

The Distinction Between Insurance Agent and Insurance Broker in California

Robert W. Hogeboom, Esq.¹

(213) 614-7304

May 2006

The legal distinction between an insurance agent and insurance broker is under examination in California following *Krumme v. Mercury* and recent investigations by New York Attorney General Elliott Spitzer which resulted in criminal and civil suits against several insurers and producers. This distinction is important in determining insurer and producer liability to insureds and third party claimants as well as the propriety of charging broker fees. This article examines the legal distinction between “agents” and “brokers” in California both from a historical perspective and in light of the recent case, *Krumme v. Mercury*. Finally, it provides an overview of the California Department of Insurance’s (“CDI”) current position on the issue.

I. Statutory Provisions

California is unique as the Insurance Code recognizes the separate concepts of agents and brokers in lines other than life insurance.² An insurance agent is defined in Section 1621 as “a person authorized by and on behalf of an insurer to transact all classes of insurance, except life insurance.” A broker is defined in Section 1623 as “a person who, for compensation and on behalf of another person, transacts insurance other than life with, but not on behalf of, an insurer.” There are separate licenses for a broker and an agent. In 1990, the Legislature added the term “fire and casualty licensee” in Section 1625 which allows brokers and agents to secure one license as a “broker-agent.” Under that license the licensee can transact insurance as both an agent and a broker. Notwithstanding, if acting as an agent, the licensee must secure and file an appointment to act as an agent executed by each appointing insurer.³ Also, if acting as a broker, the licensee must post a bond with the CDI.⁴

The Insurance Code, however, expressly permits a broker to perform certain limited acts on behalf of an insurer. Specifically, Section 1732 states “[a] person licensed as a fire and casualty broker-agent acting as an insurance broker may act as an insurance agent in collecting and transmitting premium or return premium funds and delivering policies and other documents evidencing insurance.”

II. Historical Perspectives

A. Introduction

Historically, the few legal cases dealing with this issue applied a “totality of the circumstances” test to determine broker or agent status, centering on various acts performed by the producer such as binding and advertising. The key case is *Marsh and McLennan v. City of Los Angeles*.⁵

¹ Robert W. Hogeboom is a senior partner with the law firm of Barger & Wolen. He has been an insurance regulatory specialist for 30 years, dealing in all aspects of insurance regulatory law, including transactional work, financial analysis, market conduct examinations, rate filings and administrative hearings, disciplinary matters and insolvency issues. He represents numerous insurers and producer clients in regulatory matters. Mr. Hogeboom has been a member of several California Department of Insurance task forces and is one of the founding members of the Federation of Regulatory Counsel, a national group of prominent insurance regulatory counsel and a member of the American Bar Association, Tort and Insurance Practice Section.

² Life insurance only recognizes agents under California Insurance Code (“CIC”) Sections 1622 and 1623.

³ See CIC Section 1704(a).

⁴ See CIC Section 1662.

⁵ *Marsh and McLennan v. City of Los Angeles*, 62 Cal.App. 3d 108 (1976).

For years, the CDI and the industry followed the 1980 CDI Bulletin, 80-6, which stated the CDI's position on broker fees and disclosure of such fees to customers. The Bulletin reflects that brokers who represented customers could charge brokers fees, while agents are precluded from charging fees on the theory that they act on behalf of the insurer.

In 2003, two plaintiff lawyers filed suit under Section 17200 of the Business and Professions Code against three insurers in the Mercury Group ("Mercury"). The suit, *Krumme v. Mercury*, asserted that brokers placing business with Mercury were "defacto agents" acting on behalf of Mercury and, therefore the charging and collection of broker fees violated Section 17200 *et seq.* of the California Business Code. The lower court agreed after examining both the relationship of Mercury with its brokers and the acts performed by brokers pursuant to their contract with Mercury. An injunction was imposed to prevent Mercury from selling insurance through brokers. The appellate court in a published opinion agreed with the lower court's determination that the brokers were defacto agents of Mercury.⁶

B. *Marsh and McLennan v. City of Los Angeles*

The most celebrated historical case that dealt with whether a producer is an agent or broker is *Marsh and McLennan v. City of Los Angeles* ("*Marsh*"). *Marsh* was a business tax case in which the City of Los Angeles charged a business tax on commissions earned by Marsh and McLennan, an insurance broker. Marsh argued that it was entitled to a refund since the tax is based on commissions paid to it by an insurer, which exempts all taxes on insurance companies under California Constitution Article XIII 28(f), except on gross premium which is in lieu of all other taxes on insurers. Marsh argued that insurers must, according to the constitution, act through agents and brokers and thus the tax on commissions is tantamount to a tax on the insurer's right to do business.⁷

The court noted that while brokers and agents are not insurers, Article XIII only exempts insurance *agents'* commission income from municipal taxes. It rejected Marsh's claim that a broker should be exempt because brokers are similar to insurance agents. The court noted that the notice of appointment under Insurance Code Section 1704 is not the sole distinguishing feature between agents and brokers. The court relied, instead, on the legal definitions of an agent and broker set forth in Insurance Code Sections 1621 and 1623. Thus, an agent is a producer who acts on behalf of the insurer to transact insurance while a broker is a producer who acts on behalf on another person who is not an insurer, generally the insured.

The court recognized that although agents and brokers are paid commissions by the insurer, they perform their functions differently. The agent is tied to the company which appoints the agent, while the broker is more of an independent middle-man, not tied to a particular company. The broker meets the specialty needs of large customers and uses that bargaining power to obtain the most favorable terms from competing companies. Nonetheless, the court recognized that there are many similarities in the services performed and monetary functions of agents and brokers. Under the *Marsh* case, the key legal distinction between the two categories of producer lies with the power to bind.⁸

C. Bulletin 80-6

In the 1970's, the charging of broker fees increased in the commercial market. This resulted in the CDI issuing Bulletin 80-6 in 1980. The Bulletin summarized for insurance producers and insurers the legal basis under which a broker fee may be added to the price of insurance. The Bulletin relied on the *Groves v. City of Los Angeles* case, which held that all payments by the insured which are part of the cost of

⁶ *Krumme v. Mercury Insurance Company*, 123 Cal.App. 4th 924 (2004).

⁷ *Marsh, supra* at 114.

⁸ Further distinctions exist based on the notion of agency appointment, the requirements in CIC Section 1648, 1662 and 1665 for eligibility of insurance brokers to file a bond, and Section 1704 and 1705 for agents to seek appointments from insurers. Finally, Sections 1621 and 1623 make it clear that an insurance agent and insurance broker act in different capacities.

insurance are premium.⁹ The DOI further asserted that general rules of agency law prohibit an agent from charging sums not authorized by the agent's principal – the insurer. “Should an insurer authorize its agents to collect ‘fees’ such fees would have to be reported as premium by the insurer, and would, of course, have to comply with the anti-discrimination statutes.”¹⁰

Brokers on the other hand are not agents of the insurer by definition. Therefore, based on the lack of an agency relationship, brokers are allowed to charge their customers fees in excess of the price of insurance with the consent of the insured.

D. Developments Since Proposition 103

Following the passage of Proposition 103 in November 1988, California changed from an open rating state for most classes of property and casualty insurance, to a prior approval state with a rigid rate application procedure. The rate review process includes a formula to determine the reasonableness of the rate. Included in the formula is an efficiency standard component which penalizes insurers for high expenses. Producer compensation is included in insurer expenses as well as all fees charged which is associated with the cost of providing the insurance.¹¹ The efficiency standard forced some insurers to reduce commissions to producers. To off-set this reduction, many producers obtained broker licenses and requested termination of their agency appointments in order to charge the customer a separate broker fee following the dictates of Bulletin 80-6.

The charging of fees resulted in an increase in consumer complaints which ultimately resulted in the CDI promulgating Broker Fee Regulations effective November, 2000. The Regulations implemented written disclosure and contract requirements before broker fees could be collected. The Regulations also provide that agents who place the coverage on behalf of an insurer may not charge broker fees.¹² However, there is no restriction on the amount of the fee charged, recognizing the amount of the fee as a contractual matter between broker and client.

III. Krumme v. Mercury

A. Lower Court Decision

Broker fees, which provide an additional revenue source for brokers, came under scrutiny in the case of *Krumme v. Mercury*. The case involved a suit by two plaintiff lawyers on behalf of the general public which was filed under Section 17200 of the California Business and Professions Code. The suit claimed that brokers placing business with Mercury were “de facto agents” acting on behalf of Mercury and, therefore, the charging of broker fees was illegal. Plaintiffs reviewed the nature of the relationship between Mercury and its brokers and argued that the relationship was in most respects the same as the relationship Mercury had with its appointed agents. Significantly, Mercury's broker contract was substantially the same as its agency contract which allowed the broker to bind coverage, advertise, receive customer leads and receive similar training as agents.

The lower court recognized *Marsh* as the leading case involving the legal distinction between the broker who, “on behalf of another person” (in most instances, the customer), transacts insurance with an insurer versus the agent who is “authorized by and on behalf of the insurer” to transact insurance. While the focus of that case was binding authority, the court in *Krumme* also looked at the broad relationship between Mercury and the broker. The lower court found that brokers and agents were “functionally indistinguishable” in their relationship to Mercury. The substance of the activities performed by brokers

⁹ *Groves v. City of Los Angeles*, 4 Cal.App. 2nd 751 (1953).

¹⁰ Bulletin 80-6, § 2.

¹¹ Fees are included in rate application filings under Miscellaneous Data. Both commissions and policy fees retained by the company and the agent must be provided. It also requires specification of what the policy fee is used for.

¹² See 10 CCR § 2189.3(c).

for Mercury coupled with their relationship with Mercury was found to be controlling. The court concluded that the brokers were defacto agents who transacted insurance on behalf of Mercury.¹³

The court also concluded that because brokers were acting within an agency relationship with Mercury, the charging of broker fees violated the letter and spirit of the broker fee regulations in common law. Thus, to lawfully charge a broker fee, the broker must be acting in the capacity of an insurance broker within the meaning of Section 1623. The court enjoined Mercury from selling insurance through unappointed defacto agents.

B. Appellate Decision

On appeal, Mercury did not focus on the lower court's findings of defacto agency. Rather, Mercury argued that the practice of employing broker-agents, who are not appointed as agents, was sanctioned by the Legislature and, therefore, insurers enjoyed a "safe harbor" from liability under the unfair competition law.

Mercury also argued that Proposition 103 largely eliminated any previously existing market reasons for distinguishing between agents and brokers. Specifically, Mercury argued that personal lines insurance was like a commodity product and the functions of the insurance producer became largely limited to customer service. For instance in auto, if the driver is a good driver, the insurer must automatically accept the risk. Thus, generic nature of the transaction reduced the significance of any distinction between the functions of agents and brokers.

Mercury further argued that the realities of the changed market are reflected in post-Proposition 103 amendments to Insurance Code provisions relating to brokers and agents, which Mercury believed vested brokers with all authority traditionally associated with agents. Among those provisions were the 1990 amendments to 1625 and 1732 (adding the term "broker-agent" thereto), which Mercury asserted drained Sections 1621 and 1623 of their operating significance and further codified the "dual agency" doctrine under which producers could act as both broker *and* agent. Mercury believed that these statutory amendments evidenced legislative recognition that brokers were permitted to perform *agency* functions beyond those listed in Insurance Code Section 1732.

Plaintiff's argument focused on the importance of 1704, which required the filing of appointment notices for licensees acting as an insurer's agent. Plaintiff concluded that if a licensee acts as an agent in any capacity except as permitted by Section 1732, the licensee is an agent and must be appointed. The CDI filed an amicus brief supporting the plaintiff's position.

The appellate court noted that neither Mercury's nor Plaintiff's argument was completely persuasive because each "selectively emphasizes favorable statutory language in isolation without attempting to fit the language into a coherent reading of all of the statutes in the Insurance Code dealing with the agent-broker issue."¹⁴ Rather, the court looked at the entire scheme of the law so that the whole could be harmonized and retain its effectiveness.

The appellate court in affirming the lower court's decision noted that while "the issue was "not free from all doubt, on balance it appears from the governing statutes, particularly 1704(a), that the Legislature has not created a safe harbor for this practice."¹⁵ The appellate court reviewed the statutory history of the evolution of the concepts of broker and agent. It looked at various sections of the Insurance Code including the legal definition of agent and broker contained in CIC Sections 1621 and 1623. It also looked at legal treatises' explanation of the fundamental distinction between an agent and broker, as well as various court

¹³ Plaintiffs successfully rebutted the presumption under CIC Section 23, that brokers are considered brokers by virtue of their designation as such.

¹⁴ *Krumme, supra* at 941.

¹⁵ *Krumme, supra* at 945.

cases including *Glen v. Rice*,¹⁶ which recognized that a person could be the agent of both parties to a commercial transaction.¹⁷

The court also analyzed Section 1625, the amendment to 1704(a) and the addition of the term “broker-agent” to Section 769 which governs the termination of a broker or agent. Finally, the court reviewed Mercury’s sponsored legislation in 2000, which added the following language to the definition of an insurance broker in Section 1623: “Every application for insurance submitted by and insurance broker to an insurer shall show that the person is acting as an insurance broker and is licensed in this State in which the application is submitted, it shall be presumed for licensing purposes only, that the person is acting as an insurance broker.”

The court upheld the statutory distinction between an agent and broker. The court also recognized that while the traditional distinction between broker and agent has receded, 1704(a) still requires the appointment of agents. Thus, the court held that “until the legislature makes an express statutory declaration to the contrary, we cannot hold that Mercury enjoys a safe harbor from the requirement that its broker-agents must be appointed in accordance with Section 1704(a).”¹⁸

Because the facts of the *Krumme* case and the arguments made by Mercury on appeal did not require the court to dissect when a producer is acting as an agent versus a broker, the court did not set forth any clear standards in that regard. Nonetheless, the appellate court did affirm the lower court decision, which as noted, focused on the acts performed by the producer pursuant to their producer contract and the relationship of such producer with the insurer.

In conclusion, the appellate court held that the extensive findings made by the trial court which establish the relationship between Mercury and its “ostensible brokers” and the control over its brokers which Mercury did not dispute were “sufficient to establish that the brokers are ostensible agents of Mercury and Mercury is therefore vicariously responsible for them.”¹⁹

IV. CDI Perspective

From the CDI’s perspective, the *Krumme* case follows the common law which relies on the statutory distinction between an agent and broker to determine whether fees are proper. The distinction also serves as the basis to determine insurer liability not only for the charging of improper fees, but for the breach of duties by agents.

The CDI maintains that the Insurance Code requires an insurance producer to be classified as either an agent or broker and that no Code, regulation or case recognizes the concept or permits an insurance producer to be classified as a dual agent.²⁰ The CDI also maintains that the Insurance Code defines a producer to be an agent, not a broker, if the producer performs *any* act on behalf of an insurer not expressly permitted under Insurance Code Section 1732. Moreover, other than as provided by Section 1732, no dual agency can exist. In other words, brokers are not permitted to engage in any agency functions other than permitted by Section 1732 without losing their status as brokers and becoming agents.²¹

¹⁶ *Glen v. Rice*, 174 Cal. 269, 272 (1917).

¹⁷ That decision was applied for the first time in the insurance context in *Maloney v. Rhode Island Ins. Co.*, 115 Cal.App. 2nd 238 (1953). In *Maloney*, the court held that a broker acting for an insured could also act as the agent of the insurer such as accepting the policy and delivering the premium.

¹⁸ *Krumme, supra* at 945.

¹⁹ *Krumme, supra* at 946.

²⁰ CDI Amicus Curiae Brief, at 1.

²¹ It is not specifically clear to this author that CIC Section 1732 defines the only acts in which a broker may perform to aid an insurer as many acts which are performed primarily for the customer also benefit the insurer. Nor is such a conclusion expressly stated by the appellate court in *Krumme*.

Consistent with its stated position, the CDI has issued Notices of Non-Compliance against insurers based on the charging of broker fees by producers alleged to be acting as de facto agents. The CDI has asserted that such fees are constructively received by the insurer as part of the premium. If insurers do not include broker fees in their rate filings, the CDI maintains that charging a premium rate in excess of what was approved by the CDI is a violation of Insurance Code Section 1861.01(c). The CDI also claims that the charging of the fee will result in prohibited rate discrimination under Section 1861.05(a).

The CDI further demonstrated its strong focus on broker and agent issues in 2004, when the Commissioner attempted to impose strict fiduciary and disclosure requirements on agents and brokers by regulation. Insurers and producers argued that the Commissioner lacked the requisite statutory authority to impose such duties and penalties on agents and brokers. Ultimately, the CDI withdrew the regulations. However, the CDI in examinations and investigations based on consumer complaints continues to scrutinize the relationship between insurers and their brokers for defacto agency and to determine whether broker and other fees charged should be imputed to insurers under agency principles per *Krumme v. Mercury*.

The CDI is currently reviewing whether fees charged by wholesalers to brokers and customers are appropriate. Since some wholesalers are appointed as agents, the CDI has asserted in recent disciplinary actions that any fee charged by such wholesalers, even to other brokers is improper under the rating law.

V. Conclusion

The difference between an agent and broker is based on the statutory definitions contained in Sections 1621 and 1623. The agent represents the insurer while the broker represents the interest of the customer or a third party. A factual determination on whose behalf the producer is acting will be reviewed by the court. In so doing, the court will review on whose behalf the producer performs various acts and whether there is a relationship with the insurer to support ostensible agency. Specifically, areas such as binding, advertising, obtaining customer leads from insurers, training and contractual arrangements with insurers are among the key areas that will be reviewed to make a factual determination.

From a historical perspective, there has been some recognition that the producer may act as both an agent and broker in the same transaction. However, if faced with this issue, the holding in *Krumme* indicates that the dual function theory will not prevent the finding of an agency relationship. Thus, if the broker performs acts for an insurer, the broker could be construed as a defacto agent of the insurer which would preclude the charging of broker fees. On the other hand, an appointed agent would be precluded in all instances from charging fees.²²

²² An insurance agent based on agreement with the insured may charge a fee for services not related to the cost of insurance since such fees would not be considered premium per *Groves v. City of Los Angeles*.