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Suitability and Non-Maleficence: A Proposal for Insurance Producer Regulatory Reform

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SUITABILITY AND NON-MALEFICENCE: A PROPOSAL FOR INSURANCE PRODUCER REGULATORY REFORM

Mark Franke[*]

I. INTRODUCTION

There are worse things in life than death. Have you ever spent an evening with an insurance salesman? –Woody Allen[1]

Let's face it: spending time with an insurance agent is probably not on the top of the list of things you *love* to do. But when you buy a new car, add an addition to your house, or get a new job that boosts your earning capacity, calling your agent is surely near the top of the list of the things you *have* to do. We call our agents—in statutory parlance, "producers"[2] —tell them about the change of our circumstances and, as painlessly and quickly as possible, aim to get the coverage we need. While we vary in our solicitude, to some extent those of us who use an agent to obtain coverage for our risks inevitably rely on our agents to understand these risks and obtain for us coverage at a reasonable cost; we ask our agents to take care of us, trusting that they will exercise basic diligence in their service to us and will "tell the truth and . . . keep their promises."[3]

But should we as a matter of course? Perhaps. After all, as

[*] The University of Michigan Law School, J.D. 2013.

[1] Jamie Frater, *Top 25 Woody Allen Quotes*, LISTVERSE, http://www.listverse.com/2007/12/09/top-15-woody-allen-quotes/ (last visited May 2, 2013).

[2] *See*, *e.g.*, PRODUCER LICENSING MODEL ACT OF 2005.

[3] Tamar Frankel, *Fiduciary Law in the Twenty-First Century*, 91 B.U. L. REV. 1289, 1291 (2011) (internal quotations and citations omitted).

a general principle, "[t]rust saves time and money. . . allow[ing] [us] to use the talents of strangers" on matters about which we lack expertise.[4] Attendant to such trust, however, lies the menace of its abuse and the cost of protecting ourselves from the harm that would result from exploitation.[5] So perhaps not. While the law generally should conform to our reasonable expectations,[6] such reliance must be objectively reasonable for a court to give recompense for any resulting harm.[7] Even if judges are loath to impose any duties commensurate to such reliance, agents are not so reluctant to invite duty, to varying degrees, from unwary consumers.[8] This paper proposes a new statutory framework of duties for the regulation of insurance producers to address the trust consumers' place in producers. It aims to impose duties on producers that are tailored to allow for a reasonable level of reliance by consumers on professionals of this type.

Heightened duties may arise by contract or statute.[9] They may also be implied in a relationship, such as the duty of care in tort law[10] or in special relationships wherein one party reposes trust and confidence in another to act in his best interest and the other accepts such trust.[11] There are, generally, two moving parts which may be tinkered with to arrive at the appropriate cocktail of duties: duty of care and duty of loyalty. The duty of care is essentially a duty to exercise proper diligence required by the task

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[4] TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 49 (2006).

[5] Frankel, *supra* note 3, at 1291.

[6] *See* C & J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169, 176 (Iowa 1975) (citing Rodman v. State Farm Mut. Ins. Co., 208 N.W.2d 903, 905-08 (Iowa 1973).

[7] *See id.*

[8] *See*, *e.g.*, TWG INSURANCE, http://www.twginsurance.com (last visited May 5, 2013) (suggesting that it will obtain "the best coverage at the lowest cost"); STILLWELL INSURANCE, http://www.stillwellinsurance.com/home.html (last visited May 5, 2013) (suggesting that the broker will find insurance companies "best suited to your individual needs" and admonishing that "it is to your advantage to have a trained professional to look out for your interests").

[9] *See* Larry E. Ribstein, *Fencing and Fiduciary Duties,* 91 B.U. L. REV. 899, 902 (2011).

[10] Where there is a foreseeable victim of a foreseeable harm which could result from the actions of an actor, the actor is generally held to have a duty to take reasonable steps to prevent such harm. *See* Tarasoff v. Regents of Univ. of California, 551 P.2d 334, 342 (Cal. 1976) (citing cases).

[11] *See*, *e.g.*, Broomfield v. Kosow et. al, 212 N.E.2d 556, 560 (Mass. 1965) (holding that the depositing of trust must be accompanied by the acceptance of such trust for a fiduciary relationship to arise).

at hand.[12] The duty of loyalty is the duty of an agent not to enrich himself at the expense of his agent; it is the renunciation of self, "however hard the abnegation."[13] When we entrust ourselves or our property to another we accordingly may do so in two ways: (1) by trusting the other will exercise sufficient thoughtfulness (care) or (2) by trusting the other to renounce their self-interest in favor of ours (loyalty). These moving parts, however, have been sliced up and re-grafted into a so-called "suitability standard" in the context of broker-dealers of financial securities. The suitability standard is less onerous than full fiduciary duties but treats broker-dealers as more than mere salespersons. A similar standard, together with other specific rules, has now been set forth in the Dodd-Frank Act for the regulation of mortgage brokers. Following the trend set by this adaptation of the suitability standard in the Dodd-Frank Act, in this paper I shall propose a modified version of the suitability standard for insurance producers and a rule not to harm when choosing among suitable contracts, what I will term a "non-maleficence" rule. Together, these will create an appropriate cocktail of care and loyalty tailored specifically to the insurance producer context.[14]

This paper begins with two premises. First, that consumers always rely upon producers to take care of their needs. Second, that producers should not enrich themselves at the expense of the customer. There are, correspondingly, two problems this paper aims to address. The first—that there is no duty for insurance producers to sell insurance contracts suitable to the customer—arises out of the deficiency of the common law of agency and the failure of licensing strategies to separate all the chaff from the grain. The second—that there is nothing that prevents producers from steering consumers to contracts which lead to better compensation outcomes for the producer while

[12] *See* In re Caremark Int'l Inv. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996).

[13] Meinhard v. Salmon, 164 N.E. 545, 548 (N.Y. 1928).

[14] The application of a suitability standard to life insurance producers has been suggested before. *See generally* Richard J. Wirth, *My Customer's Keeper: The Search for A Universal Suitability Standard in the Sale of Life Insurance*, 24 W. NEW ENG. L. REV. 47 (2002). Professor Wirth's study, however, focused on the appropriate calculations for defining the scope of a customer's need for life insurance in connection with a possible suitability analysis and the correspondingly appropriate life insurance products. *See id.* at 63-69. The current study focuses on applying a suitability requirement and non-maleficence rule to all insurance producers.

costing the consumer more—arises out of compensation arrangements that may lead to a producer steering a consumer to an insurer or a policy that puts more dollars in the producer's pocket.

The law regulating the placement of consumer insurance contracts by insurance producers is fractured. As a matter of the common law, it is a complicated question of fact to whom producers owe their allegiance as agents.[15] Moreover, there is usually no duty to advise the customer on the appropriateness of a given insurance contract for the particular customer. The law generally treats producers as the mere salesmen that were the subject of Mr. Allen's lament.[16] But, due to the high verification costs and lack of expertise with respect to consumers of insurance contracts, the law does not reflect the reasonable expectation that producers will take care of the consumer purchasers.[17] While increasing requirements may increase transaction costs, this may be offset by increased trust in markets that accompanies the better advice and the reduction of information asymmetries.[18]

In the area of compensation arrangements that cause producer-customer conflicts of interest, some states address the problem through a broker fee disclosure requirement. Others require, upon request, commission and quote comparison disclosures.[19] Even if these disclosures provide the information needed for the market to solve these conflicts of interest, the efficacy of disclosures to consumers is questionable. Moreover, the market for consumer insurance contracts is not such that information is widely incorporated into the price that consumers are willing to pay. Lastly, all states license producers, but licensing fails to ensure that each transaction is consummated

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[15] For a discussion of agency, see *infra* Section III.A.1.

[16] For a discussion of producer duties under the common law, see *infra* Section III.A.2.

[17] *See* FRANKEL, *supra* note 4, at 52 (noting the relationship between monitoring costs and heightened duties); *see also* Daniel Schwarcz, *Reevaluating Standardized Insurance Policies*, 78 U. CHI. L. REV. 1263, 1325 (2011) (noting the low likelihood that consumer insurance purchasers would understand the contracts, even if they had access to them).

[18] *See* Raymond H. Brescia, *Capital in Chaos: The Subprime Mortgage Crisis and the Social Capital Response* 56 CLEV. ST. L. REV. 271, 314 (2008) ("[The l]aw can [provide] trust . . . by the creation of fiduciary duties that may help to offset information asymmetries.").

[19] For a discussion of fee and compensation disclosures, see *infra* Section III.C.B.

with the consumer's interest in mind.[20]

This paper will use the examples of the suitability requirements imposed upon brokers of financial securities by Financial Industry Regulatory Authority (FINRA), the self-regulating organization (SRO) of the financial industry, the record-keeping requirements imposed on securities brokers by the U.S. securities laws, the anti-steering provisions of the Dodd-Frank Act applicable to residential mortgage brokers, and the rules promulgated pursuant to Dodd-Frank and the securities laws by the Securities and Exchange Commission (SEC) and the Consumer Financial Protection Bureau (CFPB), all of which provide useful models for the regulation of insurance producers. Before arriving at its end, this paper will begin with a brief introduction to the categories of insurance producers. It will follow with an exposition of the two problems this paper's proposal aims to ameliorate and, in so doing, exposit and critique the current regulation of insurance producers through the common law, licensure, and compensation disclosure regimes.

II. INTRODUCTION TO INSURANCE MARKET PRODUCERS

As a preliminary matter, it is important to make clear that the contracts which insurance producers broker are adhesion contracts,[21] as this is essential to the nature of a producer's role in the transaction. While contrary to the classical contract law notion that a contract should be a "meeting of the minds," adhesion contracts have come to be accepted because they facilitate a more efficient economy. These contracts reduce transaction costs, notwithstanding the risk that the terms may unfairly protect the party who offers them.[22] To protect against such risk, state legislatures may expressly dictate acceptable terms for the insurance contracts or delegate the authority to approve the terms of contracts to state regulators.[23] In light of the regulatory oversight of the contract terms and the fact that, in

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[20] For a discussion of licensing regimes for insurance producers, see *infra* Section III.C.A.

[21] *See* 1-1 CORBIN ON CONTRACTS § 1.4 (1993) (internal citation omitted).

[22] *Id.*

[23] *Id.*; *see*, *e.g.*, Texas Ins. Code, Tit. 10, Subtit. 1, Ch. 2301, Subch. A, § 2301.006 (requiring that the insurance commissioner approve of any form used for writing property and causality insurance prior to use by an insurance company).

most cases, consumer insurance contracts cover relatively small risks, direct negotiation is not necessary.[24] It follows that it is equally unnecessary to have an agent of the insurer with authority to negotiate terms of the contract to broker the transaction. As such, most consumer contracts are consummated through a third party producer without such authority.[25]

An insurance producer is "an individual or . . . firm, with some degree of independence from the insurer, which stands between the buyer and the seller of insurance."[26] There are a few types of insurance producers: exclusive agents, managing general agents, brokers, and independent agents. Exclusive agents act as an authorized and exclusive representative of one, or primarily one, insurer.[27] Managing the general agents are a specialized type of broker who can underwrite on behalf of insurers and place contracts with insurers.[28]

Brokers are generally understood to be firms who serve as market makers with a multi-regional scope and providing a wide range of sophisticated services such as modeling risk, managing captive insurers, loss control services, and risk modeling and management.[29] Brokers are generally considered to be agents of the insured, notwithstanding that they often consummate "agency appointment" contracts undertaken with the insurers.[30] Independent agents are sometimes characterized as non-exclusive agents of the insurer,[31] and sometimes as independent of the insurer.[32] The line between brokers and independent agents blurs as a practical matter, for they often perform nearly identical services to the purchasers of policies,[33] but independent agents tend to be smaller, regional service providers to primarily small

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[24] LEE R. RUSS, COUCH ON INSURANCE 3d. § 1:2 (2012).

[25] *Id.*

[26] J. David Cummins & Neil A. Doherty, *The Economics of Insurance Intermediaries*, 73 J. RISK & INS. 359, 360 (2006).

[27] *Id.* at 360-61.

[28] *See Managing General Agent (MGA)*, IRMI, *http://www.irmi.com/online/insurance-glossary/terms/m/managing-general-agent-mga.aspx* (last visited May 5, 2013).

[29] Cummins & Doherty, *supra* note 26, at 361.

[30] *Id.*

[31] *See, e.g.*, *id.*

[32] See *Agent/Broker Compensation Disclosure*, ZURICH IN NORTH AMERICA, http://www.zurichnaproducercompensation.com/Welcome.aspx (last visited May 5, 2013) (noting that Zurich "value[s], and customers rely on, agents' and brokers' trusted professional advice" and that "brokers and independent agents are not employed by Zurich").

[33] Cummins & Doherty, *supra* note 26, at 361.

businesses and consumers.[34] Cummins and Doherty suggest that the true distinction between brokers and independent agents is the volume and breadth of services offered.[35] The use of terms in the industry for the various intermediaries is, in a word, muddled.[36]

Baker and Logue note that a purist might insist that the term agent should only be used to describe someone who acts as an agent of the insurer.[37] The taxonomy of producers, however, is immaterial to this study, as its proposal is to apply a blanket suitability standard and non-maleficence rule upon all producers who broker consumer insurance contract transactions.[38]

III. THE PROBLEMS

A. Problem 1: Producers Have No Duty to Advise

Notwithstanding that insurance producers are often the only person the end consumer interacts with at the time of contract formation; producers in general have no duty to guide the consumer to a contract that is suitable to their needs. This section will describe more fully the first problem this paper aims to address through the imposition of a modified suitability requirement. It will lay out the common law principles of agency

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[34] *Id.*

[35] Cummins & Doherty, *supra* note 26, at 361.

[36] *See*, *e.g.*, Leslie Jackson Conwell, *The Role of Health Insurance Brokers: Providing Small Employers with a Helping Hand*, CENTER FOR STUDYING HEALTH SYSTEM CHANGE Issue Brief No. 57, 2 (Oct. 2002),http://www.hschange.com/CONTENT/480/480.pdf ("*Brokers* are typically independent agents . . . .") (emphasis in original).

[37] TOM BAKER & KYLE LOGUE, INSURANCE LAW [Manuscript Ch. 2, page 41] (3d ed. 2013) (on file with author). It appears that California is one state which actually adheres to this framework, calling only those producers not appointed and without actual authority to bind the insurer a "broker" and those producers who are appointed, who have a delineated scope of actual authority in their agency contract. Stephen L. Young, *When May Broker-Agents Charge Fees?*, at 1-2, http://www.ibawest.com/pdf/Articles/WhenMayBrokerAgentsChargeFees.pdf. In addition, insurers are required to file notice with the California Department of Insurance when any such appointment is made. *Id.*

[38] The proposed duty framework contained herein should be applied to both individual producers acting on their own behalf and upon larger producers, those fitting Cummins and Doherty's definition of "broker," *see supra* notes 29-30 and accompanying text, by the acts of its employees according to *respondeat superior* principles.

applicable to insurance producers and the limited duties they owe the consumers they serve.

1. Agency

Insurance brokers sit in a curious position: as they providing a service to the consumer, while being paid by insurance companies.[39] Who is their master? Where do their loyalties lie? Is an insurance broker only a market maker? Is an insurance broker an advisor to the policy purchaser? Or both? Is the insurance broker an agent of the insurer? Are there reasons to believe that a particular insurance broker has a special relationship to the policy purchaser such that the latter reposes trust and confidence in the former? These questions permeate the common law duties owed by an insurance broker to the consumer purchaser. The answers to these questions determine the scope of a broker's duties to a purchaser.

Depending on the facts and circumstances of a given transaction, courts come out differently on the question of who is a producer's principal.[40] Obviously, this is a fact-intensive inquiry, requiring judicious analysis by the fact finder,[41] which this paper proposes replacing with a new standard and rule imposed upon all producers who transact with consumers.

The extent of a producer's duties to consumer purchasers of insurance is limited in part because producers are generally considered special agents.[42] In the classical sense, an agent is a fiduciary of its principal and is subject to his or her principal's control.[43] An agent must "act loyally for the principal's benefit in all matters connected . . . [to] the agency relationship."[44] There are two types of agents: general and special. A general agent is one with authority to act on behalf of his principal in a series of transactions involving ongoing service.[45] A special agent is one

[39] *See* 1-2 Responsibilities of Insurance Agents and Brokers § 2.10.

[40] Daniel Gregory Sakall, *Can the Public Really Count on Insurance Agents to Advise Them? A Critique of the "Special Circumstances" Test*, 42 ARIZ. L. REV. 991, 991-93 (2000).

[41] *See* Schimmel Fur Co. v. American Indem,. Co., 440 S.W.2d 932, 938 (Mo. 1969) (holding that the question of whether a broker is an agent of the insured, the insurer, or both is a question of fact).

[42] RUSS, supra note 24, at § 46:1, at 46-7.

[43] *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

[44] RESTATEMENT (THIRD) OF AGENCY § 8.01 (2006).

[45] RESTATEMENT (SECOND) OF AGENCY § 3 (1958). Note that the third restatement abandoned the definitions of general and special agents.

who is "authorized to conduct a single transaction or a series of transactions not involving continuity of service."[46] As a special agent, therefore, producers have no ongoing duties to any policy purchaser for whom they broker a contract.[47]

Moreover, an insurance producer often acts as a dual agent, that is, as an agent of the insured in some respects and an agent for the insurer in others.[48] For instance a broker may act as an agent for the insurer by collecting premiums and delivering them to the insurer and as an agent for the insured in the brokering of an insurance contract.[49] The key to the dual agency concept is that the dual roles must not create a conflict of interest.[50]

Most case law and scholarship on agency principles applicable to producers focuses on the extent to which acts or statements of producers can be imputed to insurers. Enough cases have been decided[51] and enough has been written[52] on the circumstances under which acts of an insurance producer may be imputed to the insurer. This paper is not concerned with the circumstances under which acts or statements of a producer may be imputed to the insurer or admitted as parol evidence. It is concerned with imposing duties upon all producers who face the consumers in the insurance marketplace to encourage trust and efficiency in the consumer insurance markets.

2. Broker Duties at Common Law

What is the scope of a producer's duty to his customer? In general, it is very limited in scope and, consistent with the notion that they are special agents, circulates around the transaction brokered. Because the contracts offered to consumers are adhesive, the primary activity of the producer is the delivery of the contract. As such, there are three sets of facts under which a policy purchaser may have a viable cause of action: (1) where the broker fails to deliver the insurance promised; (2) where the broker fails to obtain certain specific coverage requested; or (3)

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[46] *Id.*
[47] RUSS, supra note 24, at § 46:38, at 46-84.
[48] *Id.*
[49] 1-2 New Appleman Insurance Law Practice Guide § 2.07[4][d] (2012).
[50] *Id.* at § 2.07[4][c][ii] (2012).
[51] *See*, *e.g.*, Economy Fire & Cas. Co. v. Bassett, 525 N.E.2d 539 (Ill. App. Ct. 1988).
[52] *See*, *e.g.*, 1-2 Responsibilities of Insurance Agents and Brokers § 2.05 (2013).

where the broker fails to obtain the amount of coverage requested.[53]

Brokers do not have any duty to determine the appropriate amount of insurance for a particular purchaser of a policy.[54] Likewise, they generally do not have a duty to advise on the coverage that a purchaser should obtain.[55] Similarly, there is no duty to explain the coverage.[56] In general, there is no reasonableness lens applied to the facts surrounding a transaction. That is, any argument that the broker should have known coverage was needed in a particular situation will likely fail.[57] In essence, the only duty owed to the purchaser is to obtain and deliver the policy requested by the purchaser.[58] That is, with the rare exception, insurance producers are generally treated as mere salespersons.[59] They merely present a quote, fill out the forms, accept the payment, and deliver the policy promised. While this duty might catch outright fraud, abusive, or dishonest behavior in connection with the delivery of the policies requested,[60] the common law courts are reluctant to impose any kind of duty upon brokers, notwithstanding the inevitable reliance upon them by consumers.

Under certain circumstances, a special relationship might arise between a broker and the insured such that a duty to advise

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[53] Saunders v. Cariss, 274 Cal. Rptr. 186, 188-89 (Ct. App. 1990).

[54] RUSS, supra note 24, at § 46:38, at 46-88.

[55] *See*, *e.g.*, Nelson v. Davidson, 456 N.W.2d 343 (Wis. 1990) (finding no duty to advise client to get additional coverage for underinsured motorist coverage); Wang v. Allstate Ins. Co., 592 A.2d 527, 532 (N.J. 1991) (finding no duty to advise on the scope of coverage for a homeowner's policy).

[56] Durham v. Mobile Oil Corp., 12 F.3d 55, 57-58 (5th Cir. 1994) (applying Louisiana law); Avila v. State Farm Fire & Cas. Co., 147 F. Supp. 570, 581 (W.D. Tex. 1999) (applying Texas Law).

[57] *See*, *e.g.*, May v. United Services Ass'n of America, Inc., 844 S.W.2d 666 (Tex. 1992) (rejecting that a broker should have known from the facts surrounding the transaction that certain coverage was needed).

[58] Kaufmann v. Leatherstocking Coop. Ins. Co., 861 N.Y.S.2d 423, 425-26 (N.Y. App. Div. 2008) (holding that, absent some special relationship, no liability may attach to a broker beyond any that may arise out of obtaining the policy on the purchaser's behalf).

[59] Trammell v. Prairie States Ins. Co., 473 N.W.2d 460, 462 (S.D. 1991).

[60] For example, in addition to the administrative penalties in a Lancaster County, PA case against a local broker, it is likely that these duties would capture the same activity. *See*, *e.g.*, Tim Mekeel, *Lancaster County insurance broker accused of overcharging customers,* LANCASTER ONLINE (Mar. 19, 2013, 4:10 PM), http://lancasteronline.com/article/local/827977_Lancaster-County-insurance-broker-accused-of-overcharging-customers.html.

the insured exists. For instance, in Michigan, a duty to advise may arise where the broker misrepresents the scope of coverage.[61] This essentially equates to a duty to correct the misrepresentation. Similarly, if the broker gives inaccurate advice to a purchaser, the same duty to correct is triggered.[62] Lastly, if the purchaser makes an ambiguous request for coverage, the broker must advise to the extent necessary to decide what coverage the purchaser is trying to obtain.[63]

A special relationship may also arise depending on how a broker holds himself out. For instance, a Georgia court held that a broker who was receiving compensation for advice and holding himself out as a specialist in ensuring adequate coverage was bound by a duty to advise.[64] Other courts have admitted parol evidence to show that a special relationship arose by implication. For instance, a New Jersey court held that where the insured asked for the "best available" coverage, that the insurance broker had a heightened duty to ensure that this was met.[65] The court based its holding on a reliance rationale—because the insured gave the broker discretion to obtain the best available coverage, there was a heightened duty to exercise this discretion in a way that obtained that end.[66]

Relatedly, but conceptually distinct, courts in some jurisdictions have suggested that brokers might be subjected to a heighted professional duty of care.[67] In negligence causes of action, the care exercised by defendants is evaluated against a hypothetical reasonably prudent person standard.[68] This inquiry, though, is tied to the circumstances of the conduct in question.[69] In occupations where you must be a specialist the law accordingly imposes the standard of care normally exercised by people in the profession.[70] In light of the relatively low barriers to licensing, imposing professional liability upon brokers may be

[61] Pressey Enters., Inc. v. Barnett-France Ins. Agency, 724 N.W.2d 503, 505 (Mich. Ct. App. 2006).

[62] Pressey Enters., Inc. v. Barnett-France Ins. Agency, 724 N.W.2d 503, 505 (Mich. Ct. App. 2006).

[63] *Id.*

[64] European Bakers, Ltd. v. Holman, 338 S.E.2d 702 (Ga. App. 1985).

[65] Sobotur v. Prudential Property & Cas. Ins. Co., 491 A.2d 737 (N.J. App. 1984) (superseded by statute in a respect immaterial to this proposition).

[66] *Id.*

[67] *See* Sakall, *supra* note 40, at 995 (citing cases).

[68] Bell v. Maricopa Med. Ctr., 755 P.2d 1180, 1182 (Ariz. App. 1988).

[69] *See id.*

[70] Hardt v. Brink, 192 F. Supp. 879, 881 (W.D. Wash. 1961).

overreaching, although it has been proposed.[71] Even with heightened educational requirements as may be required under the proposed change of law in this paper, imposing professional liability will not induce consumers to bring actions against negligent producers, as the damages at issue here are relatively small.[72] Also, insurance producers are categorically different than other professionals, such as lawyers and doctors, whose allegiances must be pure in order to adequately serve their client's interest. Such professionals are entrusted generally with property and issues of much higher consequence. Conversely, producers are market makers, albeit in a specialized field, so, while no duty to advise is inappropriate, a full professional standard of care is likewise inappropriate.

All "duties" discussed above could, however, be treated simply as creatures of contract. An oral contract to obtain an insurance policy, even if the policy would last for more than one year, is not barred by the statute of frauds.[73] An oral agreement to obtain a policy as instructed is likely per se enforceable.[74] But even if it were not, in the event that the consumer purchaser changes its position in reasonable reliance on the producer's promise to obtain the policy, promissory estoppel would likely bar any defense on statute of frauds grounds.[75]

In any event, the duties imposed upon producers are minimal under the common law and they do not at all conform to the reasonable expectation that to some extent insurance agents will take care of people by providing them with policies that are suitable to their situations. Indeed, many even invited reliance by consumers to varying degrees.[76]

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[71] *See generally* Sakall, *supra* note 40, at 995.

[72] *See*, *e.g.*, Leslie Scism, *Insurance Fees, Revealed*, (March 30, 2012 5:08PM EDT), http://online.wsj.com/article/SB10001424052702304177104577305930202770336.html (noting that on a $1000 brokered automobile insurance policy, the commission would be roughly $150-200).

[73] 4-12 CORBIN ON CONTRACTS §12.8[I][A] (citing cases).

[74] *See* Saunders, 224 Cal. App. 2d at 909 (suggesting that the duty of a broker to obtain the policy it promises could be characterized as an oral contract).

[75] *See* RESTATEMENT (SECOND) OF CONTRACTS §139.

[76] *See supra* note 8 and accompanying text.

B. Problem 2: Compensation Arrangements Causing Conflicts of Interest

This section will now outline the second problem this paper aims to ameliorate through the non-maleficence rule, namely, how compensation arrangements between producers and insurers creates conflicts of interests between producers and consumers. This is a recognized problem,[77] the solution for which has been disjointed among the states.

Compensation for insurance brokers can come in four basic forms: salaries, commissions, bonuses, and fees. Depending on whether a broker is self-employed or not, the compensation sources may differ. Typically, a large portion of an insurance broker's income comes from commissions.[78] Commissions are usually calculated as a proportion of the premium amounts paid by the insured.[79] Compensation may also be based upon volume of sales, that is, the number of policies sold,[80] or tied to the profitability of the contract for the insurer.[81] Producers may also charge broker fees.[82] Commissions are paid by the insurer,

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[77] *See* INSURANCE JOURNAL, *N.Y. Attorney General Targets Insurance Broker Compensation Arrangements* (April 23, 2004), http://www.insurancejournal.com/news/national/2004/04/23/41434.htm (discussing in part the "placement service agreements" which encourage producers to steer consumers to purchase contracts from certain insurers in order to obtain the more favorable compensation).

[78] *See* Bureau of Labor Statistics, U.S. Dep't of Labor, *Occupational Handbook*, 2012-13 Edition, Insurance Sales Agents, http://www.bls.gov/ooh/sales/insurance-sales-agents.htm. (last visited May 5, 2013).

[79] *See*, *e.g.*, ZURICH AMERICAN INS. CO., *Agent/Broker Compensation Schedule – Auto Liability*, *http://www.zurichnaproducercompensation.com/AutoLiability.aspx* (last visited May 5, 2013).

[80] *See* Joanne Wojcik, *Contingent Commissions back in the spotlight,* BUSINESS INSURANCE (July 17, 2011), http://www.businessinsurance.com/article/99999999/NEWS050101/399999919; *see*, *e.g.*, UNITED HEALTHCARE, *Overview of Producer Compensation*, http://www.uhc.com/legal/overview_of_producer_compensation.htm (last visited May 5, 2013) (noting that bonuses and "override" payments may be made "in recognition of a high volume of sales").

[81] *See*, *e.g.*, ZURICH AMERICAN INS. CO., *Agent/Broker Compensation Schedule – Workers' Compensation*, http://www.zurichnaproducercompensation.com/WorkersCompensation.aspx (last visited May 5, 2013).

[82] *See* STATE OF NEW YORK INS. DEP'T, Circular Letter No. 22 (Aug. 25, 1998), *available at http://www.dfs.ny.gov/insurance/circltr/1998/c198_22.htm*

essentially splitting the premium with the producer.[83] In addition, broker fees are paid by the insured.[84]

As a basic matter, it stands to reason that since commissions are paid on the total premium amounts, the producer will have an incentive to try and push premiums higher by covering more risks. The more risks covered, the higher the premiums.[85] In the alternative (depending on the producer's go-to-market strategy and the contractual compensation arrangements with carriers), the producer might also aim to sell as many policies as possible. Also, where one insurer pays a higher commission rate, a broker will have an incentive to steer consumers to such insurer over another, even if that policy will cost the consumer purchaser more.[86] In the case of sales targets, the incentive may be in the opposite direction. If a broker is employed by a brokerage house that pays bonuses based upon hitting sales targets, this may create incentives to sell policies that do not adequately cover risk—whether by risk type, in coverage amount, or with higher deductibles—in the pursuit of higher sales figures.

C. *Other Regulatory Methods and their Deficiencies*

Aside from the common law duties, or lack thereof, there are also other statutory and regulatory methods of regulating insurance producers, two of which are licensure and

(noting the existence of additional fees charged by brokers directly to the end consumer purchaser of the insurance contract).

[83] *See* ZURICH AMERICAN INS. CO., *Agent/Broker Compensation Schedule – Workers' Compensation*, Table, http://www.zurichnaproducercompensation.com/WorkersCompensation.aspx (last visited May 5, 2013) (showing percentage amounts paid for commissions on workers' compensation insurance contracts).

[84] *See* Stephen L. Young, *When May Broker-Agents Charge Fees?*, at 1, http://www.ibawest.com/pdf/Articles/WhenMayBrokerAgentsChargeFees.pdf (suggesting that fees may be charged by brokers, so long as disclosed).

[85] *See generally*, Jessica Bosari, *What Really Goes into Determining Your Insurance Rates*, FORBES.COM (Jan. 8, 2013 11:53AM), http://www.forbes.com/sites/moneywisewomen/2013/01/08/what-really-goes-into-determining-your-insurance-rates/ (last visited May 8, 2013) (discussing risk factors and relationship of them to premiums).

[86] Depending on the phase of the underwriting cycle, insurers may pay higher commissions. For instance, early in the cycle where they are trying to build out their pool in a specific risk type or geography, they may pay higher commissions to induce brokers to push their insurance products over a competitors'. *See* Conwell, *supra* note 36, at 2.

compensation disclosure. While these may eliminate some degree of the two problems at issue here, they do not suffice for the reasons outlined below.

1. Licensure

Broker licensing regimes among the states are more or less uniform. The National Association of Insurance Commissions (NAIC) began an effort to make licensing uniform in 1999 with the Producer Licensing Model Act (PLMA). As of 2009, the federal Government Accountability Office reported 47 states had adopted this act.[87] The NAIC followed the PLMA with issuing standards for licensure, which, by 2008, the NAIC boasted had been adopted in large part by many states.[88] These standards, among other issues, address things like minimum age, citizenship, education level, acceptable versions of study and verifications on such study, test procedures, standards, retesting rules, background checking procedures, and minimum personal integrity standards.[89] As with other professional licensing regimes, these circulate around minimum competency and character standards.[90]

While competency standards exist to make sure that the broker we rely upon is worthy of our trust in the subject matter, character standards make sure that brokers are not predisposed to morally untrustworthy acts. The PLMA provides in section 12 the bases upon which a license may be denied, not renewed, or revoked.[91] The grounds for denial, non-renewal or revocation of a license ambulate back and forth between fraudulent or dishonest acts,[92] such as outright fraud or forgery,[93] to criminal or morally

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[87] UNITED STATES GOV. ACCOUNTABILITY OFFICE, Report to Congressional Requesters, *Insurance Reciprocity and Uniformity: NAIC and State Regulators Have Made Progress in Producer Licensing . . . but Challenges Remain* (April 2009), at 15, *available at* http://www.gao.gov/assets/290/288231.pdf.

[88] NAT'L ASS'N OF INS. COMM'RS, *NAIC Licensing Assessment Aggregate Report of Findings* (Feb. 19, 2008), at 4-5, http://www.naic.org/documents/committees_ex_pltf_plwg_PLC_assessment_aggregate_report.pdf.

[89] *Id.* at 11-12.

[90] *See*, *e.g.*, MODEL RULES FOR PROF'L CONDUCT, Preamble [4] – [5] (providing for the general requirements of competency and conformance with the law in personal affairs for attorneys).

[91] PRODUCER LICENSING MODEL ACT OF 2000, § 12.

[92] *See*, *e.g.*, *id.* §12 (A) (1) (providing that providing "incorrect, misleading, incomplete, or material untrue information in the license application" is

reprehensible acts, such as felony convictions or not complying with any child support obligation to which a licensee is subject.[94] Violation of any insurance law may also constitute a ground for denial.[95]

This framework points to actions, which serve as proxies for competency and moral trustworthiness, which correspond with predispositions for adequate care and loyalty. In this sense, by a broadly sweeping sorting mechanism, licensure attempts to address the same issues that the duties of care and loyalty do. Licensing standards do a good amount of work to sort the grain from the chaff, but they do not require a producer to provide policies suitable to the consumer purchaser. Moreover, they do not prohibit the sale of a higher priced policy in order to get a higher commission unless such an act rises to the level of an unfair trade practice.[96]

2. Fee Disclosures

In 1998, insurance regulators in New York became aware of additional fees being charged, in addition to commissions, by brokers. In a circular, the regulator noted that the charging of these fees absent disclosure gave rise to "a perception that brokers are conflicted in their loyalties."[97] Moreover, the circular noted that the charging of these fees may violate section 2110 of the New York Insurance Law, which prohibits dishonest and untrustworthy practices by brokers.[98]

This is a wider issue that has been recognized by the community of insurance commissioners of many states. In 2006, the President of the NAIC noted that state commissioners had continued to examine the potential for conflicts of interests that arise from undisclosed fees and commissions.[99] In 2004, Eliot

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grounds for denial, non-renewal, or revocation of license).

93 *Id.* § 12 (A) (8), (12).

94 *Id.* § 12 (A) (2), (6), (13).

95 PRODUCER LICENSING MODEL ACT OF 2000, § 12(A)(2).

96 *See id.* § 12(A)(7).

97 STATE OF NEW YORK INS. DEP'T, Circular Letter No. 22 (Aug. 25, 1998), *available at* http://www.dfs.ny.gov/insurance/circltr/1998/c198_22.htm.

98 *Id.*

99 *See* Public Remarks of Allessandro Iuseppi, President of the National Association of Insurance Commissioners, NAIC Financial Summit, March 21, 2006, at transcription pages 8-9, *available at* http://www.naic.org/Releases/2006_docs/finical_summitt_Address_NAIC_issues-IUPPA.pdf.

Spitzer sued March & McLennan Cos., Aon, and Willis Group—the three largest brokerage houses in the U.S.—alleging that the brokers had been steering its clients toward certain insurance carriers in exchange for additional payments from such carriers.[100] There were other similar suits against smaller producers.[101] More recently, the Federation of Risk Management Associations called upon the European Parliament to pass laws requiring basic fee disclosures by producers as well.[102]

Some fee disclosure rules require only disclosure of fees additional to commissions paid by insurers.[103] New York's Insurance Regulation 194 requires disclosure of not only fees but also commission amounts, if the consumer requests it after an initial required disclosure by the broker that he or she "will receive compensation . . . in whole or in part on the insurance contract the [producer] sells . . . ."[104] This initial disclosure may be performed orally or in writing.[105] The initial disclosure does not have to include any factors which affect the amount of compensation the broker will receive;[106] it must only state that the consumer can obtain additional information on the "nature, amount and source" of the compensation upon request.[107] The consumer may also obtain a list of "alternative quotes presented to the producer" by the carriers.[108]

Disclosure has been deemed a sufficient solution to other

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[100] Kathy M. Kristof, *Insurance Broker to Settle Charges*, LOS ANGELES TIMES (Jan. 6, 2006), http://articles.latimes.com/2006/jan/06/business/fi-ulr6; *see* INSURANCE JOURNAL, *N.Y. Attorney General Targets Insurance Broker Compensation Arrangements* (April 23, 2004), http://www.insurancejournal.com/news/national/2004/04/23/41434.htm.

[101] *See* Kristof, *supra* note 100 (noting the suit and $2 million settlement of suit brought by Spitzer against Universal Life Resources of Del Mar, Cal. and the action also waged against Universal Life Resources by the California insurance commissioner).

[102] Sarah Veysey, *FERMA Urges fee disclosures for all insurance buyers*, BUSINESS INSURANCE (March 19, 2013 10:13AM), http://www.businessinsurance.com/article/20130319/NEWS04/130319819.

[103] *See, e.g.*, Cal. Code of Reg., Tit. 10, Ch. 5, Subch. 1, Art. 6.8, § 2189.3(d) (requiring disclosure of fees in accordance with an Appendix A); *see also* Cal. Code of Reg., Tit. 10, Ch. 5, Subch. 1, Art. 6.8, Appendix A (providing that fees are payments made by the policy purchaser to the broker are in addition to commissions that may be paid by carrier).

[104] 11 N.Y.C.R.R. § 30.3(a)(3).

[105] 11 N.Y.C.R.R. § 30.3(a).

[106] 11 N.Y.C.R.R. § 30.3(a)(3).

[107] 11 N.Y.C.R.R. § 30.3(b)(1).

[108] 11 N.Y.C.R.R. § 30.3(b)(2).

problems in financial products regulation, such as the U.S. securities laws. The securities laws, however, presuppose that, because the capital markets are presumptively efficient, that all public information is incorporated into the price of the security.[109] Therefore, the reasoning goes, it is immaterial whether the end purchaser reads or understands the disclosure, as dutiful equity analysts, being the soldiers of efficiency that they are, pore over the disclosure forms and the price shifts according to their buy/sell recommendations.

Consumer insurance contracts are not traded on an exchange. Therefore, it is less likely that information is necessarily incorporated into the price that consumer purchasers are willing to pay for insurance contracts. Also, the Regulation 194 disclosures are not going to sophisticated analysts, but to the consumers themselves. It is an open question whether, even if the purchasers do request the additional disclosure, that they read and understand them. The disclosure forms produced by Independent Insurance Agents and Brokers of New York, Inc. (IIABNY), a private trade group,[110] allow for the compensation to be disclosed in a percentage or number.[111] Most people understand the difference between a proportion and an absolute number, but would they be willing to do calculations? The tables IIABNY provides for the comparison of quotes are more promising. They lay things out plainly enough including, most importantly, the compensation that the producer will receive.[112]

If whether entrusting ourselves to our brokers is reasonable depends on the cost of verifying the truth and honesty of their assertions,[113] these disclosures may reduce monitoring costs. The efficacy of such monitoring depends directly on whether the information is requested and, if so, whether it is read and understood. Even if consumers do not make disclosure

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[109] *See* Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988).

[110] *See* INDEP. INS. AGENTS AND BROKERS OF NEW YORK, *About us,* http://www.iiabny.org/AboutUs/Pages/default.aspx ("[IIABNY exists to fulfill the educational, political, and business interests of our . . . agencies and . . . employees").

[111] INDEP. INS. AGENTS AND BROKERS OF NEW YORK, *Statement of Compensation, Ownership Interest, and Prohibition Against Rebating, available at* http://ny.iiaa.org/Advocacy/Reg194/2_Comp_Ownership_Rebating.pdf.

[112] *See* INDEP. INS. AGENTS AND BROKERS OF NEW YORK, *Description of Alternative Quotes*, *available at* http://ny.iiaa.org/Advocacy/Reg194/2_AltQuotesPresented_PC.pdf.

[113] *See* FRANKEL, *supra* note 4, at 52.

requests, the fear of requests might deter unscrupulous practices as well.

The New York Department of Financial Services stated to the author that they do not have any data on how often consumers actually request the additional disclosures because "agents are not required to report this information to [the department]."[114] To the author's knowledge, there are no public sources of such data either. Perhaps Regulation 194 has curbed unscrupulous practices, but this would depend on how often additional disclosures are requested, whether consumers read and understand the information provided, what consumers do with the information, or whether reputational risk provides a sufficient deterrent. The SEC recently published a study showing that most Americans surveyed lacked basic financial literacy,[115] which may cast doubt on the efficacy of disclosures directly to consumers. While reputational risk may have some deterrent effect, it is not clear that it is sufficient.[116] Moreover, the duties imposed or implied by law or equity have replaced in large part the norms that bind closely-knit communal societies with the transition to a modern market-based economy wherein economic incentives lead to moral hazard.[117] Thus, reputational risk may be insufficient to deter unscrupulous steering by producers, even if it has some minor demonstrable deterring effect.

IV. THE SUITABILITY STANDARD

A suitability standard applies to broker-dealers[118] of

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[114] E-mail from Patricia Douglas, Ass. Ins. Examiner, Consumer Assistance Unit of the New York Department of Financial Services, to the author (May 3, 2013, 2:00PM EDT) (on file with author)

[115] SEC. & EXCH. COMM'N, *STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS* (AUG. 2012), AT III, *AVAILABLE AT* HTTP://WWW.SEC.GOV/NEWS/STUDIES/2012/917-FINANCIAL-LITERACY-STUDY-PART1.PDF.

[116] At least as far as the large brokerage houses are concerned, the specter of a reputational stain may be limited in efficacy where cash flow is king. *See* Kenneth J. St. Onge, *Aon Will Begin Accepting Contingent Commissions Again*, Insurance Journal (Aug. 2, 2010), *available at* http://www.insurancejournal.com/magazines/features/2010/08/02/159998.htm (noting that, notwithstanding five year prohibition on the same under the Spitzer settlement, Aon would begin to accept contingent commissions again).

[117] *See* Brescia, *supra* note 18, at 313.

[118] A broker is a person in the business of effecting transactions in securities on the account of others. 15 U.S.C.A § 78c(a)(4)(A). A dealer is a person in the business of buying and selling securities on its own account. 15

financial securities under FINRA rules, the securities laws, and now, pursuant to Dodd-Frank, residential mortgage brokers as well. This section will introduce the suitability standard as applied to both, the additional rules added by Dodd-Frank for mortgage brokers to supplement and will tailor the suitability standard to that context.

A. Introduction to the Standard as Applied to Broker-Dealers

The suitability standard essentially requires that a broker-dealer know his customer and, given this knowledge, make recommendations upon some reasonable basis that the product is suitable specifically to the customer.[119] This standard imposes a lighter duty than full fiduciary duties, which is generally viewed as the highest standard under the law.[120] It essentially operates as a pared down duty of care. Implicit in the notion of finding a suitable product is a certain amount of diligence. One must study the terms of the instrument, its volatility, its historical returns and future outlook in order to determine if it is a good investment. In addition, the suitability standard requires the broker-dealer to consider the particular customer's appetite for risk and investment goals and compare prospective securities available for purchase against them.

Where a broker-dealer of securities recommends a security to an investor, the broker-dealer must conclude, first, that the investment product in question would be suitable for that investor.[121] That is, if a product recommended by a broker-dealer were to turn out a sham product, then the broker-dealer might be held to have not discharged its obligations under this prong if he could have discovered the sham with reasonable diligence. Second, the broker-dealer must look to the particular customer in question and determine whether the product is suitable to the consumer specifically based on the individual's characteristics,

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U.S.C.A § 78c(a)(5)(A). They are often referred to together, as rules are often applicable to both.

[119] FIN. INDUS. REGULATORY AUTH., *FINRA Manual*, Rule 2111(a), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=13390&element_id=9859&highlight=2111 (last visited May 6, 2013).

[120] SEC. INDUS. AND FIN. MKTS. ASS'N, *FIDUCIARY STANDARD RESOURCE CENTER*, OVERVIEW, *AVAILABLE AT* HTTP://WWW.SIFMA.ORG/ISSUES/PRIVATE-CLIENT/FIDUCIARY-STANDARD/OVERVIEW/.

[121] Frank A. Hirsch, Jr., *The Evolution of the Suitability Standard in the Mortgage Industry*, 12 N.C. BANKING INST. 21, 26 (2008).

such net worth, finances, investment goals, risk aversion, and tax status.[122]

While Rapp suggested that the FINRA suitability standard does not prescribe a care standard,[123] this is not entirely correct. He was correct to state that the standard operates more as an *ex post* mechanism for evaluating the reasonableness of a particular recommendation made by a broker in light of the investment goals of the purchaser.[124] But, just because the FINRA rule does not state the level of attention to the purchaser's interests required does not mean that there is no standard of care. Indeed, the standard is stated in the rule itself—reasonableness—a standard that permeates the Anglo-American common law and which has a definite and clear meaning, even if it is always tied to the facts and circumstances to which it is applied. These rules incorporate the common law concept of reasonableness.[125] Reasonableness in this context means that if a reasonably prudent stockbroker would not have recommended the stock in light of its risk profile and the investment goals of the purchaser, then such recommendation is not reasonable.

The SEC, through Rule 17(a)(3)(17), also requires broker-dealers who deal in securities transactions with individuals to obtain relevant information in order to make a customer-specific suitability determination. Aside from personal biographical and contact information, this rule requires that broker-dealers obtain account investment objectives (e.g., for retirement), the annual income of the individual, his or her net worth, and whether he or she is employed in a brokerage firm.[126] The text of the rule states that broker-dealers "shall make and keep . . . the following books and records" of which the above records are included.[127] But it also excuses any non-compliance of a broker-dealer on account of the "neglect, refusal, or inability" to provide relevant information by a customer.[128] So long as a broker-dealer makes a good faith

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[122] *Id.*

[123] Robert N. Rapp, *Rethinking Risky Investments for that Little Old Lady: A Realistic Role for Modern Portfolio Theory in Assessing Suitability Obligations of Stockbrokers*, 24 OHIO N.U. L. REV. 189, 192 (1998).

[124] *See id.*

[125] *Cf.* Pasquantino v. United States, 544 U.S. 349, 358 (2005) (noting in the context of statutory interpretation that "long-established and familiar principles" of the common law are presumed to be retained unless statutory purpose indicates clear contrary purpose).

[126] 17 C.F.R. § 240.17a3(a)(17).

[127] 17 C.F.R. § 240.17a3(a) (2013).

[128] 17 C.F.R. §240.17a3(a)(17)(i)(C) (2008).

effort to obtain the required information, they will not run afoul of the rule.[129] But broker-dealers function as market makers for whom the regulators tailored a rule, which corresponds to what the regulators deem to be appropriate given their function.

Administratively, the efficacy of any suitability standard requires information gathering and record keeping effort requirements. The good faith excuse, while to an extent undermining the efficacy of the broker-dealer suitability standard, reflects what might be called a forearm's length nature of the transaction. While not a full arm's length away such that no duties at all are required, full fiduciary duties are not imposed either. The issue lies in the "reasonable basis" requirement of the suitability standard. In the absence of required record keeping, there is little evidence to refute any reasonable basis manufactured *ex post*.

SRO's, in this case FINRA, must enforce compliance with these rules.[130] Non-compliance by an SRO may result in the SRO's suspension of authority to regulate its members, the revocation of its registration with the SEC, and censure or other limitations on its activities.[131] Similarly, the SEC may also do the same to any member of the SRO in order to protect the interests of investors.[132] It follows that the teeth of these enforcement mechanisms when it comes to the broker-dealers transacting with purchasers of securities is in the prevention of members from working in the industry.

However, a private plaintiff may also bring an action under Rule 10(b)(5), which prohibits misrepresentations and fraud committed with scienter in connection with the purchase or sale of a security.[133] The Supreme Court has stated that this private right is available to purchasers and sellers of the securities.[134] In order to bring an action under 10(b) for breach of the suitability requirement, a plaintiff must prove:

(1) that the securities purchased were unsuited to the

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[129] *See Broker-Dealers: Why They Ask for Personal Information*, SECURITIES AND EXCHANGE COMMISSION, http://www.sec.gov/answers/bd-persinfo.htm (last visited Sept. 27, 2013).

[130] *See* Securities Exchange Act of 1934, 15 U.S.C. § 78s (2013).; *see also* 17 C.F.R. § 240.19g2-1(a) (2013).

[131] *Id.*, § 19(h)(1) (2013).

[132] *Id.*, 19(h)(2) (2013).; *see also id.* 3(b) (2013). (including in the definition of "member" any broker-dealer "who agrees to be regulated by [an SRO]").

[133] *See* 17 C.F.R. §240.10b-5 (2013).

[134] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975).

buyer's needs; (2) that the defendant knew or reasonably believed the securities were unsuited to the buyer's needs; (3) that the defendant recommended or purchased the unsuitable securities for the buyer anyway; (4) that, with scienter, the defendant made material misrepresentations (or, owing a duty to the buyer, failed to disclose material information) relating to the suitability of the securities; and (5) that the buyer justifiably relied to its detriment on the defendant's fraudulent conduct.[135]

B. Suitability Standard as Applied Mortgage Brokers

The Dodd-Frank Act takes the suitability rule and modifies it to the context of regulating mortgage brokers and tailors it with additional rules specific to this context. In addition to its myriad of other reforms, the Dodd-Frank Act of 2010 addresses the activities and qualifications of mortgage brokers, which it terms "mortgage originators."[136] First it requires that all mortgage brokers be duly qualified and registered or licensed as required under state or federal law and that such brokers have a unique identifying number which it places on all documents associated with any transaction they broker.[137] It also imposes upon depository institutions a duty to ensure that these requirements are met.[138]

But, the Act goes further. It directly imposes upon the brokers a modified suitability requirement. A broker may not steer a consumer to undertake any residential mortgage that "the consumer lacks a reasonable ability to repay" or that has "predatory characteristics or effects."[139] These rules apply to creditors, the ultimate counterparty to the mortgages, as well.[140] Regulation Z, promulgated by the Consumer Financial Protection Bureau pursuant to its obligation to do so under the Dodd-Frank Act (but not yet adopted on the date this article went to print), prescribes "ability to repay" information that

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[135] Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1031 (2d Cir.1993).

[136] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 1602 (2013) (amending the Truth in Lending Act to define a mortgage originator as anyone "takes," "assists a consumer in obtaining or applying to obtain," or "offers or negotiates terms of" a residential mortgage loan).

[137] *Id.* § 1639a-b (adding Section 129B(b)(1)(A)-(B) to the Truth in Lending Act).

[138] *Id.* (adding Section 129B(b)(2) to the Truth in Lending Act.

[139] *Id.* (adding Section 129B(b)(3)(A) to the Truth in Lending Act).

[140] *See id.* § 1639c.

mortgage brokers must collect.[141]

1. Additional Rules for Mortgage Brokers

Moreover, a broker may not steer a consumer to a mortgage that is not a "qualified mortgage" if the consumer qualifies for a qualified mortgage. A qualified mortgage is a mortgage that lacks certain characteristics, for instance, negative amortization, interest-only payment, balloon payments, or terms that exceed 30 years along with stricter underwriting requirements.[142] This essentially equates to a prohibition on selling a consumer on a mortgage, which has characteristics that are known to be problematic for consumer mortgage borrowers if a mortgage that lacks these characteristics is available. These provisions are likely due to the lack of regulation of the terms of mortgages leading up to the financial crisis. This is a point of contrast with the consumer insurance contract terms, which are subject to regulatory approval by state commissioners of insurance.[143] However, the qualified mortgage rule is still instructive as it serves as the model for the anti-maleficence rule proposed here.

Dodd-Frank goes even further. It places a blanket ban against financial incentives paid to mortgage brokers by any person at all on account of the terms of the mortgage contract it brokers.[144] It also totally disallows the receipt of compensation from both the creditor mortgagee and the consumer mortgagor.[145] Both of these provisions obviously raise a conflict of interests concern between the mortgage broker and consumer mortgagor.[146]

Having laid out now the suitability requirement as applied to broker-dealers and mortgage brokers, the study now turns to the proposed framework for producer regulation.

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[141] *See generally* 12 C.F.R 1026.43(c) (1)-(2) (2013). See Note

[142] *See* 12 C.F.R. 1026.43(e) (2013). See Note

[143] *See*, *e.g.*, *supra* note 23 and accompanying text.

[144] Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 1403 (2013) (adding section 129B(c)(1) to the Truth in Lending Act).

[145] *Id.*

[146] *See* BUREAU OF CONSUMER FINANCIAL PROTECTION, *Loan Originator Compensation Requirements under the Truth in Lending Act*, Final Rule; official interpretations, at 148-49, 301 (Jan. 10, 2013), *available at* http://files.consumerfinance.gov/f/201301_cfpb_final-rule_ability-to-repay.pdf.

V. SUITABILITY AS ALTERNATIVE TO THE DEFECTS OF THE COMMON LAW AND LICENSURE REGIMES

Like the Dodd-Frank Act did with mortgage broker regulation, this paper proposes a suitability rule modified to the producer regulation context and supplemented by an additional rule to address the unique regulatory challenges of this context. As shown above, the common law in general treats producers as mere salespersons. But, like mortgage brokers and broker-dealers of securities, producers perform a much larger role in the consumer insurance markets than the duties the common law imposes upon them would suggest. As of 2004, at least 32% of the personal lines market was intermediated by some type of producer.[147] As of 2009, when you combine personal lines with property and casualty insurance, almost 50% of the market is brokered by independent agents or brokers.[148] If the producer has no duty to advise them, then how do they know if they are getting the appropriate coverage for their risks?

A suitability standard, tailored to the facts of the insurance industry, should be applied to producers in order to ameliorate any under- or over-coverage that may result from either a lack of care or steering to unsuitable contracts by producers. As I will show below, together with the non-maleficence standard, a suitability standard would curb producers' incentives to offer products unsuitable to their customers. Moreover, legislatures and regulators should consider imposing the compliance onus on the insurers to make sure their producers adhere to these requirements. This will help to discourage the wastefulness of fighting for access to deeper pockets by imputation of producer acts to the insurer that has plagued the common law on this subject.[149] Beyond this, it would

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[147] *See* Cummins & Doherty, *supra* note 26 at 363 (noting that 32% of total personal lines insurance market intermediated by independent agents or brokers and that some is also brokered by exclusive agents). As of 2009, it appears that number was roughly the same. Madelyn Flannagan & Peter van Aartrijk, *2009 Property-Casualty Insurance Market: Opportunities & Competitive Challenges for Independent Agents and Brokers*, 5 INDEPENDENT INSURANCE AGENTS AND BROKERS OF AMERICA, at *http://www.independentagent.com/Resources/Research/SiteAssets/MarketShareReport/IIABA-Marketshare-Report-2010.pdf* (last visited Sept. 27, 2013) (see table entitled "2009 Personal lines").

[148] *See* Flannagan & van Aartrijk, *supra* note 147, at 5 (48.8%).

[149] For discussions of imputation of producer acts to insurers, see *supra* notes 51-52.

give attorneys general a clear, centralized strategy for rooting out producer carelessness and conflicted actions.

The provisions of Dodd-Frank related to mortgage brokers are instructive, because the relationship between a mortgage broker and a consumer borrower is similar to the relationship between a producer and consumer purchaser. Both are the face that the end consumer sees and interacts with. Before the financial crisis, mortgage brokers were primarily paid on two bases, through direct fees paid by the borrower[150] and through contingent payments from the ultimate creditor based on the interest rate increases from a baseline, which increase with the yield spread premium (and so the profitability of the loan to the creditor).[151] These compensation sources, in essence, directly correspond to the broker fees and the contingent payment sources of income discussed above in connection with producer compensation.[152]

Moreover, there are huge information asymmetries between producers and consumer purchasers of insurance, just like between mortgage brokers and consumer mortgagors.[153] Depending on the type of insurance, consumers may only purchase the coverage in question a few times in their lives. As noted above, a New Jersey court once held that a producer who was asked to obtain the "best available" coverage was under a duty to do just that based upon a reliance rationale and the reposing of discretion in the producer.[154] While not requiring a producer to obtain the "best available" policies, the suitability standard proposed here is based on the same rationale, as to a certain extent consumers always repose discretion in their producers.

Additionally, consumer insurance policies are not available for review pre-purchase.[155] Even if they were, however, there is scant likelihood that the average consumer would know

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[150] Herbert J. Cohen, *How are Mortgage Brokers Paid?*, at *http://www.realtor.com/home-finance/homebuyer-information/how-are-mortgage-brokers-paid.aspx* (last visited Sept. 27, 2013).

[151] *See Id.*

[152] *See supra*, notes 81-82 and accompanying text.

[153] James Lacko & Janis Pappalardo, *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms*, FEDERAL TRADE COMMISSION, ES-12 (June 2007), *available at http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf*.

[154] *See Sobotur*, 491 A.2d at 737.

[155] Schwarcz, *supra* note 17, at 1318-25.

what they say.[156] While the average producer might also have doubts as to what they say, they are in a better position to find out and, therefore, the onus should be upon the producer.[157] This is exactly the scenario wherein it is reasonable for a person to rely on the person selling the consumer a policy. An untrained person, who has spent his time and efforts developing alternative skills to offer the world, cannot be expected to understand everything he needs to know in order to get the coverage he needs.[158]

A. Producer Suitability Recommendations

The first step of a producer suitability standard would be relatively easy. Assuming that the producer delivers accurate data to the insurer, the quotes and contracts provided to the producer should satisfy the first step of a suitability standard, namely, that the policies offered be suitable to some consumers. But producers should also have a duty to know their customer, at least as to elements relevant to obtaining the appropriate coverage consistent with the consumer purchaser's appetite for self-insuring, co-insurance, and deductible levels. For instance, state regulators could require that producers gather information such as, in the case of property insurance, an official appraisal on the value of the property they wish to insure and the extent to which the policy purchaser wants that value covered, which would include a discussion of the relationship between the scope of coverage and/or higher premiums. The same could go for a discussion of co-insurance and deductible levels. These types of discussions would be akin to a discussion of investment objectives and appetite for risk as a securities broker might have with his client. They could impose a duty to ensure compliance upon insurers, to lessen the regulatory burden and place on the entities that can most easily bear it.

In general, producers now only ask questions related to the risks covered. For instance, for home insurance, they may ask the customer if there is a swimming pool, whether the house's exterior is flammable (e.g., wood) or inflammable (e.g., stone), and the address of the home and its appraised value. Some of the

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[156] *Id.* at 1325.

[157] *Cf.* Symposium, *The Future of Law and Economics: The Negligence-Opportunism Tradeoff in Contract Law*, 20 HOFSTRA L. REV. 941, 942-43 (1992) (discussing the least cost avoider rationale in tort and contract theory).

[158] *See* FRANKEL, *supra* note 4, at 49 (noting the importance of relying on others for efficiency reasons).

better producers may ask for information related to the motivation for getting insurance.

Under the proposed suitability standard, the producer should also be required to discuss the consumer purchaser's appetite for bearing risk of losses through self-insurance, or increasing deductibles or co-insurance levels. Based on this information, then, the producer should go and obtain policy quotes that match the consumer's level of risk aversion. They should also advise the consumer specifically what types of exposure they would be subject to under each policy.

The producer should also be required to obtain the appraised value and only insure up to that value. Insurers are bound only to pay for the replacement value of property, subject to the policy limits, by the principle of indemnity.[159] Therefore, even if the market value of a house in a neighborhood where housing prices are rising suggest a higher resell value, the appraised value would be the better marker of value that the producer should use so as not to extract premiums higher than what the insurer would ever have to pay out in an attempt to increase premiums.

Courts have gone so far as to say that to impose any duty to advise upon brokers would be too onerous for them, as they generally lack the necessary education and knowledge to advise purchasers properly.[160] Not imposing these duties makes sense in light of the relatively low educational requirements for becoming a licensed broker in most states.[161] I believe this view is unacceptable. The fact that the only actor who transacts directly with the producer justifies a basic advising duty. Like a broker-dealer or a mortgage broker, producers do much more than take orders and fill them. They hold themselves out as people the

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[159] *See* ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES AND COMMERCIAL PRACTICES, PRACTITIONER'S EDITION §3.1(a), 135 (1988).

[160] Rushing v. Frazier 477 So.2d 1317, 1319-20 (La. Ct. App. 1985).

[161] For instance, the National Association of Insurance Commissioners (NAIC) reported in 2008 that at least 35 states had adopted the recommended standard that no high school diploma is required. NAT'L ASS'N OF INS. COMMISSIONERS, *NAIC Producer Licensing Aggregate Report of Findings*, Feb. 19, 2008, http://www.naic.org/documents/committees_ex_pltf_plwg_PLC_assessment_aggregate_report.pdf. The motivation for recommending such a low education level is not elucidated in the report. This paper suggests that educational requirements should be raised, at least to the extent necessary to give effect to the suitability standard and non-maleficence rule proposed here.

consumer public needs and as people who will hold themselves to a basic level of care.

The suitability requirement, however, does not adequately address the potential for conflicts of interest that arise out of the compensation arrangements between insurers and producers.[162] Indeed, for this reason, Dodd-Frank required the SEC to produce a study to evaluate whether a higher standard should be applied to broker-dealers.[163] In the study, the SEC recommended that a higher fiduciary standard should be imposed upon broker-dealers.[164] This was met with extreme approbation from the industry.[165] In the same way that broker-dealers "are not just order takers,"[166] producers are not just order takers, as consumers inevitably rely on them to some extent and have no way to evaluate their veracity. Nor do consumer purchasers of insurance get the opportunity to review the policy beforehand.[167]

Where fee disclosure requirements attempt to do this, they either fail to provide the necessary information regarding the compensation from insurers to producers. Even if they provide sufficient information, the disclosures are made to consumers who may lack the appropriate sophistication to evaluate them. It would be better to just impose a rule that prevents the harm that concerns us, which this paper's non-maleficence rule aims to do.

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[162] *See* Tim Sobelewski, *Fiduciary vs. Suitability – Which Standard is Best?*, FINANCIAL PLANNING ASS'N at http://www.fpanet.org/ToolsResources/ArticlesBooksChecklists/Articles/FinancialPlanning/FiduciaryvsSuitabilityWhichstandardisbest/ (last visited Sept. 27, 2013) ("[The suitability standard] does not demand that your broker do what is *best* for you—only that it is "suitable.") (emphasis in original).

[163] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. §§ 78o, 80b-11 (2013).

[164] *See* SECURITIES & EXCHANGE COMM'N, *Study on Investment Advisers and Broker-Dealers*, January 2011, at ii, *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

[165] *See* Elizabeth MacBride, *Fiduciary Standard Soon May Regulate Broker-Dealer Deals*, CNBC.COM, (April 29, 2013, 12:00AM EDT), http://www.cnbc.com/id/100662116 (quoting former SEC chairman Arthur Levitt who commented that the imposition of the new standard "is extremely important, otherwise the industry wouldn't be fighting it").

[166] *Id.* (quoting Arthur Levitt).

[167] *See* Schwarcz, *supra* note 17 at 1318-25 (discussing the lack of transparency and unavailability of consumer insurance contracts for review pre-purchase).

B. Producer Non-Maleficence Rule

Similar to mortgage broker regulations, where Congress found that a suitability standard alone was not sufficient, so too does this paper propose a non-maleficence rule to address a challenge unique to insurance producer regulation. To further curb any incentive on account of the compensation arrangements between insurers and producers, additional legislative-teeth are needed. Instead of an all-out ban on incentive arrangements like in Dodd-Frank, which may be needed at times for legitimate reasons such as filling out the pool of risks in a given market,[168] the non-maleficence rule would state:

> [W]here there are two policies which are equally suitable to the particular consumer but with different compensation outcomes for the producer, the producer may not choose to sell the policy which leads to a better compensation outcome for him, unless that policy is equal or less in price than the policy which would lead to the worse compensation outcome for him.

In this way, the producer would practice non-maleficence, in that he would not harm the consumer by choosing the policy that leads to a better outcome for him.

Maleficence would be measured in the price paid. The benefit of this rule would be in its ease of administration. Bright line rules are administratively convenient and, therefore, efficient.[169] While bright line rules can create a "blueprint for fraud"[170] or other surreptitious non-compliance, this non-maleficence rule does not exist in a vacuum. Indeed the first prong of this proposed reform is a standard-based care requirement. Only after the collection of all possible insurance contracts is delimited to those suitable substantively to the particular customer before the producer, then the inquiry abandons any further substantive inquiry for a pure comparison in terms of premium prices. The producer may not simply sell a lower priced contract if he reasonably cannot argue that it substantively meets the needs of the consumer.

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[168] *See infra* note 172-83 and accompanying text.

[169] *See* Atwater v. City of Lago Vista 532 U.S. 318, 3547 (2001) (Justice Souter commenting that bright line rules lead to administrative convenience).

[170] Elaine A. Welle, *Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement* 56 WASH. & LEE L. REV. 519, 562 (1999).

This simple approach is appropriate. Imposing upon producers any higher duty would, firstly, be unnecessary in light of the relatively small risks that are covered through consumer insurance contracts.[171] Second, a higher duty may impose too high a cost on the producer in terms of worry and administrative effort than is justified by the compensation received.[172] Lastly, a blanket proscription of financial incentives may actually impede the underwriting cycle, a key peculiarity of the insurance business, and may also impede competitiveness of the insurance markets.

This last point bears additional consideration. Depending on where an insurer is in its underwriting cycle, which is the period of time during which an insurer's profits go from a high point to a low point and then back again,[173] an insurer may pay higher commissions in the first high point, when they are trying to attract more business, and lower rates during the time when they are trying to reestablish profitability.[174] The underwriting cycle is a creature peculiar to the insurance industry.[175] It is a product of the supply of insurance contracts in a given market, which arises as a result of insurers flooding a market with contracts in an effort to capitalize on a profit opportunity.[176]

Profit opportunities are often driven by a rise in interest rates, which increases returns on investments insurers make in the capital markets.[177] The glut of supply drives premium rates down,[178] which increases actuarial insolvency risk. When a rash of losses occur then, the premiums charged then do not cover the losses and then insurers are either forced out of business, tap into reserves (which decreases return on equity) or have to be propped up by affiliates.[179] Following this, the insurers who survive the downward sloping profit period are able to charge higher premiums and restore profitability.[180]

As an initial matter, we might ask why we tolerate the

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[171] *See supra* note 24 and accompanying text.

[172] *See* Scism, *supra* note 72.

[173] David J. Nye, et al., *The Causes of the Medical Malpractice Cycle: An Analysis of Claims Data and Insurance Company Finances*, 76 GEO. L.J. 1495, 1525 (1988).

[174] Conwell, *supra* note 36 at 2.

[175] Nye, et al., *supra* note 172, at 1525.

[176] *Id.*

[177] *Id.* at 1526.

[178] *Id.*

[179] *See generally*, *id.*

[180] *Id.*

underwriting cycle. Basically, it is a product of the business model. Where premiums equal expected losses from an insured pool,[181] which they aim to do,[182] insurance companies make no profit off of premiums. Therefore, profit must come from somewhere, which is through investment in the capital markets.[183] To induce market participants to enter the market, there must be some profit incentive and, since this incentive in this context arises from returns on investments, we tolerate this because the insurance markets are essential to the operation of society.[184]

Allowing competitive commission arrangements, combined with adequate solvency oversight by state insurance regulators, can encourage efficiency in the consumer insurance markets and ensure that large conglomerates are not extracting rents from the market.[185] The tension between the commission arrangements and the non-maleficence rule will allow for competition while also protecting the consumer from conflicted steering by producers. Because the terms of insurance contracts are reviewed and approved by regulators,[186] the predatory terms concern present in the residential mortgage markets is inapplicable to the consumer insurance market. Therefore, the non-maleficence rule only requires that, among suitable contracts, the producer may not choose one that results in a better compensation outcome for him if that contract will cost the customer more.

Enforcement of this producer suitability and non-maleficence rule should allow for a private right of action along

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[181] *See* John A. Fibiger & Stephen G. Kellison, 23 TRANSACTIONS OF SOC'Y OF ACTUARIES 1, 1-3 (1971).

[182] *See id.*

[183] *See Insurance Asset Management: Internal, External, or Both?,* NATIONAL ASS'N OF INS. COMM'N, ET AL. at http://www.naic.org/capital_markets_archive/110826.htm (last visited Sept. 27, 2013) ("Insurance companies, by their very nature, accumulate substantial amounts of cash that are used to purchase invested assets.").

[184] *See* Eberhaud Faust, *The Fundamental Role of Insurance: Enabling Economic Growth and Social Development,* MUNICH RE, at 4, http://www.genevaassociation.org/Portals/0/COP15_Munich_Re_presentation.pdf (last visited Sept. 27, 2013).

[185] I define rent-seeking here as the act by one party to a contract increasing its wealth without any correlative value creation for its counterparty. That is, it is the extracting of wealth from an already established and static reservoir of value. *See* Ward Farnsworth, THE LEGAL ANALYST 66 (2007).

[186] *See*, *e.g.*, *supra* note 21.

the lines allowed under the broker-dealer suitability standard. However, due to the relatively low damages,[187] there may be little incentive for private actors to bring suits. Therefore, imposing a duty upon insurers to make sure that any producer who brokers its insurance contracts, much like what is proposed under Dodd-Frank with respect to the ultimate mortgage creditor whose residential loans are brokered by mortgage brokers. Insurance commissions could periodically review compliance and recommend to attorneys general where investigations are appropriate in addition to unfair trade practices actions.

VI. Conclusion

In his characteristically adenoidal tone, Woody Allen might be tempted to amend his statement: "There are worse things than death, have you ever spent an evening reading about insurance producer regulation?" The regulation of insurance producers, while perhaps not demanding of popular attention,[188] is a perennial issue for insurance professionals—forever on the minds of scholars, practitioners, regulators and industry participants. While strides have been made in recent years to lessen the conflicts of interest created by the compensation arrangements through disclosure regimes, the efficacy of these is questionable. Similarly, the common law and licensure regimes are wholly inadequate in protecting the consumer purchasers of insurance reasonable reliance upon producers.

While more study should be completed on what factors producers should consider when determining whether a policy is suitable, the consumer purchaser's appetite for bearing risk, the replacement value of the property and the motivation for buying insurance should be considered. After searching for suitable policies, the producer should be bound by a non-maleficence rule, where he must give the consumer the best priced option, no matter the compensation outcome for the producer. In the event that there are two suitable options with equal price but differing compensation outcomes, the producer may choose the one with the better compensation outcome in order to ensure that insurers

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[187] *See* Scism, *supra* note 72.

[188] *But see* Leslie Alderman, *Getting a Guide for the Jungle of Individual Health Policies*, NEW YORK TIMES, at B5 (Sept. 11, 2010) *available at http://www.nytimes.com/2010/09/11/health/11patient.html?_r=0* (discussing in part the advisability of calling state insurance regulators to determine if any complaints have been filed against a broker before using them).

can ride their underwriting cycle through offering higher commissions where required to build market share, which will have the effect of increasing competitiveness in the market for consumer insurance.