



Formerly The Foundation for Taxpayer & Consumer Rights

1750 Ocean Park Boulevard, #200, Santa Monica, CA 90405-4938 • Tel: 310-392-0522 • Fax: 310-392-8874 • www.consumerwatchdog.org

April 23, 2008

Honorable Assembly Member Joe Coto
Chair, Insurance Committee
State Capitol, Room 2013
Sacramento, CA 95814

Re: AB 2956 – OPPOSE

Dear Assembly Member Coto:

As an organization that has spent the last twenty years fighting for insurance consumers' rights in California, Consumer Watchdog (formerly the Foundation for Taxpayer and Consumer Rights) must oppose AB 2956.

Your bill would increase the cost of auto insurance for motorists by overturning a recent court ruling that protects customers from paying deceptive and illegal broker fees to people who in fact are agent representatives of insurance companies. Current law establishes that no person collecting broker fees from a consumer may act on behalf of an insurance company. In the key ruling, *Krumme v. Mercury*, the Court further outlined the criteria that distinguish brokers from agents. AB 2956 would blur those lines, widening the pool of individuals who are considered brokers by allowing those who engage in activities heretofore considered marks of an “agent” under *Krumme* to collect broker fees.

By allowing many insurance sellers who currently are compensated for their services through a regulated agent’s commission to also charge an unregulated broker fee, AB 2956 would authorize a double-dipping in which insurance customers will be forced to pay the same person both an agent commission and a broker fee. In the midst of an economic disaster that is wreaking havoc on so many Californians, and most particularly the lower income residents of the state, your bill imposes a new insurance cost yet it provides no consumer benefit, or even protection.

The bill’s effect will hit hardest in low-income communities, where independent agents will quickly redefine themselves as brokers and begin slapping customers with an additional broker fee. We do not doubt that you will agree that the poorest Californians can least afford to pay \$150 to a double-dipping insurance agent.

Under California law, all insurance companies must sell the lowest priced policy from any of their affiliated companies to any good driver who wants it.

Though some have argued that allowing more people to be brokers is important to induce sellers to provide services in low-income communities, we find that logic outrageous and patently discriminatory. Consumers of lower income are not served by authorizing a system that allows insurers to charge them more for the same product and service available to others. That is the opposite of fairness.

Proposition 103, approved by voters in 1989, requires insurance companies to set rates based primarily on driving record, miles driven and experience – thus limiting the importance insurers can place on factors like ZIP code or education, the proxy indicators of race or income.

Proposition 103 also requires insurance companies to “take all comers,” which means that insurers must provide any good driver in the state with the lowest priced insurance policy sold by the company or any of its affiliates. Further, every company must have a toll-free number or website available to every driver in the state to ensure that they can get a quote or find an insurance seller who will sign them up for insurance.

Insofar as proponents claim that this bill would allow more brokers to serve low-income consumers, they only mean that more agents who currently only charge customers once would transform themselves in the wake of this bill into brokers who can charge those customers twice.

But these changes are not directed solely at low-income consumers but virtually all Californians who buy insurance and will be forced to spend more to get the same exact service they are getting today.

AB 2956 would directly undermine *Krumme v. Mercury*, the case that created a template for ensuring that customers are not improperly charged broker fees by producers who are otherwise agents and represent the company’s interests. Your bill would obscure the issue that *Krumme* clarified.

The Insurance Code makes the distinction between brokers and agents quite clear. Section 1621 defines an “agent” as working “on behalf of” the insurer. Section 1623 defines “broker” as working “on behalf of” another person, but not the insurance company. The plain language of these statutes states that an insurance licensee cannot be classified as a “broker” (and cannot charge a broker fee) if it acts on behalf of the insurance company in the transaction.

AB 2956, as proposed to be amended, would replace the definition of a broker in Section 1623, and the clarification issued in *Krumme*, by allowing anyone selling insurance to be presumed to have the right to charge a broker fee so long as they identify themselves as a broker and disclose that fee. The bill then alters current law to make it much more difficult for an overcharged consumer or a regulator to rebut the presumption that this person is a broker. The bill installs a “totality of the circumstances” test as the burden for proving that someone is an agent rather than a broker. Let us be clear: This is not declarative of existing law. Section 1623 of the Insurance Code as it currently reads and as it has been administered by regulators and the Courts is far more protective of consumers than this proposal. A “totality” standard would broaden the scope of activities that agents could engage in and still call themselves brokers and charge unregulated fees.

Even worse than widening the allowable activities of a broker, by mandating a legal presumption that any person who identifies himself as a broker is telling the truth, your legislation would, in effect, eliminate the broker/agent distinction entirely. The high cost an individual would face to challenge such a claim versus the possible recovery of what, at most, would be a several hundred dollar fee, means that such challenges will simply not be brought. Without them, insurance agents can call themselves brokers with impunity.

AB 2956 would reverse the significant strides that the Department of Insurance and the courts have taken to enforce the broker/agent distinction in the marketplace, and thus to protect the integrity of the insurance agent appointment law (section 1704(a)) and the rate regulation and discrimination provisions of Prop 103. Doubtless, insurers using so-called “brokers” would like to see those provisions undermined so that they can continue to use broker fees as sales incentives in violation of the letter and spirit of Prop 103. As you know, insurance rates and premiums are regulated under Proposition 103, but broker fees are not. As we explain below, insurers, in a quest to claim lower rates, want to unbundle some of their regulated premium and offload a portion of that into the unregulated broker fees that would be blessed by this proposal.

AB 2956 is the latest in a long line of previous legislative attempts to legalize broker fees that were successfully challenged by the Department of Insurance and in the courts. Below we detail the history of this issue, which, we believe illustrates why this proposal should be rejected. First, however, let us offer an amendment that could allay the concern that this bill would authorize wide-scale double dipping by insurance producers.

RECOMMENDED AMENDMENT

Consumer Watchdog does believe that consumers could benefit from additional protection and greater clarity in this area where insurers, and the so-called “brokers” who sell their products, have often taken advantage of the public.

A producer who is “double-dipping,” that is, being paid by both the insurer and the consumer, is serving two masters. The loyalty of a producer is more likely to be weighed in favor of the insurer who produces a steady income, instead of the individual consumer. The “broker” who relies on commissions from an insurance company cannot also independently represent the consumer who is paying him to do the same. Paid representatives of insurance companies should not be allowed to charge consumers a fee for ostensibly acting in the consumer’s interest. We urge you to amend your bill to prohibit this type of impossible dual loyalty.

We propose adding the following language:

Insurance Code §1623.05 (a) Any producer who charges a broker fee shall be prohibited from receiving any commission from an insurer involved in the transaction.

(b) An insurance producer who receives any commission from an insurer as part of an insurance transaction shall be prohibited from charging a broker fee associated with that transaction.

To the extent the Legislature believes it essential to assure producers of their right to charge broker fees, we believe it is the Legislature's obligation to ensure that consumers are protected from duplicative charges and the weakening of the broker's obligation to work on behalf of the customer who is paying them.

BACKGROUND: AUTO INSURANCE MARKETING IN CALIFORNIA

Personal (as opposed to "commercial") auto insurance in California is a \$19 billion per year industry. There are three ways that auto insurance is marketed to California consumers: 1) through exclusive, or captive, agents, 2) by company employees or 3) through a sales force of "independent agents and brokers."

Insurers using the "exclusive (aka 'captive') insurance agent" distribution system comprise approximately one-third of the market. State Farm, Farmers and Allstate are the leading companies that utilize this model. These carriers file formal "appointments"¹ for each of their agents with the Department of Insurance. Under state law, insurance companies are liable for the conduct of their agents. Under well-established principles of insurance law, these agents cannot add broker fees onto the premiums.² To do so would be to charge consumers twice for the same service, or to "double-dip." Agents are paid a commission for their auto insurance sales by the insurance companies. In turn, these commissions are part of the rates that insurance companies submit for approval of the Commissioner pursuant to Proposition 103 (Insurance Code section 1861.05(a)).

Insurers that sell policies through exclusive agents maintain control over their agents, having vetted them before making an appointment and retaining the essential power to hire and fire them. These captive agents generally watch out for the carriers' interests, follow the carriers' instructions, perform field underwriting at the point of sale and instantly bind the risk. The agents, in return, enjoy brand identification with the carriers, displaying their signs prominently and reaping the benefits of brand advertising, including carrier sponsored media campaigns. The agents earn their income through commission compensation, paid as a percentage of the premium. Agents cannot tack on additional fees.

Another one-third of the market uses the "direct writer" system. 21st Century, CSAA and Southern California Auto Club are among the leading "direct writers." They do not use agents or brokers – their sales are made by employees inside the company. Like those companies that utilize agents, the direct writers are liable for the acts of their employees, who cannot charge broker fees. Like commissions, the salaries of these in-house sales people are factored into the insurance rates that are reviewed by the Commissioner.

The remaining third of the market utilizes the "independent agent-broker" sales system, the subject of AB 2956. Mercury, Progressive, Infinity, Coast National/Bristol West, and Viking are among the companies in this segment of the market. These carriers use "independent agents" and "brokers" to market their products. Unlike "captive agents" or insurer employees, which represent only one company, "independent agents" may sell more than one insurer's products.

¹ Insurance Code section 1704(a)

² State Department of Insurance Bulletin 80-6; 10 C.C.R. §§ 2189.1 *et seq*, the 'Broker Fee Regulations.'

Still, the agents are formally appointed by each insurer with which they work, often maintaining appointments from as many as a dozen companies. As with the captive agents, companies are liable for their independent agents' errors and omissions and the cost of their commissions are passed on to policyholders through approved rates. These agents can serve customers seeking insurance from a specific company, or they can help a customer shop for the best-priced policy among those companies with which the agents have a formal appointment. Either way, the independent agents' legal obligations remain with the company, not the customer, and their compensation is in the form of the Department of Insurance approved commission. No fees can be added.

Brokers, under California law, are meant to be altogether different than any of the other types of insurance sellers. (Agents and brokers are known generically as "producers.") Most importantly, in contrast to captive or independent agents, "brokers" do not represent an insurance company.³ Rather, they are hired by and represent the consumer/policyholder. For that reason, insurers are not liable for the actions, errors or omissions of a broker. Compensation for a broker comes in the form of a broker fee. A broker fee is a payment by the customer to a broker for providing specialized placement services, such as determining and choosing among available markets for sophisticated or hard to come by insurance products, determining the best fit for the customer, compiling necessary information for the application, and otherwise generally providing high level insurance liaison services between the customer and the carrier. Traditionally, the carrier or its commissioned agent performed all underwriting and paid no commission to the broker. Rather, the broker would be compensated solely by the broker fee. It is now a standard practice for brokers to receive a commission as well. Because the broker fee is charged by an entity that is neither employed nor appointed by the insurer, it is not built into the Commissioner approved rates of an insurer.

Brokers are prevalent in commercial insurance; the names Marsh & McLennan and Aon spring quickly to mind. There has historically been little, if any, true personal lines brokerage because auto and homeowners insurance policies are mass marketed and present none of the complexities of, for example, products liability policies, professional malpractice insurance, or worker's compensation coverage. There is scant need for brokerage or justification for a broker fee in personal lines.

We'll put aside for the moment the fact that brokers are hardly necessary for personal lines insurance in order to discuss the legal role of a broker. In order to be a broker and maintain the right to charge a broker fee, the insurance sales person must be unequivocally independent of insurers. In the sale of auto insurance, that would mean the broker can assist a customer in the insurance transaction, but they don't assist the company by conducting the underwriting or binding coverage. That work is left to agents or employees of the company who are compensated by the insurer, protected legally by the company and legally obligated to it. The

³ The Insurance Code distinguishes an "insurance agent" from an "insurance broker." Section 1621 defines an "agent" as working "on behalf of" the insurer. Insurance Code section 1623 defines "broker" as working "on behalf of" another person, but not the insurance company. The plain language of these statutes states that an insurance licensee cannot be classified as a "broker" if it acts on behalf of the insurance company in the transaction.

broker's job, in essence, is to help the customer determine their insurance need and then bring the prospective policyholder to the doorstep of the insurer. For that they can charge a broker fee.

BROKER FEE ABUSE

The "broker" classification has become the locus of abusive practices for several insurance companies. For example, Mercury and its sales people have used the "broker" label in order to avoid formally appointing agents, carrier vicarious liability, and, critically, to charge consumers broker fees. However, the company's practice of using so-called "brokers" rather than independent agents has not carried with it the substantively different roles and responsibilities of agents and brokers. Instead brokers provide the same application and field underwriting services to insurers as agents do, and, in fact, they do not render any more services on behalf of consumers than agents do.

The would-be "brokers" advertise to the public that they "shop the market" and this "shopping the market" makes them "brokers." There is no law that says shopping the market is what defines and distinguishes a broker. In the personal lines market, "brokers" are no different from independent agents in that they have access to only those insurance companies that will give them contracts. (Indeed, at least in Mercury's case, courts have ruled they actually are independent agents.) These "brokers" "shop" only a small number of insurance companies – those companies that the "brokers" *have applied to* and that the insurers have *screened, vetted and accepted*.

Rather, the test of being a broker is whether the licensee acts on behalf of the policyholder or the insurance company. As is noted above, independent agents (agents with multiple agency appointments and who do not charge broker fees) also "shop the market" but only among those companies they have contracts with – exactly like many of the self-proclaimed "brokers." These independent agents are agents because they act on behalf of the insurance companies by performing such tasks as field underwriting and binding. When "brokers" perform these same tasks they therefore are also properly classified as agents under the Insurance Code.

For over 25 years, the Department of Insurance has condemned the practice of agents adding broker fees on top of premiums as a violation of the anti-discrimination provisions of the Insurance Code.⁴ The Department held that all compensation received by an agent for the company is premium; therefore, the addition of broker fees by producers who may call themselves "brokers" but are acting in the capacity of company agents violates the traditional prohibition against rate discrimination. The passage of Proposition 103 intensified regulatory concern over the charging of broker fees by licensees who are really agents. The practice violates Prop 103's rate regulation rules requiring the pre-approval of a company's entire rate, including payments to its agents. The practice also runs afoul of Prop 103's rule against unfair discrimination when a customer who buys from an agent who charges a broker fee pays more than an identically situated customer who buys without paying a fee.

⁴ SDI Bulletin 80-6

Indeed, as shown in the following section, Mercury first changed from an appointed agent distribution system to a “broker” system immediately after Prop 103 passed, and its intention was to circumvent the initiative for its competitive advantage.

THE EVOLUTION OF THE MERCURY “BROKER” SYSTEM

Founded in 1961, Mercury did not have the brand recognition to command a captive agent sales force that the traditional market leaders such as State Farm held. It therefore marketed through a system of independent agents, producers who sold the products of multiple carriers. All of these producers were appointed agents of Mercury. Mercury used financial incentives to stimulate sales; it had a base commission rate of 15%, well above the industry norm of 10-12%, plus compensation contingent on production volume and loss performance. In this way, Mercury encouraged the independent agents to steer business to Mercury. Mercury also developed brand recognition through extensive cooperative advertising campaigns, in which its agents were encouraged to participate.

Mercury, like the established industry leaders from which it sought to take business, vetted and controlled the producers it would allow to sell its products. Mercury has long held the reputation of having stringent underwriting standards; its applications are more complicated and take longer to fill out, and its loss ratios have been low by industry standards. As the years passed, a Mercury producer “appointment” became increasingly coveted and difficult to get, and Mercury exercised heavy-handed control over its agents with respect to field underwriting, both directly and by a system of rewards and punishments based on producer loss ratio performance.

After the passage of Proposition 103, Mercury was faced with the challenge of continuing its program of building market share by providing high financial incentives to trusted agents in a new environment in which their rates and pricing system would be scrutinized and subject to stringent regulation.

Mercury came up with a device by which it intended to markedly increase the compensation it paid its agents without disclosing the higher costs of the compensation either to the public or to regulators.

Without making any functional change in its agency relationships with its producers, including underwriting control, marketing synergy and brand identification, and its system of commission and loss ratio rewards and punishments, Mercury switched hundreds of appointed agents to broker status beginning in 1989. These “brokers” then began to add broker fees onto Mercury’s premiums. The amount of these fees was and remains unregulated. And yet, in advertising its rates to the public, Mercury could continue to run “comparative rate” pieces claiming that its rates were substantially below those of State Farm, Farmers, and Allstate.

Mercury, by stripping 700 agents of their agency appointments, and changing the word “agent” to “broker” in a new standard form contract,⁵ enabled the charging of broker fees.

⁵ There were other minor modifications, but that was largely the gist of the change from agent to broker.

As noted above, under Proposition 103, a carrier is supposed to charge all similarly situated consumers the same premium. Further, the Department of Insurance considers fees added by agents to be part of the premium. An example will illustrate the unfairness and illegality of Mercury's "broker" system.

At the point of sale, a customer buying an \$800 Mercury auto policy from a Mercury appointed agent would pay \$800 and the agent would receive a \$120 commission from Mercury. The same customer walking into a Mercury broker would pay \$800 plus a broker fee of \$150 for a total of \$950; the broker would receive a total of \$270 consisting of the commission and the broker fee. Mercury would not submit the broker fee to the Department of Insurance rate bureau for approval; the fee remains below regulatory radar. Meanwhile, Mercury could advertise the rate of \$800 to the public and steer customers away from State Farm, Farmers, and Allstate, whose publicly approved rates are higher, even though the cost to the customer may be less than the \$950 actually charged to the Mercury customer.

Mercury's violation of the law has succeeded. Since 1989, Mercury has become a top-tier insurer, having the second largest share of the California auto insurance market in 2006, only behind State Farm.

Much of the independent agent and broker segment of the market has followed suit by converting to a sham "broker" sales force, partly for the advantages and partly in an attempt to keep up with the undisputed industry leader, Mercury. Broker fees have thus become rampant in California's personal lines auto market. The broker fees raise the ultimate cost of insurance and are neither capped nor regulated. Broker fees between \$100 and \$250 are common. These fees allow the so-called "brokers" to "double dip", because in addition to the fees, these "brokers" also, tellingly, receive agent commissions from the insurers.

KRUMME v. MERCURY

Under Insurance Code section 1704, an insurer is obligated to "appoint" its agents. This serves two purposes: first, it makes the insurer vicariously liable for the errors and omissions of the agent; second, it prohibits the charging of broker fees, per the "Broker Fee Regulations" of November 23, 2000, in 10 Cal. Code Regs. section 2189.1 *et seq.*

In 2000, the Department of Insurance sent Mercury a draft Notice of Non-compliance, alleging that Mercury was marketing through a system of *de facto* agents who should have been appointed under section 1704(a). The Department alleged that by enabling its 700 *de facto* agents to charge broker fees, Mercury was violating the rate regulation statutes and failing to pay premium tax to the state. The investigation, however, was dropped by then-Insurance Commissioner Chuck Quackenbush, who accepted a \$50,000 campaign contribution from Mercury Chairman and CEO George Joseph, two weeks later.

In June 2000, *Krumme v. Mercury* was filed in San Francisco Superior Court on behalf of the general public to force Mercury to appoint its "broker" sales force and to stop the charging of illegal broker fees. The allegations in the Mercury case were that the "broker" classifications were a sham and that all of Mercury's producers needed to be appointed under section 1704(a).

The complaint sought an appointment injunction and, consistent with the Department's longstanding ban against broker fees charged by agents, an injunction against broker fees on Mercury business.

The Court concluded that there was no difference between the functioning of the agents and brokers in their relationship to Mercury. Mercury appealed the judgment, and an appellate panel unanimously affirmed the judgment in full. The Insurance Commissioner submitted an *amicus curiae* brief to the Court of Appeal endorsing the findings and the judgment.

The court relied in part on the five-part test that the DOI put in a letter (the "Hart letter") to the Legislature in 2000, to differentiate producers into agents and brokers:

- The insurer has given binding authority and other authorities to the producer;
- The insurer has given complete access to the underwriting and eligibility guidelines to the producer;
- The insurer has given its official forms and applications to the producer for the producer to use;
- The insurer refers to the producer as an agent in its advertising and consumer contacts and;
- The producer places a significant percentage of its business with the insurer.

WHAT KRUMME v. MERCURY SOLVED

Krumme v. Mercury created a template – the five-part test listed above – for ensuring that customers are not improperly charged broker fees by producers who are functioning as agents of a company, whether they are called an agent or a broker. Since losing the suit, Mercury has converted all but two of its 700 "brokers" back to agents who are forbidden from charging broker fees.

In March 2005, Mercury filed a motion to dissolve the injunction in *Krumme v. Mercury*. The Court denied the motion and ruled that Mercury was continuing to exercise control over its "broker" sales force. The Court was especially concerned that Mercury was continuing to use the power to "hire and fire" to constrict the market channel for Mercury insurance and, in so doing, to force brokers to perform front line underwriting for Mercury and otherwise to do its bidding. The Court ruled that Mercury's control over "brokers" was a badge of agency.

However, in July 2005, the Court modified the injunction to allow Mercury to continue to use brokers as long as Mercury implemented and maintained compliance with a list of requirements, including eliminating its control over brokers. The Court specifically required Mercury, as a condition of continuing to market through brokers:

1. to accept business from any bonded licensed broker who maintained errors and omissions insurance – the "take all brokers" requirement, and
2. not to pay commissions to brokers rewarding broker performance for Mercury, such as profitability of submitted business or loss ratio performance.

The Court did not apply the “take all brokers” measure to all insurance companies and brokers; in light of Mercury’s long history of heavy-handed control over its “broker” sales force, the Court only applied the remedy to Mercury. By doing business with only a select group of brokers and using discipline and termination to control them, Mercury constricted the market for consumers who turn to brokers when buying auto insurance. The Court set this condition in order to open the broker channel to free competition so that any licensed broker could submit prospective customers to Mercury.

In addition to our suggested amendment above, we would urge you to consider an alternative approach to this issue and require all insurers to consider applications submitted by any broker, as the Court required of Mercury.

As we have discussed in this letter, we believe that AB 2956 would result in significant cost increases for insurance consumers without providing any additional benefits to those customers. For the reasons outlined above, Consumer Watchdog opposes the bill. Please contact us with any questions you have.

Thank you for considering our views.

Sincerely,



Douglas Heller



Carmen Balber