

# E&O Risk Management: Meeting The Challenge Of Change

## Agency/Carrier Relationships – Law of Agency



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# Agent/Carrier Relationships - Law of Agency

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## Objectives:

- *Learn the concept of the law of agency*
- *Understand how the agency relationship is established*
- *Provide a closer look at the agents duties to carriers*
- *Explore key provisions of agency agreements and underwriting guidelines that could create potential E&O exposures*

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## INTRODUCTION

Independent insurance agents are uniquely positioned to meet their customers' insurance needs with access to multiple carriers in the insurance marketplace. While this is a great strength, the relationships with carriers and customers and the duties agents owe to each can become blurred. It is critical that insurance agents understand these relationships so they can protect themselves against potential claims arising out of a failure to meet the minimum standards of care owed each of these parties.

This module explores how the law of agency affects agencies' legal and business relationships between themselves and their insurance carriers. It will look at how agency relationships are created and how to reduce potential E&O exposure from various duties and obligations. Agencies need to be vigilant in regard to meeting the duties of their authority in representing carriers as well as how that authority is perceived by others. In recent years there has been an increase in the number of claims where the insurance carrier either pursues a direct action against the agent prior to payment of a claim or pays the underlying claim and then seeks to recover the loss payment from the agent. If a carrier is financially harmed as a result of an agency's wrongful acts, the carrier may have a right of action against the agency for any damages it sustains. In past years, this may have not happened but don't bank on the agency being safe from anyone when there's money on the table.

## THE LAW OF AGENCY

"Agency" is a term that denotes a legal relationship established when one party represents another. Before an "agency" relationship is created, both parties must voluntarily agree to enter into the relationship which can be done in writing or orally. When an "agency" relationship is created the agent steps into the shoes of the principal and acts on the principal's behalf, per the terms of the agreement. In the insurance agency relationship, the agent often acts on behalf of the carrier in an insurance transaction with a third party (the insured).

## ESTABLISHING AN AGENCY RELATIONSHIP

An agent has **three types of authority to bind a principal** to any agreement made with a third party. These authorities are recognized under the law of agency for all agents, including insurance agents. They include:

1. Express Authority
2. Implied Authority
3. Apparent Authority

Anytime an agency is unsure about its authority in representing the carrier, the carrier should be contacted for clarification.

## **Section 1: Express Authority**

Under the law of agency, express authority may be oral or written. In either case, the principal expressly indicates the extent of authority they are granting to their agent to act on their behalf. This generally comes in the form of an agency agreement. These agreements are unique to each carrier and it is extremely important that agents thoroughly review each carrier agreement and understand the duties both they and the insurance company have. If an agent has any questions or concerns about the agreement, they should consult with an attorney. Agency agreements outline the duties the agent owes to the carrier in exchange for the right to market the carrier's products. Various provisions may be individually negotiated with each agency but most agency agreements address (within the contract or by attached addenda or schedule) the following:

- Types of policies that can be sold and territory where the agency is authorized to operate
- Binding authority (what types of policies the agent may bind, what limits may be bound, what types of vehicles, timeframes for forwarding submissions on coverage is bound, etc.)
- Policy issuance procedures (how/when applications must be transmitted to the carrier; training agency personnel on the use of the carriers' proprietary software is extremely important.)
- Broker of Record requirements
- Premium collection and remittance procedures (direct and agency bill)
- Commission rates, profit sharing plans or other contingencies
- Mix of business (e.g. Personal Lines and Commercial Lines, Personal Lines only, etc.)
- Indemnity obligations of the parties
- E&O insurance requirements (limits and deductible)
- Claims handling procedures
- Intellectual property matters, including the use of carrier trademarks, logos, etc.

Provisions in the agency agreement and any attached addenda should be strictly followed. Not doing so will open up the agency to potential E&O exposure from the carrier.

**Risk Management Tip:**

**Express authority may be created by either a written or oral contract. If the contract is oral, disputes may later arise regarding the scope of duties or obligations under the agreement. If at all possible, it is preferable that the terms of any agency relationship be memorialized in writing in order to avoid any potential misunderstanding with respect to the duties and obligations of either party, and to ensure that the duties and obligations which are enforced are those which were understood at the time the agency relationship was established. When in doubt, document.**

## **Section 2: Implied Authority**

Not everything that an agent is required to do in an insurance transaction is found in the agency agreement or the attached addenda. There are certain duties that an agency must perform that are implied in the performance of duties on behalf of the principal. Establishing an agency relationship through implication, where there is an express agency relationship, the courts may also extend the agent's authority to that which is implied in the relationship – i.e. that authority which is proper, usual and necessary to the exercise of the authority expressly granted. For example, if not specifically addressed in the agency agreement, implied authority may allow an agent to:

- accept payment of an insurance premium on behalf of the carrier
- issue automobile ID cards or other evidence of insurance placed with the carrier
- place a carrier's logo on signs, websites, etc. to advertise their relationship

## **Section 3: Apparent Authority**

Apparent authority occurs when a third party believes, by all appearances, that the agent has authority to transact business on behalf of the principal, even when no authority actually exists. If the carrier has created or allowed a situation to occur such that a *reasonable* third party would assume that the agent has authority, the principal may have to honor the contractual promise made by its agent.

Agents may bind the carrier to a policy with a third party even in cases where the carrier did not authorize the agent to do so. See the below example:

### **EXAMPLE OF APPARENT AUTHORITY**

*A customer routinely buys and sells commercial real estate. In the past, the customer contacted the producer when they purchased a new property. Each time they gave that producer information over the phone about the property and the producer verbally indicated that coverage was bound and followed up with a written binder. On this occasion the newly acquired property did not fit the underwriting appetite of the usual carrier and the producer said not to worry they would bind it with a surplus carrier. The producer did not have the same binding authority with the surplus lines market, but failed to mention this to the customer. Within hours of the producer's verbal confirmation that the coverage was being bound, the property suffered a loss. If the customer reasonably believed that the producer had the authority to bind coverage, the courts could hold the surplus lines carrier responsible. The carrier then would in turn make claim against the agency.*

The purpose of “apparent authority” is to protect the third party, even though it may seem unfair for the principal to be held responsible for the wrongful acts of their agents. Although the carrier may be held responsible for the agent’s actions, the carrier may decide to bring an action against the agent to recover any costs incurred.

## **GENERAL AGENT DUTIES TO CARRIERS**

Because of the Law of Agency, there are various general obligations an insurance agent may owe to an insurance carrier, which differ, depending upon the carrier, and the circumstances, as well as the law of each state. Obviously, complying with the terms of the agency agreement is a given but there are other general duties to consider:

- Fiduciary Duty
- Loyalty
- Accounting – Collection of Premium
- Disclosure of information

### **Section 1: Fiduciary Duty**

The word fiduciary comes from the Latin *fides* which means faith and *fiducia*, meaning trust. Where a high level of trust arises in connection with the insurance agent-principal relationship, it can be considered to be a fiduciary one.

Often fiduciary relationships involve the handling of money. The producer-carrier relationship falls in this category. Producers may have state laws that regulate the ability or inability to commingle funds of the agency and their carriers. These state laws may require that trust accounts be established to protect the carriers' money from potential agency creditors. Regardless of these state laws, however, the carrier must have a high degree of trust that any money received by the producer, that belongs to the carrier, will be promptly sent to the carrier at the appropriate time.

In the agency-carrier relationship the agent also acts as the carrier's front-line underwriter. The producer, as the legal representative of the carrier, has usually been granted binding authority. The carrier must place their trust in the producer to only bind coverage exposures that meet the carrier's underwriting guidelines

## **Section 2: Loyalty**

The agent has the duty of loyalty to its principal. The duty of loyalty embraces several subsidiary obligations, including:

- refraining from competing with the principal,
- taking action on behalf of or otherwise assisting the principal's competitors,
- not acquiring a material benefit from a third party in connection with actions taken through the agent's use of the agent's position,
- not using or communicating confidential information of the principal for the agent's own purposes or those of a third party.

***Challenge of Perceived Dual Agency*** - In some states, where a customer procures insurance through an agent, a dual "agency" relationship may be found to exist. As an agent this can create a question of who you are representing during the insurance buying process. Customers may not be clear about whom an independent agent represents and may assume that the agent is only representing the customer's interest. In a single insurance transaction, an independent insurance agent's representation may vary between the customer's interest and that of the carrier.

## Class Discussion

*A prospect inquires about purchasing automobile insurance. The agent discusses basic auto insurance coverage, including your state's mandatory coverage(s). The agent assists the prospect in deciding which coverages would best fit their specific needs. The prospect then inquires about the cost of the proposed auto insurance program. The agent reviews the prospect's driver information, driving record and loss history. The agent determines which of the carriers represented would find this prospect acceptable, based on their underwriting guidelines. Taking into account that carrier's application, the agent obtains any additional required information. Along with the auto quote the agent discusses some the carrier's proprietary endorsements, including the additional cost of each option. The prospect decides to purchase the auto policy, including some of the endorsement options discussed. The agent prepares a binder and collects the premium due.*

- *Based on the above scenario, when is the agent a representative of the prospect and when are they a representative of the carrier?*
- *At various stages in this insurance transaction would the agent simultaneously owe duties to both the prospect/insured and the carrier? What are those duties?*
- *Do you believe that independent insurance agents have a greater exposure to an E&O loss due to this dual "agency" exposure, when compared to other insurance marketing systems? Why or why not?*
- *What suggestions can you make to avoid a possible E&O claim arising out of this and similar situations?*

### **Section 3: Accounting – Collection of Premium**

Often times the premiums due on a new insurance transaction are collected by the producer and checks are made out by the customer to the agency, and then owed to the carrier (less any commission due). These net premiums may be held for a period of time before the agency turns them over to the carrier in accordance with the terms of the agency agreement. The majority of states require that the agency must be able to distinguish the money owed to

carriers from operating funds belonging to the agency. Individual state insurance laws dictate whether the producer may or may not commingle the premiums owed to a carrier with their own funds. The commission portion of these funds cannot be moved to the agency's operating account until the carrier has been paid (or funds returned to the customer, in the case of return premium.) In the absence of state commingling laws, there are Federal fraud statutes governing the use of other peoples' money. Regardless of whether the agency is required by state law to have separate accounts, at a minimum, agencies must be able to provide an accounting of these funds.

#### **Section 4: Disclosure of Information**

Since the agent is representing the principal, and since the agent's knowledge is imputed to the principal, it is reasonable for the principal to expect that their agent will provide them with any material information of which the agent is aware. In an insurance transaction, this material information would affect the carriers' decisions regarding acceptance or denial of the account, the extent of coverage offered based on the understanding of the exposures being transferred, and the premium charged for this transfer of risk. Below are a couple of examples commonly experienced by agents:

1. The customer asks the agent if they should turn in a claim for fear the insurer will cancel or non-renew them. As soon as the agent becomes aware of a claim, they agent has a duty to report this to the insurer regardless of the customers instructions to the contrary. Explain to the customer that failure to report a claim to the carrier on a timely basis could result in the claim later being denied for late notice. The agent could be held responsible in the form of an E&O claim.
2. The agent becomes aware of a change in the risk mid-term. An example may be an elderly widow dies and her adult children have her house on the market. The agent should report this to the carrier.

## Class Discussion

*During a routine agency audit, an agency principal has discovered that one of their new producers has provided inaccurate payroll information to one of their carriers on several accounts. The error may simply be a mistake due to the producer's inexperience or the inaccurate reporting may be intentional to reduce the premium for competitive reasons.*

- *What steps should the agency take to correct the situation?*
- *What changes should the agency make to ensure this does not occur in the future?*