

FEDERATION OF REGULATORY COUNSEL, INC.

CALIFORNIA STATUTORY CHANGES TO PROTECT BROKER FEE CHARGES ON INSURANCE POLICIES

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In the 2006 Summer Edition of the FORC Journal, this author reported on the legal conflict relating to the distinction between an insurance agent and broker in California.¹ Whether an insurance producer is deemed to be an agent or broker in an insurance transaction is important in order to determine insurer liability for agent's conduct, insurer compliance with the rating law, and the propriety of broker fees charged by brokers.

Since 2004, broker fees have been under attack by class action lawyers who aligned themselves with then Insurance Commissioner Garamendi,² who was in his second term as California Insurance Commissioner. In the leading case of *Krumme v. Mercury*,³ class action lawyers who sought refunds of all broker fees alleged that brokers who placed business with Mercury Insurance Company performed acts on behalf of Mercury, were controlled by Mercury, and thus were defacto agents of Mercury ineligible to charge broker fees.

In its amicus brief filed in the case, the California Department of Insurance ("CDI"), relying on the statutory definition of a broker, asserted that brokers who performed "any act" on behalf of an insurer would be designated as an agent of that insurer subjecting the broker to a refund of collected broker fees and a violation by the insurer of the California rating law for failure to file and obtain approval for the fees charged.⁴

The legal basis relied on by the plaintiff lawyers and the CDI included: 1) the definitions of agent and broker in Sections 1621 and 1623 of the California Insurance Code ("Code") which establish that the agent transacts on behalf of the insurer while a broker, on behalf of another person, transacts insurance with, but not on behalf of the insurer.⁵ Plaintiffs argued that i) these definitions preclude a broker from transacting insurance "in any way" on behalf of an insurer; and ii) that Section 1732 of the Code provides an exception only for a broker to act as an agent in the collection and transmission of premium, returning premium funds and delivering policies and other documents evidencing insurance.⁶

In support of the plaintiff lawyers, the CDI helped advance the "any one act" test by codifying as a precedent the "any one act test" in a settlement involving American Reliable Insurance Company. That case involved a settlement in which the Commissioner created a list of criteria or factors which could be undertaken only by an appointed insurance agent. The Insurance Commissioner announced through his Order that the factors listed were a precedent for future cases.⁷

Although the appellate decision in the *Krumme* case did not agree that the "any one act" test was the test to determine broker v. agent, the fact that the CDI supported the one act theory through the precedential decision gave plaintiff lawyers an opportunity to file additional class action suits against insurers and brokers seeking refunds of broker fees. Subsequently, two suits were filed under a defacto agency theory asserting that the brokers were underwriting and binding policies on behalf of the insurer, acts which could only be performed by agents. The first was against Infinity Insurance Company and broker Eastwood Insurance Services, and the second against Coast National Insurance Company, and broker Academy Insurance Services. Plaintiff lawyers also submitted demand letters to other insurers threatening similar litigation.

PROPOSED SOLUTION GOALS

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In 2005, two of the producer trade associations criticized Garamendi's any one act test on broker fees. The Alliance of Insurance Agents and Brokers began advancing a legislative solution to representatives of agent and broker groups to denounce any one act and codify "totality of the circumstances" as the test to determine the status of a producer as an agent or broker. Independent Brokers and Agents of the West (IBA West) took the lead in successfully challenging the precedential decision, alleging in a legal brief to the Office of Administrative Law that the precedential decision was an underground regulation, since it had not followed the regulation adoption process.⁸

After Steve Poizner was elected Insurance Commissioner in 2006, members of his Agent and Broker Advisory Committee suggested that further clarification between agents and brokers was needed in order to put an end to class action suits. A special subcommittee which consisted of members of various producer groups and legal experts was appointed to recommend a solution to clarify the difference between an agent and a broker.⁹ The subcommittee concluded that legislation was needed: i) to provide greater specificity in the definition of "broker"; ii) to eliminate legal challenges which claim that insurance agents act as defacto agents under the "any one act" test; and iii) to confirm by statute the long-standing common law test of "totality of the circumstances" in situations where it was not clear whether a broker was acting as a broker or agent.

The subcommittee members then drafted and sponsored what became AB 2956.

OPPOSITION

The cornerstone to determine whether a producer is an agent or broker is the totality of circumstances test which is commonly used in agency law. This incorporates a review of all of the facts and circumstances to determine on whose behalf the producer is acting.¹⁰

In opposition to the legislation, the plaintiff lawyers argued that "totality" was not the appropriate test to determine whether a producer should be classified as an agent or broker. They argued that the existing language in Section 1623 combined with Section 1732 suggested that a licensee may not act on behalf of the insurer in any respect other than as permitted in Section 1732 and still enjoy broker status.

Consumer Watchdog, a leading consumer advocate and drafter of Proposition 103, also opposed the legislation arguing that broker fees were a method of "double-dipping" in which insurance customers are forced to pay the same person both an agent commission and a broker fee.¹¹ Consumer Watchdog suggested alternative language that a producer that charges a broker fee should be prohibited from receiving any commission from the insurer.

The Assembly Insurance Committee Analysis, which was favorable to the bill, relied on the reasoning in *Krumme v. Mercury* that the court did nothing to change the long-standing common law rule that whether a producer is acting as a broker or agent is determined by the totality of the circumstances and the fact that the court had rejected the "any one act" theory as advanced by the CDI as the correct rule of law.¹²

On the Senate side, the legislative consultant also in agreement with his counterpart in the Assembly, noted that in the leading case on the issue, *Marsh & McLennan v. City of Los Angeles*,¹³ the court looked at the totality of the circumstances to determine agent or broker status.¹⁴ The legislative counsel noted that while "totality" recognizes the uniqueness of each case, in order to resolve perceived vagueness of that term, a definition of "totality" would be helpful. As a result, the proposed legislation was amended to include a definition of totality.¹⁵ Although members of Commissioner Poizner's subcommittee sponsored AB 2956, the Commissioner opposed the first version of the bill, suggesting that the bill was incomplete and needed to include a list of acts that brokers would be prohibited from engaging in.

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The drafters then provided language to resolve the concerns of the legislative consultant and the Commissioner by providing language on the meaning of totality of the circumstances, how it should be applied, and creating four specific acts which brokers could not engage in. The legislation also included a list of disclosures to be given by the broker to the customer, covering among other disclosures, the broker fee amount and services to be provided. As a result of these changes, the Commissioner ended his opposition and supported the bill.

LEGISLATION

A summary of AB 2956 is as follows:

1. The presumption of broker as contained in Section 1623 was changed. The former language created a presumption of broker "for licensing purposes only" if the application showed that the person is acting as a broker and licensed as a broker. This language was considered too vague. AB 2956 changed the presumption language by: (a) clarifying that a person is presumed to be acting as an insurance broker if the person is licensed to act as a broker, maintains a broker bond, and a written agreement signed by the consumer includes disclosures on each of the following:

- i. that the person is transacting on behalf of the consumer;
- ii. a description of the basic services to be performed as a broker;
- iii. amount of broker fee charged;
- iv. if applicable, the fact that the broker may be entitled to receive compensation from the insurer for the consumer's purchase of insurance.

Newly created Section 1623(b) permits a wholesale intermediary broker to avail itself of the presumption if it provides the above written disclosures to the retail broker.

Section 1623(c) provides that any of the following acts will rebut the presumption: if the licensee is appointed; has a written agreement with the insurer authorizing the licensee to obligate or bind the insurer without prior notification; appoints a licensee; or is authorized to pay claims. In all other cases, the presumption of broker status may be rebutted based only on the totality of the circumstances which, upon review of all facts and circumstances, reflects that the broker is acting on behalf of the insurer as opposed to the customer.

Section 1623(e) defines "totality of the circumstances" as evidence indicating whether the producer is acting on behalf of the insurer or on behalf of a third person. It also sets forth that the evidentiary determination is made through a review of all relevant facts and circumstances. It establishes that the review cannot be limited to any particular fact or factors or requires that any particular circumstance receive greater or lesser weight than another circumstance. Finally, Section 1732 was clarified to permit a broker, on behalf of an insurer, to collect and transmit premium and deliver policies evidencing insurance.

While the totality of the circumstances test refers specifically to the presumption in Section 1623, legislative consultants for both the Assembly and Senate confirmed in their written analysis of the bill that totality of the circumstances had been the long-standing test in California to determine whether a producer is acting as a broker or agent and rejected the "any one act" test argued by class action lawyers and the CDI.

THE EFFECT OF AB 2956

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When the bill became law on January 1, 2009, Plaintiff's class suit against broker Eastwood was in the discovery phase. Plaintiff sought reimbursement of broker fees charged by Eastwood on business it placed with Infinity Insurance Company from 2003-2007. Eastwood filed a Motion for Summary Judgment. On July 15, 2009, Orange County Superior Court Judge Ronald L. Bauer granted Eastwood Insurance Services' Motion for Summary Judgment filed in the class-action suit, *Munn v. Eastwood* finding that:

1. As in *Krumme*, the plaintiffs alleged that Eastwood was not a broker acting on behalf of the customer, but a defacto agent acting on behalf of Infinity.
2. The plaintiffs' arguments on defacto agency were that:
 - i) Infinity's broker agreement was a defacto agency agreement which exerted control by Infinity over Eastwood; and
 - ii) Eastwood performed defacto field underwriting for Infinity and bound coverage at the point of sale.¹⁶

Plaintiffs argued that if a broker acts on behalf of an insurer in any way, the broker is an agent, and it is immaterial what the broker's relationship is with the customer. The court disagreed with each of the plaintiff's arguments.

Although it is a Superior Court case, the court's written decision is the first since *Krumme* and AB 2956 to distinguish the difference between an agent and broker in a broker fee dispute case. The decision confirmed the totality of the circumstances as the test to determine agent or broker, and dismissed the "any one act" test advocated by plaintiff. Further, the court found that Eastwood met the presumption of broker as amended by AB 2956.

In its ruling, the court held:

- 1) That the essential issue in the case was whether Eastwood was acting as an insurance agent on behalf of Infinity or an insurance broker on behalf of the plaintiffs-insureds. Eastwood contended that at all times it had acted as a broker entitled to charge its customers a broker fee.
- 2) In focusing on which test should be applied to determine the agent/broker question, the court concluded that "any of the proposed tests lead to the conclusion that Eastwood was acting as a broker..."¹⁷
- 3) Without making a final determination on the retroactive effect of the revised presumption language in AB 2956 (see Section 1623(a)), Judge Bauer held that the AB 2956 legislative history reflects the desire to clarify existing law rather than change the law. He noted that the history "implies that the earlier presumption language of Section 1623 should be given the same meaning and effect as the new version." The court also held that Eastwood's standard written broker fee agreement with its customers met the disclosure requirements which trigger the application of the new presumption language.
- 4) In the event the new presumption language in Section 1623 is not applicable since the suit was brought before January 1, 2009, the court applied the totality of the circumstances test in examining Eastwood's business to determine whether it was a broker or an agent. The court dismissed plaintiffs' claim that Eastwood was underwriting and binding policies on behalf of the insurer.¹⁸

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AFTERMATH OF AB 2956

On September 4, 2009 Consumer Watchdog filed a proposed state-wide ballot measure which among other issues seeks to restrict broker fees in California. Under this initiative, a broker would be prohibited from charging a broker fee if the broker receives a commission from the insurer on the transaction. It further requires that broker fees be fair and reasonable and not unfairly discriminatory. It requires the Commissioner to adopt regulations to establish broker fee limits. The initiative would define as premium any amount charged by an insurer or its agent, thereby subjecting all charges to the review and approval of the Department and be subject to premium tax.

The initiative attempts to regulate broker fees that are not part of the rate and nullify AB 2956, which was unanimously passed by the legislature last year. It appears that Watchdog's intent is to qualify the initiative for California's November 2010 ballot.¹⁹

CONCLUSION

AB 2956 resolved a decade of the CDI and plaintiff lawyers' attempt to curtail the charging of broker fees by advocating the "any one act" test as the basis to clarify the difference between an agent and broker. AB 2956 codified the long-standing totality of the circumstances test through amendment to CIC Section § 1623. Whether Consumer Watchdog will be able to nullify the effects of AB 2956 and curtail the charging of broker fees will depend upon whether its initiative proposal will qualify for the November 2010 ballot and then be approved by a majority of voters in that election.

Endnotes

1. FORC Quarterly Journal of Insurance Law and Regulation, Vol. XVII, Edition II, June 1, 2006.
2. John Garamendi served his second term as California Insurance Commissioner from 2002-2006.
3. *Krumme v. Mercury Ins. Co.*, 123 Cal.App. 4th 924 (2004).
4. CIC Section § 1861.05 *et seq.*; § 2641.1 *et seq.* Title X, California Administrative Code.
5. CIC Section § 1621: "An insurance agent is a person authorized by and on behalf of an insurer to transact all classes of insurance except life insurance." § 1623: "An insurance broker is a person who, for compensation and on behalf of another person, transacts insurance other than life insurance with, but not on behalf of, an insurer."
6. § 1732: "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."
7. 2006 CDI Decision and Order, File No.: DISP 06091926.
8. Petition to the Office of Administrative Law on behalf of the Independent Brokers and Agents of the West, September 26, 2006.
9. ABAC Subcommittee on Distinguishing Agents and Brokers: Robert Hogeboom - Barger & Wolen, LLP; Mike D'Arelli and David Nielsen - Alliance of Insurance Agents and Brokers; Hank Haldeman - The

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Sullivan Group; Shari McHugh - National Association of Financial and Insurance Advisors; Ken Nigohosian and Alan Smith - Western Insurance Agents Associates; Clark Payan and Steve Young - IBA West; and Ted Pierce - Surplus Lines Association.

10. See *General Acc. Assur. Co. v. Caldwell*, 59 F.2d 473, 475 (1932) ("whether the broker is acting for the insured or as an agent of the insurer will depend upon the special circumstances proved"). Also see *Detroit Transcontinental Ins. Co.*, 105 Cal.App. 395, 399 (1930) ("the question of agency must be determined from all the facts and circumstances of the case together with the conduct and communications within the parties"). Also see *Maloney v. Rhode Island Insurance Company*, 115 Cal.App. 2d 238 (1953) ("the actual relationship is determined by what the parties do and say...").
11. Consumer Watchdog letter to Joe Coto, Chair-Insurance Committee, dated April 23, 2008.
12. Assembly Committee on Insurance Analysis compared by Mark Rakich, dated April 24, 2008.
13. *Marsh & McLennan of Cal., Inc. v. City of Los Angeles*, 62 Cal.App. 3d 108 (1976).
14. Senate Committee and Banking Finance and Insurance Consultant Michael Miller, June 18, 2008.
15. CIC Section § 1623(e) for the purposes of this section, "Totality of the Circumstances" means "evidence indicating whether a broker/agent was acting on behalf of the insurer or was acting on behalf of a third person. In determining the totality of the circumstances, all relevant facts and circumstances shall be reviewed and the review is not limited to any particular fact or factors, and this section does not require that any particular circumstance receive greater or lesser weight."
16. *Munn v. Eastwood Insurance Services*, Superior Court of California, County of Orange, Minute Order of Judge Ronald L. Bauer, dated July 15, 2009.
17. Tests include: i) new presumption language in 2956 effective 1-1-09; ii) prior presumption language in 1623; and iii) totality of the circumstances.
18. Plaintiff counsel filed a Notice of Appeal on September 10, 2009.
19. The Stop Insurance Overcharges Act by Consumer Watchdog, certified by California Secretary of State, November 3, 2009.