BRIEFING: THE SPITZER INVESTIGATION

INTRODUCTION

This memorandum provides an overview of the ongoing investigation by New York Attorney-General Eliot Spitzer into broker contingent commissions, the complaint brought by Mr Spitzer[1] (the "Spitzer Complaint") and related litigation, and the potential exposure of London market insurers to antitrust enforcement actions and class actions in the United States. We then outline potential exposure to enforcement actions in the UK and EU.

THE SPITZER INVESTIGATION AND OTHER U.S. LITIGATION

The litigation history of broker contingent commissions actually began back in 1998 when the New York Insurance Department, after an investigation, issued a circular instructing brokers doing business in that state to disclose to their clients, in considerable detail, contingent commission agreements with insurers. The circular also instructed insurers to keep certain records pertaining to those commissions. There is some indication that some brokers did not comply with that circular and disclosed contingent commission agreements only when specifically asked to do so by clients, and then only in general terms.

In 2003, one insurer urged the New York Insurance Department to undertake another investigation and prohibit or restrain the practice. After the Department did not undertake an energetic investigation, it appears that this company asked the Washington Legal Foundation, a conservative public-interest law firm, to write to Mr Spitzer to request an investigation. Mr Spitzer then subpoenaed the three largest U.S. property/casualty brokers (Marsh, Aon and Willis) and a number of large property/casualty insurers, including Ace, AIG and Hartford.

When the media reported on the Spitzer investigation, class-action lawyers filed suit against the brokers and insurers in various locations, including Chicago and San Francisco. At that time, the plaintiffs' main legal theories were that contingent commissions (i) breached the broker's fiduciary duty to its client by putting the broker's interest in commissions ahead of the client's interests in obtaining the best policy terms and conditions, and (ii) were an unfair or deceptive business practice under so-called "little FTC Acts". A leading plaintiffs' firm, Milberg Weiss, filed a federal court class action against the three large brokers, alleging violations of the Racketeer Influenced and Corrupt Organizations (RICO) Act.

The subsequent Spitzer Complaint broke new ground by, for the first time, alleging antitrust violations. The complaint essentially alleges that Marsh, in order to maximise receipt of contingent commissions, "steered" business to favoured insurers by staging false bidding contests. It is alleged that the client would be informed that its coverage needs would be

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[1] *People of the State of New York v Marsh & McLennan Companies, Inc, and Marsh, Inc,* No. 04403342 (Sup. Ct, New York County, Oct. 14, 2004). See *http://www.oag.state.ny.us/press/2004/oct/oct14a_04_attach1.pdf.*

subject to a bidding contest between different carriers to obtain the best possible price and terms, but that in reality (according to the allegations) the broker picked the winning bidder in advance and arranged for other bidders to submit artificially high bids. The Spitzer Complaint also alleged that sham bidding (i) constituted a fraudulent business practice prohibited by a New York statute, and (ii) violated New York's securities laws (the Martin Act).

The Spitzer Complaint did not name any insurer as a defendant but specifically referred to Marsh dealings with Ace, AIG, Hartford and Munich American and described those four carriers as "co-conspirators". Marsh and the four insurers have parted company with more than a dozen officials, and at least five of these have pleaded guilty to criminal charges and are cooperating with Mr Spitzer.

Subsequent to the Spitzer Complaint against Marsh, plaintiffs' lawyers added Ace, AIG, Hartford and Munich American as defendants in the New York RICO action and additionally alleged federal and state antitrust claims. This complaint seeks treble damages against the defendants.

There is a second aspect of the Spitzer investigation which has not yet resulted in a complaint. Spitzer is investigating alleged "tying" by Marsh of its primary insurance brokerage services to the use of its reinsurance intermediary, Guy Carpenter. Mr Spitzer is also investigating whether Aon "tied" its direct insurance brokerage to the purchase of reinsurance from Aon reinsurer affiliates.

U.S. LEGAL ANALYSIS

Bid-rigging is one of the most serious offences under U.S. federal and state antitrust laws. The U.S. Department of Justice often brings criminal charges against companies and its officers involved in bid-rigging. Companies engaging in bid-rigging are also liable for treble damages to those injured by the practice. Insurers found guilty of bid-rigging would probably, absent a settlement, lose their licence or right to do business.

Bid-rigging is unlawful *per se*: in other words, if an agreement to rig bids is proved to exist, it will be presumed to be unlawful. The agreement cannot be defended on the basis of ignorance of the law, reasonableness of the bid prices, or other business justification. There is an irrebutable presumption that such practices injure competition without the need to prove actual injury.

Bid-rigging can take several forms, but the type alleged in the Spitzer Complaint is an agreement between the broker and carriers that a designated bidder would win the bid and that the other carriers would submit artificially high bids to ensure that outcome. The Spitzer Complaint can also be read as alleging a second *per se* unlawful offence, namely making an allocation of markets. The Spitzer Complaint essentially alleges that insurers agreed not to compete with one another's existing customers.

Companies engaged in bid-rigging are liable for treble damages to any buyers affected by the practice. Damages are equal to the difference between the rigged price and the hypothetical lower price which would have existed in a freely competitive market absent the bid-rigging. Because the offence is regarded as so serious, courts will often allow liberal proof of damages.

The Spitzer bid-rigging allegation, and the "copycat" allegation in the private class action, have substantially increased insurer exposure. Under broker fiduciary duty theories, it would be difficult to obtain damages from an insurer. The insurer has no fiduciary duty to its client and, because the broker is acting as a representative of the client rather than the insurer, the broker's failure to disclose could not be imputed to the insurer. In contrast, all parties to an anti-competitive agreement are jointly and severally liable for damages. Thus, any insurer found to be guilty of bid-rigging would be liable for treble damages, not just to its own policyholders, but to all policyholders affected by the alleged conspiracy.

In response to the Spitzer Complaint, other state attorneys-general and many state insurance departments have subpoenaed the records of U.S. insurers. The National Association of Insurance Commissioners (NAIC) has formed a task force to coordinate this investigation and also to propose legislation or regulations directed at contingent commissions.

In *Hartford Fire Insurance v. California,* 509 U.S. 764 (1993), the United States Supreme Court held that the U.S. has subject matter jurisdiction under its antitrust laws over offshore insurers and reinsurers whose conduct substantially affects U.S. commerce, even though those companies are not licensed, admitted or regulated in the U.S. Thus, U.S. antitrust laws potentially reach foreign insurers and reinsurers whose alleged anti-competitive conduct relates to risks in the U.S. The Supreme Court rejected an argument that the U.S. should forego the exercise of this jurisdiction under principles of comity, that is, deference to the laws of the jurisdiction in which the insurer or reinsurer was domiciled. The court held that this comity defence would be available only where the application of U.S. antitrust laws would force insurers or reinsurers to be in violation of the laws of their domestic jurisdiction. Indeed, in the *Hartford Fire* litigation (which involved alleged boycotts in connection with the adoption of an absolute pollution exclusion clause), several Lloyd's syndicates were named as defendants in suits brought by state attorneys-general and the class-action bar.

THE UNITED KINGDOM

In the UK, any regulatory breach is likely to be within the jurisdiction of the Financial Services Authority (FSA). The FSA regulates entities which carry on insurance business in the United Kingdom, and with effect from 14 January 2005 will assume responsibility for the regulation of insurance intermediaries. The FSA has reported that it is monitoring the Spitzer litigation, and a recent report[2] identified that the FSA assisted in setting the terms of an internal review by Marsh of its UK operations. The outgoing regulator for insurance intermediaries, the General Insurance Standards Council (GISC), has received some complaints that the use of contingent commissions was crossing the limitations of permissible business, but stopped short of carrying out a full official investigation as the complainants did not wish to be named in the potential inquiry.[3]

Bid-rigging and failure to disclose hidden commissions would be in breach of the FSA's Principles for Business and (more specifically) the Insurance Conduct of Business (ICOB) rules, which provide detailed implementation of those rules. The Principles for Business which are most relevant are principle 1 (a firm must conduct its business with integrity),

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[2] *The Times,* 28 October 2004.
[3] *The Washington Times*, 25 October 2004.

principle 5 (a firm must observe proper standards of market conduct), principle 7 (a firm must pay due regard to the information needs of its clients and communicate information to them in a way which is clear, fair and not misleading) and principle 8 (a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client).

ICOB 2.3.2 General Rules provides as follows:

> *"A firm must take reasonable steps to ensure that it, and any person acting on its behalf, does not:*
>
> *(1) offer, give, solicit or accept an inducement; or*
>
> *(2) direct or refer any actual or potential business in relation to an insurance mediation activity to another person on its own initiative or on the instructions of an associate;*
>
> *if it is likely to conflict to a material extent with any duty that the firm owes to its customers in connection with an insurance mediation activity or any duty which such a recipient firm owes to its customers in connection with an insurance mediation activity ."*

On 23 June 2004, the FSA issued a letter to the chief executives of UK-regulated insurers.[4] In this letter, the FSA stated, in no uncertain terms, that payments from insurers to brokers to ensure that the insurer's products are included on the broker's panel or recommended list "*would be incompatible with the fundamental principle that a firm must not conduct business under arrangements that might give rise to conflicts with its duty to customers*".

The FSA's Enforcement Division investigates possible breaches of rules. If it considers that rules have been broken, a range of sanctions is available to it. The FSA's powers include:

- public censure;
- withdrawing a firm's authorisation;
- imposing penalties or unlimited fines;
- applying to the court for an injunction and/or restitution orders; and
- prosecuting various offences.

In respect of Lloyd's, the FSA delegates much of its regulatory activity to the Council of Lloyd's (the "Council"). Managing agents are required to comply with the FSA COB rules, and also with provisions in the Lloyd's byelaws and codes of practice. Pursuant to the Lloyd's Core Principles for Underwriting Agents ("LCPUA"), most notably principles 1 and 3 respectively, an agent should observe high standards of integrity and deal openly and fairly, and take all reasonable steps to avoid causing harm to the standing or reputation of Lloyd's.

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[4] See *http://www.fsa.gov.uk/pubs/ceo/ceo_letter_23jun04.pdf.*

Just as bid-rigging and the failure to disclose hidden commissions are likely to breach FSA rules, such acts are also likely to be in breach of the LCPUA.

Whilst the FSA has enforcement authority, it also maintains cooperation arrangements with the Society of Lloyd's for cases of regulatory concern or of misconduct which is of interest to both regulators. The Society maintains enforcement powers in furtherance of its objective to provide reasonable safeguards for, among others, Lloyd's policyholders. The Society's powers of enforcement are broadly comparable to those of the FSA, although the Society does not have powers to prosecute criminal offences or to prohibit individuals from regulated activities generally other than at Lloyd's.

It has recently been reported (*Insurance Day*, 16 November 2004), that the Lloyd's franchise board has asked Lloyd's managing agents to ensure that their syndicates are not involved in any deals which could be deemed to fall within the sphere of bid-rigging or price fixing.

In terms of competition law, bid-rigging is contrary to the UK's Competition Act 1998 (the "Competition Act") and the Enterprise Act 2002 (the "Enterprise Act"), which are regulated by the Office of Fair Trading (OFT).

The Competition Act is closely modelled on Articles 81 and 82 of the EC Treaty, which are discussed below. It prohibits (i) agreements which prevent, restrict or distort competition and which may affect trade within the UK, and (ii) conduct which amounts to an abuse of a dominant market position and which may affect trade within the UK. Where conduct is capable of affecting trade between EU member states, EU law applies and this is discussed below.

The Enterprise Act works alongside the Competition Act, and introduces a criminal offence for individuals who dishonestly engage in certain cartel agreements, including bid-rigging arrangements and price fixing (the "cartel offences"). Pursuant to section 189(5), a bid-rigging arrangement is one where, in response to a request for bids for the supply of a service or product in the UK, a party is precluded from bidding or parties make bids in accordance with prior arrangements.

Sanctions for anti-competitive conduct include:

- penalties and/or prosecution;
- competition disqualification orders; and
- civil claims on behalf of consumers for damages or for a sum of money.

Pursuant to section 190 of the Enterprise Act, a person who is guilty of a cartel offence is subject to up to 5 years' imprisonment and/or a fine. Pursuant to section 204, the OFT may also apply to courts for a Competition Disqualification Order (maximum 15 year period) in respect of a director of an undertaking. Sections 18 and 19 of the Enterprise Act provide for claims to be brought before the Competition Appeal Tribunal ("CAT") on behalf of consumers. Finally, pursuant to the Enterprise Act section 17, any third party with a sufficient interest in a decision given by the OFT may appeal directly to the CAT. The OFT operates leniency programmes for both undertakings and individuals coming forward with information

of the existence of cartel activity. The OFT provides detailed guidance on the requirements for, and extent of, leniency.

Under the general law applicable to agents, brokers are under fiduciary obligations to their clients. These require them:

- to act in the interests of their client at all times;
- to ensure that their personal interests do not conflict with their duties to their client; and
- not to make a secret profit (a secret profit is any remuneration over and above a reasonable market rate which has not been disclosed to and agreed by the client).

As providers of professional services, intermediaries are also under a duty to use reasonable skill and care in the provision of their services to clients. This would include finding and recommending insurers who are suitable for the client, both as to their security and the price of coverage.

THE EUROPEAN UNION

The European Commission is aware of the Spitzer Complaint and is studying available market information. No formal investigation has been announced (yet), but the Commission is understood to be reviewing input from consumer groups.

Anti-competitive behaviour in the EU is regulated by Articles 81 and 82 of the EC Treaty. Article 81 applies to anti-competitive agreements, decisions or concerted practices. Article 82 prohibits the abuse of a dominant position. The provisions apply only to conduct capable of appreciably affecting trade between EU member states. It is not, therefore, necessary to demonstrate actual effects,[5] nor need all member states be affected. Indeed, the rules may apply even where only part of a member state, such as a region or province, is affected.

Undertakings may be subject to Articles 81 and 82 of the EC Treaty irrespective of whether they are European. The European Court of Justice has expressly exercised jurisdiction over non-EC companies in relation to agreements which have been "implemented" in the EC.[6] The manner of the implementation is irrelevant. Furthermore, a non-EC parent company may be found liable for any infringements committed by its EC subsidiaries.[7]

By virtue of Article 81, various forms of price fixing are prohibited, for example collusive tendering. As the object of such behaviour is to restrict competition, it is not necessary to prove any anti-competitive effects. The onus is, therefore, on the parties to show that their practices do not appreciably affect competition or trade between member states or, if there is an effect, that the practices are exempt under Article 81(3) (see below). Exemption under Article 81(3) is one of the main differences between the U.S. and EC treatment of such cases, although it is extremely unlikely that collusive tendering practices would be exempt.

[5] *Commission Guidelines on the Effect on Trade Concept*, paragraph 23.
[6] Cases C-114/85 *etc., Ahlstrom Oy v Commission* [1988] ECR 5193.
[7] Cases C-48/69 *etc.*, *ICI v Commission* [1972] ECR 619.

Under Article 82, the abuse of a dominant position is absolutely prohibited, *i.e.,* no exemption is possible. A "dominant position" is the economic strength which enables an undertaking to prevent effective competition by allowing it to behave independently of its competitors, customers and ultimately consumers.[8] The Commission may also find that two or more independent economic entities are united by such economic links that they collectively hold a dominant position *vis-à-vis* the other operators on the same market.[9]

Abusive behaviour under Article 82 includes, but is not limited to:

- unfair pricing or other unfair trading conditions;
- discrimination, *e.g.,* applying dissimilar conditions; and
- tying, *i.e.,* making the conclusion of contracts subject to acceptance of supplementary obligations.

The consequences of infringing EU competition legislation include the following:

- a fine may be imposed of up to 10% of the undertaking's annual turnover;[10]
- actions for interim measures and damages may be brought in national courts;
- contractual obligations may be rendered unenforceable; and
- an order may be made requiring the party to cease and desist from carrying on the infringement or to adopt positive measures to bring the infringement to an end.[11]

It is important to note that there are no criminal sanctions for infringement of the EC competition rules on a European level, although these may exist under national legislation.

Over the years, the Commission has conducted significant investigations into the insurance sector in relation to insurance and reinsurance pools, shipping insurance, aviation insurance and also in the context of the recent adoption of a "block exemption" Regulation. As a result of the modernisation process of EU competition law, the Commission is expected to intensify its investigations into all sectors of the economy.

Lastly, the Commission has adopted a "leniency" policy, set out in its Leniency Notice.[12] Under this notice, the Commission may grant immunity from fines for anti-competitive behaviour to the first undertaking to submit evidence which may enable it to take a decision to investigate a cartel or find an infringement. Undertakings which do not qualify for immunity but cooperate with the Commission may be eligible to receive a reduction in their fine. Bid-rigging is specifically referred to in the Leniency Notice.

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[8] Case 27/76, *United Brands v Commission* [1978] ECR 207.
[9] Case [1990] 4 CMLR 535, *Italian Flat Glass*.
[10] Council Regulation 1/2003, Article 23.
[11] Council Regulation 1/2003, Article 7.
[12] *Commission notice on immunity from fines and reduction of fines in cartel cases*, 2002/C45/03.

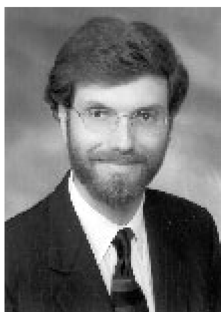
On 1 December 2004, the French publication *Les Echos* reported that risk managers were seeking "greater transparency regarding remuneration" and that they intended to "submit the debate" to the EU. The president of the European federation of risk managers (FERMA) was quoted as saying that agreements in this area had had little practical effect, and that they therefore intended to set up working groups at the EU level, for risk managers, brokers, insurers and regulators, to recommend a regulatory framework and new disclosure practices.

ABOUT THE AUTHORS

Steptoe & Johnson has over 400 lawyers in the United States and Europe, with offices in London, Brussels, New York, Washington DC, Los Angeles and Phoenix.

Mark F. Horning specialises in insurance antitrust. He is former Chair of the Insurance Industry Committee of the Antitrust Section of the American Bar Association and is editor of the leading insurance antitrust treatise, the *Insurance Antitrust Handbook.* Mr. Horning represented one of the defendants in the *Hartford Fire* litigation, has represented other defendants in numerous Attorney-General *parens patriae* and private class-actions, and has represented parties or *amici curiae* in all of the Supreme Court cases involving insurance antitrust issues over the past two decades. He frequently supervises antitrust compliance reviews for insurance carriers. Mr. Horning additionally represents insurers in complex regulatory litigation with state insurance departments.

John L. Jacobus is currently conducting an internal investigation for a firm client in connection with the Spitzer investigation. He has extensive familiarity with insurer and reinsurer practices in the large property and casualty markets which are the focus of the Spitzer investigation. He frequently represents primary insurers and reinsurers with respect to coverage arbitrations in these markets. Prior to joining Steptoe & Johnson, Mr. Jacobus was a Trial Attorney at the U.S. Department of Justice in Washington, D.C., and has extensive civil investigative and trial experience.



Kenneth P. Ewing is another Steptoe partner who specialises in antitrust. He has represented numerous clients in investigations and enforcement actions by the Antitrust Division of the Department of Justice and the Federal Trade Commission. He is currently working with Mr. Jacobus in an internal company review relating to the Spitzer investigation. Mr. Ewing is a contributing author to *The International Comparative Legal Guide to Merger Control 2005.*

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