A nervous insurance industry

Suits, allegations focus spotlight on practices

The 'black eye' being suffered by the industry as a whole has raised the consciousness of both the crooked and the straight and has made consumers more aware, as well

Insurance executive Jerry Stump: 'If there were no profit-sharing arrangement, there would be less incentive to bring in profitable clients to the insurance carriers. It would then become a volume incentive'

By Deborah Nason

In mid-October, the New York Attorney General's office sued a national insurance brokerage, Marsh & McLennan Companies (MMC), for fraud and antitrust violations, citing "widespread corruption" within the insurance industry. The suit contended that MMC used inflated and phony bids, and steered business to a few carriers that paid special, higher commissions. While the suit was dropped 11 days later as a result of actions taken by MMC's board, the entire insurance industry feels as if it has been slapped in the face. And businesses in the Blue Ridge Region are on the defensive.

"The whole brokerage world is getting a black eye," says Walker Sydnor, president of regional insurance brokerage Scott Insurance, with headquarters in Lynchburg. "The thing that troubles me," he says, "is that at certain levels, we compete with [MMC], and we don't have the same [payment] arrangements."

Indeed, says Jerry Stump, president and CEO of Humphrey Stump & Haynie Insurance in Salem, which he describes as a middle-sized player in Virginia, "I got locked out of a deal because my potential client didn't realize he signed an exclusivity agreement with MMC." He says this effectively caused the client substantially more in premiums.

The New York complaint makes reference to MMC's use of "contingent commissions." However, that reference is misleading, says Shad Steadman, president and COO of Rutherfoord Companies, a regional insurance brokerage firm based in Roanoke.

He draws a distinction between the industry standard profit-sharing commission, paid by an insurance carrier if an agency provides a certain amount of profitable business; and "placement service agreements," a type of extortion, whereby insurance carriers were (allegedly) pressured by MMC to pay special commissions to be one of a few companies to whom the brokerage would steer customers.

Says Sydnor, "Contingent commissions ... go back to the earliest days of the insurance business. Many industries use incentives in their businesses the

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same way. My concern is that these agreements are coming under attack, [but] they're not necessarily bad."

'Less incentive'

Stump agrees. "If there were no profit-sharing arrangement," he says, "there would be less incentive to bring in profitable clients to the insurance carriers. It would then become a volume incentive."

The lawsuit is based on violations in six different areas, three of which are specific to New York law. Francis H. "Chip" Casola, an attorney with Woods Rogers PLC, specializes in cases involving antitrust issues and other forms of white collar crime. He explains the other three "causes of action" that have a broad application across the rest of the U.S.

• **Unjust enrichment**. Based on the idea of fairness, this common law concept is not in any statutes, says Casola. "It asks, 'Is it fair for this defendant to keep the profits it (allegedly) obtained or should the law imply a contract to pay over those profits to avoid the defendant's unjust enrichment?"

• **Common law fraud**. Referring to the notion of misrepresentation, he says that MMC agents (allegedly) said they were acting in the best interests of their clients, "when actually they (allegedly) had mixed loyalties and were being paid to steer business to certain insurance companies."

• **Antitrust**. This concept refers to MMC's (alleged) collusive and anti-competitive behavior. Casola says this count is probably similar to federal antitrust law, which prohibits any conspiracy in restraint of trade. He cites MMC's (alleged) bid-rigging, which included seeking fictitious quotes from insurance companies, and quid-pro-quid behavior ("you'll get the next contract if you falsely bid on this one."), as well as MMC's (alleged) agreement to collusively divide up the market and allocate customers among insurers.

Casola expects other related suits to follow soon. "It's worth noting that this case was brought solely by the New York Attorney General," he says, "and it wouldn't bar claims being brought under federal law by federal enforcement agencies. Also, private class action lawsuits could result."

Protections

How do agencies protect their clients from such unethical behavior? And how can clients protect themselves?

Steadman says that because Rutherfoord has contingent agreements with all its major insurance companies, there is no incentive to favor any one company. Furthermore, he says "We do not share any contingency income with our agents, so that keeps them from steering business. We use [contingent commissions] for our normal operating expenses." He points out that these commissions typically make up less than five percent of Rutherfoord's revenues, and are less than one percent of a premium's cost.

Stump uses an example to show why incentive compensation is not large enough to influence the smaller players in the industry. "A typical client—say a contractor with 25 employees—will pay about $60,000 per year for [coverage such as] workers compensation, auto, general liability, property, equipment, etc." This yields about $6,650 in total revenue, $2,300 of which goes to the sales agent. The remaining $4,350 is applied to agency overhead.

Manipulating business toward the highest commission opportunities is like shooting yourself in the foot. Says Sydnor, "If you don't have your client with the right company ... and don't do the best possible job [for him], there are a lot of other agencies out there competing for your client."

Stump safeguards his clients interests through his three-person "gatekeeper" department, run by his co-owner (and brother). "He reviews the applications of incoming business and makes sure we take the higher road," explains Stump. "He analyzes the information to make sure everything is represented fairly and accurately. He and his employees interview the [sales agents] to make sure they asked the right questions. It's a huge interview process for us."

"Most businesses have more trust in me than a national broker," says Stump, "because we can relate; we have similar problems. Our health and auto insurance escalates just like theirs

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does."

Regulation

Clients in Virginia have more regulatory protection than other states, according to Brian Gaudiose, Deputy Commissioner of Agent Regulation for the Commonwealth. "In Virginia," he says, "agents are only appointed as an agent of the company, not the client [as in New York]. Therefore it gives the regulators more leverage if an agent does something wrong."

Bob Bradshaw is executive vice president of the Independent Insurance Agents of Virginia, a non-profit business league representing 430 agencies throughout the state. "The general public and many businesses oftentimes do not understand the insurance industry," he says. "The other problem ... is that even in a pretty sophisticated situation, many don't really want to take the time to walk through an entire policy."

He suggests a list of questions for clients to ask their agents:

- How many companies do you represent? Which ones?
- Which of those are best for my type of operation and why?
- Have you colluded with any of these companies to provide false bids?
- Could I have a name of a company you have placed with this company?
- Do you have a placement service agreement with this company?
- What is your commission relationship with these companies?
- What other incentives and bonuses do you get?
- What risk management help is available [through your relationships with these companies]?

Says Steadman, "We can't paint everyone with the same brush. There needs to be a distinction drawn between these national brokers and the local and regional insurance firms. We weren't capable of negotiating these types of [agreements]. It may not have been illegal, but it calls into question their ethics."

"It's like an indictment of the industry. And it's disheartening to the hard-working agents and other agency employees."

(Contributing editor Deborah Nason lives in Roanoke County and was the Journal's Contributor of the Year in 2003.)