STATE OF KANSAS

OFFICE OF THE ATTORNEY GENERAL

2ND FLOOR, KANSAS JUDICIAL CENTER, TOPEKA 66612-1597

ROBERT T. STEPHAN
ATTORNEY GENERAL

MAIN PHONE: (913) 296-2215
CONSUMER PROTECTION: 296-3751
TELECOPIER: 296-6296

December 3, 1992

ATTORNEY GENERAL OPINION NO. 92-150

The Honorable Ron Todd
Commissioner of Insurance
Kansas Insurance Department
420 S.W. 9th Street
Topeka, Kansas 66612-1678

Re: Corporations--Cooperative Societies--Bylaws and Regulations

Insurance--General Provisions--Premiums; Amounts Charged in Accordance with Act; Certain Rebates or Other Inducements Prohibited

Synopsis: The statutes prohibiting rebates, found at K.S.A. 40-941 (fire insurance) and 40-1122 (casualty insurance), are intended to protect against unfair discrimination. An insurance cooperative's distribution of patronage dividends based upon the purchase of insurance results in unfair discrimination and unless the cooperative members are considered a class for purposes of rate regulation, violates the prohibition against rebates.

Additionally, the distribution of patronage dividends (that derive solely from commissions received from the sale of insurance) to cooperative members that are not licensed as insurance agents violates K.S.A. 40-241g. Cited herein: K.S.A. 17-1501; 17-6001; 40-214; K.S.A. 1991 Supp. 40-239; 40-240; 40-241, as amended by L. 1992, ch. 19, § 2; K.S.A. 40-241g; 40-467 (Gen. S. 1923); 40-917 (Gen. S. 1927); K.S.A. 1991 Supp. 40-927; 40-928; K.S.A. 40-941; 40-1122.

* * *

Dear Commissioner Todd:

You inquire whether insurance agencies, incorporated under the cooperative society provisions of K.S.A. 17-1501 et seq., circumvent the Kansas insurance department's authority to prohibit inducements and rebates, as prescribed by K.S.A. 40-941 and K.S.A. 40-1122. Your question deals with an insurance cooperative's return of certain dividends to their shareholders based upon insurance purchases. Your second question is whether an insurance agency incorporated in such a manner violates K.S.A. 40-241g by sharing commissions with non-agent shareholders of the cooperative.

Both your questions involve the same set of facts. You indicate that currently there are two Kansas insurance cooperatives comprised of insurance agents organized for the purpose of selling insurance. Both insurance cooperative corporations state in their articles of incorporation that they are organized to provide agri-related insurance to their membership including but not limited to crop hail insurance and/or fire and casualty insurance. Membership is open only to producers of agricultural commodities and to other cooperatives of like character, both who must patronize the cooperative corporation. The cooperatives are incorporated under K.S.A. 17-1501 et seq. and state, in accordance with the act, each will distribute the net profits of its business by first paying a fixed dividend upon its stock and second, each will prorate the remainder of its profits among its stockholders based upon their purchases of insurance from said cooperative corporation.

The issue presented by your first question is whether the dividend paid to cooperative members upon their purchases, i.e. patronage dividends, (in accordance with the requirements of incorporation as a cooperative) amounts to an unlawful rebate. For purposes of clarification we point out that this question involves the regulation of the business in which these cooperatives have chosen to engage -- the business of insurance. A corporation is not subject to regulation by the insurance department unless it has chosen to engage in the business of insurance. If corporations are subject to special statutory regulation, such regulation governs over the incorporation statutes. K.S.A. 17-6001(c).

It appears from the facts presented that the profits being distributed by the cooperatives derive primarily from the commissions made by the insurance agents. In lieu of a salary the commissions are returned to the corporation pursuant to a contract between the cooperative, as a licensed agency, and the insurance agent. Commissions and other income (if any) are distributed as profits (less the operating costs) to the members in the form of a fixed dividend to shareholder members and in the form of patronage dividends to members who purchase insurance. Whether the distribution of patronage dividends that derive from commissions amounts to a rebate depends on what the statute in question is intended to prohibit or guard against.

The prohibition against rebating appears in K.S.A. 40-941 and provides in pertinent part:

> "No broker or agent shall knowingly charge, demand or receive a premium for any policy of insurance except in accordance with the provisions of this act. No insurer or employee thereof, and no broker or agent shall pay, allow, or give, or offer to pay, allow or give, directly or indirectly, as an inducement to insurance, or after insurance has been effected, any rebate, discount, abatement, credit or reduction of premium named in the policy of insurance, or any special favor or advantage in the dividends or other benefits to accrue thereon, or any valuable consideration or inducement whatever, not specified in the policy of insurance, except to the extent provided for in an applicable filing . . . .
>
> "Nothing in this section shall be construed as prohibiting the payment of commissions or other compensation to duly licensed agents, and brokers, nor as prohibiting any insurer from allowing or returning to its participating policyholders, members or subscribers, dividends, savings or unabsorbed premium deposits."

A similar restraint is placed on casualty insurers and their agents. <u>See</u> K.S.A. 40-1122.

These provisions are broad and encompassing. On its face the statute prohibits the offering or giving, as an inducement, rebates, discounts, abatements, credits or reduction of premium, special favors or advantages in dividends, any valuable consideration or inducement whatever, unless such is specified in the policy of insurance. This prohibition applies both before and after the insurance has been effected and covers both direct and indirect attempts to pass such consideration or benefit. While a specific exception is enumerated in the above-cited statute for the return of dividends, savings or unabsorbed premium deposits by insurers, no such provision is provided permitting licensed insurance agents to make such refunds.

Before we can attempt to interpret and apply the statute, we must understand why it exists. "It is not the words of the law but the internal sense of it that makes the law; the letter of the law is the body; the sense and reason of the law is the soul." Mahone v. Mahone, 213 Kan. 346, 350 (1973), [quoting from the dissent of Mr. Justice Harlan in the Civil Rights Cases, 109 U.S. 3 (1883), 27 L.Ed. 835, 3 S. Ct. 18]. In construing statutes, the purpose and intent of the legislature govern when the intent can be ascertained, and in determining legislative intent, we may properly consider historical background and the circumstances attending the legislation's passage and the legislation's purpose. Jackson v. City of Kansas City, 234 Kan. 317 (1984). In other words, we may use what was happening at the time the law was passed, why the law was necessary and what this particular law was designed to accomplish in determining the statute's intent. We find the historical evolution of K.S.A. 40-941 (hereinafter the anti-rebating statute) quite extensive and useful.

In 1909 Kansas enacted the first rate regulatory law in the country. L. 1909, ch. 152, § 7. It included an anti-rebating statute that eventually evolved into the one in question. [K.S.A. 40-467 (R.S. 1923 comparative table of sections shows the change to K.S.A. 40-917) (L. 1927, ch. 231, sec. 40-917)]. The rate regulation was prompted by competitive forces that were ruining insurers and causing great loss to their unprotected policyholders. The competition was first manifested by rate cutting that occurred with or without company sanction since insurers appointed agents with the authority to bind coverage and establish the rates charged. In competing for business, agents reduced rates as the competitive situation required. The resulting rate wars often left insurers committed to providing coverage at inadequate rates. The agents, having no financial stake, were under little or no pressure to avoid writing risks of high loss potential. Compounding the problem, the agents, having the ability to move the business from one insurer to another, controlled the business causing companies to compete for the business by paying higher commissions.

Thus, historically the development of insurance rate regulation was predicated on the need (1) to collect the full rate charged in order to render the rates reliable, (2) to avoid discrimination as between policyholders, and (3) to preserve insurer solvency. Additionally much of the rate control was utilized in efforts to exercise control over commissions. "Monitoring Competition: A Means of Regulating the Property and Liability Insurance Business," a study authorized by the National Association of Insurance Commissioners, Supplement to the 1974 Proceedings of the NAIC, pp. 9-10.

Does the distribution of patronage dividends that derive from commissions (less operating expenses) result in rate discrimination? The regulation of insurance does not forbid all rate discrimination, only unfair discrimination. Couch on Insurance 2d (Rev. ed. 1984) § 30:54. Fair discrimination involves different classes paying different rates based on a legitimate difference -- different risks, different exposure factors and different expense elements. Unfair discrimination, on the other hand, is a differentiation between like individual members of a class bearing the same risk but paying different rates. In order to find that the distribution of patronage dividends (commissions less operating costs) results in unfair rate discrimination we must find that both the member of the cooperative and another purchaser of agri-related insurance who is not a member of the cooperative are members of the same class and are paying different rates in order to have each of their like risks covered.

In order to understand fair and unfair discrimination one must consider that the rate that an insurance consumer pays consists of three factors. The insurer, before filing a rate with the insurance department, must take into account his losses (the risks that he is going to cover, <u>i.e.</u> loss associated expense), his expenses (what he is going to pay to market the insurance, <u>i.e.</u> costs of operation) and his profits. A portion of his expenses or costs of operation are those paid out as commissions to insurance agents that sell the insurance. When person A who is a cooperative member pays his premium, the insurer receives the <u>net</u> premium minus the agent's commission. When person B, who is not a cooperative member, pays his premium, the insurer receives the same net premium minus the agent's commission. Both A and B pay the same amount for the insurer to cover their like risks. The difference between A and B is that A gets some of the marketing costs (commissions) back and B does not. Admittedly, there is a difference in how much A ultimately paid in premiums and how much B paid.

In order to be fair the difference must be based on a legitimate reason. Unlike insurers who set rates, however, insurance cooperatives do not. The cooperative must sell insurance at the rate set by the company or insurer. K.S.A. 1991 Supp. 40-928(h). Rates (as approved by the insurance department) necessarily include the expenses incurred by the agent and the company (insurer) in selling the insurance. These filed rates shall not be "excessive, inadequate or unfairly discriminatory." K.S.A. 1991 Supp. 40-927. It is clear that insurers are allowed to take into account mass-marketing discounts. K.S.A. 1991 Supp. 40-927. See Independent Insurance Agents and Brokers of Washington v. Herrman, 468 P.2d 1068, 1069 (Wa. 1971). (Insurer allowed to discount premium in a mass-marketing program partly because of discounted commissions).

Based on the foregoing, insurance cooperatives cannot pass savings on to insurance purchasers without violating the prohibition against unfair discrimination unless the members are considered a class based on bulk purchase of agri-insurance where everyone is treated alike. The statute prohibits rebates not because they are malum in se but because rebates can result in unfairly discriminatory rates where at the insurance agent's whim one purchaser of insurance gets a discount and another similarly situated insurance purchaser does not. The question of class (whether the members of a cooperative can be considered a class for purposes of insurance premium rating) involves a policy determination based on rate regulation and is thus a factual determination which is outside the scope of this legal opinion. In the absence of this finding, members of the cooperative and other similarly situated purchasers of insurance that aren't members remain in the same class of insured for purposes of our conclusion.

The anti-rebating statute, K.S.A. 40-941 is also intended to protect against the insolvency of the insurer; solvency, however is not affected by the application of the statute to our facts because the insurer receives the same amount of net premium from the member of the cooperative and another purchaser of insurance with like risks. In other words, the insurer receives the same net premium from the insureds regardless of how much commission is returned to any insured.

In conclusion, we opine that insurance agencies incorporated under the provisions of the cooperative society statutes found at K.S.A. 17-1501 et seq. violate the insurance department's statutory prohibition against rebates. More specifically, we opine that an insurance cooperative's distribution of patronage dividends results in unfair rate discrimination unless the cooperative members are considered a class. The determination of class involves a policy determination about rate regulation that can only be made by the insurance department after a full and fair investigation. We note that our conclusion is a narrow one to be tempered by the insurance department's policy regarding rate regulation and the evils that the statute is intended to remedy. See Van Arsdale-Osborne Brokerage Co. v. Stull, 131 Kan. 676, 679 (1930) (whether rates are lacking in uniformity and whether practices are discriminatory are matters for the regulation, control and determination of the superintendent of insurance.); Farmers Coop. v. Wichita Bd. of Trade, 121 Kan. 348, 352 (1928) (a discussion in dicta of what may or may not be a rebate by a cooperative).

Finally, you inquire whether such arrangements as previously described may also violate K.S.A. 40-241g, regarding the sharing of commissions with non-agents. The statute states:

> "An agent may divide or share commissions with other agents licensed to write the same kind or kinds of insurance: Provided, the solicitation of such business shall be subject to the provisions of K.S.A. 40-214 and 40-241f."

The statute permits the sharing of commissions with other agents licensed to sell the same kinds of insurance, provided the person or entity is authorized to transact the business of insurance (K.S.A. 40-214), and if the agent is not the insurer's agent, the agent must place such business through an agent that is the insurer's agent (K.S.A. 40-241f).

We should presume, for the sake or brevity, that "dividing" or "sharing" does not include payments made for services, leases, pursuant to employment contracts, expenditures on behalf of spouses and dependents, or other such usual and customary transfers of income. Rather, we believe the term "sharing" must be construed in the context of statutes regarding insurance agent licensing. That context, of course, is the situation where, through referrals, assistance or partnerships, licensed agents agree to divide commissions derived from premiums from the sale of insurance policies.

We do not believe this statute is applicable to those situations where the agent is an employee of a corporation, as commissions are "owed" to the employer as part of the employment relationship rather than "shared" as is contemplated by the statutory language. And, where a licensed agent passes commissions to an incorporated entity licensed as an agent under K.S.A. 1991 Supp. 40-2410, such as a cooperative corporation, such may constitute a "sharing" of commissions but is authorized by K.S.A. 40-241g.

An entity licensed as an agent, such as a cooperative, may not share or divide commissions with non-agents. Unless all those receiving patronage dividends are licensed as agents to sell the same kind of insurance, they may not "share" the commissions received by the agents from the sale of insurance. Thus consistent with our answer to your first question, the distribution of patronage dividends, that derive solely from commissions, to cooperative members not licensed as agents violates K.S.A. 40-241g.

Very truly yours,

Robert T. Stephan

ROBERT T. STEPHAN
Attorney General of Kansas

Guen Easley

Guen Easley
Assistant Attorney General

RTS:JLM:GE:jm