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APPELLATE COURT RULES CONTINGENT COMMISSIONS ARE LEGAL IN NEW YORK

The payment of contingent commissions to insurance brokers and agents has received a substantial amount of attention since 2004. Probes initiated by New York Attorney General Elliot Spitzer (now Governor) into both bid-rigging practices and the payment of contingent fees to brokers who steer business to particular insurance companies have resulted in lawsuits and settlements that have dramatically affected the use and disclosure of contingent commissions. Although contingent commissions may not have been illegal per se, Attorney General Spitzer addressed the use of such commissions in concert with bid-rigging, branding such commissions as tantamount to kickbacks, and pressuring significant players in the industry to forgo the use of such commissions. As a result, many prominent insurers and brokers have stopped using contingent commissions on some or all lines of business, and many have agreed to provide full disclosure of all broker commissions to insureds.¹

Earlier this month, however, the New York Supreme Court, Appellate Division, ruled that contingent commissions are not illegal, and such arrangements may not always need to be disclosed - a holding that seemingly runs counter to the recent momentum against the use of contingent commissions. In *Hersch v. DeWitt Stern Group, Inc.*, 2007 NY Slip Op 06567, the New York Appellate Division, First Department, modified a trial court judgment and directed, *inter alia*, that:

Plaintiff's ... causes of action, which are based on allegations that the existence of a contingent commission agreement between defendant and the company that issued the subject insurance policy should have been disclosed to him, should have been dismissed as well. *Contingent commission agreements between brokers and insurers are not illegal* (see *Amusement Bus. Underwriters v American Intl. Group*, 66 NY2d

¹ The agreements between major brokers such as Marsh & McLennan and Willis and the New York Attorney General's Office and the New York Insurance Department were recently amended to allow these brokers to take revenue for servicing accounts, electronic processing, preparing reports and other services previously prohibited under the agreements. The amendments do not, however, expressly allow the payment of contingent commissions.

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878 [1985]), and, in the absence of a special relationship between the parties, defendant had no duty to disclose the existence of the contingent commission agreement (see *Wender v Gilberg Agency*, 304 AD2d 311, 311-312 [2003], lv denied 100 NY2d 507 [2003]). (emphasis added)

In *Hersch*, plaintiff contacted the defendant insurance broker to request that the broker procure insurance to cover, *inter alia*, the plaintiff's cooperative apartment unit. While the policy contained an "Additions and alterations" provision, full coverage for additions and alterations could only be provided with the purchase of a rider to the policy. Although the Court found that there are triable issues as to whether the plaintiff requested additional coverage for additions and alterations to his cooperative unit (which was ultimately damaged in a fire that led to the lawsuit), the Court dismissed causes of actions based on the alleged existence of a contingent fee arrangement.

To buttress its position that contingent commission agreements between brokers and insurers are not illegal, the Appellate Division referenced *Amusement Bus. Underwriters v American Intl. Group*, 66 NY2d 878 (N.Y. 1985), a case from the Court of Appeals, New York's highest court, involving a claim under a contingent commission agreement. While the Court of Appeals addressed a variety of issues in determining the proper damages in that case, the Court in no way questioned the legality of contingent commissions, implicitly affirming the permissibility of such compensation agreements.

The Court in *Hersch* further held that absent any special relationship between the insured and the broker, the defendant broker had no duty to disclose the existence of the contingent commission agreement. The *Hersch* court cited to a prior Appellate Division case, *Wender v. Gilberg Agency, Inc.*, 304 A.D.2d 311 (N.Y. App. Div. 1st Dept. 2003), in which the plaintiff asserted that he replaced his disability policy in reliance upon the defendant agent's advice. The plaintiff claimed that that he would not have relied on such advice had the defendant revealed that his contract with the agency contained an "exclusive dealing" clause.² The *Wender* court held that plaintiff had no cause of action for fraud based on the agent's concealment of the "exclusive dealing" clause and plaintiff's alleged resulting reliance on the agent's advice because:

...the record establishes only a standard consumer-insurance agent relationship, albeit over an extended period of time, in which the agent's only duty was to obtain the policy requested by plaintiff within a reasonable period of time or inform plaintiff that he could not do so ... Absent a "special relationship" of trust and confidence, the agent was under no duty to disclose to plaintiff his contractual commitments...

Wender at 311.

² This clause, per the Court, prohibited the agent from doing business for any carrier other than the one whose policy he recommended and plaintiff selected.

The Appellate Division's decision in *Hersch* makes it clear that contingent commission arrangements are legal. This decision is noteworthy especially in light of the fact that New York has enacted no legislation and promulgated no new regulations concerning contingent commissions in the wake of Mr. Spitzer's investigations. Not only have there been no legislative or regulatory developments declaring contingent commissions to be illegal, but also an Insurance Department Circular Letter, effective since 1998, specifically opines on the permissibility of contingent commissions.

Circular Letter 22 (1998) acknowledged that compensation was being paid to brokers by insurers as additional compensation for the placing of business without such information being furnished to insureds. The Department, in Circular Letter 22, agreed to permit such arrangements, provided that all compensation arrangements between an insurer and a broker be disclosed to insureds prior to the purchase to "enable insureds to understand the costs of the coverage and the motivation of their broker in placing the business." Circular Letter 22 is currently posted to the Regulatory Actions section of the Insurance Department's "Department Investigation into Broker and Insurer Compensation Practices, Finite Reinsurance Practices and Title Insurer Practices" webpage.

The Appellate Division's finding in *Hersch* that contingent commission arrangements are legal comports with existing judicial authority cited by the court, and perhaps explains why the New York Legislature and the Department of Insurance have been reluctant to change existing law and regulations as a result of the investigations conducted jointly by Attorney General Spitzer and the New York Insurance Department. This finding also seems to contrast significantly with agreements entered into between New York and major brokers that included, as an apparent component of the penalty for bid-rigging violations, pledges by the brokers to forgo the use of contingent commissions. The *Hersch* decision calls into question whether a legal foundation exists to challenge the use of such compensation arrangements absent any element of bid-rigging.

Furthermore, the finding in *Hersch* that in the absence of a special relationship between the parties, the broker had no duty to disclose the existence of contingent commission arrangements appears to conflict with the Insurance Department's guidance provided under Circular Letter 22. As the Department's Circular Letter does not carry binding legal authority, the *Hersch* decision now stands as a counter-indication to the Department's directive to disclose contingent commission arrangements in every instance.

NEW YORK STATE INSURANCE DEPARTMENT CIRCULAR LETTER NO. 11 ADDRESSES IMPROPER NON-RENEWAL OF HOMEOWNER POLICIES

The New York State Insurance Department recently issued Circular Letter 11 (2007) to address what the Department has determined to be the improper non-renewal of homeowners policies. The Circular Letter responds to instances where insurers have reportedly non-renewed homeowners



insurance policies on the ground that the insureds do not also have other insurance business, such as automobile or life insurance, with the insurer or its affiliates.

The Department considers conditioning the renewal of homeowner's insurance on the existence of other insurance with the insurer to be an unlawful inducement in violation of New York Insurance Law § 2324. Insurance Law § 2324(a) provides that no authorized insurer shall:

... give or offer to give any valuable consideration or inducement of any kind, directly or indirectly, which is not specified in such policy or contract...

N.Y. Insurance Law § 2324(a).

According to the Department, an insurer that conditions the renewal of homeowners policies on having other insurance business with the insurer is in violation of Insurance Law § 2324 because such a requirement is an inducement to policyholders to maintain supporting business with the insurer. Because Insurance Law § 2324 prohibits an authorized insurer from giving or offering to give any valuable consideration or inducement of any kind, directly or indirectly, that is not specified in the policy or contract, or engaging in unlawful rebating or discrimination, the Circular Letter provides that insurers engaging in such practices must so inform the Insurance Department, and must immediately cease non-renewing policies using the supporting business condition. Such insurers must also rescind any non-renewal notices that have not yet taken effect.

If you would like more information on this or any other insurance, reinsurance or insolvency regulatory actions, please feel free to contact Francine L. Semaya, Esq., Chair, Insurance Corporate and Regulatory Practice Group, at (212) 908-1270, fsemaya@cozen.com or Laurance D. Shapiro, Esq. at (212) 908-1363, lshapiro@cozen.com. Comments in this Insurance Corporate and Regulatory Alert! are not intended to provide legal advice. Readers should not act or rely on information in the Alert! without seeking specific legal advice.