Beyond Disclosure: The Case for Banning Contingent Commissions

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INTRODUCTION

In November 2004, New York’s prominent Attorney General (and now Governor) Eliot Spitzer accused insurance broker Marsh & McLennan of defrauding its clients by accepting “contingent commissions.” Contingent commissions are bonuses that insurers pay to brokers and independent agents (collectively “independent intermediaries” or “producers”) for bringing the insurer a particularly large volume of profitable customers. Since Spitzer’s initial attack on contingent commissions, his office has parlayed similar accusations into six settlement agreements with major insurance industry companies, twenty guilty pleas from these companies’ executives and officers, and approximately $3 billion in restitution and penalties. According to the latest count, more than twenty states have opened their own investigations into misconduct in the insurance industry. And seven states, with more expected to follow, have passed legislation to combat the types of practices Spitzer uncovered. Federal officials have monitored these responses closely, with some suggesting that they expose fundamental problems with lodging insurance regulation at the state—rather than federal—level. In short, during the last two years contingent commissions have caused a scandal unparalleled


3. The prominence of Spitzer’s initial attack on contingent commissions is partially attributable to the fact that employees at Marsh & McLellan had solicited purposely inflated price quotations from some insurers. This “bid rigging” allowed Marsh to steer its clients to particular insurers by falsely convincing them that the insurer had prevailed in a competitive process of price quotation. The sole benefit to Marsh, and its guilty employees, was the receipt of additional contingent commissions. See Sean M. Fitzpatrick, The Small Laws: Eliot Spitzer and the Way to Insurance Market Reform, 74 FORDHAM L. REV. 3041, 3046-47 (2006). Subsequent investigations, however, have revealed that Marsh’s undeniably fraudulent practice of bid-rigging was isolated to a small number of the giant insurance broker’s employees; bid-rigging was not, as initially seemed plausible, widespread among insurance brokers and insurers in the property-casualty industry. See id.


5. Fitzpatrick, supra note 3, at 3050 n.39.

6. Id. at 3064.

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in the history of the property-casualty insurance industry.\textsuperscript{8}

According to critics of the practice, contingent commissions create a conflict of interest for ostensibly independent intermediaries. Unlike ordinary premium-based commissions, which are a fixed percentage of an individual insurance customer's premiums, contingent commissions are paid to intermediaries based on the volume and profitability of business they refer to insurers.\textsuperscript{9} The size and structure of the contingent commissions that insurers offer to intermediaries therefore vary significantly. This variability means that intermediaries can often increase their commissions by "steering" clients to insurers that provide suboptimal coverage for their customers' needs.\textsuperscript{10}

Despite the recent controversy surrounding contingent commissions, these payments and similar performance-based commissions remain common in most property-casualty insurance markets.\textsuperscript{11} Contingent commissions are ubiquitous among independent insurance agents, who provide 40% of ordinary consumers with insurance products covering their homes, automobiles, or small businesses.\textsuperscript{12} Contingent commissions are also widely used in insurance markets involving sophisticated insurance purchasers—where brokers rather than agents are the dominant type of intermediary.\textsuperscript{13} Although each of the four largest insurance brokers have disclaimed contingent commissions in response

\begin{itemize}
  \item \textsuperscript{8} See Fitzpatrick, supra note 3, at 3041.
  \item \textsuperscript{9} See Cummins & Doherty, supra note 2, at 379.
  \item \textsuperscript{11} See J. ROBERT HUNTER, CONSUMER FED'N OF AM., CONTINGENT INSURANCE COMMISSIONS: IMPLICATIONS FOR CONSUMERS 2 (2005), \url{http://www.consumerfed.org/pdfs/contingent_commissions_study.PDF}.
  \item \textsuperscript{12} Id. at 4 ("C]ontingent arrangements exist in most lines of insurance sold to consumers . . . . In personal auto and homeowners insurance, agent-based insurers cover about 40 percent of the market."). Captive agents or direct writers, both of whom sell only a single insurer's policies, obviously do not receive contingent commissions.
  \item \textsuperscript{13} In theory, independent agents and brokers differ in the extent to which they are legal agents of the policyholder or the insurer. See KENNETH S. ABRAHAM, INSURANCE LAW & REGULATION 56-57 (3d ed. 2000); 7 ERIC MILLS HOLMES, HOLMES' APPLEMAN ON INSURANCE 2D: LAW OF INSURANCE AGENTS § 47.5, at 326 (1998). Insurance brokers are typically described as general legal agents of the insurance consumer who are free to place the consumer's business with whatever insurer the consumer or broker chooses, whereas independent insurance agents ostensibly function as independent contractors who sell the products of multiple different insurers. See ABRAHAM, supra, at 56-57. In practice, the difference between these two types of intermediaries is often hazy at best. See TOM BAKER, INSURANCE LAW AND POLICY 66 (2003); Colin Sammon, Comment, Insurance Agent and Broker Liability: Crossing the Two Way Street, 29 OHIO N.U. L. REV. 237, 238 (2002). Indeed, several states have abandoned the distinction between agents and brokers altogether. See HOLMES, supra, § 47.6, at 338; Fitzpatrick, supra note 3, at 3054 (noting Connecticut as one example). To the extent that there is a meaningful practical distinction between these two intermediaries, it is that brokers tend to serve relatively sophisticated clients, whereas agents tend to serve less sophisticated ordinary consumers. See Fitzpatrick, supra note 3, at 3055. It is this latter distinction—based on the level of sophistication of the insurance purchaser—that is relevant for the purposes of policy analysis. Consequently, this Article structures its analysis around consumer sophistication rather than the agent/broker distinction.
\end{itemize}
to pressure from Spitzer’s office,\textsuperscript{14} the majority of brokers have refused to do so.\textsuperscript{15} And a handful of insurers that currently claim to have abandoned contingent commissions have merely adopted “supplemental compensation” arrangements, which retain the same performance-based contingency structure that generates the underlying conflict of interest.\textsuperscript{16} In effect, such “supplemental compensation arrangements” are contingent commissions by a different name.\textsuperscript{17}

Independent insurance intermediaries defend their continued receipt of contingent commissions by arguing that competition can adequately address the payments’ potential dangers.\textsuperscript{18} To date, this argument has apparently convinced state regulators and legislatures: the vast majority of reform proposals permit contingent commissions so long as they are adequately disclosed.\textsuperscript{19} And each of the approximately half-dozen states that has enacted reforms has merely imposed disclosure requirements.\textsuperscript{20} Indeed, Spitzer himself has suggested that contingent commissions might be acceptable in some parts of the industry if


\textsuperscript{15} See David Dwanka, Mid-Level Insurance Brokers Defend Contingent Commissions Amid Growing Criticism, BESTWIRE, May 8, 2006.


\textsuperscript{17} Accordingly, this Article uses the term “contingent commission” to encompass “supplemental compensation” agreements. Cf. Roberts, supra note 16, at 1 (noting that the Chubb agreement states that “a fixed commission paid to a producer, set prior to the sale of a particular insurance product, and that may be based on, among other things, the prior year’s performance of the producer” is not considered a contingent compensation”). For more on the distinctive issues that supplemental compensation arrangements pose, see infra notes 163-164 and accompanying text.

\textsuperscript{18} See Dwanka, supra note 15.

\textsuperscript{19} See Fitzpatrick, supra note 3, at 3050 n.39 (noting that over twenty states have opened investigations into contingent commissions as of May 2006, and that “[l]egislative and administrative market reform efforts have targeted disclosure of compensation received by insurance producers, as opposed to proscribing contingent commissions themselves”). These disclosure requirements do not require disclosing the size of the contingent commissions associated with a particular transaction. Indeed, such disclosure might well be impossible given that contingent commissions are calculated at year’s end.

\textsuperscript{20} See id. at 3064. Many of the most important states for insurers, including California and New York, have not yet adopted reforms. Id.
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insurers informed consumers about their existence.\(^{21}\)

Significantly, academic commentary has supported this disclosure-based response to contingent commission schemes. The most notable claim in the extant literature is that because contingent commissions are based on insurers’ profitability, they encourage producers to inform insurers about the risk characteristics of potential purchasers ("insureds") in ways that would otherwise be impossible.\(^{22}\) Some have therefore concluded that contingent commissions can help consumers by reducing information asymmetries between them and their insurers. This would limit adverse selection, a highly theorized problem in insurance markets, which occurs when high-risk insureds purchase more insurance than low-risk insureds, potentially causing premiums to spiral upward as "good" risks forego insurance altogether. Given this and other potential benefits of contingent commissions, commentators have argued that insurance purchasers, so long as they are informed, should be allowed to choose brokers and agents who accept contingent commissions.\(^{23}\) According to these writers, not only would meaningful disclosure empower insureds over regulators, but it also would prompt more careful scrutiny of intermediaries’ actions, thereby limiting the likelihood that insureds would be steered toward suboptimal insurance.

This Article questions the emerging consensus among state officials and academics that disclosure is a sufficient solution to the problems that contingent commissions pose. Both the substance and the strength of this challenge depend upon the sophistication and knowledge of insurance purchasers. For this reason, this Article first analyzes consumer insurance markets—such as homeowners, renters, and automobile insurance—where purchasers tend to be relatively unfamiliar with many elements of the insurance industry. It then proceeds to commercial insurance markets, such as directors’ and officers’ (D&O) insurance and business automobile insurance, where purchasers are assumed to be knowledgeable and rational about their insurance options.

The Article concludes that a disclosure requirement in consumer insurance

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21. In a speech to the National Press Club, Spitzer stated that the use of contingent commissions "may be appropriate" in certain segments of the insurance industry when they are disclosed to consumers. Press Release, Nat’l Ass’n of Prof’l Ins. Agents, PIA National Encouraged by Remarks Made by N.Y. Attorney General Eliot Spitzer on Contingent Commissions (Jan. 31, 2005), available at http://www.pianet.com/NewsCenter/PressReleases/1-31-05.htm.

22. See Cummins & Doherty, supra note 2, at 386-89; Fitzpatrick, supra note 3, at 3060-61; see also Gary Biglaiser, Middlemen as Experts, 24 RAND J. ECON. 212 (1993) (showing that middlemen can help reduce adverse selection in a variety of markets, but not discussing the role of a contingent commission payment structure in this process).

markets is unlikely to address meaningfully the core risk of contingent commissions—the potential for inefficient steering. In fact, contingent commissions are merely one example of a common type of regulatory problem, termed a "trilateral dilemma" by Professor Howell Jackson, which lawmakers consistently regulate in ways that go beyond mere disclosure. In a generic trilateral dilemma, market intermediaries extract side payments from other professionals for steering business to them. For instance, a real estate agent may recommend a particular lawyer to his customers in exchange for kickbacks from the lawyer. Trilateral dilemmas tend to be immune to disclosure-based remedies for three basic reasons, each of which squarely applies to contingent commissions. First, consumers who rely on intermediaries to recommend other service providers generally have an inherently limited capacity to assess the end-service provider's relative strengths and weaknesses. Second, because intermediaries interact closely with their customers, they can discriminate between sophisticated and unsophisticated customers, taking advantage of the latter by giving them biased advice while providing more objective advice to the former. Finally, customers often have a relationship of trust with their intermediary that blunts any tendency to scrutinize the advice they receive. Just as each of these considerations has generally supported robust government regulation of most trilateral dilemmas, they also support affirmative government intervention in the case of contingent commissions.

Not only are the risks of contingent commissions large in consumer insurance markets, but the benefits of these payments are minimal at best. The core benefit of reduced adverse selection that commentators have offered in support of contingent commissions is both significantly overstated and highly speculative in consumer insurance markets. Extensive empirical research has consistently shown that adverse selection is not a significant problem in these insurance markets. Moreover, there is little empirical evidence that contingent commissions really do improve insurers' information about potential insureds, and significant theoretical reasons to believe that they do not. Weighing these costs and benefits of contingent commissions, the Article suggests that the optimal regulatory solution may be to ban contingent commission arrangements in consumer insurance markets.

A disclosure-based response to contingent commissions in commercial insurance markets, where purchasers tend to be sophisticated about insurance

24. See infra Section II.A.
26. See Jackson & Burlingame, supra 25.
27. See id.
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options, is more likely to be effective than in consumer insurance markets. But this Article demonstrates that even when insurance purchasers are both informed and rational, there are still reasons to be concerned about a disclosure-based response. First, disclosure of contingent commissions may result in rational and informed insurance purchasers seeking out intermediaries who accept contingent commissions even though they would prefer such commissions to be banned due to the risk of steering. The reason for this divergence between market behavior and individual purchaser preferences is that those who purchase insurance through an intermediary that does not receive contingent commissions may signal to insurers that they view themselves to be high-risk. If so, then insurers will charge an increased premium for consumers who purchase insurance in this way, undermining the extent to which consumers’ informed market choices reflect their actual preferences regarding contingent commissions. Second, the adverse selection defense of contingent commissions is also questionable in commercial insurance markets. Contingent commissions may erode the relationship of trust between independent intermediaries and their clients and consequently shift, rather than eliminate, the information asymmetry that results in adverse selection.

Part I of this Article reviews the arguments in the extant literature about the costs and benefits of contingent commissions. It shows that the key concern with respect to contingent commissions is the risk associated with inefficient steering. It also explains how contingent commissions may improve insurance markets by reducing adverse selection. Part II applies the framework developed in Part I to consumer insurance markets. It argues that the limitations of disclosure in solving trilateral dilemmas create a significant risk that insurance intermediaries will continue to steer their customers toward inefficient arrangements in the absence of more robust regulation. It also argues that the risks associated with adverse selection in consumer property-casualty insurance markets are small, and that they are not appreciably reduced by contingent commission payments. For these reasons, Part II concludes that lawmakers should consider banning contingent commission payments in consumer insurance markets. Part III applies the framework developed in Part I to commercial insurance markets. It develops a theoretical model that shows that even fully informed insurance purchasers may not make decisions about their insurance intermediaries that reflect their actual preferences regarding contingent commissions. It also shows that the capacity of contingent commissions to reduce adverse selection is limited because of their potential to induce strategic, inefficient behavior by rational high-risk insureds. Part III concludes that disclosure in commercial insurance markets, like disclosure in consumer markets, may be an insufficient regulatory solution, but that empirical work is needed before a policy prescription can be endorsed.
I. THE CONTINGENT COMMISSION DEBATE: INCREASED STEERING VS. REDUCED ADVERSE SELECTION

The current debate about contingent commissions focuses on their impact on the incentives of independent intermediaries. These payments shift such incentives to be less aligned with those of insurance consumers and more aligned with those of insurers. As a result, independent intermediaries that receive contingent commissions may tend to act in ways that initially appear less favorable for the consumer and more favorable for the insurer.

This Part reviews, but does not critique, the two key ways in which the literature has suggested this may occur. Section A describes the argument that contingent commissions cause intermediaries to steer their customers to suboptimal insurance arrangements. Section B then reviews the primary defense of contingent commission payments: that they create an incentive for intermediaries to share relevant customer information with insurers in a way that limits adverse selection. Section C considers some alternative defenses of contingent commissions, but concludes that they are generally unpersuasive. This Part therefore seeks to frame the basic contingent commission debate as involving two competing claims: that contingent commissions increase steering, and that they decrease adverse selection. The remainder of the Article builds off of this framework.

A. Contingent Commissions and Inefficient Steering

Independent insurance intermediaries help facilitate efficient purchases by matching customers with insurance options that fit their needs and preferences. Insurers vary substantially based on their reputations for claims handling, financial strength, and risk management services. Even the scope of coverage that an insurer provides—in both its base policies and its endorsements—can vary. The role of independent intermediaries is to help their customers understand these variations in quality and assess what policy

29. See Consumer Reports Investigates: Surviving the 'Hard Market' in Homeowners Insurance, CONSUMER REP., Sept. 2004, at 36 (describing how homeowner insurers differ significantly with regard to the percentage of customers reporting problems with claims or delayed payment); Homeowners Insurance: Report, CONSUMER REP., Jan. 1999, at 16 (suggesting that consumers, when choosing an insurer, consider customer satisfaction with claims handling among other factors).


31. Some homeowners insurance companies, for instance, provide their insureds with free washing machine hoses in order to limit the risk of flooding. See Meg Green, Top of Their Game, BEST’S REV., Dec. 2006, at 32.

type is best for their needs. Additionally, independent intermediaries can help their customers identify pricing differentials among insurers that are not attributable to differences in quality. This is not uncommon even in price-competitive insurance markets: insurers often differ in the focus of their underwriting, meaning that they are willing to offer certain types of individuals—for instance, those who do not drink any alcohol—lower rates than other insurers. Independent intermediaries can help match their customers with the insurer that employs underwriting criteria most favorable for the customer.

Contingent commissions may cause ostensibly independent intermediaries to deviate from this market-matching role and to steer insureds to suboptimal insurance arrangements. To understand why, consider the basic structure of contingent commissions. These payments are bonuses, which insurers pay to intermediaries in addition to ordinary premium commissions. While premium commissions are stable—a simple percentage of an insured’s total premium—contingent commission arrangements vary considerably. In general, the size of an intermediary’s contingent commission is based on two variables: (1) the amount of insurance business that a particular intermediary refers to the insurer, as measured in total premiums; and (2) the profitability of that business, which is usually measured by the insurer’s loss ratio. In most cases, intermediaries are only entitled to contingent commissions if they meet threshold levels of both sales volume and profitability. Once intermediaries reach these qualifying levels, their commissions typically increase with better results along either dimension.

This payment structure is likely to alter the ways in which independent intermediaries direct their customers to insurers. Most obviously, independent intermediaries may steer their clients to insurers that pay contingent commissions based on the profitability of the business written or profitability and volume. The loss ratio is the "ratio between premiums paid and losses incurred during a given period." BLACK'S LAW DICTIONARY 958 (7th ed. 1999). Premiums on both new policies and policy renewals are generally treated similarly in these calculations, which are almost always made on a yearly basis. Cummins & Doherty, supra note 2, at 374-75. In some cases, contingent commission arrangements may be based only on profitability, not volume. However, according to Cummins and Doherty, "the great majority of the arrangements covering the smaller intermediaries is based on the profitability of the business written or profitability and volume." Cummins & Doherty, supra note 2, at 379. Marsh and McLennan’s contingent commission arrangements were distinctive in this regard, paying Marsh solely based on the volume of premiums that it brought to a given insurer. See id. at 16 n.20.

See Abraham, supra note 13, at 56-66; see also Cummins & Doherty, supra note 2, at 360.
34. See generally Green, supra note 31, at 26 (describing how some of the most profitable property-casualty insurers focus on underwriting only particularly safe risks, and pass off some of the resulting cost savings to their insureds).
35. See Hunter, supra note 11, at 2-8; Press Release, supra note 1.
36. See Cummins & Doherty, supra note 2, at 374-75.
38. See Wilder, supra note 37, at 5. In some cases, contingent commission arrangements may be based only on profitability, not volume. However, according to Cummins and Doherty, "the great majority of the arrangements covering the smaller intermediaries is based on the profitability of the business written or profitability and volume." Cummins & Doherty, supra note 2, at 379. Marsh and McLennan’s contingent commission arrangements were distinctive in this regard, paying Marsh solely based on the volume of premiums that it brought to a given insurer. See id. at 16 n.20.
39. See Wilder, supra note 37, at 5.
commissions over those that do not: intermediaries will generally earn more in contingent commissions when their customers buy insurance through an insurer with whom the intermediary has a contingent commission contract. 40 Contingent commissions may also induce intermediaries to steer their customers to certain insurers in a number of less obvious situations. For instance, even when an independent intermediary can earn contingent commissions from multiple different insurers, the intermediary may maximize its profits by steering its customers to an insurer that offers the most lucrative commission. Alternatively, an intermediary might profit by steering a customer to an insurer whose contingent commission contract has a minimum-volume requirement on the cusp of being satisfied, even though a different insurer was the best match for that particular consumer. 41 Yet another possibility is that an intermediary might profit by steering relatively high-risk insureds to insurers who do not offer contingent commissions, so as to maintain a good “loss ratio” with the insurers who do offer contingent commissions. 42

To illustrate these dynamics more concretely, consider an insurance agent who has contingent commission arrangements with two insurers, X and Y. The arrangement with insurer X provides that the agent is entitled to an additional 1% of the insured’s premium if the agent’s book of business—the customers the agent successfully refers to the insurer—reaches $1 million of premiums for the year and generates $100,000 of profit. The arrangement with Y is identical, except that it entitles the intermediary to an additional 2% of the insured’s premium if the triggering conditions are met. Initially the agent will have an incentive to steer customers to both X and Y, rather than to other insurers, so that he can meet the million-dollar premium requirement for both insurers. If he reaches this plateau with Y but not before year’s end, he may then start

40. One exception, noted below, is that an intermediary may actually maximize contingent commissions by steering an insured who is high-risk to an insurer with whom the intermediary does not have a contingent commission arrangement.

41. See Wilder, supra note 37, at 19. Another potential risk for consumers is that contingent commissions may cause independent intermediaries to be insufficiently aggressive in seeking payment for their client’s insurance claim. See HUNTER, supra note 11, at 7-8. Generally independent intermediaries not only help their customers select appropriate coverage but also manage the ongoing relationship between the customer and insurer, transmitting premium payments and negotiating claims. See generally ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW § 35 (1987) (describing the role of intermediaries in facilitating the purchase of insurance). Because contingent commissions reward independent intermediaries based on the insurer’s profitability, they create a disincentive for intermediaries to maximize the claims payment their clients receive: the less the client receives, the more profitable the intermediaries’ book of business is with the insurer, and thus the more the intermediary stands to gain in contingent commissions. The danger of this effect is unclear, however, as insurance consumers are likely to be quite sensitive to their intermediaries’ capacity to successfully negotiate claims; payment on claims is likely to be almost as salient a consideration for most consumers as policy price. See Fitzpatrick, supra note 3, at 3062 (“Anyone with practical experiences in the insurance business knows that customers make lasting judgments about intermediaries and insurers based on their behavior in the claims-paying context . . . .”).

42. This last scenario may be an example of efficient steering. For elaboration, see infra text accompanying notes 68-71.
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referring more customers to \( X \). Once the agent is comfortable that he will meet the premium requirements for both \( X \) and \( Y \), he may then start referring lower-risk customers to \( Y \) in order to maximize \( Y \)'s profits, and thus to increase the likelihood of hitting the profit target that is linked to the payment of the contingent commissions.

This steering is potentially problematic because the insurers that pay contingent commissions to an intermediary may not best suit a particular insured’s risk preferences and needs. At the very least, these insurers will tend to charge more than other insurers in order to support the costs of paying contingent commissions. A recent study found that insurers pass through the entire cost of contingent commissions to their insureds.\(^4\) The study controlled for insurers’ size, financial leverage, mix of business by line, and diversification across lines of business.\(^5\) In other words, while insurers pay contingent commissions to intermediaries, consumers ultimately bear the cost of these payments in the form of increased premiums.\(^6\) Insurers that pay contingent commissions may be suboptimal for reasons other than price, however. These insurers may provide coverage that deviates from a customer’s preferences with regard to claims handling, financial strength, risk management services, or coverage scope. Although there is no empirical evidence that insurers paying contingent commissions are systematically worse than other insurers along these quality dimensions, there are certain to be instances in which the best insurance choice for the consumer will not align with the insurance option that pays his or her intermediary the most in contingent commissions. To the extent that independent intermediaries prioritize their receipt of contingent commissions over their market-matching role, then customers will often receive insurance of a quality and price that is not best for their needs.

Of course, sales personnel in a variety of other industries likely face similar incentives to promote specific product types. Although lawmakers do not typically worry about these conflicts of interest, contingent commissions are distinctive for two important reasons. First, unlike a car salesman or a store

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\(^4\) Cummins & Doherty, supra note 2, at 383. Insurers also pass through the full costs of premium commissions to their insureds. Id. These estimates were derived using data that exploited the fact that different insurers offer different levels of contingent commissions. Id. at 380-83. It is therefore not inconsistent with the argument presented later, see infra notes 168-170 and accompanying text, that insurers may adopt a strategy of charging more to insurance consumers who purchase from intermediaries that completely disclaim contingent commissions.

\(^5\) Cummins & Doherty, supra note 2, at 380-83.

\(^6\) As the authors of the study rightly note, the mere fact that insurers who pay contingent commissions also tend to charge more for their insurance does not necessarily mean that these insurers are worse for the consumer. If the increased costs attributable to contingent commission payments create benefits for the consumer in the form of reduced adverse selection, see infra Section I.B., and these benefits outweigh the price increase as well as the other potential costs of contingent commissions, then consumers are better off purchasing insurance from these intermediaries, see Cummins & Doherty, supra note 2, at 381-83.
clerk, independent intermediaries actively advertise their independence. The website of the Independent Agents and Brokers of America encourages consumers to purchase insurance through an independent intermediary rather than through a captive agent or direct underwriter because independent agents are not beholden to any one company. Rather, the website claims that they are "value hunter[s] who look[] after your pocketbook in finding the best combination of price, coverage and service" because "serving you is your independent agent's most important concern." Similarly, prospective customers are given brochures explaining that their independent agent "shop[s] among various companies" to "find the best combination of coverage, price and service—the best value for your insurance dollar." These brochures describe the agent as someone "who . . . goes to bat for you when you need help or advice" and who "is your Personal Insurance Adviser—someone you can count on and trust." Each of these claims of independence is confirmed by the simple, but important, fact that independent agents have their own storefronts or office buildings, which advertise the independent agent's company name, not the names of insurers. This professed independence is one of the primary reasons that insureds choose to purchase their insurance through independent intermediaries. By contrast, consumers understand that sales agents often have an incentive to steer their customers to particular (usually more expensive) products, and discount the advice they receive accordingly.

Second, ordinary consumers typically have little capacity to compare insurance products on their own without the benefits of independent advice from intermediaries. Insurance is a complicated and intangible product with

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46. See Hunter, supra note 13, at 3; infra notes 138-140 and accompanying text; see also Money on the Table, Leader's Edge, Jan.-Feb. 2007, available at http://www.ciab.com/Content/ContentGroups/Leaders_Edge_Magazine2/2007/Jan-Feb3/Money_on_the_Table.htm ("The distinction between an agent and broker has been lost because most agents present themselves as representing the interests of the insured.") (quoting Bobby Reagan, Reagan Consulting)).


48. See id.; see also Hunter, supra note 11, at 3. Such language is also common in insurance brokers' materials. Indeed, Marsh & McLellan's website proclaimed that "[o]ur guiding principle is to consider our client's best interest in all placements" and added: "We are our clients' advocates, and we represent them in negotiations. We don't represent the [insurance companies]." See Marsh Complaint, supra note 10, ¶ 6.


50. Id.

51. See, e.g., The Motley Fool, Insurance Center: Basics, http://www.fool.com/insurancecenter/basics/basics07.htm (last visited Apr. 11, 2007) ("An independent insurance agent represents a number of insurance companies and can more objectively weigh pluses and minuses across many companies and types of insurance.").

52. See generally Schwarcz, supra note 32, at 1412-22 (discussing the avenues by which insurance consumers learn about different insurance options and the limitations of these sources of information).
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which most consumers have very little experience or knowledge. Moreover, insurers' reputations imperfectly reflect the underlying quality of their products and services. In markets with such limited consumer information, truly independent intermediaries are crucial for market outcomes to be efficient. Independent advice is significantly less important in markets where products have relatively well-understood features and accurate reputations.

Defenders of contingent commissions admit that the practice theoretically creates conflicts of interest for independent intermediaries, but they argue that competition will minimize the negative impact of these conflicts, especially when supplemented with disclosure. For most independent producers, contingent commissions constitute only a small fraction of their overall revenue, with estimates ranging between 4% and 6% on average. The vast majority of most intermediaries' compensation instead derives from ordinary premium commissions. As such, defenders of contingent commissions reason that the primary goal for independent intermediaries is to sell insurance and generate premium-based commissions. Doing so, of course, critically depends on attracting and retaining customers. According to these commentators, were brokers and independent agents systematically to steer their customers to over-priced, low-quality coverage, their loss in premium revenues would far exceed


54. See Schwarz, supra note 32, at 1413-15 (arguing that insurers' reputations do not perfectly reflect the overall quality of their products because, while reputation is largely a function of friends' and families' experience, few insurance consumers receive the most important features of their insurance—protection against low-probability, high-cost losses).

55. See ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW § 32(b) (2d ed. 1996) ("In forming a contract, an insured relies not upon the text of the policies but on the general descriptions of the coverage provided by the insurer and its agents during the time the insured is considering submitting an application."); Biglaiser, supra note 22, at 221 (describing how intermediaries can help facilitate efficient purchasers in markets where information is imperfect); W. David Slawson, Standard Form Contracts and Democratic Control of Lawmaking Power, 84 HARV. L. REV. 529, 547 (1971) (noting that the average consumer "depends on an insurance agent and insurance company to sell him a policy that 'works' for its intended purpose in much the same way that he depends on a television salesman and television manufacturer").

56. See Biglaiser, supra note 22, at 221.

57. One survey found that, on average, contingent commissions account for only 6% of the revenues received by independent agents. Anne Gron, Compensation and Industry Profitability: Evidence from the Property-Casualty Insurance Industry, 71 J. BUS. 407, 410 (1998) (citing INDEP. INS. AGENTS OF AM., AN INDEPENDENT AGENCY'S GUIDE TO PROFIT-SHARING/INCENTIVE COMPENSATION AGREEMENTS (1988)). Other surveys have found similar, though slightly lower, figures for insurance brokers. Cummins & Doherty, supra note 2, at 375 n.16 (citing CONNING & CO., COMMERCIAL INSURANCE BROKERS: THEY SNOOZE, THEY LOSE (1999) (finding in a survey of brokers that contingent commissions accounted on average for 5% of brokers' revenues in 1994 and 4.6% in 1999)). For both brokers and independent agents, the percentage of revenue attributable to contingent commissions varies widely. One survey, for instance, found that some brokers received almost 12% of their revenue from contingent commissions, while others received only 1% of their revenue from such commissions. See id. at 365 tbl.2.

58. See Cummins & Doherty, supra note 2, at 375; Fitzpatrick, supra note 3, at 3056.
whatever minimal gain they could receive in contingent commissions.\textsuperscript{59} This is especially true given the competitiveness of most property-casualty insurance markets.\textsuperscript{60} Disclosure of contingent commissions, while not strictly necessary for this competitive process, can help facilitate it. Such disclosure encourages insurance consumers to monitor the quality of their intermediaries’ advice or, alternatively, to insist on intermediaries who do not accept contingent commissions.

It is for similar reasons, these commentators have suggested, that few officials or regulators worry about whether ordinary, premium-based commissions will cause intermediaries to steer their customers to particularly expensive insurance. Although intermediaries could theoretically increase their premium-based commissions through steering in the short run, market forces deter this result in the long run.\textsuperscript{61} The same logic applies, according to these writers, to contingent commissions. To the extent that insurance costs more when the insurer pays contingent commissions, the best explanation is that this

\begin{itemize}
\item \textsuperscript{59}See Cummins & Doherty, supra note 2, at 385 (arguing against the notion that intermediaries receiving contingent commissions will steer customers because “contingent commissions account for only about 5 percent of revenue,” and “[i]ntermediaries who make inferior placements in pursuit of higher contingent commissions are balancing a small gain against the possibility of a much larger loss, i.e., the loss of the premium-based commission if the client becomes dissatisfied and switches to a competitor’’); Fitzpatrick, supra note 3, at 3061-62 (noting that concern that intermediaries will steer consumers to suboptimal insurers is not “utterly unfounded,” but dismissing it because “insurance intermediaries are normally more concerned with the risk of losing a good customer to a competing producer than they are with any marginal inducements that may be provided by any one insurance carrier”).

\item \textsuperscript{60}For a response to this argument, see infra Section II.A, which argues that competitive forces are unlikely to negate the costs of contingent commissions. This does not mean that the industry as a whole is not competitive on price. See J. DAVID CUMMINS, DEREGULATING PROPERTY-CASUALTY INSURANCE 2-3 (2002) (explaining that deregulation of property-casualty insurance could benefit consumers because “the insurance industry is competitive”); Paul Joskow, Cartels, Competition and Regulation in the Property-Liability Insurance Industry, 4 BELL J. ECON. & MGMT. SCI. 375, 391 (“The property-liability insurance industry possesses the structural characteristics normally associated with the idealized competitive market: a large number of firms, operating in a market with low concentration levels, selling essentially identical products, provided at constant unit costs and with ease of entry of new and potential competitors.”). For an argument that the industry is not competitive with regard to policy drafting, see Schwarcz, supra note 32, at 1401-26.

\item \textsuperscript{61}There are at least three important distinctions between the conflicts of interest generated by premium-based commissions and those generated by contingent commissions. First, premium-based commissions create a very simple type of conflict: they mean that producers earn more when their customers pay more. By contrast, because contingent commissions are linked to insurers’ profits, they create a complicated array of conflicts that can impact advice about insurance quality as well as price. Insurers’ profits can increase either if the price of the insurance is too high or if the cost of the insurance is too low. Market forces will generally be better at limiting large price differentials in insurance than at addressing biased advice about quality or the necessity of different insurance options. See infra text accompanying notes 114-128. Second, premium-based commissions are much easier to disclose effectively to insurance consumers than are contingent commissions because the former operate only on individual transactions. In contrast to contingent commissions, whose impact on an independent intermediary can only be assessed when looking at aggregate, year-end data, individuals can immediately deduce the relevance of differential premium-based commissions. See infra note 119 (explaining that this difficulty in disclosing contingent commissions potentially can be overcome by the use of retrospective supplemental compensation arrangements). Third, premium-based commissions are generally standard across the industry within a given insurance line. See infra note 164.

\end{itemize}
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extra cost is warranted by the benefits that contingent commissions create for the consumer. 62

B. Contingent Commissions and Adverse Selection

The core defense of contingent commissions rests on the observation that these payments align the interests of independent intermediaries and insurers: both are better off when the insurer makes a profit on the intermediary’s book of business. As two insurance economists, J. David Cummins and Neil A. Doherty, have recently argued in an influential paper, 63 this commonality of interests potentially alters intermediaries’ behavior in a significant way: it encourages intermediaries to help insurers charge their customers an actuarially appropriate premium. If insurers charge an intermediary’s customer a premium that is too low, then the intermediary’s loss ratio for that insurer will suffer, reducing the expected amount of the intermediary’s contingent commission. If, on the other hand, the insurer misjudges the customer’s risk level in the other direction and charges a premium that is too high, the customer may purchase insurance through a different insurer or decide to forego purchasing insurance altogether. The expected value of the intermediary’s contingent commissions will decrease in this situation as well.

According to Cummins and Doherty, independent intermediaries that receive contingent commissions can theoretically help insurers set appropriate premiums by informing them about a potential insured’s risk profile. 64 Independent brokers and agents interact directly with potential insureds and often have longstanding relationships with these clients. These intermediaries may therefore possess information about potential insureds that would

62. See Cummins & Doherty, supra note 2, at 394.
63. The study was funded by the American Insurance Association. See id. at 359 (acknowledging funding from the Association). On the influence of this argument, see, for example, Fitzpatrick, supra note 3, at 3060-61; and Andrea Ortega-Wells, Wharton Study Finds Agents, Brokers Play Critical Role in Buying Process, INS. J., June 8, 2005, available at http://www.insurancejournal.com/news/national/2005/06/08/55791.htm.
64. Cummins & Doherty, supra note 2, at 386-89; see also Laureen Regan & Sharon Tennyson, Agent Discretion and the Choice of Insurance Marketing System, 39 J.L. & ECON. 637, 639 (1996) (“The agent is the first contact the insurer has with a potential policyholder and may be able to obtain information about the customer which would be difficult or costly for the firm to verify.”). There is significant evidence that “captive” insurance agents, who work only for one insurer and therefore do not receive contingent commissions, do indeed perform this information-gathering role. For instance, one training manual for an insurer’s captive agents instructs them to treat all potential insureds as “suspects” and to “[b]e proactive and selective in your prospecting activity” and “ruthless in getting rid of” bad risks. RICHARD V. ERICKSON ET AL., INSURANCE AS GOVERNANCE 226 (2003). Another insurance company manual insists that agents consider “the desirability of the client’s entire account,” and another reminds agents that it is through their “application of ability, knowledge, experience and courage that risks can be selected properly and produce a profit for the insurer.” Id. at 228. A major work in the sociology of insurance thus finds that agents are “instructed that the selection and rating process is shot through with discretion.” Id. at 239.
otherwise be unavailable to insurance companies. In some cases, this information may consist of concrete facts about the insured that are not captured in the ordinary insurance application process. For instance, an intermediary may know that a potential insured was nearly sued earlier in the year, but that the potential plaintiff unexpectedly dropped the suit for personal reasons. Perhaps more frequently, though, an intermediary's informational advantage may consist of subjective impressions about an insurance consumer's risk level that are impossible for the insurer to discern through application forms. The intermediary may observe, for instance, that a small business owner tends to miss scheduled appointments or looks disheveled and disorganized. Without contingent commissions, Cummins and Doherty suggest, there would be "no incentive for the agent to reveal the information about policyholder risk types" to the insurer unless the insurer engaged in costly monitoring of its agents.

Contingent commissions may improve insurer information even if intermediaries and insurers do not explicitly communicate with one another. As described above, contingent commissions may cause intermediaries to steer relatively high-risk insureds to insurers that do not offer contingent commissions, so as to maintain a good "loss ratio" with those insurers that do. The better an intermediary's loss ratio is, the more he or she will receive in contingent commissions. Consequently, contingent commissions may allow insurers to know that they are receiving relatively low-risk insureds from their intermediaries irrespective of their direct communications with these intermediaries. In this way, contingent commissions may actually create efficient, rather than problematic, steering.

65. See Cummins & Doherty, supra note 2, at 386.
66. See Regan & Tennyson, supra note 64, at 639 ("It is widely acknowledged that agents often employ subjective criteria in evaluating insurance applicants."). Agents selling homeowners insurance, for instance, have been told to identify whether potential insureds live near a "'hangout' for a local youth gang," whether they keep their home clean, or whether a household pet appeared "unusual or vicious." Erickson et al., supra note 64, at 230, 232. As the manual explained, "[p]oorly kept or poorly maintained premises may indicate a lack of responsibility on the potential client's part," and "[o]bvious damage to furniture, carpets, and other personal property can also indicate a moral or liability hazard." Id. at 230. One insurance agent operator explained that sometimes he rejected an insurance applicant after meeting with him because he "had a 'gut feeling' that the person was simply 'bad luck.'" Id. at 247. Insurers often grant a similar level of discretion to their agents when it comes to automobile insurance, with one auto insurance manual explaining that "[a]gents working in the field are in the best position to know or observe any undesirable characteristics of the clients as operators of the vehicle." Id. at 264.
67. Cummins & Doherty, supra note 2, at 389. It is modest support for this argument that some insurers offer differential commissions to their captive agents based on the loss ratio of that agent's book of business. See Erickson et al., supra note 64, at 246. The explicit purpose of this scheme is to improve the agent's selections of risks. See id. at 246-47.
68. See supra note 42 and accompanying text.
69. See supra note 37 and accompanying text.
70. For a critical response to this argument, see infra notes 157-161 and accompanying text.
71. See supra note 42.
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To the extent that contingent commissions do indeed improve the information that intermediaries transmit to insurers, the increase in efficiency is potentially significant. Decreasing information asymmetries between insurers and insureds is particularly valuable in insurance markets because of the possibility that such asymmetries result in adverse selection.\textsuperscript{72} Adverse selection "is commonly described as the tendency of persons with relatively greater exposure to risk to seek [more] insurance protection."\textsuperscript{73} It can occur when insurance consumers have information about their potential risk that insurers cannot observe, making it difficult for insurers to offer insurance to low-risk individuals at an actuarially fair price. This potentially results in a self-reinforcing trend: low-risk insureds tend to forego insurance because it is too expensive for them, resulting in mostly high-risk insureds purchasing insurance, resulting in a further price increase.\textsuperscript{74}

C. Other Potential Benefits of Contingent Commissions

Any productive assessment of contingent commissions must compare the risk that the practice biases intermediaries' advice against the prospect that it improves insurer information and thus limits adverse selection.\textsuperscript{75} To date, most of the other arguments concerning contingent commissions that commentators

\textsuperscript{72} See George Priest, The Current Insurance Crisis and Modern Tort Law, 96 Yale L.J. 1521, 1541 (1987) ("Adverse selection is a problem central to every insurance context, and it dominates the insurance function."). The seminal article describing adverse selection in the insurance market is Michael Rothschild & Joseph Stiglitz, Equilibrium in Competitive Insurance Markets, 90 Q.J. Econ. 629 (1976).

\textsuperscript{73} Priest, supra note 72, at 1541. Priest explains the adverse selection problem as follows: An insurer must collect into a risk pool individuals with a sufficiently narrow range of exposure to risk for the insurance to remain financially attractive to each member of the pool. The insurance premium for the pool must be set according to the average level of risk brought to the pool. The wider the range between high-risk and low-risk pool members, the greater the difference between the average risk and the risk of low-risk members. Low-risk members pay a premium that, because it is based on an average which includes high-risk members, is more than they would have to pay if they could be segregated into a risk pool of their own. If the disparity between the premium and the risks added by low-risk members becomes too substantial, low-risk members may drop out of the pool because they find alternative means of protection cheaper than market insurance.

\textit{Id.}

\textsuperscript{74} A secondary benefit of facilitating credible communication between independent intermediaries and insurers, which Cummins and Doherty do not discuss, is that doing so may improve the efficiency of the insurance investigation process. Insurance intermediaries can more efficiently inquire about a client's risks than an insurer because intermediaries need only do so once in order to transmit those conclusions to multiple different insurers. Regan & Tennyson, supra note 64, at 639. By contrast, if the entire process of vetting the risks associated with potential insureds were left to each insurer, then multiple insurers would need to conduct repetitive inquiries whenever an insured was turned down for coverage by the first insurer. If contingent commissions facilitate intermediaries' willingness and ability to transmit accurate information to insurers, then it may shift parts of the investigative process from insurers to intermediaries and thus reduce the number of duplicative inquiries that need to be made. See \textit{Id.}

\textsuperscript{75} One additional relevant consideration, introduced \textit{infra} Section III.B, is that contingent commissions may induce strategic, socially inefficient behavior by high-risk, sophisticated insureds.
and advocates have advanced are largely unconvincing and serve to muddy the key analytical issues. This Section reviews these issues and explains why they ought not to factor significantly in the ultimate policy analysis.

1. Contingent Commissions as a Method of Expanding Insurance Coverage

In a recent paper, two leading insurance economists argued that contingent commissions may be desirable because they can help expand the insurance market to cover theoretically insurable losses that are not identified in the governing policy.\(^\text{76}\) In a number of circumstances, insurers can efficiently cover insureds' losses even though the applicable policy does not provide such coverage.\(^\text{77}\) Despite the exclusion of these losses from policy terms, the paper suggests that independent intermediaries may be able to induce insurers to pay such nonverifiable losses ex post when doing so is efficient: not only do independent intermediaries have the expertise to decide when insurance can efficiently be provided for nonverifiable losses, but they have the power to remove their customers from an insurer that fails to pay for such losses.\(^\text{78}\) But intermediaries, according to the argument, will only have a strong incentive to police coverage for nonverifiable losses to the extent that they receive some slice of the value that is generated by extending insurance in this way.\(^\text{79}\) Contingent commissions, the article concludes, can serve this role because the intermediary receives commissions in proportion to the insurer's profitability, which includes the additional rent the insurer charges for covering nonverifiable losses.\(^\text{80}\)

This argument is unpersuasive for two reasons. First, it is unlikely that contingent commissions actually enhance independent intermediaries' willingness to punish insurers who do not provide coverage for nonverifiable losses.

\(^\text{76}\) Doherty & Muermann, supra note 23.

\(^\text{77}\) See id. at 3-4; Schwarcz, supra note 32, at 1401-26 (arguing that insurance policies may fail to provide efficient coverage due to various market failures in the drafting of insurance policies). Such events may not have been anticipated, may have been too complicated to include in the contract, or may have been excluded from the contract due to market imperfections. See Doherty & Muermann, supra note 23, at 3-4.

\(^\text{78}\) See Doherty & Muermann, supra note 23, at 6-8. Interestingly, this theory is consistent with a recent article in which Jason Scott Johnston has argued that, in a variety of contexts, standard form contracts facilitate ex post bargaining between consumers and company employees who have the authority to grant exceptions from the terms of these contracts. See Jason Scott Johnston, The Return of Bargain: An Economic Theory of How Standard-Form Contracts Enable Cooperative Negotiation Between Businesses and Consumers, 104 MICH. L. REV. 857 (2006). Of course, Doherty and Muermann's claim is not simply that insurers grant exceptions from insurance policy terms ex post, but that independent insurance agents and brokers facilitate that role. It is this latter claim that is rejected above.

\(^\text{79}\) Doherty & Muermann, supra note 23, at 9 ("In our model, brokers seek future efficiency gains because they can capture rents directly from value added.").

\(^\text{80}\) See id. at 8-9.
losses ex post. The fact that intermediaries receive contingent commissions actually creates an incentive for them not to punish insurers who do not cover nonverifiable losses ex post: insurers profit more from this result, meaning that the contingent commissions that intermediaries receive are larger.\textsuperscript{81} Admittedly, contingent commissions may encourage intermediaries to claim, ex ante, that they will police nonverifiable losses. But they—just like insurers—will invariably face the opposite incentive ex post. In the end, the only reason that the article concludes otherwise is that it assumes that insureds are fully aware of intermediaries' reputations for negotiating coverage for nonverifiable losses ex post.\textsuperscript{82} Yet this assumption about insurance intermediaries is no more plausible than the assumption that insureds can directly observe insurance companies' reputations for ex post settlement of nonverifiable claims. The authors specifically reject this "informational assumption" as too "strong."\textsuperscript{83} In truth, though, insureds are likely to be better able to observe insurers' tendencies to pay nonverifiable claims ex post than to observe intermediaries' tendency to advocate for this result.\textsuperscript{84} The latter cannot easily be inferred from claims histories, and significantly more information is available about insurers' reputations than intermediaries' reputations: there are fewer insurers than intermediaries, and information about insurers' payment practices and service levels are readily available from consumer magazines and websites.\textsuperscript{85}

A second limitation of this argument is that it is unclear why contingent commissions are any better at inducing intermediaries to facilitate the coverage of nonverifiable losses than ordinary premium-based commissions. If insurance premiums are higher because insurance coverage has been expanded to include coverage for nonverifiable losses, then intermediaries will be compensated through higher premium-based commissions. Contingent commissions, then, are not necessary for the underlying argument about nonverifiable coverage to work.

\textsuperscript{81} See supra note 41.

\textsuperscript{82} See Doherty & Muermann, supra note 23, at 14 (stating the assumption that "[e]ach policyholder observes [the broker's] settlement of a non-verifiable claim, or the broker's penalty on the insurer if it is not paid").

\textsuperscript{83} Id. at 13 (arguing that while brokers are not "strictly necessary to create a market for non-verifiable losses," the "informational assumptions are strong" because "all policyholders must observe all of the incumbent insurers [sic] claim payments to all policyholders and be prepared to switch if even one policyholder is denied").

\textsuperscript{84} The fact that insurance purchasers can evaluate the reputations of insurers better than the reputations of intermediaries does not mean that, in absolute terms, insurance consumers are generally informed about insurers' reputations. See supra note 54 and accompanying text.

\textsuperscript{85} See Schwarz, supra note 32, at 1419 (describing how insurance consumers rely on secondary material to learn about their insurance options); see also supra note 29 (citing Consumer Reports articles discussing insurers' reputations for claims handling).
2. Contingent Commissions as a Protector of Small Agencies

Another argument advanced in favor of contingent commissions is that they are necessary to prevent the "bankrupt[cy] [of] hundreds of small insurance agencies in communities throughout America" and the consequent "further consolidation of insurance brokerage business in large global firms." The logic of this argument is that contingent commissions function as "house money" that is necessary for insurance agencies to pay for their basic overhead expenses. According to this argument, without contingent commissions, a disproportionate amount of money would be retained by employee-agents of small agencies. The reason is that employee-agents have disproportionate bargaining power over the agencies that employ them: employee-agents can easily move to competing agencies because they own their "book of business," allowing them to take their existing clients with them to another agency if they move themselves. Contingent commissions ensure the viability of small insurance agencies in the face of this asymmetric bargaining power, the argument goes, because they are typically paid only at year's end and are thus largely invisible to the agency's employee-agents. As such, these commissions can be surreptitiously retained by the agency and used to pay for its basic expenses.

The argument that banning contingent commissions will bankrupt an inefficiently large number of small independent insurance agencies ignores economic forces in two related ways. First, it is highly unlikely that insurance agents' compensation depends on the visibility to agents of their employers' profits. In competitive labor markets, employees' wages are set by their marginal value to their firms. Employees need not know precisely how much they contribute to their employers' bottom line for this to be so: if they contribute more than they are paid, then a competing firm will offer them a higher wage. If

86. Fitzpatrick, supra note 3, at 3042; see also Albert Lloyd & Craig Niess, The Impact of Contingent Commissions on Independent Agents, Ins. J., Mar. 12, 2007, available at http://www.insurancejournal.com/magazines/east/2007/03/12/features/78016.htm ("The very ability of an agency to service and support itself hinges on the fact that contingents are considered a legitimate revenue stream."). Fitzpatrick does not argue that contingent commissions are necessary for the survival of small, niche insurance brokers. See Fitzpatrick, supra note 3, at 3059. The reason, presumably, is that the brokerage market is much more consolidated than the insurance agency market, and so it seems less plausible that independent agents can demand salaries in excess of their value to their employer-brokers.

87. See Fitzpatrick, supra note 3, at 3058-59.

88. Id. at 3058.

89. See id. at 3059 (arguing that smaller, independent intermediaries have long attempted to "preserve the confidentiality of contingent commission arrangements" in order to "keep[] such information from the agency’s own employees," because "contingent commissions provide a vital pool of ‘house’ money that funds the basic overhead of their firms," without which many of these intermediaries could not remain in business).

90. The argument discussed in this Subsection clearly rests on the assumption that markets for insurance intermediaries are indeed competitive. To the extent they are not, then the underlying argument that contingent commissions are necessary to protect small insurance agencies falls flat.
they contribute less, they will be fired or their wage will be decreased.\textsuperscript{91} Second, if banning contingent commissions would indeed bankrupt some small insurance agencies for the reasons described above, then this would probably be a good outcome. The premise underlying this defense of contingent commissions is that some insurance agencies have only been able to maintain their presence in the marketplace by concealing from their employees the true extent to which these employees contribute to overall profits. But if this is so, then the costs incurred by agencies in supporting their agents—by providing advertising, coordinated filing services, office space in which to meet customers, and the like—must be less than the value of those expenditures. And in that case, the efficient outcome would be for the individual agent to move to another agency that adds enough value to the overall transaction to cover its costs.\textsuperscript{92}

3. \textit{Contingent Commissions as a Protector of Small Insurers}

A third defense of contingent commissions is that they may allow relatively small insurers to enter the market more easily by inducing independent intermediaries to steer customers to new insurers. Although intermediaries might ordinarily stay away from new insurers that have not developed a reputation, contingent commissions can induce them to go with these insurers by offering them what amounts to a "bonus" payment. Ultimately, the argument goes, this is beneficial for the competitiveness of the insurance market because it reduces barriers to entry.\textsuperscript{93}

This argument in favor of contingent commissions is also limited, though its recognition of the impact that contingent commissions can have on intermediaries' behavior is noteworthy. In many markets where reputation is important, new entrants may find it advantageous to provide heavy discounts that cannot be sustained in the long run. This strategy allows new firms to gain some initial market penetration and, more importantly, to credibly signal to consumers that the firm believes in its products: after all, the firm's strategy is a losing one if consumers who initially move to the firm to take advantage of its low prices do not then stay with the firm once prices have normalized.\textsuperscript{94} But there is little reason why such promotional discounts need be made to insurance intermediaries, as opposed to insureds themselves in the form of lower prices. To the extent that new insurers offer lower premiums that offset their weaker


\textsuperscript{92} The only potential reason this might not be true is if the resulting industry structure were uncompetitive. But it is hard to imagine that, even if contingent commissions do artificially prop up some insurance agencies, banning them would fundamentally alter the composition of the marketplace such that a competitive marketplace would be transformed into an uncompetitive marketplace.

\textsuperscript{93} Cummins & Doherty, supra note 2, at 385-86.

reputation, at least some intermediaries are likely to recommend this option to their customers. And while this strategy may not be as effective as contingent commissions in quickly recruiting new clients, such reduced premiums signal equally well to the marketplace that the insurer believes in the product that it provides. Because this signal, rather than the initial influx of business that accompanies it, is the crucial mechanism by which new entrants establish themselves with low initial rates, contingent commissions are not necessary to reduce barriers to entry in insurance markets.

4. Contingent Commissions as a Facilitator of Limited Insurer-Intermediary Interactions

A final argument in favor of contingent commissions is that these payments may promote efficiency by inducing agents to focus on selling the policies of a limited number of insurers. In many ways, this argument is simply the flip side of the steering argument described above. Just as contingent commissions may cause intermediaries to steer their customers to suboptimal insurance, they may also cause intermediaries to focus their sales efforts on a few insurers who pay the largest contingent commissions. This may reduce transaction costs: it is presumably cheaper for agents to focus on the mechanics of selling only a few insurers’ products. Insurers, as well, may benefit from receiving customers through a limited array of familiar independent intermediaries, assuming the number of customers remains constant.

This defense of contingent commissions is ultimately insignificant. Independent intermediaries certainly incur a cost when they choose to sell an additional insurer’s policy line. But contingent commissions are not necessary to ensure that intermediaries appropriately account for this cost in their decision-making. Intermediaries directly bear this cost, whether or not they are paid contingent commissions. By contrast, if there are costs to the insurer from selling policies to the customers of an unfamiliar intermediary, then it is true that the intermediary may not take these costs into account in deciding how to direct its customers. If so, then contingent commissions might promote efficiency. Yet it is hard to imagine that the non-underwriting costs to an insurer of receiving a client from a relatively less familiar intermediary are substantial. By necessity, insurers that sell their products through independent intermediaries must be adept at the mechanics of providing coverage for

95. Even if intermediaries could not be trusted to recommend insurers who provided promotional discounts on premiums, there is no reason why new insurers could not compensate intermediaries using methods other than contingent commissions, such as higher premium-based commissions.

96. See supra Section I.A.

97. To the extent that insurers who distribute their policies through independent intermediaries do enjoy underwriting efficiencies from dealing with familiar intermediaries, this argument collapses into the adverse selection argument, described in Section I.B, supra.
customers referred by hundreds of different intermediaries. This is true whether or not the insurer offers contingent commissions: even an insurer that pays contingent commissions to only a few independent agents will receive business from hundreds of independent intermediaries. 98

II. CONTINGENT COMMISSIONS IN CONSUMER INSURANCE MARKETS

The emerging consensus among lawmakers and commentators is that, given the competing costs and benefits of contingent commissions, these payments should be permitted in consumer insurance markets so long as they are appropriately disclosed to consumers. 99 Such a disclosure regime is primarily intended to limit the core potential cost of contingent commissions—that they cause intermediaries to steer consumers to suboptimal insurance. 100 At the same time, a disclosure-based response does not interfere with the potential of contingent commissions to reduce adverse selection.

This Part challenges the argument that disclosure is a sufficient regulatory or legislative response to contingent commission payments in consumer insurance markets. Drawing on the experiences of regulators in addressing other trilateral dilemmas, Section A argues that the core cost of contingent commissions—the risk of steering—is both significant and largely intractable when consumers purchase insurance through intermediaries that accept

98. Although the marginal cost of processing customers from an entirely new intermediary may be significant, this is likely to be a one-time cost for the insurer: the intermediary’s name and address must be placed in the computer, and the intermediary will likely have to sign a distribution contract. However, the effect that contingent commissions have on the ultimate number of independent intermediaries from which an insurer receives business is likely trivial.

99. The leading model legislation, drafted by the National Conference of Insurance Legislatures, requires disclosure only when a producer is paid by both the insurance consumer and the insurer—a rare occurrence. That disclosure must acknowledge that “compensation [from an insurer] will be received by the producer or affiliate,” and the customer must receive “a description of the method and factors utilized for calculating the compensation to be received from the insurer or other third party for that placement.” PRODUCER COMPENSATION DISCLOSURE MODEL, AMENDMENT TO THE PRODUCER LICENSING MODEL ACT § 1(A)(1) (Nat’l Conference of Ins. Legislators 2005), http://www.aba.com/aba/documents/abia/NCOILFinalMarkup.pdf. Another, more effective proposal would inform the insurance consumer in all circumstances that:

OUR FIRM HAS AGENCY CONTRACTS WITH THE FOLLOWING INSURANCE COMPANIES:_

IF YOU CHOOSE, OUR FIRM WILL ACT AS A “DUAL AGENT,” REPRESENTING BOTH YOU AND THE INSURERS WHO HAVE APPOINTED US, IN YOUR INSURANCE PURCHASE. IF WE ACT AS A “DUAL AGENT,” WE WILL BE COMPENSATED ON A COMMISSION BASIS, WITH OUR COMMISSION BEING INCLUDED IN YOUR POLICY PREMIUM AND PAID BY THE INSURER YOU SELECT. WE MAY ALSO BE ELIGIBLE TO RECEIVE ADDITIONAL COMPENSATION FROM THAT INSURER BASED ON THE OVERALL VOLUME AND PROFITABILITY OF THE POLICIES WE WRITE WITH THAT INSURER. INFORMATION ABOUT SUCH ADDITIONAL COMPENSATION FOR WHICH OUR FIRM MAY BE ELIGIBLE CAN BE FOUND ON OUR WEB SITE, AND IS ALSO PROVIDED BY THE INSURERS WE REPRESENT ON THEIR WEB SITES.

Fitzpatrick, supra note 3, at 3069-70.

100. See supra Section I.A.
contingent commissions. The mere disclosure of contingent commissions does not meaningfully alter this risk, which is largely a function of inherent informational asymmetries between consumers and intermediaries. Nor does disclosure of any type allow consumers to assess meaningfully the magnitude or probability of this risk. Section B continues by arguing that the primary theoretical benefit of contingent commissions—their capacity to mitigate adverse selection—is insignificant in consumer insurance markets. Even if adverse selection were a serious concern in these markets, contingent commissions might not actually improve the information about consumer-insureds that insurers receive from independent intermediaries. Weighing the core costs and benefits of contingent commissions, Section C concludes that regulators or legislatures should ban these payments in consumer insurance markets.

A. Disclosure, Steering, and Trilateral Dilemmas

Although contingent commissions have only recently emerged as a significant issue for regulators and legislatures, government officials have frequently addressed analogous consumer market problems, known as “trilateral dilemmas.” In a trilateral dilemma, market intermediaries extract side payments from other professionals in exchange for steering business to them. Trilateral dilemmas involve three parties: a consumer, a market intermediary that influences the consumer’s decisions about hiring additional service providers, and a third-party service provider. In these situations, the third-party service provider may make side payments to the market intermediary in exchange for its referral of business. For instance, when consumers purchase a home, they typically rely on a number of market intermediaries, such as realtors and mortgage brokers, who themselves provide advice on choosing additional service providers such as lawyers and lending institutions. In such circumstances, the intermediary (the realtor or mortgage broker) may advise the customer to choose a particular service provider (a lawyer or lending institution) based on whether that service provider makes a side payment to the intermediary. Another prominent example of a trilateral dilemma is the potential that investment managers (market intermediaries) will select particular brokerage firms to execute trades on behalf of the investor based on

101. These arguments thus pose a direct challenge to the claim made by defenders of contingent commissions that competition in the insurance industry will eliminate the inefficiencies associated with contingent commissions. See supra notes 57-62 and accompanying text.
103. See id.
104. See id. One recent and controversial example of this concerns the propriety of mortgage brokers receiving “yield-spread” premiums from their lending institutions. See also Kathleen C. Engel & Patricia McCoy, A Tale of Three Markets: The Law and Economics of Predatory Lending, 80 TEX. L. REV. 1255, 1264 (2002).
the brokerage firm's side payments to the investment manager.\textsuperscript{105}

In many, if not most, trilateral dilemmas, legislatures and regulators have determined that the risk that intermediaries will provide biased advice to their customers is significant, and that it cannot be sufficiently ameliorated by using disclosure to foster competition.\textsuperscript{106} For instance, one of the goals of the Real Estate Settlement Procedures Act (RESPA) of 1974\textsuperscript{107} is to protect consumers from exploitation associated with biased advice from real estate intermediaries.\textsuperscript{108} To do so, section 8 of RESPA not only erects certain disclosure requirements, but also flatly prohibits a variety of side payments to real estate settlement providers.\textsuperscript{109} Similarly, section 28(e) of the Securities Exchange Act of 1934\textsuperscript{110} is partly intended to limit the risks associated with side payments to investment managers.\textsuperscript{111} It not only requires that investment managers disclose the side payments that they receive from brokerage firms, but also limits the types of side payments that can be made: brokerage firms can only provide side payments to investment managers in the form of "brokerage and research services" that redound to the benefit of clients.\textsuperscript{112}

Recently, public pressure to eliminate even these very narrow side payments has increased.\textsuperscript{113} Other instances of trilateral dilemmas that are regulated in ways that extend beyond mere disclosure include employers' choices of 401(k) providers and bankers' arrangements with telemarketers.\textsuperscript{114}

For each of these trilateral dilemmas, there are three basic reasons why disclosure has only a limited capacity to facilitate competition and thus to protect consumers from receiving biased advice. First, for disclosure to allow for an effective market response, consumers must have a basic understanding of

\begin{enumerate}
\item 105. See Jackson & Burlingame, supra note 25.
\item 106. See id.
\item 108. See Jackson & Burlingame, supra note 25. As Jackson and Burlingame explain, see id., RESPA was partially motivated by a government study that concluded that the payment of kickbacks in real estate sales was "widely employed, rarely inure[s] to the benefit of the home buyer, and generally increase[s] total settlement costs." U.S. DEP'T OF HOUS. & URBAN DEV. & THE VETERANS ADMIN., HUD-F-5, REPORT ON MORTGAGE SETTLEMENT COSTS 5 (1972). Although the study actually recommended that Congress set maximum settlement costs, Congress ultimately took a less drastic measure in RESPA by prohibiting kickbacks and unearned fees and creating a private right of action. See 12 U.S.C. § 2607. For a popular account of the conflicts of interest associated with real estate brokers, see STEVEN D. LEVITT & STEPHEN J. DUBNER, FREAKONOMICS 55-89 (2005).
\item 112. 15 U.S.C. § 78bb(e)(1).
\item 114. See Jackson & Burlingame, supra note 25.
\end{enumerate}
the underlying services they are receiving and the prices those services should cost.115 Otherwise, consumers will be unable to assess whether their end service providers are charging too much or providing too little, even if they know that this is potentially the case. In most trilateral dilemmas, however, consumers do not understand much about the underlying services they are purchasing; that is precisely why they seek out the advice of an intermediary. Second, even when disclosure effectively informs some sophisticated consumers, competition cannot protect the interests of other, less sophisticated consumers if intermediaries can distinguish between these two groups and can offer advice accordingly.116 Such discrimination is easy in the case of many trilateral dilemmas, as intermediaries typically know a lot about their customers and are specifically trained to provide individualized advice to them.117 Third, disclosure may be ineffective when intermediaries have a position of power over—or a relationship of trust with—consumers, as they often do in trilateral dilemmas.118 In such circumstances, consumers will be more likely to ignore the prospect that financial incentives will cause an intermediary to offer biased advice.

These explanations for the limited capacity of disclosure and competition to protect consumers in most trilateral dilemmas apply squarely to contingent commissions in consumer insurance markets. First and most importantly, insurance consumers typically have a limited understanding of the underlying insurance transaction that no conceivable disclosure could remedy. Even assuming that consumers would read and understand a contingent commission

115. Id. at 43; cf. Steven L. Schwarcz, Rethinking the Disclosure Paradigm in a World of Complexity, 2004 U. ILL. L. REV. 1 (arguing that certain firms’ financial arrangements, such as those of Enron, are so complex that regulation should go beyond a disclosure-based paradigm).


117. For instance, litigation has uncovered various cases of such discrimination by lending agents. See ELIZABETH WARREN & AMELIA WARREN TYAGI, THE TWO INCOME TRAP 135-36 (2003) (quoting one loan officer who explained that “if someone appeared uneducated, inarticulate, was a minority, or was particularly old or young, I would try to include all the [additional costs] CitiFinancial offered” (alteration in original)). Another well-documented example of this phenomenon occurs in the automobile context, where salesmen are given wide latitude to negotiate prices so that less sophisticated consumers who do not know better can be charged more, while the business of more sophisticated consumers can be retained by significantly lowering the car’s price below the sticker amount. See Ian Ayres, Fair Driving: Gender and Race Discrimination in Retail Car Negotiations, 104 HARV. L. REV. 817, 845 (1991) (finding evidence that automobile retailers sell cars for higher prices to minorities, and suggesting that part of the reason may be that sellers use race as a proxy for how much consumers shop for better prices); Ian Ayres, Further Evidence of Discrimination in New Car Negotiations and Estimates of Its Cause, 94 MICH. L. REV. 109, 138-40 (1995) (similar).

118. See Jackson & Burlingame, supra note 25. Jackson and Burlingame note an additional reason why market forces may not correct for side payments in many trilateral dilemmas: intermediaries typically purchase a wide array of settlement services, and the consumer has a limited capacity to monitor all of these at once. This is less of an issue in the insurance context, as the intermediary generally only arranges for a single service provider. See id.
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disclosure—a generous and limited assumption—119—they will be ill-equipped to police the underlying conflict of interest or to assess its significance. Insurance consumers generally do not know how to assess the quality of different insurance options: the risks associated with an insurer’s “fair” financial rating, for instance, are beyond the ken of most insurance consumers, including many small businesses and otherwise savvy individuals.120 Similarly, most insurance consumers have no idea which insurers have a poor reputation for claims management or use insurance policies that are narrower than the standardized coverage forms.121 Indeed, it is precisely for these reasons that consumers choose to rely on independent insurance intermediaries.122

Without the ability to assess the quality of different insurance options, even consumers who are aware of contingent commissions are susceptible to being steered to insurers that are too expensive, of low quality, or otherwise inappropriate. Although informed consumers can compare the prices available through different intermediaries or the relative commissions that intermediaries receive, these comparisons are largely unhelpful when they are decoupled from the ability to assess the quality of the associated insurance options. Insurance may appear reasonably priced even if it is actually quite expensive for the level of coverage and services provided, while more expensive insurance may in fact be the best deal for the consumer.123 Similarly, the mere fact that an intermediary receives a large contingent commission from a recommended insurer hardly means that her advice is necessarily suspect. Without some

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In order for disclosures to be effective, consumers must, of course, read and understand them. But consumers often do not read long and complicated disclosures, and frequently do not understand them when they do. See Howard Latin, “Good” Warnings, Bad Products, and Cognitive Limitations, 41 UCLA L. REV. 1193, 1242 (1994). To the extent that lawmakers do indeed opt for a disclosure-based solution, supplemental compensation arrangements can significantly improve the effectiveness of disclosure by reducing the complexities of contingent commission arrangements to a single number that indicates the size of the intermediaries’ conflict of interest. See infra notes 163-164 and accompanying text.


121. See Schwarz, supra note 32, at 1413-15 (describing the limits of reputation as a vehicle for informing insurance consumers about the quality of their insurance options); id. at 1417-18 (describing how some mega-insurers can use policy language that is narrower than industry norms because they can generate their own actuarial data and enjoy other economies of scale in drafting policy language).

122. See Slawson, supra note 55, at 547 (“[The average consumer] depends on an insurance agent and insurance company to sell him a policy that ‘works’ for its intended purpose in much the same way that he depends on a television salesman and television manufacturer.”).

123. This variation in product quality, in addition to price, is part of what distinguishes the conflicts of interests associated with contingent commissions from those associated with premium commissions. See supra note 61 and accompanying text. Unlike contingent commissions, premium commissions do not create any incentive for intermediaries to sell insurance of similar price but lower quality as compared to alternative policies.
capacity to independently evaluate the intermediary’s advice, price and commission information is of limited use.\textsuperscript{124}

It is precisely because insurance is so difficult for most consumers to understand that the dominant method of regulating the industry is through mandatory requirements and prohibitions rather than disclosure-based schemes. Insurance policies are in many ways the most complex financial services that firms offer on the open market because their value is contingent on the insurer’s underlying financial stability, the content of the policy itself, and events unrelated to the insurer’s assets or the governing contract.\textsuperscript{125} Contrast these characteristics with securities and mutual funds, for example, whose value can be ascertained based solely on the governing contract and the companies’ assets.\textsuperscript{126} This differential in inherent complexity explains why securities and mutual funds are typically regulated via relatively nonintrusive measures (such as disclosure and general standards of conduct), whereas insurance regulation often takes the form of specific requirements or prohibitions (such as capital requirements).\textsuperscript{127} Recall, however, that when it comes to trilateral dilemmas in the mutual fund industry, the regulatory strategy of the Securities Exchange Act has uncharacteristically gone beyond disclosure because of concerns that investors could be steered to overly expensive brokerage services.\textsuperscript{128} If the opaqueness of the services that brokerage firms

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\item Spitzer’s investigation of Marsh & McLennan provides modest evidence of the insufficiency of disclosure when insurance purchasers have a limited understanding of the underlying insurance product. Cf. Fitzpatrick, supra note 3, at 3047-52 (suggesting that Marsh was unique and that its bid rigging cannot be extrapolated to the rest of the industry). These investigations revealed that Marsh brokers solicited purposefully inflated price quotations from some insurers in order to steer clients to other insurers and to maximize Marsh’s receipt of contingent commissions. See Marsh Complaint, supra note 10, ¶¶ 43-66. Marsh’s customers were highly sophisticated firms, at least some of whose risk managers were undoubtedly aware of contingent commission payments. See Fitzpatrick, supra note 3, at 3049 n.33 (noting that insurers publicly report the payment of contingent commissions in their annual statements filed with the state insurance department). Yet Marsh’s bid-rigging rendered these firms unsophisticated as to the appropriate pricing of their policies, enabling Marsh to steer them to suboptimal insurance. The fact that Marsh employees were willing to take this risk may, as others have pointed out, have been an unfortunate result of the company’s internal structure. See Fitzpatrick, supra note 3, at 3047 (noting that Marsh’s Global Broking division—the division in which all of the bid-rigging took place—derived its income solely from its receipt of contingent commissions). But the fact that they were able to succeed, at least for a significant period of time, suggests how easy it can be for knowledgeable intermediaries to offer questionable, debatable, or even flatly wrong advice to customers who may be abstractly aware of a potential conflict of interest. See Hunter, supra note 11, at 2 (“If large sophisticated consumers of insurance can be easily cheated and overcharged, unsophisticated individual and small business buyers are even more vulnerable to such sharp practices.”).

\item See Howell E. Jackson, Regulation in a Multisected Financial Services Industry: An Exploratory Essay, 77 WASH. U. L.Q. 319, 330, 356-57 (1999) (explaining that insurance is a particularly complex financial arrangement because the assets and liabilities of insurance companies are hard to determine).

\item See id. at 323-25 (securities); id. at 327-28 (mutual funds). See generally Howell E. Jackson & Edward L. Symons, Jr., Regulation of Financial Institutions (1999) (exploring differences in the regulation of various financial services industries and suggesting that many of these differences are attributable to the level of complexity associated with the target industry).

\item See Jackson, supra note 125, at 353-60.

\item See supra notes 111-113 and accompanying text.
\end{enumerate}
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provide for investors warrants a solution to that trilateral dilemma beyond disclosure, then the same should presumably be true in the context of a more complex financial service.

The second reason that market forces do not protect consumers from most trilateral dilemmas—that intermediaries can distinguish between sophisticated and unsophisticated consumers—also applies in the contingent commission context. When intermediaries can identify unsophisticated consumers, they can steer them to less qualified service providers who make lucrative side payments to the intermediary while directing sophisticated purchasers to objectively superior insurers. Intermediaries can thereby exploit unsophisticated consumers without suffering any serious market penalties for doing so.\textsuperscript{129} Insurance intermediaries are particularly likely to be able to identify and steer uninformed insurance customers in this way because of the close contact they have with their clients. Disclosure does nothing to limit this risk. In fact, disclosure may actually help intermediaries to assess the sophistication and responsiveness of their customers by providing a test of an insurance consumer’s relative skepticism and sophistication. Insureds who read a disclosure and ask follow-up questions displaying an understanding of the underlying conflict of interest are relatively less likely to overlook inefficient steering to suboptimal insurers. By contrast, consumers who quickly sign a disclosure without reading the text, or who seem to misunderstand the meaning of the disclosure, will be much more enticing targets for self-interested producers predisposed to steering.

An empirical study of an Arizona independent insurance agency substantiates the risks of such discrimination against unsophisticated consumers by insurance intermediaries.\textsuperscript{130} The agency, which remained unidentified, employed eight agents with no ownership stake in the company and three “equity agents” who received a portion of the agency’s profits.\textsuperscript{131} Because the contingent commissions the company received were paid directly to the company, the three equity agents stood to gain more from maximizing contingent commissions than did the nonequity agents. Additionally, only the equity agents handled “house” accounts, which (1) either originated in another agency that the company subsequently acquired or had originally been handled by an agent who had retired, and (2) did not fit the portfolio or expertise of any nonequity agent.\textsuperscript{132} The defining characteristics of the customers in these house accounts strongly suggest that they were less sensitive than other agency customers to the level of service they received from their agent. This hypothesis was corroborated by the fact that house accounts were three times more likely than other accounts to pay their premiums directly to their insurer.

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\textsuperscript{129} See supra note 116 and accompanying text.

\textsuperscript{130} See Wilder, supra note 37, at 1-3.

\textsuperscript{131} Id. at 6.

\textsuperscript{132} Id.
rather than to pay them through the agency, indicating disengagement with their insurance agent. The study concluded that contingent commissions significantly impacted the recommendations that the equity agents gave to their less responsive consumers, finding that “the prospect of contingency fees [led] equity agents to increase the frequency with which they placed house accounts with insurers offering contingency fees by more than 50%.” In other words, equity insurance agents matched customers with different insurers depending on customers’ responsiveness, steering less responsive customers toward insurers that paid the agency contingent commissions.

A third reason that mere disclosure and competition cannot resolve many trilateral dilemmas is that the relationship between market intermediaries and their consumers often induces trust and reliance that limit consumers’ willingness to question the advice they receive. Once again, this concern is significant in the insurance context. Many consumers develop longstanding relationships with their agents or brokers that induce both reliance and trust. Indeed, because of the complexities of insurance, an intermediary’s capacity to recommend proper coverage often critically depends on how well the intermediary understands the consumer’s particular needs. Independent intermediaries therefore devote significant resources toward cultivating the trust of their clients. As a result, intermediaries can sugarcoat potential deficiencies in insurance coverage and may avoid having to deal with them at all. Of the few customers who inquire about their prospective insurer’s financial strength, virtually none will challenge their intermediary’s cursory response that the insurer’s capacity to pay claims is good—regardless of whether they are aware of their intermediary’s potential conflict of interest. This is particularly true given that insurance consumers must make numerous decisions about unfamiliar matters, such as deductibles, policy limits, endorsement options, and alterative insurers.

133. See id. at 7-8.
134. Id. at 10.
135. Although equity agents also tended to place a disproportionate percentage of their customers with insurers that maintained contingent commission contracts with the agency, the statistical significance of this effect was unclear. Id.
136. This concern, for instance, was one of the motivating factors that led Congress to regulate the trilateral dilemma involving real estate intermediaries in RESPA. See Jackson & Burlingame, supra note 25.
137. See infra notes 183-184 and accompanying text.
138. See supra notes 46-51 and accompanying text.
140. Although any meaningful disclosure of contingent commissions would presumably occur before discussion of these matters, few consumers will literally walk out the door of a broker or agent upon seeing a disclosure form. Rather, to the extent that a disclosure can influence a customer’s decision about purchasing insurance through an intermediary, it is likely to do so after the customer has gathered basic information about the insurance options available through the intermediary.
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Competition, even when it is facilitated by a disclosure requirement, is thus ultimately limited in its capacity to protect insurance consumers from being steered to inappropriate or overly expensive insurance. Although contingent commissions represent only a small portion of intermediaries' total compensation, they can nonetheless tempt intermediaries to provide biased advice to their customers, as the Arizona insurance agency study demonstrates. Competition can do little to check this temptation, even when the potential risk of steering is disclosed, because consumers have a limited capacity to identify biased advice from their intermediary. And when consumers do spot trouble, intermediaries can quickly change their tune, thus retaining the business of sophisticated insureds while continuing to exploit less sophisticated customers. Often not even this adjustment will be necessary, as intermediaries will be able to overcome consumers' potential concerns by invoking the relationship of trust that exists between them.

B. Evaluating the Adverse Selection Argument

The primary defense of contingent commissions is that they may reduce adverse selection by inducing intermediaries to convey risk information to insurers that the latter would otherwise be unable to observe. Although theoretically sound, this argument suffers from three significant limitations when it comes to consumer insurance markets. First, while adverse selection is a commonly theorized problem, the available empirical evidence suggests that it is not nearly as significant a problem in consumer insurance markets as the wealth of theoretical literature suggests. As a recent article by Professor Peter Siegelman explores in detail, empirical studies on long-term care insurance, term life insurance, health insurance, and automobile insurance have each found no evidence of adverse selection. There are

141. See supra note 57 and accompanying text.
142. See supra Section I.B.
143. See generally Siegelman, supra note 28.
148. The most compelling exception to this trend is a famous article documenting adverse selection in a health insurance market in which employee-insureds were able to select between alternative health insurance plans offered as a part of a subsidized group plan through an employer. David M. Cutler & Richard J. Zeckhauser, Adverse Selection in Health Insurance, 1 FRONTIERS HEALTH POL'Y RES. 1 (1998). But the risks of adverse selection in such “cafeteria style” insurance arrangements are unique. Thomas Buchmueller & John DiNardo, Did Community Rating Induce an Adverse Selection Death Spiral? Evidence from New York, Pennsylvania, and Connecticut, 92 AM. ECON. REV. 280, 280-81
various potential explanations for the persistent finding that most consumer insurance markets do not suffer from adverse selection. In many cases, such as life insurance, it is likely that insureds often do not have better information about their risk levels than insurers once contractually required disclosures by insureds are taken into account.\(^\text{149}\) In other instances, such as automobile insurance, insureds may not be able to translate whatever informational advantage they have into better predictions about their risk levels than those generated by expert insurers.\(^\text{150}\) This is particularly likely given emerging evidence that lay people are more subject to systematic cognitive biases than experts.\(^\text{151}\) A third explanation for the lack of adverse selection in most consumer insurance markets is that low-risk individuals also tend to be relatively risk-averse. This risk aversion leads low-risk individuals to value insurance more highly than high-risk individuals, which tends to counteract adverse selection.\(^\text{152}\) Whatever the explanation, though, the evidence seems clear that adverse selection is not nearly as significant a threat as defenders of contingent commissions suppose.

The second significant limitation to the adverse selection defense of contingent commissions is that it is unclear whether intermediaries who receive such commissions actually transmit better information to insurers than do other intermediaries. There is significant sociological evidence that captive agents, who work solely for a given insurer and thus do not receive contingent commissions, play a nontrivial underwriting role for those insurers.\(^\text{153}\) However, the evidence that independent intermediaries also play this underwriting role when they receive contingent commissions is much less clear. The likelihood of such complicated information transfer may be low when it comes to the relatively run-of-the-mill underwriting decisions that underlie most consumer insurance markets.\(^\text{154}\) Such underwriting requires simple and easily administrable algorithms,\(^\text{155}\) which may well preclude

\(^\text{149}\) Siegelman, supra note 28, at 1241.

\(^\text{150}\) See id. at 1242-47.

\(^\text{151}\) Nonexperts tend to place too much importance on salient events, to be overly optimistic in assessing their own risk levels, to treat low risk-levels as equivalent to zero, and to over-estimate the likelihood of affect-laden risks, such as that associated with nuclear waste. See Cass Sunstein, The Laws of Fear, 115 HARV. L. REV. 1119 (2002) (reviewing PAUL SLOVIC, THE PERCEPTION OF RISK (2000)). Experts, by contrast, can avoid such errors by focusing on a defined set of limited variables and by employing methods that tend to debias their results. See id. at 1144-56.

\(^\text{152}\) See Siegelman, supra note 28, at 1264-74.

\(^\text{153}\) See supra note 64.

\(^\text{154}\) See supra notes 171-173 and accompanying text.

\(^\text{155}\) See KENNETH ABRAHAM, DISTRIBUTING RISK 78 (1986) ("[A]n efficient classification system does not strive to make its premiums equal expected cost beyond the point where that goal is worth achieving.").
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incorporating nuanced information conveyed by intermediaries.\(^{156}\)

Finally, to the extent that insurers do indeed use information from intermediaries to make underwriting decisions, contingent commissions may not improve either the quality or the reliability of this information. An insurance company can generally monitor the type of insureds an intermediary refers to it merely by evaluating the loss ratio—a measure of insurer profitability\(^ {157}\)—of the intermediary’s book of business. Insurers maintain loss ratios for each of their independent intermediaries in the ordinary course of business, and they can easily use those measures to determine whether an intermediary’s book of business generates more or less profit than the initial underwriting criteria suggested it would. Insurers can adjust their willingness to take insureds from particular intermediaries accordingly. Consequently, although contingent commissions may indirectly create an incentive for intermediaries to keep their loss ratios at a profitable level,\(^ {158}\) they are hardly necessary for this purpose given the more direct methods available to insurers—dropping, or threatening to drop, intermediaries with a consistently poor loss ratio. And unlike the defense of contingent commissions, this monitoring is not simply theoretical.\(^ {159}\) As one independent insurance agency operator explained, his agency “guarded [its] loss ratio very, very carefully because having a good loss ratio over the book of business is what enables you to negotiate favorable rates and go to new insurers and sign them up if you need them.”\(^ {160}\) Most insurers, the agent explained, carefully consider the loss ratios in agencies’ books of business when deciding whether to do business with them.\(^ {161}\)

C. Toward Banning Contingent Commissions

In consumer insurance markets, contingent commissions pose serious conflicts of interest for ostensibly independent intermediaries. They encourage these intermediaries to pursue higher commission rates rather than guide their

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156. For this reason, “[i]ndividual companies are increasingly less likely to undertake their own home inspections or direct field investigation of an applicant. Instead, moral risk assessment is centralizing into data systems operated by information service companies that supply the insurance industry.” See ERICKSON ET AL., supra note 64, at 241.

157. See supra note 37.

158. See supra notes 68-71 and accompanying text.

159. Indeed, one underwriting manager for a multinational insurer has stated that “we have expressed to [brokers] time and again and built up over time what our likes and dislikes are from an underwriting standpoint.” If the broker can demonstrate that its “risks fit,” then the insurer “pursue[s] it aggressively . . . [i]ntermediaries incentive commission deals” for the broker. ERICKSON ET AL., supra note 64, at 227. Similarly, another underwriter explained that costs are often too high for insurers to investigate each potential insured on their own, and they often, therefore, need to “take a little bit on trust . . . , dealing with the right broker.” Id. at 241.

160. Id. at 247.

161. Id. at 248.
customers to the insurance that best meets their needs or is most affordable. This conflict of interest is particularly problematic in insurance markets because consumers have an inherently limited understanding of their insurance needs and options. They often cannot, therefore, make optimal purchasing decisions without unbiased advice. Indeed, independent intermediaries justify their very existence on this basis, promising to look after their customers’ needs. Given this fundamental information asymmetry, as well as the dynamics of the intermediary-customer relationship, disclosing contingent commissions to consumers will ultimately do little to mitigate the conflicts of interest that contingent commissions generate. Indeed, lawmakers have consistently recognized as much in the case of structurally similar trilateral dilemmas that plague other industries. 162

Meanwhile, the core defense of contingent commissions—that they reduce adverse selection by aligning the incentives of intermediaries and insurers—is largely illusory and is based on suspect assumptions when it comes to consumer insurance markets. Adverse selection is simply not a significant problem in consumer insurance markets. Even if it were shown to be a genuine problem, the claim that contingent commissions can actually alleviate the problem is both empirically unsupported and logically questionable given the limited underwriting criteria that most insurers use to price relatively small risks.

Simple cost-benefit analysis therefore strongly suggests that contingent commissions ultimately harm insurance consumers. Thus, there is a strong case to be made that state legislatures and regulators should go beyond a simple disclosure requirement to address these harms in consumer insurance markets. One intriguing, but ultimately limited, option is to replace contingent commissions with “supplemental compensation schemes” that base intermediaries’ commission levels on the volume and profitability of business

162. As is described above, lawmakers have often gone beyond mere disclosure when addressing trilateral dilemmas in other contexts. See supra notes 102-114 and accompanying text. Admittedly, though, regulators have not always adopted an outright ban of side payments when faced with a trilateral dilemma. Section 8 of RESPA, for instance, only prohibits some types of side payments to real estate intermediaries. See supra notes 108-109 and accompanying text. Similarly, section 28(e) allows brokerage firms to make side payments to investment managers in the form of investment-related services. See supra note 111 and accompanying text. In part, these and other moderated responses to trilateral dilemmas may simply have been the result of political compromise. But they also may represent wise policy decisions that are driven by factors not present in the contingent commission context. For instance, some commentators have argued that allowing brokerage firms to pay investment managers for investment-related services helps to improve securities markets by encouraging managers to engage in efficient investment research. See, e.g., Johnsen, supra note 11, at 91-104. Without these payments, the argument goes, investment managers would engage in too little investment research for a variety of reasons, including the fact that such research redounds to the benefit of all the investment manager’s clients, creating a collective good problem. See id. at 95. Regardless of the persuasiveness of this argument, there is obviously little that is analogous in the case of contingent commissions. Ultimately, then, although most trilateral dilemmas tend to be resistant to disclosure-based solutions, the policy prescription in such cases depends on the specific features of the trilateral dilemma at issue.
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that they have steered toward an insurer in the past. Although some have suggested that these newly emerging arrangements avoid the conflicts of interest associated with contingent commissions because they are "retrospective rather than prospective," this argument is clearly unpersuasive: the retrospectiveness of supplemental compensation arrangements merely shifts forward the potential pay-off of steering customers to suboptimal insurance. Instead of receiving increased contingent commissions in the current pay period for directing customers to a particular insurer, independent intermediaries will receive increased supplemental compensation in the next pay period for doing so. Nonetheless, supplemental compensation arrangements, because they are set prior to the sale of an insurance product, may be easier to disclose to consumers than contingent commissions: unlike contingent commissions, the size of which are unknowable at the time of insurance sales, supplemental compensation arrangements provide intermediaries with a specific and quantifiable bonus for each additional consumer they direct to the insurer. They may be preferable to contingent commissions for that reason.

However, even retrospective supplemental compensation schemes coupled with a strong disclosure requirement are unlikely to limit meaningfully the risks of inefficient steering. Such schemes do not address the underlying reasons why disclosure has a limited capacity to protect consumers from trilateral dilemmas. Regardless of how well consumers understand that their intermediaries face a potential conflict of interest, consumers are still subject to inefficient steering because they do not understand the quality and price tradeoffs of their insurance options. As such, most consumers will be unable to police the quality of the advice they receive from their intermediaries or to calculate the expected costs of this limitation. Those that are sophisticated enough to understand these issues will be unable to protect the interests of

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163. Roberts, supra note 16 (quoting Robert A. Rushbult, CEO of Independent Insurance Agents and Brokers of America).

164. Moreover, supplemental compensation schemes would still produce variability in the commission rates that insurers pay because they link compensation to an individual producer's "performance" for different insurers. So long as insurers vary their commission rates by the volume of business directed to it, differentials in commission rates will persist, and so too will the risk of steering. By contrast, when an insurer offers the same commissions to all intermediaries, regardless of the volume or profitability of their business, then competition should ensure that commission levels across insurers remain even for a given type of coverage. Indeed, anecdotal evidence suggests that premium commissions tend to be quite flat for a given type of insurance, though rigorous evidence on this point is not currently available. See Money on the Table, supra note 46 (quoting a number of experts who implicitly agree that premium commissions for a given line of insurance are currently quite flat due to competition, but who disagree about whether this result would obtain were contingent commissions banned). Although the size of premium commissions does tend to vary significantly across lines of insurance, see Cummins & Doherty, supra note 2, at 377-78 tbl.5 (collecting data from the National Association of Insurance Commissioners), that is hardly surprising, as the role of the intermediary depends significantly on the line of insurance in question.

165. Indeed, it is for precisely these reasons that the discussion in Section II.A explicitly assumed that consumers would read and understand a contingent commission disclosure. See supra note 119 and accompanying text.
other, less sophisticated, consumers, given the capacity of intermediaries to distinguish between sophisticated and unsophisticated insureds. And while an effective disclosure might constrain the relationship of trust that often exists between intermediaries and their clients, when it fails to do so consumers will still be subject to inefficient steering.

Given the inability of creative regulatory restrictions to limit the potential for inefficient steering, it is likely that the optimal regulatory approach is to ban contingent commissions in consumer insurance markets. Indeed, the cost-benefit analysis described above suggests that the only clear drawback to this proposal is the administrative cost of implementing the rule. Although the mere act of banning contingent commissions would not be costly, policing that ban might be. In particular, insurers could replicate contingent commission arrangements with retrospective supplemental compensation schemes. This commission arrangement would be significantly more difficult for regulators to police because it could be accomplished without the insurers ever publicly revealing their rationale for offering variable commission rates. Ultimately, though, a sufficiently clear statute or regulation, combined with a large penalty, should dissuade insurers from adopting this type of approach. In the final calculus, then, the benefits of banning contingent commissions and similar insurer-financed bonuses for independent intermediaries—at least in consumer insurance markets—are likely to significantly exceed the costs.

III. CONTINGENT COMMISSIONS IN INSURANCE MARKETS WITH SOPHISTICATED INSUREDS

Although disclosure may be an insufficient response to contingent commissions in consumer insurance markets, it is less clear whether something more than disclosure is needed in commercial insurance markets. This Part explores the likely impact of disclosure in these markets, where insurance purchasers are far more sophisticated than conventional consumers. It concludes that there may be sound reasons to consider banning contingent commissions in the commercial context, but that more empirical research is needed before a regulatory approach can be confidently embraced.

Section A begins the argument by showing that even if disclosure

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166. The inability of supplemental compensation schemes to limit the pernicious effects of contingent commissions should be contrasted with the soft-money compromise that allows brokerage firms to pay investment managers for investment-related services. This partial ban, at least in theory, helps to improve securities markets by encouraging investment managers to engage in efficient investment research. See Johnsen, supra note 111, at 91-104; see also supra note 162. As is described above, however, no one has yet proposed a similar partial ban of contingent commissions that could effectively limit the risk of inefficient steering created by contingent commissions.

167. Another potential strategy for implementing a ban would be to require insurers to pay a single, market-determined, premium commission rate for a given policy type to all independent intermediaries with whom they do business.
meaningfully informs insurance purchasers about the costs of contingent commissions, market outcomes cannot necessarily be trusted to reflect actual purchaser preferences. The intuition behind this outcome is that insurance purchasers who understand the risks of contingent commissions may rationally choose a market outcome that is inconsistent with their true policy preferences in order to signal to insurers that they are low-risk. Section B extends this argument to show that the contingent commissions may have a limited capacity to mitigate information asymmetries in sophisticated insurance markets, in which adverse selection may indeed be a significant problem. This Section presents an alternative model of contingent commissions in which insurance purchasers are allowed to mimic low-risk insureds when dealing with insurance intermediaries. Under the model, the benefits of contingent commissions in reducing adverse selection are smaller than earlier models suggest, and they are potentially swamped by new, additional costs resulting from high-risk insureds engaging in socially inefficient strategic behavior.

A. Steering and Signaling in Sophisticated Insurance Markets

Even in insurance markets where insurance purchasers tend to be relatively sophisticated and informed, disclosure of contingent commissions may fail to cause purchasers to guard sufficiently against the risk of steering. The basic reason is that informed and rational insureds who choose to purchase insurance through non-contingent-commission intermediaries may be penalized for this decision, as their choice signals to insurers that they are likely to be higher-risk than their directly observable characteristics suggest. As defenders of contingent commissions have argued, intermediaries who accept contingent commissions may have an incentive to help insurers correctly set prices by providing them with additional information about insureds' risk levels. But while accurate pricing improves the efficiency of the insurance market as a whole, it harms insurance purchasers who are higher-risk than insurers would otherwise believe. As such, these insureds will seek to hide their high-risk status. One way of doing so is by purchasing insurance through intermediaries that do not use contingent commissions—and that therefore do not communicate additional information to insurers. Given this general

168. The assumption here that purchasers are “informed and rational” means that they understand that contingent commissions may induce intermediaries to reveal information to insurers. Arguably, there is an intermediate stage in which purchasers would not understand this implication of contingent commissions but would be able to determine that the costs of steering are relatively small and make their decisions accordingly. However, even this intermediate stage of information would still make it difficult to rely on insurance purchasers' market decisions as expressing their actual preferences. Without understanding that contingent commissions improve communication between insurers and intermediaries, purchasers would have little sense of the potential benefits of contingent commissions.

169. See supra Section I.B.

170. A second way for insurance purchasers who pose a higher risk than their clearly observable
preference, insurers will tend to charge those who purchase insurance through such intermediaries a higher premium than their observable characteristics would suggest should be charged.

This result is counterintuitive because, in most markets, effective disclosure to sophisticated purchasers—whether the underlying risk concerns the potential safety failure of a product or the prospect that a service will be ineffective—is enough to ensure that regulatory oversight is not needed. If insurance markets are different, however, because the purchaser’s attributes largely define the product: the meaning of a promise to pay for specified losses is dependent on the promisee’s likelihood of suffering those losses. For this reason, even if insurance purchasers are fully informed about contingent commissions (through disclosure or otherwise), the market cannot be relied upon to produce the socially optimal result.

A key assumption in this argument—as in the adverse selection defense of contingent commissions more generally—is that insurance intermediaries can and do communicate insureds’ risk levels to insurers when they receive contingent commissions, but not otherwise. Although this claim is questionable when it comes to consumer insurance markets, it is more plausible in commercial insurance markets where the insureds are sophisticated actors. Underwriting decisions in such insurance markets tend to be less mechanistic than in consumer markets because they involve more risk, higher premiums, and more heterogeneous and sophisticated insureds. This lack of mechanistic underwriting, combined with lower numbers of insureds per intermediary, may also limit the capacity of insurers to make inferences about intermediaries based on their loss ratios. In any event, the assumption that contingent commissions improve insurer information plays just as vital a role here as it does in the claim that contingent commissions can reduce adverse selection. To the extent that the assumption is incorrect, both arguments fail. Yet if

characteristics might suggest to hide this fact is to mimic low-risk insureds when dealing with their insurance agents or brokers. See infra Section III.B. The result described in this Section, whereby insureds who purchase insurance through non-contingent-commission intermediaries pay a market penalty, still applies under that alternative assumption.

171. If consumers understand the risks associated with a product or service and nonetheless choose to purchase it, then they generally must value the product or service more than the combined cost of the purchase price and expected risk. See, e.g., STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 51-53 (1987) (arguing that products liability law is not needed if consumers are informed about product risks); Alan Schwartz & Louis L. Wilde, Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests, 69 VA. L. REV. 1387 (1983) (arguing that courts should not intervene in standard form contracts if a sufficiently large minority of consumers are informed about these contracts).

172. See supra Section I.B.

173. See supra notes 153-160 and accompanying text.

174. Cf. supra text accompanying notes 154-156.

175. Cf. supra text accompanying notes 157-161.

176. See supra Section I.B.
contingent commissions do not reduce adverse selection, then the case for banning them is clear: there is little reason to permit a costly practice that has no benefits.

To develop this signaling argument more thoroughly, consider a group of insureds that, from an insurer’s perspective, all have the same observable risk level, designated $R_O$. Suppose that each insured also has one of two actual risk levels, which are equally distributed among the population.\textsuperscript{177} Some insureds, designated $R_L$, have a lower actual risk level than their observable characteristics suggest, and some insureds, $R_H$, are actually more risky than their observable characteristics indicate. For ease of discussion, let us define the difference between insureds’ actual risk levels and their observed risk levels as their “residual risk.” Thus, $R_L$ types have a negative residual risk and $R_H$ types have a positive residual risk. Both $R_L$ and $R_H$ know their own risk types. Suppose further that insureds can purchase insurance through two types of intermediaries,\textsuperscript{178} both of which are capable of identifying whether an insurance purchaser is $R_H$ or $R_L$. Some intermediaries, designated $CC$, receive contingent commissions and, for this reason, will credibly communicate an insured’s residual risk level to insurers. Doing so allows the intermediary to maximize contingent commissions because it facilitates the appropriate pricing of policies. Other intermediaries, designated $NCC$, do not receive contingent commissions and therefore do not contribute to the insurer’s underwriting efforts by transmitting information about potential insureds’ residual risk.\textsuperscript{179}

This simple model helps illustrate why, if informed purchasers are allowed to choose between $CC$ and $NCC$ intermediaries, insurers will rationally conclude that those who choose an $NCC$ intermediary are more likely that not to have a high residual risk ($R_H$). $R_H$ types will generally have an incentive to hide their residual risk from insurers so that they are not charged an actuarially fair premium, which is higher than they would otherwise pay. They cannot do so by going to a $CC$ intermediary, as the $CC$ intermediary conveys this risk

\textsuperscript{177} This is not nearly as strong an assumption as it first appears to be. Insurers are generally thought to be quite good at calculating roughly accurate averages of risk levels across defined populations. If the average risk level is close to the median, then there will be an approximately equal number of people who are more risky than average compared to those who are less risky than average.

\textsuperscript{178} This assumption can be challenged because purchasers can bypass intermediaries altogether and obtain insurance through an insurer that offers direct underwriting, either over the phone or the Internet. ABRAHAM, supra note 13, at 56. But this option, of course, requires completely foregoing the advice of an intermediary who can identify insurance needs and suggest various options. Moreover, it is only available from a limited number of insurers for a limited number of insurance lines, such as automobile and homeowners insurance. See id.

\textsuperscript{179} Another objection is that under some reform proposals, insureds can force an agency not to accept contingent commissions. In this scenario, a single agent or broker would accept contingent commissions or not depending on each client’s stated preference. See Fitzpatrick, supra note 3, at 3069-70. This scenario, however, would not impact the analysis because insurers, of course, would know in any given case whether an agent or broker was accepting contingent commissions. They could therefore simply treat the intermediary differently based on whether or not it was accepting contingent commissions for a given transaction.
information to the insurer.\textsuperscript{180} By going to the \textit{NCC} intermediary, by contrast, \textit{RH} types can attempt to hide their true status. Contrast this with \textit{RL} types, who actually gain from credibly communicating their true risk status to insurers, and who therefore have an affirmative incentive to purchase insurance from a \textit{CC} intermediary. Countervailing factors, most notably the risk of receiving biased advice due to steering, may, of course, counteract this effect. But so long as any countervailing forces equally affect both \textit{RH} and \textit{RL} types, insurers can rationally infer that a higher percentage of \textit{RH} than \textit{RL} types will prefer \textit{NCC} intermediaries, and a higher percentage of \textit{RL} than \textit{RH} types will prefer \textit{CC} intermediaries.\textsuperscript{181} Insurers, knowing this, will set their premiums accordingly and will impose a surcharge for the purchase of insurance through an \textit{NCC} intermediary.

This “surcharge” decreases the extent to which informed purchaser choices reveal actual purchaser preferences. The reason is that the cost insurers add to purchases through an \textit{NCC} intermediary is not tethered to the actual costs associated with that choice. To see why this matters, consider a low residual risk insured (\textit{RL}) who, if given the choice between banning contingent commissions and mandating them, would prefer a ban because of the possible costs associated with steering. Even though this insured is \textit{RL}, he or she would prefer to be lumped together with all insureds and treated as having an average risk level (\textit{Ro}) rather than pay the costs associated with steering and be recognized as a genuine \textit{RL}. But when given the choice between these two options in the marketplace, this insured might nonetheless choose to purchase insurance from a \textit{CC} intermediary because purchasing from an \textit{NCC} intermediary would falsely signal that the insured had a high residual risk level, resulting in the insured paying a higher premium than would be paid by an average risk (\textit{Ro}).

\textbf{B. Mimicry: A New Adverse Selection Model for Sophisticated Insurance Markets}

As noted above, the core defense of contingent commissions—that they reduce adverse selection—has some traction in sophisticated insurance markets, where there are fewer reasons to be skeptical about the importance of adverse selection.\textsuperscript{182} But even in these sophisticated insurance markets, contingent commissions may fail to improve adverse selection problems

\textsuperscript{180} This is not true, of course, if \textit{RH} types can hide their risk status when dealing with \textit{CC} intermediaries. The implications of such deception are considered \textit{infra} Section III.B.

\textsuperscript{181} In theory, if the costs of steering were sufficiently high for all insureds, then both \textit{RH} and \textit{RL} types would go to \textit{NCC} intermediaries. This result is unlikely given that different insureds are likely to weigh the costs of steering differently. In any event, this result would be the functional equivalent of banning contingent commissions, and so does not undermine the analysis.

\textsuperscript{182} See \textit{supra} notes 143-152 and accompanying text.
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significantly. To make this argument, this Section expands on the model of contingent commission payments presented above, but adds an additional assumption—that RH insureds can, for a cost, mimic RL insureds when interacting with intermediaries. This assumption is first explained and justified in Subsection 1. The model, which is developed in Subsection 2, suggests that RH insureds may choose to purchase insurance through CC intermediaries and to mimic RL insureds strategically in a way that both creates new social costs and mitigates the capacity of contingent commissions to reduce adverse selection. Under the model, contingent commissions shift, rather than eliminate, the informational barrier that causes adverse selection. In other words, while contingent commissions encourage the free flow of information between insurers and intermediaries, they simultaneously discourage the free flow of information between insurance purchasers and intermediaries.

1. The Mimicry Assumption

Sophisticated insurance purchasers ordinarily have a clear incentive to be honest with their insurance brokers or independent agents. Independent insurance intermediaries help “buyers to identify their coverage and risk management needs and [match] buyers with appropriate insurers.”183 These risk-management services are particularly important for sophisticated insurance purchasers, who tend to have complicated risk-management needs. If these potential insureds are not truthful and forthright about their potential liabilities, then their intermediaries will not be capable of providing these services. An intermediary’s capacity to identify an insured’s vulnerabilities and to offer concrete methods for reducing risk is obviously compromised when insureds withhold complete and accurate risk information. Similarly, if insureds are not completely forthright about their risk profiles, their agents or brokers may be unable to recommend or investigate truly comprehensive insurance options. In fact, many endorsement options are specifically designed so that they will be particularly appealing to relatively high-risk insureds.184 Intermediaries that do not know that an insured is relatively high-risk will have little reason to investigate or recommend these endorsements.

When intermediaries receive contingent commissions, however, insurance purchasers’ ordinary incentive to be truthful with their brokers or agents may be overwhelmed by a contrary incentive. In the model outlined above, informed and sophisticated insurance purchasers will understand that an agent or broker who receives contingent commissions may disclose otherwise unobservable

183. Cummins & Doherty, supra note 2, at 360.
184. This is the classical solution to the adverse selection problem pioneered by Rothschild and Stiglitz. See Rothschild & Stiglitz, supra note 72, at 643.
risk information to insurers. For this reason, informed RH insureds may have an incentive to hide their residual risk level when they purchase insurance through a CC intermediary. By mimicking an RL insured and purchasing insurance through a CC intermediary, the high residual risk insured may be able to receive a discounted premium from the insurer: the CC intermediary, believing the customer to be RL, will signal this misunderstanding to the insurer, who will charge the incognito RH customer a low premium.

In many cases, determined RH insurance purchasers will be able to successfully mimic RL insureds when interacting with intermediaries. To do so, the insured need not alter verifiable or easily observable facts—any such information is presumably observable by insurers directly and is thus not part of the insured's residual risk. Rather, the insured would merely need to alter evidence relevant to residual risk, meaning evidence that the insurer would not observe without the input of the intermediary. For instance, the insurance purchaser might fail to mention idiosyncratic risks about which the producer did not directly inquire. The normally nonchalant businessman might well put on a front of hyper-vigilance for his visits to his broker. If this proved impossible, he might send a particularly safety-minded subordinate to meet with the broker or agent. In cases in which a broker or agent had historical knowledge of the company's poor safety habits, the insured could switch intermediaries and wipe the slate clean. Such deception is likely to be successful because an intermediary's comparatively superior knowledge about an insured depends almost exclusively on his or her direct interactions with the insured.

Of course, these efforts at mimicry would be costly for insurance purchasers. First, and most obviously, mimicry would require the additional effort of strategizing about how to mimic an RL insured. Second, insureds who did mimic would forego at least some of the risk mitigation advice that independent intermediaries provide to their clients. Third, as noted above, insureds who camouflage their risk levels potentially forego receiving advice about desirable endorsements or alternative policy options.

2. The Consequences of Mimicry

To understand the circumstances under which RH insureds will rationally choose to mimic RL insureds and the consequences of such mimicry, consider

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185. To the extent that even sophisticated insurance purchasers do not understand this, there is even more reason to believe that steering is a significant problem and that contingent commissions genuinely decrease the quality of insurance that these purchasers ultimately receive. See supra Section II.B (discussing how, even assuming that insureds understand the implications of an intermediary's contingent commission disclosure, they still may be steered to inefficient coverage).

186. See supra note 177 and accompanying text.

187. See supra notes 64-67 and accompanying text.
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the following extensions of the model introduced in Section A. Suppose that the actuarially fair premium for all insureds, when insurers cannot distinguish between residual risk types, is \( P \). For \( R_L \) insureds, the actuarially fair premium is reduced by an amount \( D \) (for a total of \( P-D \)) and for \( R_H \) insureds, it is increased by \( D \) (for a total of \( P+D \)).\(^{188}\) Insureds that purchase through a \( CC \) intermediary must pay a cost, \( S \), in addition to their premium, which represents the potential that they will be “steered” to a low-quality insurance arrangement for a given price. This might include relatively less comprehensive coverage, a less financially secure insurer, or an insurer with a bad reputation for claims payment.\(^{189}\) Because insureds have variable insurance needs and information about those needs, the size of \( S \) is assumed to vary among both \( R_H \) and \( R_L \) insureds.

Only \( CC \) intermediaries can credibly communicate information to insurers about an insured’s residual risk. \( R_H \) insureds, however, may not be forthright about their residual risk level, and they are capable of either revealing their true residual risk level to brokers or mimicking the risk level of an \( R_L \) insured. Intermediaries cannot distinguish between actual \( R_L \) insureds and \( R_H \) insureds who mimic low-risk status. To mimic an \( R_L \) insured, high-risk insureds must pay a cost \( X \) that reflects the costs of changed behavior, decreased risk mitigation advice, and the possibility of foregoing desirable endorsement or alternative policy options.\(^{190}\) Again, because insureds will have different insurance needs and information about those needs, the cost of \( X \) will differ among \( R_H \) insureds. These basic parameters, including those introduced above,\(^{191}\) are summarized below:

\[
\begin{align*}
R_L &< R_O \\
R_H &> R_O \\
\text{For } R_L, \text{ Premium} &= P-D \\
\text{For } R_H, \text{ Premium} &= P+D \\
\#R_L &= \#R_H \\
CC &: \text{can communicate the insured’s residual risk level} \\
NCC &: \text{cannot communicate the insured’s residual risk level} \\
S &: \text{Increased steering cost an insured pays for a } CC \text{ intermediary (varies among insureds)} \\
X &: \text{Amount } R_H \text{ must pay to mimic } R_L \text{ (varies among } R_H \text{ insureds)}
\end{align*}
\]

Given these basic parameters, consider how insurers and purchasers will respond. First, note that insurers will only set two premiums: one for insureds who purchase insurance through an \( NCC \) intermediary, and one for insureds who purchase insurance through an \( CC \) intermediary.
who purchase insurance from a CC intermediary who reports that a purchaser appears to be \( R_L \). Insurers will not set a third premium for insureds who purchase insurance from a CC intermediary reporting that a purchaser appears to be \( R_H \). The reason is that \( R_H \) insureds will never reveal their true status to a CC intermediary. Doing so would lead the CC intermediary to tell the insurer about \( R_H \)'s high-risk status, causing the insured to pay the premium \( P+D \). Instead, it will always be a better option (though not always the best), for the \( R_H \) insured to purchase through NCC intermediaries, who cannot communicate residual risk levels. Because insurers do not receive any credible information about the residual risk level from NCC intermediaries, they would not know that \( P+D \) was the actuarially fair amount to charge. Even if most customers of NCC intermediaries were \( R_H \)—as Section III.A predicts—the insurer could not presume that they all were; at least some \( R_L \) purchasers would choose to purchase through an NCC broker if they viewed \( S \) to be large, and thus the actuarially fair premium for insurance purchased through an NCC broker would have to be less than \( P+D \).

Second, note that insurers, in setting premiums, can partially induce self-sorting by \( R_L \) and \( R_H \) types if they charge a lower premium to insureds who purchase through CCs than those who purchase through NCCs. Both \( R_L \) and \( R_H \) insureds will always prefer to purchase insurance from an NCC unless they can receive a lower premium through a CC: purchasing through a CC imposes cost \( S \), and there is no countervailing benefit unless the price of insurance is lower. But insurers can induce some insureds to purchase insurance through a CC intermediary by charging a lower premium, which will offset the cost of \( S \) for some insureds. This group of insureds who purchase from a CC in response to a decrease in premiums will consist primarily of \( R_L \) rather than \( R_H \) types. The reason is straightforward: the total cost to \( R_L \) insureds of purchasing through a CC intermediary will be less than for \( R_H \) insureds because the \( R_H \) insureds must pay \( X \), the cost of mimicking, if they purchase through a CC. (Recall from above that it will never be sensible for \( R_H \) to purchase from a CC and not to mimic.) By contrast, both \( R_L \) and \( R_H \) pay precisely the same cost when they purchase through an NCC intermediary, as that intermediary cannot credibly signal any residual risk information to the insurer.

Based on these conclusions, the insurer's optimal pricing strategy will be to charge a premium \( P-A \) (for some \( A \) such that \( A<D \)) for insureds who purchase through CC intermediaries, and to charge a premium \( P+B \) (for some \( B \) such that \( B<D \)) for insureds who purchase through NCC intermediaries. This strategy is superior to either charging the same price to all insureds, or charging a higher price to insureds who purchase through CC intermediaries, because

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192. Notably, this is consistent with the possibility that contingent commissions reduce adverse selection. To the extent that a CC intermediary can reduce adverse selection, purchasers will experience this effect in a reduced premium.
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neither of those strategies achieves any advantage in appropriately pricing risk. Moreover, the strategy is optimal when \( A \) and \( B \) are both less than \( D \) because the pool of insureds who purchase from either type of intermediary will almost certainly be heterogeneous. The only scenario in which the insurer could achieve a complete separating equilibrium\(^\text{193} \) is if the premium discount for CC intermediaries over NCC intermediaries outweighed all \( R_L \)'s valuations of \( S \), but did not outweigh any \( R_H \)'s valuations of \( S+X \). Because different insureds value \( S \) and \( X \) differently under the model's assumptions, such a separating equilibrium does not occur. This analysis is presented visually, in the following figure:

\[
\begin{align*}
\text{Intermediary Choice} & \quad \text{Mimic or Reveal} & \quad \text{Total Cost} \\
& \quad \text{Reveal} & \quad P + D + S \\
& \quad \text{Mimic} & \quad P - A + X + S \\
\text{CC} & \quad & \quad \text{(Potentially Chosen)} \\
\text{RL} & \quad & \quad \text{(Potentially Chosen)} \\
\text{NCC} & \quad \text{Reveal} & \quad P + B \\
& \quad \text{Mimic} & \quad P + B + X \\
& \quad & \quad \text{(Not Chosen)} \\
\end{align*}
\]

\[
\begin{align*}
& \quad \text{Reveal} & \quad P - A + S \\
\text{CC} & \quad & \quad \text{(Potentially Chosen)} \\
\text{RL} & \quad & \quad \text{(Potentially Chosen)} \\
\text{NCC} & \quad \text{Reveal} & \quad P + B \\
& & \quad \text{(Potentially Chosen)} \\
\end{align*}
\]

- \( P = \text{Premium for average risk insured} \)
- \( D = \text{Actuarially fair change in premium based on risk level} \)
- \( X = \text{Penalty for mimicry} \)
- \( S = \text{Steering cost} \)
- \( B = \text{Surcharge for purchasing from non-contingent commission broker} \)
- \( A = \text{Bonus for purchasing from contingent commission broker} \)

\(^{193}\) In a separating equilibrium, all purchasers of different types choose different options, thus fully revealing their type indirectly. See DOUGLAS G. BAIRD ET AL., GAME THEORY AND THE LAW 140-47 (1994).
As this simple model clarifies, \( R_H \) insureds will tend to mimic \( R_L \) insureds if \( P-A+X+S < P+B \). By simple arithmetic, this reduces to \( X+S < B+A \). Thus, \( R_H \) insureds will mimic if the difference in premiums between \( CC \) and \( NCC \) intermediaries (i.e., \( B+A \)) is larger than the cost of steering \( (S) \) plus the cost of mimicry \( (X) \). When this is the case, \( R_H \) insureds will find it profitable to incur the costs of both \( S \) and \( X \).

Moreover, mimicry results in potentially substantial social costs and mitigates the capacity of contingent commissions to reduce adverse selection. All of the costs of mimicry \( (X) \) and some of the costs of steering \( (S) \) are social as well as private costs: overall social welfare decreases when insureds undertake costly measures to change their behavior, forego valuable risk mitigation advice, chance purchasing insufficient insurance, or purchase insurance that is of poor quality. Simultaneously, the private benefit to \( R_H \) of mimicking \( R_L \)—the premium reduction of \( B+A \)—is not a social benefit and actually limits the capacity of contingent commissions to mitigate adverse selection.\(^{194}\) Indeed, under the model, \( R_H \) insureds never reveal their status to \( CC \) brokers or agents, meaning that these agents never have any information to reveal to insurers. Importantly, adverse selection does decrease in the model, but not for the reason highlighted by other writers or to the extent that these writers have suggested. Instead, adverse selection only decreases because insureds who purchase through a \( CC \) intermediary are more likely to be low-risk than insureds who purchase through an \( NCC \) intermediary, allowing insurers to address adverse selection by charging higher premiums to the latter group of insureds. But this method for reducing adverse selection is limited: it only allows insurers to improve their information imperfectly, by making potentially incorrect inferences about insureds' residual risk levels based on their purchasing decisions.

Ultimately, the model suggests that the costs of mimicry, even ignoring the cost of steering, may exceed the benefits of reduced adverse selection. Offering sophisticated purchasers a choice about how their intermediaries are compensated may induce high-risk insureds to take socially costly measures in order to transfer wealth from low-risk insureds to themselves. The opportunity to mimic a low-risk insured (and therefore to receive a lower premium) may be an enticing benefit for the high-risk insured, but it is actually a social cost.

\(^{194}\) Note that in the model, as observed supra Section III.A, insureds may well prefer a system in which contingent commissions are banned to one in which they have the choice of \( CC \) or \( NCC \) intermediaries. In a world without contingent commissions, low-risk insureds, like high-risk insureds, pay a premium \( P \) for insurance. Compare this with the equilibrium result in a world with disclosure: low-risk insureds have the choice of paying premium \( P+B \) or \( P-A+S \). If \( S>A \), then low-risk insureds are unambiguously worse off in a world where contingent commissions are available as compared to a world in which such payments are banned. The same reasoning applies to high-risk insureds: following the same logic as above, they will be worse off if \( X+S>A \). In other words, if low-risk insureds are worse off, then so too are high-risk insureds.
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Indeed, it allows high-risk insureds partially to undo the benefits of reduced adverse selection that proponents of contingent commissions have identified. To accomplish this feat, high-risk insureds must incur a number of real costs associated with convincing their broker that they are low-risk insureds.

C. A Possible Need for Intervention in Sophisticated Insurance Markets

The preceding analysis suggests that, under a plausible set of assumptions, contingent commission payments may reduce the efficiency of commercial insurance markets, even though insurance purchasers in these markets are both informed and rational. First, it explains how even informed insurance purchasers may opt for the services of an intermediary that accepts contingent commissions in order to signal to insurers that they view themselves to be low-risk. The fact that these informed purchasers rely on contingent commission intermediaries does not, therefore, prove that this is the efficient market outcome. In fact, as Section B has explained, the costs of contingent commission payments in these markets are not limited to the prospect of steering. Sophisticated insurance purchasers, knowing that intermediaries who receive contingent commissions have an incentive to communicate risk information to insurers, may choose to purchase insurance through a broker or agent that accepts contingent commissions while masking information suggesting that they are relatively high-risk. High-risk insureds’ “mimicry” of low-risk insureds not only undermines the capacity of contingent commissions to reduce adverse selection, but it creates additional social costs: it impedes the intermediary’s ability to offer his or her clients risk-mitigation advice or to suggest appropriate coverage options.

The policy implications of these theoretical models, of course, are unclear and require empirical work testing the assumptions and predictions of the competing theoretical models. Two predictions, in particular, could be tested based on the theoretical model above. First, Section A has predicted that insureds who purchase through intermediaries that have disclaimed contingent commissions will pay premiums that are higher than what they otherwise would have paid. Second, Section B has predicted that high-risk insureds will be less forthcoming with contingent commission intermediaries than they are with intermediaries that disclaim contingent commissions. Because almost all intermediaries accepted contingent commission payments from some insurers until 2004, the possibility of testing these propositions has only recently emerged. Empirical work in this area is, therefore, both an exciting and promising frontier for research.

CONCLUSION

Attorney General (now Governor) Spitzer’s opening salvoes against
contingent commissions held the promise of reshaping the relationship between insurers and independent intermediaries. In the last two years, however, insurers, brokers, independent agents, and academics have turned the tide, transforming accusations of fraud in core industry practices into a mere requirement that insurance consumers be shown one more standardized form. Unfortunately, such disclosure will do little to limit the risks of steering in consumer markets. Disclosure may alert consumers to the fact that their intermediaries have a potential conflict of interest, but it will not equip them to limit the consequences of this conflict of interest, in light of the inherent informational asymmetries existing between insurance consumers and intermediaries. Lawmakers must weigh these costs against the theoretical possibility that contingent commissions reduce adverse selection, a problem that empirical evidence suggests is insignificant in consumer insurance markets. The resulting cost-benefit analysis provides a strong case for going beyond disclosure in consumer insurance markets—and perhaps even banning contingent commission payments in all their manifestations.

By contrast, the optimal regulatory solution is unclear when it comes to sophisticated insurance markets, where insurance purchasers can meaningfully be informed about contingent commissions. There are, however, theoretical reasons to believe that even in these insurance markets, disclosure is too limited a response. Insurance purchasers might well make market choices that do not reflect their actual preferences regarding the desirability of contingent commissions. This result may exacerbate adverse selection and may create additional social costs. Although it is too early to embrace regulatory oversight of contingent commissions in sophisticated insurance markets, it is also premature to assume that market forces will produce efficient results.