2009

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Daniel Schwarcz
University of Minnesota Law School, schwarcz@umn.edu

Recommended Citation
Daniel Schwarcz, *Differential Compensation and the "Race to the Bottom" in Consumer Insurance Markets*, 15 Conn. Ins. L.J. 723 (2009), *available at* http://scholarship.law.umn.edu/faculty_articles/567.

DIFFERENTIAL COMPENSATION AND THE "RACE TO THE BOTTOM" IN CONSUMER INSURANCE MARKETS

Daniel Schwarcz[*]

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This contribution to a symposium on insurance intermediaries analyzes insurers' compensation of independent agents and brokers in consumer markets. It focuses on various forms of "differential compensation," whereby an intermediary's compensation differs depending on the insurer with which the consumer ultimately purchases coverage. Such differential compensation, the article argues, undermines competition among consumer insurers with respect to non-price product attributes. This, in turn, increases the risk of a "race to the bottom" in consumer insurance markets, as insurers focus on selling the cheapest coverage possible that is consistent with legal restrictions. To address these problems, this article suggests that insurers who rely on independent agents to sell consumer lines of insurance should be prohibited from paying different rates of compensation to different agents for the sale of the same line of insurance.

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In 2004, a series of lawsuits filed by the New York Attorney General challenged insurers' long-standing payments of year-end bonuses to insurance brokers. The lawsuits alleged that these payments, known as contingent commissions, created conflicts of interest that undermined

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[*] Associate Professor, University of Minnesota Law School. For helpful comments, I thank Hazel Beh, Tom Cotter, Sean Fitzpatrick, Kristin Hickman, Claire Hill, Brett McDonnell, Francesco Parisi, Jeffrey Stempel, an anonymous referee, attendees of the Insurance Intermediaries panel at the 2008 Annual Association of Law Schools, and participants in a research seminar at the Department of Risk Management and Insurance at Georgia State University. This symposium piece builds off of my earlier article, Daniel Schwarcz, *Beyond Disclosure: The Case for Banning Contingent Commissions*, 25 YALE L. & POL'Y REV. 289 (2007).

brokers' professed loyalty to their clients.[1] "If the practices identified in our suit are as widespread as they appear to be," the Attorney General stated, "then the industry's fundamental business model needs major corrective action and reform."[2]

Within months of these allegations, the commercial insurance industry had indeed changed significantly. Each of the four largest insurance brokers pledged to end their practice of accepting contingent commission payments from insurers.[3] Because of the concentration of the insurance brokerage industry – the three largest brokers, Marsh, Aon, and Willis enjoyed more than a 54% market share among the top 100 brokers in 2004[4] – this shift dramatically impacted the entire market. Meanwhile, the prominence of these allegations led corporate risk managers and other sophisticated insurance purchasers to demand from their brokers previously-undisclosed details about contingent commission arrangements.[5] Although many small brokers still accept contingent commissions, many other brokers (including the four largest) now publicly tout their refusal to accept such commissions in marketing themselves to their clients.[6]

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[1] *See generally* Sean M. Fitzpatrick, *The Small Laws: Eliot Spitzer and the Way to Insurance Market Reform*, 74 FORDHAM L. REV. 3041, 3047 (2006) (reviewing the trajectory of Attorney General Spitzer's investigation of contingent commissions); Daniel Schwarcz, *Beyond Disclosure: The Case for Banning Contingent Commissions*, 25 YALE L. & POL'Y REV. 289 (2007).

[2] Press Release, Eliot Spitzer, New York Attorney Gen., Investigation Reveals Widespread Corruption in Insurance Industry (Oct. 13, 2004), *available at* http://www.oag.state.ny.us/press/2004/oct/oct14a_04.html.

[3] *See* Schwarcz, *Beyond Disclosure*, *supra* note 1, at 291-92.

[4] *See* J. David Cummins & Neil A. Doherty, *The Economics of Insurance Intermediaries*, 73 J. RISK & INS. 359, 364 (2006).

[5] *See* David Dwanka, *Mid-Level Insurance Brokers Defend Contingent Commissions Amid Growing Criticism*, BESTWIRE, May 8, 2006.

[6] *Broker Compensation: Hearing Before the New York Ins. Comm'r* (2008) (testimony of Don Bailey, CEO of Willis) (testifying that Willis does not accept contingent commissions because they pose a "clear and obvious conflict of interest") *available at* http://www.ins.state.ny.us/agbrok/br_cmp_indx.htm.

For all of this reform in *commercial* insurance markets, virtually nothing has changed about the way intermediaries in *consumer* insurance markets are compensated. In both property/casualty and life/health consumer insurance lines, most independent insurance agents continue to receive increased compensation from insurers to whom they steer a significant amount of business.[7] And, unlike sophisticated insurance purchasers, most consumers continue to have no real understanding of these practices and the impact they may have on the advice that insurance agents offer.

From a doctrinal perspective, this divergence in consumer and commercial insurance markets may appear to be perfectly reasonable. The insurance brokers that service commercial insurance markets are generally considered to be legal agents of policyholders.[8] By contrast, the independent insurance agents that populate consumer insurance markets are usually described primarily as legal agents of insurers, rather than consumers, and therefore have more limited (if any) fiduciary obligations to policyholders.[9] Consequently, compensation structures that create conflicts of interest appear to be more troubling doctrinally in commercial markets than in consumer markets.

But from an economic perspective, the differential reform in commercial and consumer insurance markets is bizarre. Unlike sophisticated commercial entities, ordinary consumers generally have limited information about the relative quality of different carriers and a bounded ability to translate the information they do have into effective decision-making.[10] As Cass Sunstein and Richard Thaler recently observed, "the benefits from holding . . . insurance are delayed, the

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[7] *See generally id.*; *see also* Richard W. Cooper, *Spitzer's Allegations of the Anticompetitive Effects of Contingent Commissions: A Shot Truly Heard Around the World*, J. OF INS. REG. 83, 100 (2007).

[8] *See* KENNETH S. ABRAHAM, INSURANCE LAW & REGULATION 56-57 (3d ed. 2000).

[9] ERIC MILLS HOLMES, HOLMES' APPLEMAN ON INSURANCE 2D: LAW OF INSURANCE AGENTS § 47.5, at 326 (1998). *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).

[10] *See* Part II, *infra*.

probability of having a claim is hard to analyze, consumers do not get useful feedback about whether they are getting a good return on their insurance purchases, and mapping from what they are buying to what they are getting can be ambiguous."[11] Consumers are therefore much more susceptible than commercial purchasers to being steered to insurance carriers they would not prefer under ideal market conditions.

Not only does such steering create mismatches between consumers and their insurers, but it undermines the competitiveness of consumer insurance markets as a whole. Although consumer insurance markets are ultra-competitive with respect to price,[12] they are remarkably non-competitive with respect to claims handling quality.[13] Indeed, many consumer insurance markets appear to be characterized by insurer-side adverse selection, wherein price competition creates a race to the bottom among insurers with respect to claims handling quality.[14] This Article argues that differential compensation contributes to this insurer-side adverse selection. By corrupting the objectivity of independent agents' advice, differential compensation undermines the primary mechanism by which consumers can ordinarily overcome informational and cognitive limitations in assessing the quality of complicated financial products.

As such, this Article proposes that insurers who rely on independent agents to sell consumer lines of insurance should be prohibited from paying different rates of compensation to different agents for the sale of the same line of insurance. Such reform would be less radical than it may initially appear. Federal regulators have long regulated commissions

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[11] CASS SUNSTEIN & RICHARD THALER, NUDGE 76-77 (2008).

[12] S*ee* J. DAVID CUMMINS, DEREGULATING PROPERTY-CASUALTY INSURANCE 2-3 (2002); Paul Joskow, *Cartels, Competition, and Regulation in the Property-Liability Insurance Industry*, RAND J. ECON. 375 (1973).

[13] *See* Section II. B., *infra*.

[14] Legal scholarship has long recognized that such price competition can cause firms to provide inefficiently poor quality when consumers cannot reliably evaluate quality due to information deficits or systematic cognitive limitations. *See generally* Oren Bar-Gill, *Seduction By Plastic*, 98 NW. L. REV. 1373, 1376 (2004); Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630 (1999); Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: Some Evidence of Market Manipulation*, 112 HARV. L. REV. 1420 (1999).

for the sale of Medigap policies, and they recently announced their intention to do the same for Medicare Advantage programs.[15] By extending these policies to the sale of all consumer insurance policies, lawmakers could provide consumers with the same protections that sophisticated commercial entities already enjoy. Even more importantly, they could enhance the competitiveness of consumer insurance markets as a whole.

I. INDEPENDENT INSURANCE AGENTS AND DIFFERENTIAL COMPENSATION

A. INSURANCE AGENTS IN CONSUMER INSURANCE MARKETS

Consumers can purchase insurance coverage directly from an insurer, or through either independent or captive agents. Captive agents are employees of a single insurer and only offer coverage with that carrier.[16] By contrast, independent agents can write business with multiple insurers and consequently provide consumers with a choice of carriers.[17] Such choice can be valuable for consumers, as insurers differ in terms of their reputations for claims handling, financial strength, risk management services, and scope of coverage offered.[18] In addition to these variations in

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[15] *See generally* Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (1990) (limiting agent compensation so that first year compensation may not be greater than twice renewal compensation, renewal compensation must be paid for at least 5 years, and replacement commissions may not be greater than renewal commissions for the product); Press Release, Center for Medicare & Medicaid Services, CMS Proposes New Protections for Medicare Beneficiaries in Medicare Advantage and prescription Programs (May 8, 2008) *available at* http://www.cms.hhs.gov/ (describing proposed regulation that would "require Medicare Advantage organizations to establish commission structures for sales agents and brokers that are level across all years and across all [Medicare Advantage] plan product types").

[16] HOLMES, *supra* note 9, at 326.

[17] Cummins & Doherty, *supra* note 4, at 375.

[18] *See id.*; Schwarcz, *Beyond Disclosure, supra* note 1, at 296-97. Independent insurance agents market themselves primarily on the basis of their capacity to help consumers compare these variations in quality and pricing. As the website of their main trade organization explains, independent agents "work with you to identify the insurance . . . that [is] right for you… and use [their] access to multiple

"quality," insurers employ differing underwriting criteria and strategies, resulting in price differentials even in highly price competitive marketplaces.[19]

Consumers may prefer independent agents over captive agents for other reasons as well. First, many insurers do not offer insurance directly to consumers or distribute their products through captive agents, meaning consumers who want to purchase policies from these insurers must go through an independent agent.[20] Second, because independent agents "own" their customer lists, insurers cannot directly solicit the agent's clients or switch those clients to a different agent. Some have argued that this ownership gives independent agents a comparatively strong incentive to serve their clients, though empirical efforts have failed to confirm this theory.[21]

Of course, there are offsetting costs associated with purchasing coverage through an independent rather than captive agent. First, just as some insurers only provide coverage through independent agents, many popular insurers, such as State Farm and Allstate, only offer coverage through captive agents.[22] In general, these insurers tend to be more

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companies to deliver those products." Independent Insurance Agents & Brokers of America – Consumer Information, http://www.iiaa.org. A brochure designed by the National Association of Professional Insurance Agents similarly explains that "by shopping among various companies, your professional agent can find the best combination of coverage, price and service -- the best value for your insurance dollar." National Association of Professional Insurance Agents, *Straight Talk about Choosing a Professional Insurance Agent*, http://www.pianet.com/Publications/ choosinganagentbrochure.htm.

[19] *See, e.g.,* Meg Green, *Top of Their Game*, BEST'S REVIEW 26 (Dec. 2006) (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).

[20] *See* Laureen Regan & Sharon Tennyson, *Agent Discretion and the Choice of Insurance Marketing System*, 39 J. L. & ECON. 637, 639 (1996).

[21] Helen Doerpinghaus, *An Analysis of Complaint Data in the Automobile Insurance Industry*, 58 J. Risk & Ins. 120 (1991); J. David Cummins & Stephen Weisbart, The Impact of Consumer Services on Independent Insurance Agency Performance (1977) (IMA Education and Research Foundation).

[22] *See* Regan & Tennyson, *supra* note 20, at 638.

publicly visible, as large insurers can more easily support a captive distribution system and may also have greater advertising incentives.[23] Second, other things being equal, coverage purchased through captive agents will tend to be cheaper than coverage purchased through independent agents.[24] Because captive agents only work with one carrier, they spend less time on each sale, meaning that they receive lower commissions than independent agents.[25] These lower commission rates may result in lower premium rates for customers, as studies suggest that insurers pass through to consumers most of the cost of agent compensation.[26]

B. DIFFERENTIAL COMPENSATION OF INDEPENDENT AGENTS

Independent agents are compensated through standard commissions on the premiums consumers pay for their coverage.[27] These "ordinary" commission rates have always varied based on the underlying line of insurance sold, as different lines of insurance require different levels of effort by insurance agents.[28] But, historically, these commission rates were relatively standard within specific insurance lines, as individual insurers offered a single commission rate to all agents. Although new insurers

[23] *Id.*

[24] Itzhak Venezia et. al., *Exclusive vs. Independent Agents: A Separating Equilibrium Approach*, 40 J. ECON. BEHAV. & ORG. 443, 444 (1999).

[25] *See* Regan & Tennyson, *supra* note 20, at 648-49.

[26] Cummins & Doherty, *supra* note 4, at 380-83. Competing factors, such as the improved quality of an insurer's underwriting criteria which is caused by increased premiums, may offset this effect.

[27] *See id.* at 374. In property/casualty insurance markets, these commissions are generally the same each year that a consumer renews a policy, whereas commission rates tend to decrease over time for life insurance sales personnel. This creates its own conflicts of interest, which are beyond the scope of this Article.

[28] *See id.* at 374-75.

occasionally offered above-market rates to break into markets, competition ultimately ensured relatively uniform commissions within product lines.[29]

In the last few years, the premium commissions that different insurers pay independent agents have begun to vary more significantly than in the past. Some insurers now negotiate their commission rates on an individual basis with agents, offering higher rates to agents that have historically directed a large volume of profitable business to the insurer.[30] As a result, many independent agents receive higher commission rates for selling policies from one insurer than another, despite competitive forces.

Even insurance agents who receive the same *premium commissions* from different insurers may nonetheless receive different *contingent commissions* from those insurers. Unlike differential premium commissions, insurers have long paid contingent commissions to independent agents.[31] Contingent commissions are year-end bonuses that some insurers pay to independent agents based on the performance of the agent's book of business with that insurer.[32] Most contingent commission contracts link this bonus to certain volume or profitability benchmarks for the agent's book of business. If the specified benchmarks are met, then the insurer pays the agent a contingent commission that usually is calculated based on the profitability and/or volume of the agent's book of business with that insurer.[33] In life and health markets, agents often receive these

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[29] *See* Schwarcz, *Beyond Disclosure, supra* note 1, at 301.

[30] *See, e.g.*, http://www.chubb.com/marketing/chubb7450.html; MetLife, *Supplemental Compensation Plan,* http://www.whymetlife.com; Rupal Parekh, *Hartford the Latest to Offer Supplementals as Replacements for Contingent Commissions*, BUS. INS., 33 (July 2007).

[31] *See* Fitzpatrick, *supra* note 1, at 3056 ("Contingent commissions have been used by insurers as an incentive mechanism for their agents for a century or more.").

[32] *Id.*

[33] 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 on that business. In most cases, intermediaries are only entitled to contingent commissions if they meet threshold levels of both sales volume and profitability. *See* Jeffrey Wilder, *Competing for the Effort of a Common Agent: Contingency Fees in Commercial*

contingent commissions in the form of in-kind benefits, such as vacation trips, rather than monetary compensation.[34]

However it is structured, differential compensation undermines independent agents' incentives to objectively present consumers with information about competing insurance options.[35] The reason is simple: they incentivize independent insurance agents to steer consumers to carriers based on considerations other than those customers' insurance needs and risk preferences. Most obviously, differential commissions encourage insurance agents to steer consumers to insurers who pay the highest commissions. But bec ause differential commissions are almost always tied in some way to the volume and/or profitability of the agent's book of

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Insurance 5 (U.S. Dep't of Justice, Antitrust Div., Econ. Analysis Group Working Paper No. EAG03-4, 2004), *available at* http://ssrn.com/abstract=418061. 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. Wilder, *supra*, at 5. In some cases, contingent commission arrangements may be based only on volume, not profitability. However, "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 4, at 379. Once intermediaries reach these qualifying levels, their commissions typically increase with better results along either dimension. *See* Wilder, *supra*, at 5.

[34] *See, e.g., Broker Compensation*, *supra* note 6, at 103-113 (testimony of F. James Ginnane) (describing various cruises to the Baltics, Sweden, Montreal and elsewhere that MassMutual paid based on annual production, and noting that "all of the carriers" he was familiar with offer similar trips), *available at* http://www.ins.state.ny.us/agbrok/br-cmp-tran-buf.pdf.

[35] Consumers who purchase insurance via a captive agent have already made a decision that they want to purchase their coverage with a particular carrier. This means they will often have already priced out several different carriers and, perhaps, asked neighbors or friends about their experiences with those carriers. By contrast, consumers who seek out coverage via an independent agent have typically not made any decisions about which carrier best suits their needs. Although they may have had a particular agent recommended to them, they generally do not even know which carriers the agent offers, much less the relative characteristics of those carriers. Rather, independent agents offer themselves to consumers as an alternative to comparison shopping among different insurers. They purport to do the comparative shopping for the consumer.

business with an insurer, they may also create more subtle steering incentives for agents.[36] For instance, they may lead agents to steer customers to an insurer that has a minimum-volume requirement on the cusp of being satisfied.[37] Alternatively, they may cause an agent who believes that a consumer is a "bad risk" to steer that consumer to an insurer with whom the agent does not have a differential commission arrangement tied to profitability.[38] Differential commissions may also increase premium costs for consumers.[39]

II. THE DESIRABILITY OF A LEGAL RESPONSE TO DIFFERENTIAL COMPENSATION FOR INDEPENDENT AGENTS

Differential compensation of sales agents is common, and often understood to be relatively benign in many industries and market contexts. For instance, salespeople in retail stores may often receive special bonuses or in-kind benefits if they reach sales targets for particular products or brands. Like independent insurance agencies, such stores often carry multiple brands and consumers may rely on the advice of salespeople in making their decisions. Given that few suggest lawmakers regulate the compensation of sales personnel in these contexts, why would a different result be warranted in insurance markets?

Part of the answer is that consumer insurance markets are often regulated in ways that would be unthinkable in other markets. For instance, state insurance departments regulate product prices and designs and license salespeople and insurers.[40] Although the desirability of specific regulations

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[36] *See* Schwarcz, *Beyond Disclosure*, *supra* note 1, at 297-301.

[37] *See* Wilder, *supra* note 33, at 19.

[38] Cummins & Doherty, *supra* note 4, at 386-89. For this reason, agents who steer "high-risk" consumers to certain insurers may theoretically undermine their client's interest by signaling to the insurer that particular consumers are relatively "high risk" and should thus be charged increased premiums. *See* Schwarcz, *Beyond Disclosure*, *supra* note 1, at 324-35.

[39] *See* Cummins & Doherty, *supra* note 4, at 383.

[40] *See generally* ETTLINGER ET AL., STATE INSURANCE REGULATION 103 (1995).

is often contentious, the notion that insurance requires robust market conduct oversight is generally accepted. The reasons are two-fold. First, consumer insurance markets are uniquely susceptible to market failure for a variety of reasons, including the complexity of the underlying product, the cognitive limitations of consumers, the prevalence of information asymmetries, and various other external forces that distort the market by, for instance, mandating the purchase of coverage. Second, the consequences of such market failure are significant. Consumers who have inadequate coverage typically do not discover that fact until after they have suffered a loss, at which point they no longer have the ability to mitigate their damages.[41]

This Part applies these general rationales for insurance regulation to differential compensation arrangements in consumer insurance markets. It concludes the market forces that ordinarily limit the pernicious effects of differential commissions are unreliable in consumer insurance contexts. Similarly, it suggests that the consequences of the resulting market failure are significant, contributing to a race to the bottom over claims-handling practices in many consumer insurance lines.

A. DIFFERENTIAL COMPENSATION AND MARKET FAILURE

In ordinary product markets, an intermediary's temptation to push expensive or high-margin products is counter-balanced by the potential for market backlash.[42] At least some consumers are likely to arrive at a store with some knowledge about competing product options, especially given the wealth of such information available on the internet. This is particularly true with big-ticket items – like high definition televisions or cars – about which consumers will often invest time in researching. Attempts to steer such consumers to inferior or overpriced products may backfire, resulting in those consumers shopping elsewhere and sharing their

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[41] Bob Works, *Excusing Nonoccurrence of Insurance Policy Conditions in Order to Avoid Disproportionate Forfeiture*, 5 CONN. INS. L. J. 505, 583-84 (1998).

[42] Howell Jackson, *The Trilateral Dilemma in Financial Regulation*, *in* IMPROVING THE EFFECTIVENESS OF FINANCIAL EDUCATION AND SAVINGS PROGRAMS (Lusardi, Annamaria ed., forthcoming 2009); Howell E. Jackson & Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 STAN J.L. BUS. & FIN. 289 (2007).

negative impressions with friends and family.[43] Although sales personnel may attempt to target uninformed consumers, such an approach can be risky as it may be hard to distinguish between informed and uninformed consumers. And even consumers that do end up purchasing inferior or over-priced products will often fail to discover this in the course of using their product.[44] Such consumers will not only hesitate before returning to the store, but they too may talk to family and friends about their negative experience.

To be sure, these market forces hardly eliminate sales contests and inducements that lead to slanted advice – there will always remain sleezy car salesmen, stores that sell over-priced and useless gadgets, and chains that push consumers to purchase over-priced accessories that add little to the overarching product. But the prospect that routine government intervention in these contexts could efficiently improve matters is slim. As this Section shows, these market forces that ordinarily protect consumers from excessive steering work poorly in consumer insurance markets.

i. *Information in Consumer Insurance Markets*

Unlike consumers in most markets, insurance consumers have access to few, if any, accurate measures of an insurer's reliability in paying claims fairly and efficiently.[45] It is, for instance, impossible for consumers to find out how often individual insurers pay claims within 30, 60, 90, or 120 days of a claim being reported; how frequently they deny claims; how frequently they are sued for payment or found guilty of bad faith; and how

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[43] For a general discussion of the role of reputation in disciplining sellers' behavior, see Benjamin Klein & Keith Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 616 (1981).

[44] In economic parlance, insurance policies are thus "credence goods" because most consumers cannot evaluate their quality even after they purchase the policy. *See* Richard Craswell, *Interpreting Deceptive Advertising*, 65 B.U. L. REV. 657, 720-21 (1985) (explaining the differences between search goods, experience goods, and credence goods in economic and legal literature).

[45] "Information about the reliability of different insurers is hard to come by [and] the quality of insurance coverage is almost impossible to assess without an expert." KENNETH ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY 176 (1986).

frequently policies are cancelled or non-renewed.[46] While consumers can look up how often complaints against specific insurers are lodged with state regulators, this data is notoriously unreliable and inconsistent.[47] Even the data published by *Consumer Reports* is highly limited, as it does not take into account the size and type of each consumer's claim and it is based on each consumer's subjective experience with the claims process.[48]

Although consumers can, and do, carefully scrutinize premium differentials from different carriers, the significance of price differentials is almost impossible to assess without a corresponding understanding of the

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[46] One recent proposal to the National Association of Insurance Commissioners (NAIC) would empower regulators to publicly disclose most of these data elements about the relative quality of insurers' claims handling, which they already collect. *See* PROPOSAL FOR CENTRALIZED DATA COLLECTION, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (Market Regulation Committee Proposal). Unfortunately, insurers have bitterly resisted the proposal under the guise of confidentiality and trade secrets. *See* Jim Connolly, *NAIC Insurer Conduct Data Scheme Riles Insurers*, NATIONAL UNDERWRITER, Sept. 25, 2008, *available at* http://www.propertyandcasualtyinsurancenews.com/cms/nupc/Breaking%20News/2008/09/25-CONDUCTRULE-jc; Chad Hemenway, *NCOIL Committee Votes Against NAIC Market Conduct Data Proposal*, BESTWIRE, Jul., 11 2008; Sean Carr, *NAIC Sets September Vote for Market Conduct Plan,* BESTWIRE, Jul. 28, 2008; Letter from Am. Health Ins. Plans, Am. Council of Life Insurers, Am. Ins. Ass'n, Blue Cross and Blue Shield Ass'n, Nat'l Ass'n of Mut. Ins. Cos., and Prop. Cas. Insurers Ass'n of Am. to Sandy Praeger, President of the Nat'l Ass'n of Ins. Comm'rs (May 27, 2008) *available at* http://www.naic.org/documents/committees_d_data_collection_comments_namic0527.pdf.

[47] *See* Daniel Schwarcz, *Redesigning Consumer Dispute Resolution: The American and British Approaches to Insurance Claims Conflict*, 83 TUL. L. REV. 735 (2009). Currently the Market Analysis and Priorities Working Group of the NAIC is working to develop better codes for the entire complaint data collection effort. *See* http://www.naic.org/committees_d_mapwg.htm (last visited February 8, 2009).

[48] Consumer Reports surveys thousands of consumers who filed claims and asks them to assess their satisfaction with the claims process. *See Consumer Reports Investigates, Surviving the Hard Market in Homeowners Insurance* Vol. 69, Issue 9, Consumer Reports. 36 (Sept. 2004); *Homeowners Insurance Report, The New Protection Game* Vol. 64, Issue 1, Consumer Reports, 16 (Jan. 1999).

differences in the underlying products.[49] A high-priced insurer may offer good coverage for a fair price, while a low-priced insurer may offer coverage that is poor, even relative to its seemingly low premiums. In fact, it is precisely for these reasons that independent agents choose to market themselves to consumers by focusing on their capacity to offer advice about competing carriers.

This lack of concrete information about the relative quality of different insurers undermines a key protection against aggressive steering in ordinary consumer markets. As described above, the fact that consumers ordinarily have the capacity to independently research and assess different product options limits the capacity of ordinary retail establishments to steer consumers to unfavorable deals. Moreover, it increases the prospect that attempting to do so will create market backlash, leading consumers who realize they are receiving poor advice to spread the word to others. But because most consumers simply do not have concrete information with which to assess the advice about the relative quality of carriers that insurance agents dispense, these protections are less robust in consumer insurance markets. This is particularly true given that insurance advice is hardly formulaic. The best insurance options for a customer may depend on numerous considerations, including the customer's risk tolerance, cash flow, preexisting relationships with carriers, and numerous other factors. This means self-serving advice can often be justified on some basis, and will rarely be obviously identifiable, even to experts.

Not only do consumers have a limited capacity to assess *ex ante* the quality of different carriers' coverage, but they also have a limited capacity to do so *ex post*. Unlike almost any other product, only a very small percentage of consumers end up using the insurance they purchase.[50] When they do, it is almost always for relatively small claims, even though the most important element of that insurance is the coverage it provides in cases of large losses.[51] Finally, consumers that do submit claims to their insurers are typically ill-equipped to judge the extent to which their insurer

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[49] Schwarcz, *Beyond Disclosure, supra* note 1, at 315.

[50] *See* Daniel Schwarcz, *A Products Liability Theory for the Judicial Regulation of Insurance Policies*, 48 WM. & MARY L. REV. 1389, 1413-15 (2007).

[51] *See id.* at 1415.

lived up to its legal obligations.[52] Consumers may therefore be susceptible to insurers' capacity to "tell a story" that appears to justify the refusal to pay a claim or a relatively low settlement of that claim.[53]

This limitation in the capacity of consumers to assess insurance quality *ex post* further limits the power of market forces to address the steering that may result from differential compensation. Ordinarily, consumers who are successfully directed to inferior or overpriced products may discover this fact over time. Consumers who feel they were so victimized can not only choose to shop elsewhere in the future, but can talk to family and friends about their experience. Because most consumers who are steered to inferior insurance will never realize this fact, they will not exact these market penalties on agents who succumb to the temptation to maximize their compensation by directing consumers to inferior arrangements.

ii. *Consumer Decision-Making about Insurance*

In ordinary markets, consumers assess the desirability of different product options using a roughly rational process, at least in the aggregate. Especially when purchases involve big-ticket items, consumers are often willing to invest a significant amount of cognitive energy into making sure that they have thought through their options and selected a product that meets their needs and desires. As a result, salespeople can often exert only a minimal amount of pressure on shaping consumers' preferences. When salespeople push inferior or overpriced products, consumers may not only resist such practices, but may choose to avoid the establishment in the future and tell their friends and families of their experiences.

Two features of insurance markets substantially undermine this reasoned purchasing behavior, and the disciplining impact it has on agents' sales efforts. First, consumers typically purchase insurance as part of a larger event or transaction, such as taking a job, moving, or buying a home or automobile. Unlike with televisions, cars, or refrigerators, consumers do not typically decide that they can finally afford a new insurance policy, or

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[52] *See* Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claims Stories, and Insurance Contract Damages*, 72 TEX. L. REV. 1395, 1407-13 (1994).

[53] *See id.*

that their old policy is out of style, obsolete, or run down.[54] But the bundled decision-making that typifies such insurance purchases is both difficult and complicated, resulting in consumers "tend[ing] to adopt simpler choice strategies to cope with that complexity."[55] Such simplistic strategies obviously enhance the capacity of sales agents to steer consumer decisions.

Second, empirical research has consistently demonstrated that consumers' preferences concerning insurance are remarkably malleable.[56] Experimental research has established that framing effects can have important implications for consumers' purchases of insurance policies. For instance, one study found that subjects were willing to pay more than twice as much for flight insurance covering "terrorism" and "mechanical failure" than they were willing to pay for flight insurance that would pay for losses for "any reason."[57] Similarly, consumers tend to have bimodal responses to low-probability, high-cost risks, either dismissing them entirely or significantly overweighing their significance.[58] Which of these outcomes

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[54] Evidence suggests that consumers rarely change carriers after they initially purchase a policy, especially outside of the auto insurance context. INSURANCE RESEARCH COUNCIL, PUBLIC ATTITUDE MONITOR 2001, Issue 2, at 5, fig. 2-3 (reporting that only 7% of homeowners or renters changed insurers in the last five years, but 23% of auto insurers did). When consumers do change insurers, they overwhelmingly cite price as the reason. *See id.* at 6, fig. 2-4.

[55] *See* Russel Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1223-34 (2003) (reviewing literature displaying this consumer tendancy to choose simple choice strategies).

[56] Consumers' decision-making processes about insurance are a complicated mix of intuitive, emotional, and rational responses that are susceptible to manipulation. *See* Horward Kunruether & Mark Pauly, *Insurance Decision-Making and Market Behavior*, 1 FOUNDATIONS AND TRENDS IN MICROECONOMICS 63 (April 2005); David Cutler & Richard Zeckhauser, *Extending the Theory to Meet the Practice in Insurance*, Brookings-Wharton Papers on Financial Services (2004); PAUL SLOVIC, THE PERCEPTION OF RISK 76-77 (2000).

[57] Eric J. Johnson, et al., *Framing, Probability Distortions, and Insurance Decisions*, 7 J. RISK & UNCERTAINTY 35, 39 (1993).

[58] Gary H. McClelland, et al., *Insurance for Low Probability Hazards: A Bimodal Response to Unlikely Events*, 7 J. RISK & UNCERTAINTY 95, 104, 108-09 (1993).

obtains often depends on the availability of the underlying risk. Thus, Californians' purchases of earthquake insurance generally increase significantly immediately after an earthquake occurs and then gradually decrease (until the next earthquake).[59] Finally, consumers' insurance decisions are significantly impacted by their affection for the item to be insured. In general, people prefer to insure against losses that involve high affect, even when holding constant the expected value of the insurance and the insured's level of wealth.[60] It is for precisely these reasons that insurers are among the heaviest advertisers of any industry.[61]

Given this malleability of consumers' insurance preferences, experienced or well-trained sales agents are likely to have a substantial capacity to steer consumers to insurers by helping to shape those consumers' preferences. This form of steering is unlikely to generate any market backlash, because it involves altering consumers' preferences. Often, this manipulation unambiguously impedes efficient market outcomes by skewing consumer assessments of objective information. This occurs, for instance, with the framing of a risk to increase a consumer's assessment of its likelihood. At the same time, other types of manipulation may admittedly operate on consumer insurance preferences in ways that are normatively ambiguous.[62] Consider an agent who focuses on a consumer's affection for an item in order to increase her desire to insure against loss to that item. Evaluating the desirability of this result within a consequentialist

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[59] *See* Paul Slovic et al., *Preference for Insuring Against Probable Small Losses: Insurance Implications*, 44 J. RISK & INS. 237, 249, 252, 254-55 (1977); HOWARD KUNREUTHER, DISASTER INSURANCE PROTECTION: PUBLIC POLICY LESSONS 26-27, 36-41 (1978).

[60] Christopher K. Hsee & Howard C. Kunreuther, *The Affection Effect in Insurance Decisions*, 20 J. RISK & UNCERTAINTY 141, 142-43, 148 (2000). Entire markets for insurance have flourished based on this principle: consider life insurance for children, which in most cases is irrational based on standard insurance theory.

[61] *See* Baker, *supra* note 52, at 1404.

[62] *See* Brett H. McDonnell, Endogenous Preferences and Welfare Evaluations, 5-6, 9-12 (Oct. 18, 2006) (unpublished manuscript), *available at*: http://ssrn.com/abstract=933089.

framework is difficult (if not impossible), because there is no exogenously-defined preference to serve as a benchmark for that evaluation.[63]

iii. *Insurance Agents' Discrimination Between Sophisticated and Unsophisticated Purchasers*

In any consumer market, plenty of consumers will be relatively uninformed and therefore susceptible to inefficient steering. But these uninformed consumers are typically protected by their more informed counterparts. Because aggressive or misleading sales efforts that are directed at informed and engaged consumers can have negative effects on a business's reputation, uninformed or rationally ignorant consumers often benefit from the presence of their more informed counterparts when sales people cannot distinguish between the two.[64]

Once again, though, this market protection against inefficient steering is less robust in insurance markets. Unlike most salespeople, insurance agents must discuss clients' personal situations in order to assess their coverage needs and facilitate insurer underwriting.[65] This process enhances agents' capacity to assess the relative sophistication of their consumers, and to offer advice accordingly. In fact, one of the earliest studies of contingent commission payments found just such a pattern of discrimination in a large independent insurance agency in Arizona: relatively engaged customers were less frequently directed to insurers that paid contingent commissions than customers who were less engaged with their insurance purchases.[66] Such consumer segmentation undermines one

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[63] *See id.* at 12, 18.

[64] Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 636-38 (1979).

[65] Schwarcz, *Beyond Disclosure, supra* note 1, at 318.

[66] *Id.* at 317-18; *see* Wilder, *supra* note 33, at 2-3, 5, 7. 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. Because the contingent commissions that the company received were paid directly to the company, the three equity agents stood to gain more from maximizing contingent commissions than the non-equity agents. Additionally, only the equity agents handled "house" accounts, which (1) either originated in another agency that

of the core protections against undue steering in ordinary markets: the capacity of an informed minority to protect the interests of other consumers.[67]

B. THE COST OF MARKET FAILURE FOR DIFFERENTIAL COMMISSIONS

Market failures, of course, are ubiquitous. And many of these market failures are better left alone than subjected to the expensive, and often ineffective (or worse), forces of government regulation. But that is not the case here. This Section argues that insurers' payments of differential compensation to independent agents facilitate a "race to the bottom" in consumer insurance markets through insurer-side adverse selection.[68] They do so by undermining the willingness of independent agents to inform consumers about insurers' claims handling practices or to counteract consumers' tendency to discount the value of quality claims handling.

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the company subsequently acquired or were originally handled by an agent who retired, and (2) did not fit the portfolio or expertise of any non-equity agent. The defining characteristics of 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, rather than to pay them through the agency, indicating disengagement with their insurance agent. The study concluded 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 place house accounts with insurers offering contingent commissions by more than 50%." *Id.*

[67] See Schwarcz, *supra* note 50, at 1406-08; R. Ted Cruz & Jeffrey J. Hinck, *Not My Brother's Keeper: The Inability of an Informed Minority to Correct for Imperfect Information*, 47 HASTINGS L. J. 635, 672, 674-75 (1996).

[68] BAKER, *supra* note 9, at 7. Just as insurer's lack of information about consumers can lead to adverse selection, consumers' lack of information about insurers can lead to the "insurer-side" adverse selection described above.

i. *Insurer-side Adverse Selection*

Part A described how insurance consumers' limited information on the relative quality of different insurance options and suspect decision-making about insurance can lead ostensibly independent agents to steer consumers to inferior insurers. But these two market conditions can also have the more general impact of undermining competition among insurers with respect to claims handling.

If a sufficiently large percentage of consumers are ill-informed about insurers' claims handling, insurers that pursue aggressive claims handling strategies (lemons) will profit more than other insurers. These insurers can pass on some of these profits to consumers in the form of lower premiums. In the long run, this will force other insurers to either drop out of consumer markets or, more likely, adopt low quality claims handling practices themselves.[69] By contrast, if a sizable number of consumers are cognizant of differences in insurers' claims handling, then some insurers will seek to appeal to these consumers by adopting a high price, high quality brand. That, in turn, could force other market players to compete over their own claims handling quality. Of course, insurers' quality/price mix would still vary, with different insurers appealing to consumers with different risk preferences. As a result, the market as a whole would compete along both of the two primary dimensions that define the insurance-policyholder relationship.

Through similar mechanisms, insurer-side adverse selection can occur if insurance consumers' decision-making causes them to under-value, or under-appreciate, differences in insurers' claims handling practices. There are strong reasons to suspect consumer decision-making about insurance generally has this character.[70] The relative value to consumers of high quality insurance depends on two considerations: (i) the likelihood they will suffer a potentially insurable loss, and (ii) the likelihood a low-quality insurer will poorly handle any such claim relative to a high-quality insurer. With respect to the former, research has consistently found that most people judge their own likelihood of suffering a loss to be lower than

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[69] *See generally* Hanson & Kysar, *supra* note 14, at 630, 722, 724-25, 746-47 (exploring how consumers' under-estimation of risks can compel a similar race to the bottom with respect to those risks).

[70] Indeed, research has consistently found that there is a "systematic tendency for insurance in practice to differ from insurance in theory." Cutler & Zeckhauser, *supra* note 56, at 3.

the average such risk, so long as they retain even a minimal amount of control over the event.[71] Thus, people in general are overly optimistic about their risk of being injured in an earthquake,[72] being involved in a car accident,[73] suffering health problems,[74] and dying young.[75] For these reasons, they also generally buy less insurance against these risks than they should, especially when no outside force – such as legal mandates or loan terms – artificially increases demand.[76]

Although less evidence exists as to how consumers evaluate the likelihood that a low-quality insurer will poorly handle a claim relative to a high-quality insurer, there are theoretical reasons to believe people will also tend to under-estimate this risk differential. In part, that is because consumers' choice of insurers involves precisely the minimal amount of control over an ultimate risk (the risk of a low-quality choice having negative consequences) that leads people in other contexts to believe their

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[71] A separate relevant strand of research has found that, when facing low-probability risks, people tend to either dismiss those risks entirely or overweigh the value of insurance against those risks. *See* SLOVIC, *supra* note 56, at 75, 77; McClelland, *supra* note 58, at 95, 108-109. This conclusion, however, has ambiguous implications for the extent to which consumers believe they will suffer an insurable loss, depending on the side of the bimodal distribution on which an insured risk falls.

[72] Jerry M. Burger & Michele L. Palmer, *Changes in and Generalization of Unrealistic Optimism Following Experiences with Stressful Events: Reactions to the 1989 California Earthquake*, 18 PERSONALITY & SOC. PSYCHOL. BULL. 39, 40-1 (1992).

[73] David Dunning et al., *Ambiguity and Self Evaluation: The Role of Idiosyncratic Trait Definitions in Self-Serving Assessments of Ability, in* HEURISTICS AND BIASES 324 (Thomas Gilovich et al., eds., Cambridge Univ. Press 2002); KUNREUTHER, *supra* note 59, at 240.

[74] Neil D. Weinstein, *Unrealistic Optimism About Future Life Events*, 39 J. PERSONALITY & SOC. PSYCHOL. 806, 807 (1980).

[75] *See* Kyle D. Logue, *The Current Life Insurance Crisis: How the Law Should Respond*, 32 CUMB. L. REV. 1, 2, 4, 23 (2001-2002).

[76] *See id.* (noting the vast majority of Americans are under-insured against the risk of dying young); KUNREUTHER, *supra* note 59 (suggesting most Californians do not purchase earthquake insurance).

risk is lower than the average such risk.[77] Additionally, however, the actual difference between low and high quality insurers is ambiguous, in that it involves numerous considerations that are hard to definitively compare across insurers, even with all relevant information.[78] Research suggests people tend to interpret such ambiguous information in self-serving ways.[79] Given that high quality insurance unambiguously costs more than low quality insurance, this bias may theoretically manifest itself in consumers dismissing potential differences in claims handling quality.

Of course, the mere fact that economic conditions in insurance markets could theoretically lead to insurer-side adverse selection does not make it so. But many consumer insurance markets do appear to be characterized by some degree of insurer-side adverse selection, with few insurers pursuing high-quality, high-price strategies. Aside from the common (though often anecdotal) observations of commentators acknowledging this equilibrium,[80] significant evidence suggests prominent national insurers such as Unum/Provident, State Farm, and Allstate have each recently engaged in systematic, national efforts to cut claims payments

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[77] *See supra* text accompanying notes 71-76.

[78] *See supra* text accompanying notes 45-53.

[79] Linda Babcock & George Loewenstein, *Explaining Bargaining Impasse: The Role of Self-Serving Biases*, 11 J. ECON. PERSP. 109, 111 (1997).

[80] *See, e.g.*, *Pitman v. Blue Cross & Blue Shield of Okla.*, 217 F.3d 1291, 1296 (10th Cir. 2000) (observing Blue Cross had "a financial interest in denying claims in order to remain economically viable as well as competitive within the insurance industry"); BAKER, *supra* note 9, at 128 (collecting specific examples of seeming insurer opportunism); Schwarcz, *supra* note 50, at 1401-26; John Langbein, *Trust Law as Regulatory Law: The Unum/Provident Scandal and Judicial Review of Benefit Denials Under ERISA*, 101 NW. L. REV. 1315, 1331 (2007) ("Even when insurance is experience rated, the insurer still has an incentive to deny claims, because the market for insurance services is intensely competitive. Low-cost providers prevail over high-cost providers."). *But see* Alan O. Sykes, *"Bad Faith" Breach of Contract by First Party Insurers*, 25 J. LEG. STUD. 405, 418 (1996) (arguing that "any insurer who frequently refused to pay covered claims would likely soon develop a reputation for behaving in this fashion and lose customers," but acknowledging that "it is plausible that insurers might occasionally behave opportunistically without suffering a prohibitive reputational penalty").

to policyholders.[81] Additionally, the insurance industry plays a significant role in limiting public access to information about different insurers' claims handling quality. For instance, insurers have collectively devoted immense energy and resources to ensuring that data about their claims handling quality, which is already collected by state insurance regulators, is not made publicly available.[82] Similarly, studies of insurer marketing and advertising suggest that individual insurers do not publicly advertise any *concrete* information about the quality of their claims handling, preferring instead vague and unverifiable promises about trust (as well as concrete promises about price, of course).[83] In a market where insurers sought to compete over the quality of their claims-handling, one would expect that some insurers would prominently resist these trends.

ii. *The Role of Differential Compensation in Explaining Insurers' Race to the Bottom*

As described above, the two economic conditions that make insurer side adverse selection a plausible, and seemingly accurate, description of consumer insurance markets are (i) consumer ignorance about claims handling quality and (ii) under-appreciation of the significance of this variable. This Section suggests that differential compensation of independent insurance intermediaries is a key contributor to this equilibrium.

Consumer markets are ordinarily able to overcome informational problems through the evolution of a network of independent intermediaries that digest complicated data and objectively present consumers with advice.[84] This process allows consumers to make informed choices that

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[81] *See* JEFFREY STEMPEL, LITIGATION ROAD: THE STORY OF CAMPBELL V. STATE FARM (2008) (displaying State Farm's practices); Langbein, *supra* note 80, at 1318-21 (displaying Unum/Provident's practices); Consumer Watchdog, *Consumer Advocates Call for Refunds, Rate Reductions, For Allstate Policyholders After Company Releases Internal Documents Revealing Intentionally Underpaid Customers*, REUTERS, Apr. 7, 2008 (displaying Allstate's practices), *available at* http://www.reuters.com/article/pressRelease/idUS187467+ 07-Apr-2008+PRN20080407.

[82] *See* documents cited *supra* note 46.

[83] *See generally* Baker, *supra* note 52.

[84] *See* Thomas F. Cotter, *Some Observations on the Law and Economics of Middlemen*, 1 MICH. ST. L. REV. 67, 69-70 (2006) (describing several economic

reflect their risk preferences despite their relative lack of understanding about the underlying market. Just as importantly, it improves the decision-making of less sophisticated consumers, by influencing insurers' reputations through word-of-mouth among consumers.[85]

In the insurance context, objective and independent market intermediaries could accomplish these ends by digesting data on claims handling quality, along with repeated first-hand observation of insurers' practices, to accurately communicate information about insurers' claims handling practices. Such information gathering services are particularly significant in consumer insurance markets, not simply because of the dearth of public information on insurers' claims handling practices,[86] but also because few consumers could independently assess such information, even if it were publicly available. The quality of an insurer's claims handling is not a monolithic concept, and could be constructed in multiple ways, with differences in metrics appearing significant when they were not, or *vice versa*. For instance, data suggesting an insurer denied a relatively high percentage of claims, or a relatively high number of its consumers sue for coverage or complain to state regulators, might simply reflect the insurer's pool of policyholders, rather than its claims handling practices.[87]

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roles for middlemen, including assisting "consumers by reducing the cost of product search and evaluation, helping consumers to find the products that best fit their needs, and helping consumers to manage risk.").

[85] This role of market intermediaries in filtering and processing information for less sophisticated parties has been extensively discussed in debates on the efficient capital markets hypothesis, which is often imagined to achieve efficiency through a similar market intermediation mechanism. *See generally* Susanna Kim Ripken, *Predictions, Projections, and Precautions: Conveying Cautionary Warnings in Corporate Forward Looking Statements*, 2005 U. ILL. L. REV. 929 (2005) (discussing the role of market intermediaries in the efficient capital markets hypothesis).

[86] *See supra* Part II.A.

[87] Insurers have themselves seized on these difficulties in assessing claims handling data as one of their primary arguments against public disclosure. *See* Letter from Wiley Rein to Sandy Praeger, Pres. of the Nat'l Ass'n of Ins. Comm'rs 6 (April 16,2008), *available at* http://www.naic.org/documents/committees_d_data_collection_comments_namic0416.pdf (resisting the public release of market conduct regulation, because "release of the information in raw form without the benefit of evaluation and interpretation would be unfair and potentially

Just as independent and objective sales agents can improve consumer information, they can also improve consumers' capacity to rationally and thoughtfully assess the trade-offs associated with purchasing relatively high quality insurance. By employing "debiasing" strategies, intermediaries may be able to counteract the tendency of consumers to under-appreciate the value of high quality coverage.[88] For instance, research suggests that people who are convinced that a potential loss is truly random generally no longer perceive they are relatively less likely than average to suffer from those losses.[89] By pointing out just how little control people have over the financial losses that are the subject of insurance, independent intermediaries could convince consumers to pay more for more reliable coverage. Similarly, independent agents might be able to concretize information about insurers' relative claims handling, thereby limiting the ambiguity of risk differentials that can trigger a self-serving interpretation of information. Even if independent intermediaries could not neutralize these biases, they might be able to counteract them.[90] For instance, independent agents could attempt to enhance consumers' evaluations of the risks attendant to low quality coverage by vividly describing these risks. Increasing the availability of risks can counteract consumers' tendency to underestimate them.[91]

Differential compensation undermines these market intermediation mechanisms by distorting the objectivity of the advice independent

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damaging to insurers, and misleading to policyholders, investors, and the public at large.").

[88] *See* Christine Jolls & Cass R. Sunstein, *Debiasing Through Law*, 35 J. LEGAL STUD. 199, 204-05 (2006).

[89] Colin Camerer & Dan Lovallo, *Overconfidence and Excess Entry: An Experimental Approach*, 89 AM. ECON. REV. 306, 307 (1999); David Dunning, Chip Heath & Jerry M. Suls, *Flawed Self-Assessments: Implications for Health, Education, and the Workplace*, 5 PSYCH. SCI. PUB. INTEREST 69, 80 (2004) ("One of the strongest moderators of unrealistic optimism is perceived control. The greater a person's perceived control over an event or its outcome, the stronger the person's optimistic bias.").

[90] *See* Johnson et al., *supra* note 57, at 48. ("[C]onsumers' decisions about insurance can be affected by distortions in their perceptions of risk and by alternative framing of premium and benefits.").

[91] Jolls & Sunstein, *supra* note 88.

insurance agents offer to consumers.[92] Agents' capacity to mitigate consumer ignorance about insurance and debias consumers in ways that promote thoughtful consideration of insurance quality depends on agents prioritizing the interests of those clients. When intermediaries are incentivized to steer consumers to insurers in order to maximize their compensation, they are also encouraged to manipulate consumer preferences and impressions to achieve this outcome. This short-circuits the ordinary market solutions to informational and decision making problems in complex consumer markets. As a result, even insurers that are interested in cultivating a high-price, high-quality market strategy have limited vehicles for effectively communicating this strategy to potentially interested consumers. This creates circumstances under which insurer-side adverse selection with respect to claims handling can (and seemingly does) flourish.

III. CRAFTING AN EFFECTIVE RESPONSE TO DIFFERENTIAL COMPENSATION

Given the need for reform described in Part II, this Part briefly concludes by considering a simple legal intervention in insurance markets that resembles measures adopted in the federally-regulated markets that relate to Medicare.[93] That reform would limit insurer compensation of independent agents selling consumer lines of coverage to premium-based commissions, and would require insurers to pay a single, flat commission rate to all independent agents in their distribution networks. It would not mandate any particular commission rate, allowing insurers to choose the rate they wanted to offer to their independent agents. Insurers could set different premium commission rates for different lines of insurance, reflecting the fact that different product lines require different levels of effort for agents. Additionally, insurers could pay different commission rates to independent agents in different states to account for premium and cost of living differences across states.

Such reform would largely eliminate the distorting potential of differential compensation, leaving independent intermediaries without significant financial reasons to promote the policies of one insurer over another. Although some insurers might offer slightly higher commission rates than others, competition would ensure that these differentials would

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[92] *See* Section II.A, *supra*.

[93] *See* Press Release, *supra* note 15.

generally be quite small.[94] To the extent that differentials in commission rates persisted, they would be much less problematic than current commission differentials. Rather than rewarding individual preferred agents who steered consumers to a particular insurer, they would reflect an insurer's decision to offer above market commissions to all independent agents who sell a particular product line. As noted earlier, such a strategy might be justifiable for new entrants in a market seeking to establish a customer base.[95] Moreover, a high commission strategy might also be sensible for insurers offering high-price, high-quality products if the sale of such products requires comparatively more effort. Indeed, some economics literature suggests that sales agents in the consumer electronics industry may receive higher commission rates, on a per-dollar basis, for the sale of high quality products than low quality products for this reason.[96]

Not only would a flat compensation rate for an insurer's independent agents help to solve the problems identified in Part II, but it would do so while imposing few administrative costs. A ban on contingent commissions or other specific compensation arrangements, standing alone, only invites insurers to design compensation structures that retain the same basic incentivizing function, but technically comply with the ban. Insurers' switch from contingent commissions to "supplemental compensation" arrangements, which retain the same performance-based contingency structure, is illustrative.[97] Because of its simplicity, a mandatory flat rate of

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[94] Tacit collusion among insurers in setting commission rates would be unlikely, given the number of insurers who rely on independent agents to distribute their products.

[95] *See supra* text accompanying note 29 (noting that this was one reason historically that insurers offered higher premium commission rates).

[96] *See* Ajay Kalra, Mengze Shi, Kannan Srinivasan, *Salesforce Compensation Scheme and Consumer Inference*, 655 Management Science (2003).

[97] *See* Sally Roberts, *Compensation Shake-Up Continues; Chubb Pays $17M, Ends All Contingents,* BUS. INS., Dec. 25, 2006 (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 contingent"). 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 unpersuasive. The fact that supplemental compensation arrangements are retrospective merely shifts

compensation for all intermediaries avoids this inefficient gaming. Moreover, it would be easy to enforce because it would operate on insurers rather than intermediaries. There are obviously fewer insurers than intermediaries (making market conduct observation easier) and insurers are less likely to engage in outright fraud than individual intermediaries who have less to lose from doing so.

Of course, mandating that insurers pay their independent agents a single commission rate is significantly more intrusive than a disclosure-based response to the problem. Not only would it be more costly to employ than disclosure, but it might distort consumer insurance markets in ways that may be hard to measure, or even predict. Nonetheless, such an aggressive intervention is prudent.

First, merely enhancing the disclosure requirements of independent agents is unlikely to mitigate the risk of steering, and the attendant risks of insurer-side adverse selection. Although I develop the limits of a disclosure-based regulatory response elsewhere,[98] the basic argument is simple: as described above, the reason that market forces do not prevent inefficient steering is that consumers generally have a limited ability to independently assess their insurance options. Merely informing consumers that their intermediaries may have a conflict of interest does nothing to address this fact. Of course, such disclosure could facilitate an agent's capacity to eschew differential compensation as a marketing technique.[99] But such efforts would be unlikely to prove profitable because consumers would have little sense of the value of such neutrality.

It is for precisely these reasons that compensation practices in consumer insurance markets have not, in fact, changed since 2004, despite the very public revelation of agents' conflicts of interest at that time and the adoption of mandatory disclosure laws in a number of states since.[100] This is particularly noteworthy given that numerous intermediaries in commercial insurance markets have voluntarily disclaimed differential

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forward the potential pay-off to intermediaries of steering customers to sub-optimal insurance. *See* Schwarcz, *Beyond Disclosure*, *supra* note 1, at 292.

[98] Schwarcz, *Beyond Disclosure*, *supra* note 1.

[99] As noted above, this is precisely what has happened in commercial insurance markets.

[100] *See* Fitzpatrick, *supra* note 1, at 3064; Cooper, *supra* note 8, at 100.

compensation to recruit and retain new clients.[101] Simply put, if potential clients are not attuned to the importance of unbiased advice or the ways in which advice can be distorted by incentive structures, they will not be swayed to change their behavior by competitors' promises of neutrality.

In fact, regulations of structurally similar conflicts of interest in other industries have often gone beyond disclosure-based strategies for precisely these reasons. Differential compensation of insurance intermediaries is one form of a common type of regulatory problem, coined a "trilateral dilemma."[102] In a trilateral dilemma, an end-service provider compensates a market intermediary in order to induce the intermediary to steer consumers' business to the end-service provider.[103] Regulations of such side payments often do more than merely require disclosure, for the precise reasons developed above. Examples include prohibitions against certain side payments to real estate settlement providers,[104] limitations on side payments that brokerage firms can pay to investment managers,[105] and limitations on attorneys' receipts of side-payments for referrals to other attorneys.[106]

Second, none of the proposed economic rationales for differential compensation appreciably enhance the efficiency of consumer insurance markets.[107] The most significant such potential benefit of differential

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[101] *See supra* text accompanying note 3.

[102] *See* Schwarcz, *Beyond Disclosure, supra* note 1, at 312-19; Jackson, *supra* note 42.

[103] Jackson, *supra* note 42..

[104] *See* 12 U.S.C. § 2607 (2006).

[105] *See* D. Bruce Johnsen, *Property Rights to Investment Research: The Agency Costs to Soft Dollar Brokerage*, 11 YALE J. ON REG. 75, 82-83 (1994); *see also* 15 U.S.C. § 78b (2008).

[106] *See* Model Rules of Prof'l Conduct R. 7.2(b) (2009).

[107] Aside from the enhanced underwriting theory addressed in the text, contingent commissions have also been defended because they: (i) may expand coverage for non-verifiable losses, Neil A. Doherty & Alexander Muermann, Insuring the Uninsurable: Brokers and Incomplete Insurance Contracts 18 (Ctr. for Fin. Studies, Working Paper Nov. 24, 2005) available at http://www.ifk-cfs.de/papers/05 24.pdf.; (ii) protect small agencies, Fitzpatrick, *supra* note 1, at 3042; and (iii) facilitate economies of scale by encouraging intermediaries to work

compensation is that it can improve the "front-line underwriting" of independent agents by giving them a stake in insurers' profitability.[108] According to this theory, agents often possess information about the riskiness of customers that insurers cannot directly observe, as they interact directly with their customers and may have long standing relationships with them. Differential compensation that is linked to insurer profitability gives agents an economic reason to convey truthful information to the insurer. Alternatively, such compensation may facilitate improved underwriting simply by causing an agent who believes that a consumer is a "bad risk" to steer that consumer to a different insurer that does not pay differential commissions.

Whatever purchase this theory may have in commercial insurance markets, it is simply implausible in the context of consumer insurance lines. The theory assumes agents do indeed have important underwriting information about their clients that insurers cannot observe directly. But insurer underwriting in consumer insurance markets is generally standardized and based on simple and easily administrable algorithms.[109] Even if independent agents did possess information that could not be captured in an insurance application, it is unlikely that insurers would find

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with fewer insurers, Cummins & Doherty, *supra*, note 4, at 386-89. For reasons developed in Schwarcz, *Beyond Disclosure, supra* note 1, at 305-11, these justifications are not persuasive. A final defense of contingent commissions – that they help small insurers to break into the market – is not in conflict with the proposal suggested herein, which would permit insurers to offer above-market premium commission rates.

[108] Cummins & Doherty, *supra* note 4, at 386-89; *see also* Regan & Tennyson, *supra note* 20, at 639 ("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. It is widely acknowledged that agents often employ subjective criteria in evaluating insurance applicants.").

[109] *See* ABRAHAM, DISTRIBUTING RISK, *supra* note 45, at 78 ("[A]n efficient classification system does not strive to make its premiums equal expected costs beyond the point where that goal is worth achieving."). RICHARD V. ERICKSON, AARON DOYLE & DEAN BARRY, INSURANCE AS GOVERNANCE 241 (2003) ("Individual companies are increasingly less likely to undertake their own home inspection or direct field investigations of an applicant. Instead, more risk assessment is centralizing into data system operated by information service companies that supply the insurance industry.").

incorporating that information into their underwriting to be cost efficient.[110] This is especially true given the lack of adverse selection in most consumer insurance markets.[111]

Of course insurance markets, like all markets, change over time. Thus, rationales for differential compensation that may not be compelling now may prove significant later. Consequently, any market intervention should be accompanied with continued monitoring and supervision. But the need for continuous re-assessment does not absolve lawmakers from ignoring conflicts of interest in consumer insurance markets that have been addressed in commercial and federally-regulated insurance markets. The failure of state lawmakers to act not only undermines the efficiency of consumer insurance markets, but it blunts the claim that consumer protection is best secured through the continuation of state-based insurance regulation.[112]

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[110] *See* H. LAURENCE ROSS, SETTLED OUT OF COURT: THE SOCIAL PROCESS OF INSURANCE CLAIMS ADJUSTMENTS 135 (1970) (explaining how insurers must adopt easily administrable rules of thumb to operate effectively).

[111] *See* Peter Siegelman, *Adverse Selection in Insurance Markets: An Exaggerated Threat*, 113 YALE L.J. 1223, 1224-5 (2004).

[112] *See, e.g.*, Press Release, NAIC Still in Opposition to Federal Regulation (Jan. 20, 2009) (On file with the National Association of Insurance Commissioners).