- (3) They increase the cost of insurance.

But in the stampede to reach these conclusions, there has been little or no critical analysis. Such an analysis shows that the case against contingent commissions is exceptionally weak.

*Contingent commissions do not create any new divided loyalties or improper incentives*

Standard commissions are paid because brokers provide services to both the consumer and the insurer:

- Most consumers do not understand insurance well enough to accurately assess, by themselves, which combination of coverage and price best fits their needs, or which insurer is best for them. Brokers assist the consumer in this analysis.

- Insurers could exclusively use employees to market their products directly to consumers, but most do not. Instead, most insurers employ salespersons who deal primarily with brokers, who in turn deal directly with consumers. In effect, each insurer uses the common pool of independent brokers to augment its sales force.

That brokers provide valuable services to both consumers and insurers is beyond serious dispute, as alternatives are readily available in the marketplace. Consumers, for example, could hire an insurance "consultant," rather than a broker, to provide insurance advice. Consultants work only for the consumer and are paid exclusively by the consumer (a "consulting fee" rather than a commission). Similarly, insurers could hire employees to market their products directly to the consumer, and most insurers do make some direct sales. But, it is evidently more efficient for most insurers to use the common pool of brokers for this purpose rather than for each to expand its own employee sales force.

The standard commission is thus paid partly to compensate the broker for the service it provides to the consumer in analyzing insurance alternatives, and partly to compensate the broker for the service it provides to the insurer in marketing its products. Contingent commissions are used, however, to give further compensation to brokers for the marketing services they provide to insurers. For most insurers, contingent commissions are a more precise method for compensating a broker for these services, as opposed to simply increasing the overall standard commission. That being the case, the contingent commission represents a more efficient way for insurers to compensate brokers as

opposed to the use of standard commissions alone.

The most common argument against contingent commissions is that they create divided loyalties or improper incentives for brokers. In fact, contingent commissions do not create conflicts of interest that do not otherwise exist with standard commissions.

Consumers look to brokers for information and advice, but insurers pay the brokers' commissions. This structure alone creates the potential conflicts attributed to contingent commissions. Because of this structure, and because different insurers can pay commissions at varying percentages of the premium, the broker's incentive to get the best deal for the consumer is always in some tension with his incentive to earn the greatest compensation by placing business with the insurer who pays the highest commission (standard or contingent). It is unavoidable that a broker is presented with a potential conflict of interest. But this structure has been one of the most basic features of the insurance business for many decades. Moreover, it is not unique to the insurance industry. Real estate brokerage, for example, functions much the same way, where brokers are compensated by sellers, even when they are assisting buyers.

Accordingly, the payment of standard commissions by insurers creates the same "divided loyalties" and "improper incentives" as contingent commissions. Yet no one scrutinizing the insurance industry has questioned the payment of standard commissions by insurers. The reason is that the conflicting incentives created by the standard commission are kept in check by market forces.

When consumers retain brokers, they expect brokers to help them get the best coverage at the lowest cost. A rational broker will seek to maximize his profit by obtaining the greatest volume of consumer business. The way a broker attracts and retains customers is by effectively serving their interests. A broker who does not effectively serve the interests of the consumer will lose customers, fail to gain new ones, and earn fewer and lower commissions. A broker who maximized his short term profit by securing deals for his customers that require them to pay higher-than-necessary premiums would suffer in the long run as his current (and potential) customers sought out more effective brokers. Thus, competition among brokers for customers demands that brokers strive for the best value for their customers, overriding the broker's short-term interest in securing the highest commission.

These market force principles apply with equal force to standard commissions and contingent commissions alike. Just as competition for customers constrains brokers from allowing the divided loyalties created by standard commissions from operating to the detriment of consumer, that same competition prevents brokers from allowing divided loyalties created by contingent commissions to harm the consumer.

Contrary to the new conventional wisdom, contingent commissions do not increase the cost of insurance.

The critics of contingent commissions argue that, because insurers include the cost of contingent commissions in their

premiums, consumers necessarily would pay less if insurers did not pay contingent commissions in the first place.

This simplistic analysis is based on the erroneous assumption that contingent commissions are not paid as compensation for actual services. As discussed above, however, contingent commissions represent a part of the total value of the marketing services the broker provides to the insurer. The market for brokerage services, not the commission structure, determines the total amount of the broker's compensation for serving as an intermediary between insurers and insured. A contingent commission is merely a device for paying a part of the broker's compensation for that service. Eliminating that device would have no effect on the total value of the broker's services, and therefore no effect on what the insurer has to pay the broker. If contingent commissions were eliminated, the full market compensation for the broker's sales services almost certainly would be reflected in higher standard commissions.

Thus, the fact that an insurer pays the broker's compensation partly through standard commissions and partly through contingent commissions, rather than entirely through standard commissions, should not increase the cost of insurance.

On the other hand, the heavy reliance of insurers on contingent commissions suggests that the contingent commission device has the opposite effect: it likely reduces the cost of insurance. The prevalence and long history of contingent commissions is strong evidence that it is more efficient to pay brokers for their marketing assistance through a combination of contingent commissions and standard commissions, rather than standard commissions alone. That being the case, forcing insurers to abandon this more efficient method of payment would increase their costs, which, in turn, ultimately would increase the cost of insurance for consumers.

## Contingent Commissions Can And Should Remain Part Of Today's Global Marketplace

Regulators need to follow the medical precept that they should "first do no harm." They should not attack and hunt to extinction a practice whose procompetitive worth has been demonstrated through long and widespread use. Eliminating contingent commissions is a bad idea, principally because such commissions appear to be an efficient device for compensating brokers for the services they render to insurers. Any alternative dictated by regulators – as opposed to the market – is likely to be less efficient and therefore increase the cost of insurance.

In order to avoid this unintended anti-consumer result, regulators must delineate with precision whatever competitive problems they believe are inherent in contingent commissions – if unconnected to bid rigging or fraud – so that insurers and brokers can structure the payment of such commissions without threat of an investigation or lawsuit.

We believe that if regulators engage in a careful analysis of the effects of contingent commissions on competition among insurers, and on consumer welfare, they will conclude that there is nothing inherently wrong with contingent commissions.

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