

## **THE AGE OF INTERNET AND DIRECT RESPONSE AUTOMOBILE INSURANCE IS HERE; SO HOW DO SUCH INSURERS COMPLY WITH NEVADA INSURANCE LAWS AND REGULATIONS?**

Vernon E. Leverty, Esq.,  
James Tyler Leverty,  
William R. Ginn, Esq.<sup>1</sup>  
(775) 322-6636

In the past decade, the advances in telecommunications and computers have created new industries and new sales models. Traditional “bricks and mortar” sales channels have eroded, while “virtual” or “electronic” sales have gone from non-existent to billions of dollars. In March 2000 an estimated 300 million people around the world had access to the Internet, and the vast majority lived in industrialized countries. In North America roughly 50 million people use the Internet daily.<sup>2</sup> By the end of 2000, approximately 40-45% of the population of North America (approximately 122 million) used the Internet.<sup>3</sup> It is estimated that by the year 2005, approximately 60-70% of the population will be online.

Initially the online population consisted disproportionately of affluent and well-educated white males. Today, however, the Internet’s demographics more closely parallel that of the general population in ethnicity and gender, although the Internet population is still more affluent than the general population. As the demographics change with the increase in use of those who are less well educated and less affluent, the statistical risk of those using the Internet also changes.<sup>4</sup>

Approximately 10% of the population was shopping online in 1999 and that number is projected to jump to 30% in 2005.<sup>5</sup> This growth in consumer sales over the Internet will also likely translate into increased insurance sales over the Internet. Consumers are becoming increasingly comfortable purchasing insurance online.<sup>6</sup> Over half of Internet shoppers claim to have changed insurance companies online in the past year.<sup>7</sup> According to Forrester Research, 30% of the 7.1 million individuals who shop for auto insurance prefer the Internet for shopping, while 46% of the remainder are very likely or extremely likely to use the Internet to learn about insurance products. The increased mobility of consumers created by the Internet makes it more difficult for the insurer to recover the up-front underwriting and policy issuance costs – the insurer loses the luxury of being able to amortize the underwriting and policy issue costs over multiple policy periods. An additional concern is the Internet channel costs, which are significantly more front end loaded than traditional models.<sup>8</sup>

By the end of 1999, 86% of all insurance transactions involved an agent or broker<sup>9</sup> and it is expected that the percentage of insurance transactions involving an intermediary will decline to an estimated 69% by 2003.<sup>10</sup> Direct-response insurance sales, the selling of insurance directly to customers without the use of costly intermediaries, is currently the fastest growing distribution channel. Between the years 1993 and 1999, UK direct auto writers enjoyed average annual growth rates of 9%. In Germany direct insurers grew at an annual rate of 5.9%.<sup>11</sup> Direct-response sales of insurance can be done via the mail, telephone solicitation, newspaper advertisements, and the Internet. Insurers, though, cite many obstacles facing Internet distribution such as “the resistance to change, threat of agent/broker/company disintermediation, lack of technology infrastructure, regulatory hindrances, and lack of industry vendor solutions.”<sup>12</sup> Furthermore, due to the unique aspect of the “direct” insurer-insured relationship, a careful balancing between the costs and the benefits of direct sales needs to be made to ensure that the risk that the insurer contracts for is correct and that the peace of mind of the insured is not illusory.

Direct-response distribution offers many financial benefits to both the seller and the consumer. Few people dispute that there may be significant cost savings by moving to the direct sales model. Sigma estimates that online distribution alone can bring a direct reduction to distribution costs of between 12-26% of premium costs.<sup>13</sup> The administrative savings potential can account for a savings of 9-15% of premium costs.<sup>14</sup> Sigma estimates that the total cost savings in personal lines savings would be approximately 30% solely due to e-business if insurers were able to exploit the complete range of e-business opportunities online.<sup>15</sup> In addition, 90% of online consumers find the ability to comparison shop for automobile services through the Internet an attractive feature.<sup>16</sup>

The infancy of the online underwriting and pricing process is characterized by imprecision. Almost every company website with online sales capabilities includes numerous disclaimers emphasizing that the quote the potential consumer is about to obtain is non-binding, only an estimate, subject to modification based on additional

information, subject to revocation at the insurer's discretion and generally not to be depended upon. Furthermore, many insurance applicants do not comprehend the intricacies of personal risk management and insurance, and as a consequence, fail to secure the proper limit and/or coverages without the assistance of an intermediary. There is also a tendency for online shoppers to shop on price alone while not considering or understanding that the contracts may differ among comparable companies, that the lowest price insurer may provide terrible service, or that the lower price insurer faces a high probability of insolvency.

### ***Direct Distribution Is Affected by State Regulation***

The Internet is here to stay, and sales over the Internet of all products, including insurance, will dramatically increase. Due to the unique nature of the Internet and the insurance regulatory scheme, the insurance industry faces a number of complications that don't face a company selling books or electronics over the Internet.

The ability to sell insurance over the Internet or other direct marketing methods requires a review of whether the insurance company may avoid using a licensed insurance intermediary, such as an agent or broker.<sup>17</sup> In Nevada, an authorized insurer may not make, write, place, renew or cause to be made, any policy of insurance of any kind upon persons, property or risks resident, located or to be performed in Nevada, except through an appointed and licensed agent in Nevada, who must countersign the policy.<sup>18</sup> Accordingly, the direct-response insurers cannot sell directly to the insured without using a Nevada licensed non-resident producer of insurance<sup>19</sup> and have a resident producer of insurance countersign the policy, and still comply with the statutory scheme set forth in the statutes. All producers of insurance must be appointed with the insurer for whom he or she produces insurance.<sup>20</sup> At most, six states still require countersignature of policies. Many states formerly requiring countersignatures have repealed such requirements.<sup>21</sup> The American Insurance Association has led a national effort to repeal countersignature requirements. "These countersignature requirements are antiquated and hamper commerce in the electronic age," said James T. Harrinton, AIA Vice President, Northwest Region.<sup>22</sup>

Any direct marketing, whether on- or off-line, creates difficulty for the evaluation of whether to offer coverage at all, and if it is to be offered, what rate will be charged to the consumer. This process, called underwriting, incorporates two elements, selection and classification. Direct-response underwriting retains the principal theoretical intentions of selecting and classifying the risk. So long as it is cost effective to collect and process information to select and classify risk, insurers will continue to do so. The least expensive manner to obtain this information is from the consumer via the application, but other traditional sources for this information are the producer, consumer investigation reports, government records, loss data, claim files and production records. All of these work to "pre-select" the applicants, and to minimize the risk to the insurer. This "pre-selection" function performed by the marketing intermediary is not present in direct-response sales. In an attempt to regain some of this information, one well-known direct-response automobile insurer uses body shop assessments to verify the condition and existence of the automobile. This information assessment model is used after the insurance is in place, and when it is used it may be in violation of state insurance laws and regulations.

In an attempt to offset the loss of the pre-selection function of producers, direct-response insurers may have unwittingly created an environment which encourages "post-underwriting." When "post-underwriting," the insurer uses information learned after a claim has been filed to determine whether or not the policy should have been underwritten at all.

The direct-response insurer may desire to complete the underwriting process quickly, and this cursory analysis of the risk may be sufficient to bind the potential consumer but is not sufficient to adequately investigate the risk. This creates a possibility that after the policyholder receives confirmation on the policy, the company may reclassify or even de-select the risk upon a closer examination. A reclassification is mandated for an upward move in premium, because no business with a profit motive will lower prices after the consumer has already agreed to the higher price. Although this "bait-and-switch" practice does not depart from traditional contract law, this practice negatively affects the insurer's reputation and provides arguments that the insurer may be engaged in bad faith if coupled with contract or insurance law failures. Even when insurers clearly state that there may be a change in the online quote, the revision may still seem like a "bait-and-switch" to the consumer.<sup>23</sup>

While the Internet has changed, but not eliminated, traditional business models, the e-business models for insurance sales are no less susceptible to the traditional forms of fraud as well as new forms of fraud. These traditional forms

of fraud are frequently caused by intentional or inadvertent omissions, such as failing to disclose a teenage driver for a vehicle, or a failure to verify the existence or use of the vehicle.

The courts have determined that both the insurer and insured must negotiate according to the concept of *uberrima fides* (utmost good faith), which stipulates that both the insurer and the insured should disclose, if asked, all relevant information available. This doctrine implies that the proposed insured must truthfully and completely answer all questions to the best of his/her knowledge and ability legalese, an incorrect answer is often used by an insurer as being a misrepresentation by the insured, and an incomplete answer or failure to disclose relevant information is often used by an insurer as a concealment by the insured.<sup>24</sup>

In a traditional insurance setting, the insurance company usually gives the agents authority to issue policies (or “bind” coverage) before the underwriting process is complete. If further investigation reveals new information that shows the applicant does not meet the insurer’s underwriting criteria, typically because of a misrepresentation or concealment in the application, the insurer may have the ability to cancel the policy. This scenario was contemplated in insurance laws and regulations. If the policy has been in force for less than 70 days and is not a renewal policy, the insurer has the ability to cancel by providing 10 days written notice for non-payment of a premium and 30 days notice for any other reason. After 70 days (or after renewal) the policy only permits the insurer to cancel for non-payment of a premium, suspension or revocation of a driver’s license, or misrepresentation of relevant facts. At the end of the policy period (typically six months or one year), the contract allows the insurer to deny renewal for any reason with 30 days advance written notice provided before the policy ceases.

When events occur that make the applicant ineligible for coverage under the insurer’s underwriting rules, the insurer may notify the customer that the coverage will not be renewed; these events cannot be the basis for terminating the insurance coverage in the middle of the term of the policy. For example, an insurer cannot cancel an insured’s automobile policy because the insured was involved in an accident, but the insurer can non-renew the policy because the insured no longer meets the underwriting criteria.

At least one major direct-response insurer issues its policy providing physical damage coverage but informs its insureds owning automobiles that are not brand new that the insured is required to have their vehicle physically inspected, and failure to obtain the inspection suspends the physical damages coverages of the policy until such inspection occurs. If the vehicle is not inspected within the selected period, then the insurer rescinds the part of the insurance contract which deals with the physical damage of the vehicle. If the insurer fails to provide 30 days notice of policy rescission for removal of the physical damage coverage as required by NRS 687B.320 within the 70 days of coverage, the insurer has failed to comply with the time period for policy rescission and has acted improperly. However, the insurer has no basis for rescinding physical coverage or the entire policy after 70 days or if the policy is a renewal by rescinding part or all of the insurance policy in violation of the statutory provisions.

### ***Conclusion***

While the Internet is making dramatic changes in the business models used by all businesses, insurers need to take exceptional care to determine that their actions are legal under the insurance codes of the various states. In Nevada, a direct-response insurer, including those selling over the Internet, must use a producer licensed by Nevada and *appointed with the insurer*. When the policy is issued by a producer who is not a resident of Nevada, the policy must be countersigned by a producer of insurance resident of the State of Nevada, and this person must receive a countersignature fee of at least 5% of the premium.<sup>25</sup> When selling in Nevada, the insurer should use producers who are residents of Nevada or, if it elects to use non-resident producers,<sup>26</sup> then it should have its own Nevada corporation.<sup>27</sup> Although Assembly Bill 618 permits the Commissioner to adopt regulations governing the use of electronic signatures, only a wet countersignature is currently authorized in Nevada.<sup>28</sup> Further, Nevada insurers should complete all underwriting within 40 days of the policy issuance to allow the policy to be rescinded within 70 days of the policy issuance and in compliance with NRS 687B.320. The Internet and direct-response insurance is upon us, and despite the Uniform Non-Resident Licensing and Reciprocity project of the NAIC, insurers still need to be certain to comply with each states laws and regulations.

### ***Endnotes***

1. Vernon E. Leverty is a member of FORC. James Tyler Leverty is a Ph.D. candidate in Risk Management and Insurance at Georgia State University. William R. Ginn is an attorney in the law firm of Leverty & Associates.

2. Conning & Company. *Internet Insurers Distribution*. Hartford, Connecticut: Strategic Study Services, 2000. p. 19.
3. CPCU Journal. The use of the Internet and electronic commerce within the property and casualty insurance industry. Summer 2000. Society of Chartered Property and Casualty Underwriters. John P Franzis.
4. James R. Garvin, "The Role of E-Commerce," North American Actuarial Journal, Volume 4, Number 3, July 2000, Society of Actuaries: Schaumburg, Illinois, p. 64.
5. Swiss Re, *The Impact of e-business on the insurance industry: Pressure to adapt—chance to reinvent*, Sigma No. 5/2000, p. 7 (NUA Internet surveys).
6. The McKinsey & Company research results were reported by E.E. Mazier, National Underwriter, The National Underwriter Company, March 26, 2000.
7. *Id.*
8. Conning & Company, *supra*, at p. 47.
9. Society of Chartered Property and Casualty Underwriters. *CPCU Journal*, Media, Fall 1999.
10. Wheeler, Bryan and et al., "Society of Chartered Property and Casualty Underwriters," CPCU Journal, Fall 1999.
11. Swiss Re, *supra*, at p. 20.
12. Garvin, *supra*, at p. 66.
13. *Id.*, at p. 22.
14. *Id.*
15. *Id.*, at p. 24.
16. *See en. 7.*
17. The agent or broker is now referred to as a "producer of insurance" by Nevada's adoption of the NAIC Producer Licensing Model Act Implementation effective July 1, 2001 by Assembly Bill 618 (AB618). Presently 37 states have adopted the NAIC Producer Licensing Model Act pursuant to National Association of Health Underwriters Progress Chart dated June 1, 2001.
18. NRS 680A.300 was not amended by AB618 and is subject to several exceptions for life insurance, health insurance, reinsurance, bid bonds, risk retention groups, and policies for transit on common carriers.
19. "'Producer of insurance' means a person required to be licensed under the laws of this state (Nevada) to sell, solicit or negotiate insurance." AB618, § 54.
20. AB618, § 96.
21. "Mass. Senate Approves Countersignature Bill," Insurance Journal Property and Casualty Magazine, July 27, 2001.
22. "Massachusetts Governor Signs Countersignature Repeal," Insurance Journal Property and Casualty Magazine, July 27, 2001.

23. Conning & Company, *supra* at p. 69.
24. NRS 687B.320.
25. NRS 680A.300(4).
26. Nevada has not adopted electronic non-resident producer licensure through the Nation Insurance Producer Registry (NIPR).
27. A Nevada corporation can be licensed as a resident insurance producer if it has persons resident of Nevada and licensed as a resident insurance producer acting on the corporation's behalf and the corporation would receive the 5% commission.
28. AB618, § 58.