

## Outside Counsel

## Expert Analysis

# Addressing Insurance Broker Compensation Disclosure

On Feb. 17, 2011, the Court of Appeals issued its much-anticipated decision in *People ex rel. Cuomo v. Wells Fargo Insurance Services Inc.*, and held that common law does not require an insurance broker to disclose to its clients incentive arrangements with insurance companies.<sup>1</sup> In so ruling, *Wells Fargo* affirmed New York precedent that insurance brokers have “dual agency status,” and noted that a broker is an “intermediary—not someone with undivided loyalty to one or the other side of the transaction.”<sup>2</sup>

*Wells Fargo*'s holding notwithstanding, the brokerage industry in New York has disclosure obligations pursuant to New York Insurance Regulation 194, which the New York Insurance Department enacted in January 2010 to implement minimum disclosure requirements regarding broker compensation from insurers. So, while *Wells Fargo* declined to find a disclosure duty at common law, brokers currently have such requirements under Regulation 194. Regulation 194 has, however, been subject to judicial challenge; and although it survived, that decision is now on appeal. Therefore, although the Court of Appeals clarified the absence of disclosure duties at common law, litigation regarding Regulation 194 creates uncertainty regarding the future landscape of brokers' obligations.

### 'Wells Fargo' Decision

Prior to the Court of Appeals' *Wells Fargo* opinion, there was speculation whether the Court might weaken its prior decision in *Murphy v. Kuhn*, 90 N.Y.2d 266, 682 N.E.2d 972, 660 N.Y.S.2d 371 (1997), which held that brokers “have a common-law duty to obtain requested coverage for their clients within a reasonable time or inform the client of the inability to do so,” but “have no continuing duty to advise, guide or direct a client to obtain additional coverage.” As such, since *Murphy*, the bar to plead a claim for broker malpractice in New York has been relatively high.

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*People ex rel. Cuomo v. Wells Fargo Insurance Services Inc.* threatened to change the dynamic. In *Wells Fargo*, New York Governor Andrew Cuomo (while he was the state's Attorney General) alleged that Wells Fargo Insurance Services Inc. breached fiduciary duties owed to its clients by entering into incentive agreements with insurance companies and not disclosing those arrangements to the clients. More specifically, Mr. Cuomo alleged that Wells Fargo breached its duty of loyalty to its clients by steering business to insurers that paid it contingent commissions,

'Wells Fargo' reaffirmed long-standing New York common law that insurance brokers are 'dual agents,' and as such are not fiduciaries.

and by not disclosing those payments to clients. Mr. Cuomo argued that although New York law does not impose upon brokers a legal duty to recommend coverages to clients, brokers nonetheless owe clients general duties of care and loyalty. Accordingly, Mr. Cuomo took the position that because brokers are representatives of their clients pursuant to New York insurance law, brokers owe clients fiduciary duties.

The Supreme Court, New York County, disagreed with Mr. Cuomo and, at the appellate level, the First Department upheld the trial court's ruling granting Wells Fargo's motion to dismiss causes of action for breach of fiduciary duty and fraud.

The Court of Appeals granted Mr. Cuomo's request for an appeal of *Wells Fargo* in January 2010. In granting the appeal, the high court appeared ready to re-consider precedent on the standard for broker liability in the process

of addressing whether Wells Fargo breached fiduciary duties by failing to disclose its acceptance of contingent commissions.

Instead, the Court of Appeals affirmed the lower courts' decisions. Noting that the complaint relied on “various legal theories,” the Court stated that ultimately, “the case rests on the rule that one acting as a fiduciary in a particular transaction may not receive, in connection with that transaction, undisclosed compensation from persons with whom the principal's interests may be in conflict.”<sup>3</sup> Having thus framed the issue, the court noted: “The rule is a sound one in general, but we conclude that it does not apply here.”

Wells Fargo had argued that *Murphy* governed the case, but the Court rejected Wells Fargo's reading of *Murphy* as too broad, noting that *Murphy* “did not imply that insurance brokers are exempt from the general rule that an agent owes a duty of loyalty to its principal.” However, the Court also did not adopt the position urged by Mr. Cuomo. Rather, quoting decades-old precedent, the Court referred to brokers' “dual agency status,” and noted that “[i]ndeed, the word ‘broker’ suggests an intermediary—not someone with undivided loyalty to one or the other side of the transaction.”<sup>4</sup> As a result, the Court held that an insurance broker was not a fiduciary and did not have a duty to disclose.

Recognizing “the complexity of an insurance broker's role,” the Court cited appellate decisions finding that New York common law does not require brokers to disclose to their clients contractual relationships they have with insurance companies, and stated: “We agree that such disclosure is not normally required—and if there are exceptions to that rule, this case does not present one.”<sup>5</sup> To this end, the Court observed that “[t]he complaint does not allege that anything Wells Fargo did was contrary to industry custom; indeed, the parties seem to agree that arrangements like those the Attorney General complains of have been commonplace, and have not generally been disclosed.”

As regards Regulation 194, the *Wells Fargo* court noted that “[t]his non-disclosure may be a bad practice. Indeed, it is prohibited by [Regulation 194], but that regulation did not exist at the time of the conduct at issue here.”<sup>6</sup> The Court acknowledged that the regulation established disclosure requirements similar to those that Mr. Cuomo sought to impose via common law, and

stated that “[a] regulation, prospective in effect, is a much better way of ending a questionable but common practice.”<sup>7</sup>

### Regulation 194

The *Wells Fargo* decision addresses common law duties, and does not impact Regulation 194, which requires brokers to make unrequested disclosures about their compensation to clients. The New York Insurance Department issued Regulation 194—titled “Producer Compensation Transparency” and codified at 11 NYCRR §30—in January 2010, out of concern for consumer awareness.<sup>8</sup> The regulation’s stated purposes are to regulate insurers’ and producers’ practices regarding the transparency of compensation and to protect the public by creating minimum disclosure requirements regarding producers’ incentive compensation.

Regulation 194 was somewhat controversial when it was promulgated, and remains so to date, in part because compensation disclosure has a long history in the insurance industry. Traditionally, agents were compensated through commissions from the insurer, and brokers received this commission as part of the insurer’s approved rate filing. In 1998, the New York Insurance Department issued a circular letter expressing concern that undisclosed compensation created an appearance of conflict or untrustworthiness (“1998 Circular Letter”).<sup>9</sup> It found that this appearance, if substantiated, could result in the revocation, suspension, or non-renewal of a broker’s license. The department believed at the time that disclosing the compensation would remedy any appearance of conflict or untrustworthiness.

After conducting its own investigation, in 2004 the Insurance Department—in conjunction with then Attorney General Eliot Spitzer—investigated Aon, Willis and Marsh, the three largest brokers, focusing on activity such as bid rigging and steering schemes involving undisclosed incentive compensation. The investigated instances concerned compensation paid by both the client and the insurer, and the transactions involved primarily very large commercial accounts. These investigations prompted public hearings and comments that culminated in Regulation 194.

Thus, Regulation 194 was drafted to address conflicts of interest that might arise due to incentive-based compensation paid by insurers to brokers. The Insurance Department sought to address this concern in the least invasive manner possible: by requiring brokers to make certain disclosures to their customers about their role in the transaction and their compensation arrangements with the insurer.<sup>10</sup> According to the department, although there is “nothing inherently improper about incentive-based compensation...a potential conflict of interest may arise when an insurance policy that would earn the producer the greatest compensation...is not the most appropriate insurance for the customer.”<sup>11</sup> By requiring disclosure of compensation arrangements, Regulation 194 is designed to educate the consumer about the possibility of conflict, while protecting the trustworthiness of the insurance producer.

### Regulation 194 as a Target

Regulation 194 has already survived a legal challenge. In *Sullivan Financial Group Inc. v. Wrynn*, 30 Misc.3d 366, 910 N.Y.S.2d 889 (Sup. Ct. Albany Co. 2010), licensed insurance producers and nonprofit professional associations representing the interests of insurance producers brought an Article 78 proceeding seeking to annul the regulation. *Sullivan* challenged the Superintendent of Insurance’s authority to promulgate Regulation 194.

Insurance Law §301 permits the Superintendent of Insurance to promulgate regulations that are consistent with state insurance laws. Petitioners in *Sullivan* argued that Regulation 194 was inconsistent with Insurance Law §2119, which requires a signed writing stating the amount of any fee, commission or thing of value paid for examining, appraising, reviewing or evaluating an insurance policy. The Supreme Court, Albany County, considered the purpose behind §2119, and found it not inconsistent with Regulation 194. Rather, the court concluded that the provisions regulate different relationships: Regulation 194 requires disclosure of the financial relationship between producer and insurer, while §2119 regulates the relationship between broker and policyholder.

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Turning to whether Regulation 194 was supported by factual predicate, the *Sullivan* court reviewed the steps the Superintendent undertook to research the issue, including the 1998 Circular Letter, the 2004 joint investigation, and the 2008 public hearings. The court found that the petitioners failed to show that Regulation 194 lacked reason and rationality.

The court also examined the burden that Regulation 194 would place on brokers. Petitioners argued that the administrative cost of responding to requests for disclosure, the additional liability exposure, and the practical difficulties of obtaining and quantifying the details of compensation created an unreasonable burden. The court acknowledged these concerns, but noted that neither side could provide a realistic estimate of the number of disclosures involved. Further, the court pointed to language in Regulation 194 that eased the burden by permitting producers to provide a reasonable estimate of incentive compensation where the “nature, amount or value” may not be known at the time. Ultimately, the court deferred to the Superintendent’s broad power to make policy judgments.

As regards common law, the *Sullivan* court saw no inconsistency between the “limited duties” owed by a broker to a policyholder at common law and Regulation 194’s requirements. Thus, the court stated: “[i]n fact, the need for Regulation 194 arises precisely because producers do not

owe a legal duty to an insured to recommend the best or most appropriate coverage.”<sup>12</sup>

On Dec. 23, 2010, the Insurance Agents and Brokers of New York and Council of Insurance Brokers of Greater New York filed a notice of appeal of *Sullivan* to the Appellate Division, Third Department. But unless and until Regulation 194 is overturned by the courts, brokers continue to be required to comply with it.

### Conclusion

*Wells Fargo* reaffirmed long-standing New York common law that insurance brokers are “dual agents,” and as such are not fiduciaries, and do not have an obligation to disclose compensation arrangements to their customers. Regulation 194 fills that gap, and requires producers to make such disclosures. Although the outcome of litigation over Regulation 194 cannot be foretold with certainty, the Court of Appeals’ nod to legislation in *Wells Fargo* as “a much better way of ending a questionable but common practice,” bodes well for the future of the regulation.

1. *People ex rel. Cuomo v. Wells Fargo Insurance Services Inc.*, \_\_\_N.E.2d\_\_\_, 2011 WL 534198 (Feb. 17, 2011).

2. *Id.*

3. *Id.*

4. *Id.* (quoting *Bohlinger v. Zanger*, 306 N.Y. 228, 230 (1954)).

5. *Id.*

6. *Id.*

7. *Id.*

8. 11 NYCRR §30.

9. N.Y. Ins. Dept. 1998 Circular Letter No. 22, Re: Disclosure of Brokers’ Compensation.

10. See N.Y. Dept. Ins. O.G.C. Opinion No. 10-11-01 (Nov. 4, 2010).

11. Regulatory Impact Statement for the Adoption of 11 N.Y.C.R.R. Part 30 (Regulation 194).

12. *Id.*