

CHAPTER 2 INSURANCE COMPANIES AND DISTRIBUTION SYSTEMS

TYPES OF INSURERS

The organization to which an insured transfers the risk of loss is known as the insurance company—also known as the insurer, carrier, or principal. According to the code, any person capable of making a contract may be an insurer subject to the restrictions imposed by the code. (CIC 150) The three main providers of insurance are private commercial insurers, private noncommercial insurers, and the government. Commercial insurers are in business to make a profit. Private noncommercial insurers operate on a nonprofit basis meaning any profits are returned to the insureds by way of lowered premiums or expanded benefits. Stock and mutual insurers are the two main types of private insurers although other forms of private insurers include fraternal, reciprocals, Lloyd's, self-insurers, and reinsurers.

Stock insurers are corporations organized for the purpose of making a profit for their stockholders. A stock company raises money by selling shares of stock; the stockholders are the owners of the company; and the affairs of the company are handled by a board of directors elected by the stockholders. The type of policy issued by stock companies is called **non-participating** (non-par) as the policyholders do not share in the company's profits. When declared, dividends are paid to the stockholders.

Mutual insurers are corporations owned by the policyowners. When a person buys an insurance policy from a mutual insurer that person is becoming an owner in the company as well as a policyholder. As an owner, the policyholder votes for the board of directors. The policies issued by mutual insurers are referred to as **participating** (par) policies as any surplus is returned to the policyowner in the form of a **dividend**. Surplus can be defined as excess earned or saved by the insurance company. Earned surplus is generated by:

- Mortality----fewer people die than expected
- Interest-----company earns more interest than assumed
- Expenses---company overhead is less than projected

Dividends are regarded by the federal government as a return to the policyowners of excess premiums charged for the insurance coverage. As such, dividends paid by mutual insurers are not taxable income. However, it also should be noted that dividends cannot be guaranteed as surplus will vary from year to year.

Assessment mutual insurance companies are distinguished by the manner in which they handle premiums. In a pure assessment mutual insurance company, no premiums are paid in advance; rather each member is assessed a portion of the losses actually experienced by the company. With an advance premium assessment mutual insurer, a premium is paid at the beginning of the policy period. If the company has a surplus, it is returned to the policyholders in the form of a dividend. If the company does not have adequate funds to cover losses, policyholders may have additional assessments levied against them. Usually any additional assessment is limited either by state law or the company's own bylaws.

An incorporated mutual insurer may be converted into an incorporated stock insurer. The process whereby a mutual insurer becomes a stock insurer is known as

demutualization or conversion. (CIC 11535)

Reciprocals (interinsurance exchanges) are unincorporated associations of individuals known as subscribers who agree to insure one another. Each subscriber is allocated a separate account in which his/her premiums and interest are recorded. If any subscriber sustains a covered loss, every subscriber's account will be assessed to pay the claim. A reciprocal is managed by an attorney-in-fact who handles the business of the reciprocal and who is normally overseen by an advisory committee of subscribers.

Fraternal insurers (fraternal benefit societies or fraternal) are life insurance carriers that are social organizations that normally are involved in charitable activities. Fraternal societies usually are incorporated without capital stock. To be considered a fraternal, the organization must be nonprofit, must have a lodge system with a ritualistic form of work involved, and have an elective form of government. Fraternal society insurance provides benefits for sickness, accident and death and such insurance may be sold only to members of the society for the benefit of its members and their families.

Lloyd's of London is not an insurer but an association of individuals who are grouped into syndicates that underwrite risks. Each individual or syndicate is individually responsible for the amounts of insurance underwritten. Lloyd's provides a meeting place and clerical services to its members. Lloyd's also assures the performance of its members by means of a governing committee and enforcing its rules of eligibility. There are Lloyd's Associations in the United States. Lloyd's provides coverage for both large and unusual risks that might not be available in the normal insurance market.

Self-insurers do not purchase insurance but rather retain the risk. A self-insurer will establish its own reserves to pay for potential losses. In order to self-insure a company would need a means of predicting possible losses and have sufficient assets to cover costs. Some companies may choose to self-insure for auto insurance, health insurance, or workers compensation insurance. The advantage of this is that a company may experience savings if losses are few, but a disadvantage is losses could be higher than expected. Frequently self-insurers will have an insurance contract with an insurance company to provide insurance above a certain level of loss.

Reinsurers are insurance companies that assume part of a risk written by a primary carrier which is referred to as the ceding company. Companies will set retention limits—that is, a maximum amount that they wish to retain on an insurance contract. If a company writes a policy for an amount more than the retention limit, it will cede anything above that amount to a reinsurer. Reinsurance treaties are an arrangement among the companies in which the companies share the risk and the premium proceeds. Policyowners do not need to know about reinsurance as the originating company will issue the check for the entire claim. The reinsurers will reimburse the originating company for their share of the reinsured amount.

Reinsurance can be written on either a facultative or treaty basis. Under the treaty basis, two or more companies agree to share large risks. The contract requires the reinsurer to automatically accept risks of a certain type(s) written by the ceding company subject to the reinsurance contract specifications. In a facultative reinsurance arrangement, the reinsurer will evaluate each individual risk offered by the ceding company and make a decision to either accept or reject the offered risk.

There are a number of reasons for companies to reinsure. Some reasons are as

follows:

- Expand its capacity
- Finance its expanding volume
- Stabilize its underwriting results
- Secure catastrophic protection against large (shock) losses
- Share large risks with other companies
- Withdraw from a class or line of business or a geographical area within a short period of time

Service providers are technically not insurers but are organizations offering health care services. These providers offer prepaid plans for hospital, medical, and surgical expenses and include Blue Cross/Blue Shield organizations, health maintenance organizations (HMOs), and preferred provider organizations (PPOs). These groups do not pay monetary benefits to the plan subscribers; they pay benefits to the provider (hospital or doctor) of medical services.

GOVERNMENT AS AN INSURER

Both the federal and state governments are insurers providing a variety of insurance programs. The federal government provides insurance for catastrophic exposures as well as social insurance. These are areas that the private insurers do not wish to be involved. The social areas involve Social Security and Medicare. The federal government also offers Serviceman's Group Life Insurance and Veterans' Group Life Insurance. Other coverages offered by the federal government include War Risk Insurance, National Flood Insurance, Nuclear Energy Liability Insurance, Federal Crop Insurance, Federal Crime Insurance, and insurance on mortgage loans (FHA).

California state government is involved in insurance too. Some areas are Medi-Cal (health benefits for the needy), unemployment insurance, state disability insurance, the California Earthquake Authority, and California State Compensation Insurance Fund (workers compensation).

Government insurance differs from private insurance in that benefits are prescribed by law, the benefits are meant to be adequate to meet the needs of the public rather than being equitable, and participation is mandatory for eligible citizens. In private insurance, a person will decide what benefits he/she needs and can afford and will be issued an individual insurance contract stating such benefits.

DOMESTIC, FOREIGN, AND ALIEN INSURERS

Companies may be classified according to where the company is domiciled meaning where the company has its principal legal residence, where it was organized, or where it was incorporated.

A company is considered to be a **domestic** insurer in the state where it was organized. Therefore, any company organized under the laws of the state of California is considered to be a domestic insurer in California, whether or not it is admitted to do business in California.

A **foreign** insurer is an insurer organized under the laws of another state within the United States, whether or not it is admitted to do business. Thus, a company organized in

Arizona is considered to be a foreign insurer in California.

An **alien** insurer is an insurer organized under the laws of any jurisdiction other than a state of the United States, whether or not admitted to do business in California. For instance, a company organized in Canada is considered alien.

ADMITTED AND NONADMITTED INSURERS

A company wishing to transact business in California must be admitted or approved to do business by the Department of Insurance. An admitted insurer receives a Certificate of Authority from the insurance commissioner allowing it to transact specified classes of insurance in California. An admitted company may be domestic, foreign, or alien. All companies not holding such a certificate are considered nonadmitted insurers and are not entitled to transact business in California. Other terms meaning admitted and nonadmitted are authorized and unauthorized.

RATING SERVICES

Insurance companies are rated by several different services. Public libraries should have this information. A.M. Best specializes in analyzing the insurance industry. Insurance companies are required to submit financial statements with various government agencies and these reports are public. A.M. Best uses this information to rate the companies and charges the insurers for this service. A.M. Best rates the companies by size, type, and financial soundness including the ability to pay claims. Best rates companies from A++ (superior) to F (in liquidation).

Other rating services that rate insurance and non-insurance companies are Moody's Investors Service, Standard & Poor's Rating Group, and Duff & Phelps Credit Rating Company. These services rate companies on their ability to pay claims. Another newer rating service is Weiss Research. These companies may be contacted at the following addresses:

A.M. Best Company
Ambest Road
Oldwick, NJ 08858 (908) 439-2200

Moody's Investors Service
99 Church Street
New York, NY 10007 (212) 553-0377

Standard & Poor's Rating Group
25 Broadway
New York, NY 10004 (212) 438-2000

Duff & Phelps Credit Rating Company
55 East Monroe Street
Chicago, IL 60603 (312) 368-3198

Weiss Research, Inc.
P.O. Box 2923
West Palm Beach, FL 33402 (407) 627-3300

CLASSES OF INSURANCE WRITTEN

An insurer cannot transact any class of insurance without first being admitted. It also cannot transact any class of insurance that is not authorized by its articles of incorporation or its charter. Thus insurers may be classified by the classes of insurance they transact. Some products sold by insurers are property insurance, casualty insurance, health insurance, life insurance, and annuities.

Property insurance covers a wide variety of potential losses to both personal and business property. Property insurance covers personal possessions, buildings, inventory, stock, and many other related losses such as business income and business interruption.

Casualty insurance is primarily to cover the liability of an individual or organization that results from a negligent act or omission resulting in bodily injury or property damage to another party. Some coverages falling under this category are automobile liability, workers compensation, boiler and machinery, crime, and general liability insurance.

Health insurance, also referred to as disability insurance, includes a number of forms of insurance to protect the insured from financial loss caused by either sickness or accident. These policies cover the financial costs of treatment for sickness or accident or may provide an income for a person disabled by sickness or accident. These policies may be written on either an individual or group basis.

Life insurance is to protect the insured from dying prematurely. It provides a sum of money to a beneficiary upon the death of the insured. Beneficiaries could be a person, business, organization, or estate of the insured.

Annuities are not insurance but are a product sold by life insurance companies that pay an income benefit for the life of the annuitant. Typically benefits are paid at retirement age and are guaranteed to pay either a fixed or variable income.

CALIFORNIA INSURANCE LAW

The body of law regulating the insurance industry is the Insurance Code. The state legislature is responsible for writing the code. Therefore, any changes to the code must be made by the state legislature. A bill must be passed and presented to the governor for consideration. If the governor does not take action on the bill within a specified number of days, it automatically becomes law.

The Department of Insurance is the agency that is responsible for enforcing the code. The insurance commissioner, an elected public official who may serve two consecutive terms, heads up the Department of Insurance (DOI). The commissioner may institute rules and regulations, known as California Regulations, to carry out the code. These rules and regulations are part of the California Administrative Code. The regulations explain how the code is to be administered and they reference the section of the code to which they apply. Among the commissioner's duties are:

- The licensing and supervision of insurance producers;
- The licensing and supervision of domestic insurers;
- Deciding which insurance companies are admitted to do business;
- Deciding the kinds of policies and insurance contracts that may be sold;

Determining the amount of reserves that an insurer must maintain;
Regulating the type of investments an insurer may make;
Investigate consumer complaints against insurers and producers;
Submit an annual report to the governor regarding the state of the insurance business in the state of California.

It should be noted that the interpretation of policy provisions is not a primary objective of insurance regulation.

One of the major concerns of the commissioner is the solvency of any company transacting business in the state. There are regulations governing the organization and ownership of a new company, capital and surplus requirements, reserves, investments, and annual reports.

As insurers collect a great deal of premium to cover potential losses, it is of utmost importance to guard against insolvency. The commissioner must conduct a financial examination of every admitted insurer at least every five years. Such examinations entail a complete review of financial affairs and general business records of the insurer. The commissioner may do an examination of an insurer any time if needed to protect the public interest. Another type of investigation that the commissioner may do is a market conduct examination. This would check the insurer's accuracy and organization of forms and records as well as advertising materials, claims procedures, and policyowner relations.

It is important to guard against misleading advertising. The NAIC developed an Advertising Code to help guard against such advertising. This code specifies words and phrases that cannot be used in advertising materials as well as requiring the full disclosure for policy renewal, cancellation, and termination provisions.

The NAIC also developed the Unfair Trade Practices Act which gives commissioners the authority to investigate insurers and producers and, if warranted, issue cease and desist orders and level penalties. Commissioners also have the power to obtain a court injunction to restrain insurance companies from using any unfair or deceptive methods.

LIFE AND DISABILITY INSURANCE RECORDS: (CIC 10508-10508.5)

Insurers which transact life and/or disability insurance in California must maintain certain records pertaining to the activities of its agent which the commissioner may inspect or examine. The records must be delivered to the commissioner within 30 days following a written demand for them. The records must be maintained for at least 5 years after the policy is delivered, or at least 5 years after the application is received if no policy was issued. The records may be originals, facsimiles, microfilm or electronic data processing printouts, and must include the names, dates, amounts and policy numbers involved, and:

The original application for each policy sold in California.

Premiums received for each policy issued.

Records showing all policies sold by every agent for each of the preceding five years.

The commissions paid for each insurance policy issued and to whom they were paid.

Records which identify any agent other than the one appearing on the application, who handled any part of the insurance transaction for which there was no compensation.

Correspondence or written proposals sent to or received from a prospect, applicant, or

insured by the insurer.

Correspondence or written proposals sent to or received from a policyholder about the election of nonforfeiture values or termination or non-renewal of a policy.

A written comparison of policy benefits, limitations, exclusions, or costs of existing accident, sickness, or long-term care insurance with proposed coverage.

A copy of the outline of coverage or disclosure statement required by law or regulation.

A copy of any correspondence between the policyholder and the agent or insurer.

Copies of correspondence between anyone acting on behalf of a policyholder or prospect and the agent or insurer.

It shall be the obligation of each life-only agent and/or accident and health agent and any other agent and insurer to preserve and maintain all applicable records defined in this section in his/her possession, in addition to those records transmitted to the insurer, at his/her principal place of business for a minimum of five years. The records shall be kept in an orderly manner so that the information therein is readily available, and shall be open to inspection or examination by the commissioner at all times.

FINANCIAL STATEMENTS AND INVESTMENTS

All insurers transacting in California must submit a report to the commissioner stating their condition as of the preceding December 31st. Insurers must file an audited financial report done by an independent CPA on or before June 30 for the previous year. Information included in the annual report will be capital, capital stock and assets, liabilities, income, expenditures, balance sheet of premium note accounts, balance sheet of all business, total amount of insurance written during the year on new policies, total amount of insurance written during the year in California, and total amount of premiums received on business in California. All securities and properties must be valued as required by the code.

An insurance company must have assets equal to the sum of its liabilities and the minimum level of capital and surplus required for admission. The amount that an insurer's assets exceed its liabilities is known as surplus. Policy dividends are paid from an insurance company's surplus. Insurers may invest assets as long as they conform to state law. Some investments insurers may make with their assets are as follows:

- County, municipal, and school district obligations
- Federal and state obligations
- Real estate mortgages
- County water district bonds
- Obligations of the U.S. Postal Service
- Collateral trust bonds and notes

INSURER SOLVENCY

Even with all of the regulatory controls, an insurer may experience financial difficulty. If this were to happen, the DOI has the authority to step in and assume control over the company's funds and management. If an insurer were to become impaired (suffering financial problems) or insolvent (cannot meet financial obligations), the DOI will try to rehabilitate the insurer. To rehabilitate or conserve means to restore the insurer to

financial soundness. Conservation proceedings may occur do to: (1) the insurer's continued transactions may be harmful to its policyholders, creditors, or the general public; (2) the insurer has not corrected any deficiency in capital or reserves as ordered by the commissioner; (3) the insurer has attempted to transfer a significant amount of assets or to merge without the DOI's approval; and (4) the last financial examination shows the insurer to be insolvent. If conservation is not possible, liquidation proceedings will be initiated. The commissioner will apply to the court for an order to liquidate and settle the business of the insurer.

GUARANTEE ASSOCIATIONS

California has two guarantee associations—the California Life and Health Insurance Guarantee Association to which all life and health insurers must belong and the California Insurance Guarantee Association to which property and casualty insurers must belong with a few exceptions. The authority to transact insurance in the state is contingent upon these insurers being a member of the appropriate association.

California Life and Health Insurance Guarantee Association (CIC 1067-1067.18)

The purpose of the California Life and Health Insurance Guarantee Association is to protect policyowners, insureds, and beneficiaries against loss when a member company is financially impaired and cannot pay its contractual obligations under life insurance, health insurance, and annuity contracts. To provide this protection, an association of insurers is created to pay benefits and members of the association are subject to assessment to provide funds. (CIC 1067.01) All admitted life and health insurers are obligated to join this association. The association is managed by a board of directors and shall consist of not less than 9 nor more than 13 member insurers. The members of the board shall be selected by member insurers and approved by the commissioner. (CIC 1067.06)

The protection of the association extends to persons who are owners of policies or certificate holders and who are residents of this state. The association also provides coverage to nonresidents if all of the following conditions are met: (1) the insurer that issued the policy is domiciled in this state; (2) the insurer never held a license or Certificate of Authority in the state in which the person resides; (3) the state in which the person resides has an association similar to the association that exists in California; and (4) the person is not eligible for coverage by the association in the state of residence. (CIC 1067.02(a)(1))

If an impaired member is a domestic company, the association may do one of the following after receiving the commissioner's approval:

Guarantee, assume or reinsure the impaired company's policies or contracts.

Provide monies, pledges, notes, guarantees or other means to ensure payment of an impaired insurer's obligations.

Loan money to the impaired company.

To provide funds to run the association, the association may assess the member insurers for the necessary amounts. If an insurer does not pay the assessment when due, it is subject to having its certificate of authority suspended or revoked by the commissioner.

The contracts covered by the guarantee association are direct, non-group life,

health, annuity, and supplemental policies or contracts and certificates under direct group life, health, annuity, and supplemental policies and contracts. (CIC 1067.02(b)(1)
Coverage is not provided for:

Any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policyholder.

Any policy or contract of reinsurance, unless assumption certificates have been issued.

Any portion of a policy or contract to the extent that the rate of interest on which it is based exceeds statutory limitations.

Guaranteed investment contracts, guaranteed interest contracts, funding agreements, deposit administration contracts, and all other unallocated annuity contracts.

Any plan or program of an employer, association, or similar entity to provide life, health, or annuity benefits to its employees or members to the extent that the plan or program is self-funded or uninsured.

Any portion of a policy or contract to the extent that it provides dividends or experience rating credits, or provides that any fees or allowances be paid to any person, including the policyholder, in connection with the service to or administration of the policy or contract.

Any policy or contract issued in this state by a member insurer at a time when it was not licensed or did not have a Certificate of Authority to issue the policy or contract in the state.

Any annuity issued by a charitable organization that is duly qualified as such under applicable provisions of the Internal Revenue Code, and that is not engaged in the business of insurance as its primary business. (CIC 1067.02(b)(2)

The benefits that the association may be liable to pay for any one life may not exceed the lesser of:

80% of contractual obligations (subject to certain limitations);

\$250,000 in life insurance death benefits, but no more than \$100,000 in net cash surrender value for life insurance;

\$100,000 in the present value of annuity benefits, including net cash surrender values.

There is a maximum aggregate amount of \$250,000 with respect to any one individual for which the association will assume liability.

With respect to any one owner of multiple policies of individual life insurance, whether the policy owner is an individual, firm, corporation, or other legal entity, and whether the persons insured are officers, employees, or other persons in whose lives the policy owner has an insurable interest, the maximum benefit is \$5,000,000 regardless of the number of the policies and contracts held by the owner.

The health insurance benefits for which the association may become liable shall in no event exceed the lesser of the following:

The contractual obligations for which the insurer is liable or for which the insurer would have been liable if it were not impaired or insolvent.

With respect to any one individual, regardless of the number of contracts, \$200,000 in health insurance benefits. This amount shall increase or decrease based upon changes in the health care cost component of the consumer price index from January 1, 1991 to the date on which the insurer becomes insolvent.

TAXATION OF LIFE INSURERS

Life insurance companies are taxed on investment income and underwriting profit.

However, a great deal of premium for life insurance is a deposit of policyowner funds and is not earned income of the insurer. The investment income for stock companies is taxed in the year it is earned and 50% of underwriting profit is taxed during the year earned while the other 50% is taxed when paid to the stockholders. Mutual insurers pay out their underwriting income as dividends to policyholders and, therefore, this tax regulation generally does not apply.

The state of California taxes insurers on premiums received by doing business in California. Every insurer transacting in California must file a premium tax return each year with the DOI.

California will impose a retaliatory tax on foreign and alien insurers if another state or country imposes taxes and fees on California insurers that are in excess of the taxes and fees imposed upon similar insurers by the state of California.

COMPANY OPERATING DIVISIONS

Within a company's organization are several managerial departments. Marketing and sales, actuarial, underwriting, claims, and administrative are such departments.

Marketing and sales is responsible for marketing the insurance product which includes advertising, promotion, and training.

Actuarial departments are responsible for the company's financial soundness. Actuaries analyze the data collected by the company. They are responsible for developing mortality and morbidity tables, preparing annual reports, and determining dividends as well as setting premiums and making sure the premiums are adequate.

Underwriting departments set standards for the selection of acceptable risks. Underwriters will evaluate the information collected on an insurance applicant and assess factors as age, occupation, insurable interest, and degree of exposure to risk. Based on this information, they will decide to accept or reject an application. If acceptable, underwriters will decide whether the applicant is a preferred risk, standard risk, or substandard risk.

Claims departments receive claims, evaluate them, and settle them appropriately. Before a life insurance claim can be paid, a death certificate would have to be received by the insurance company.

Administrative departments will handle the issuing of policies, policy changes, billings, and other policy services.

PRODUCERS

Producers are licensees who sell insurance products including agents, brokers, and solicitors.

An **agent** is appointed by an insurance company to sell its products and represents the insurer, not the insured. A **life-only agent** is authorized to transact insurance coverage on human lives, including benefits of endowment and annuities, as well as benefits in the event of death or dismemberment by accident and benefits for disability income. An **accident and health agent** is authorized to transact insurance coverage for sickness, bodily injury, or accidental death and may include benefits for disability income

as well as 24- hour coverage. (CIC1626) An **insurance agent** is a person authorized, by and on behalf an insurer, to transact all classes of insurance other than life insurance. (CIC 31)

A **broker** is a person who is not appointed by an insurer, but rather for compensation acts on behalf of a client to transact insurance other than life insurance. (CIC 33)

A **solicitor** is a natural person employed by an insurance agent or broker to aid in transacting insurance, other than life insurance. (CIC 1624) Solicitors work in support of the sales efforts of the agent/broker who employs them.

In California there is no such thing as a life broker or health broker or a life solicitor or health solicitor.

DISTRIBUTIONS SYSTEMS

Marketing is the method used by insurance companies to sell their products. Companies market their products by either using agents to sell their products or selling directly to the public through mass marketing.

An agent may be either an independent agent or an exclusive agent. An **independent agent** is a person who has an agency agreement with more than one insurance company. In such cases, the insurer does not train or finance the agent, but develops a relationship with a licensed agent to sell its products. The agent is responsible for financing his own agency. Such an arrangement gives the agent the ownership of the business he/she writes. Accordingly, the agent may place the insurance business with any company he/she represents and may transfer the insurance from one company to another if he/she deems it in the best interest of the client.

An **exclusive or captive agent** is a person who enters an agreement to represent one insurance company or a group of insurers that have a common ownership. Frequently an exclusive agent will be paid a training allowance for a period of time while being trained and getting established. An exclusive agent is compensated by commissions and renewal commissions after the first year. The insurer retains the ownership of the business and should the agent leave the company to work for another insurer, the book of business is given to another agent to service. Technically, exclusive agents are regarded as independent contractors paid commissions for the business written. The company provides a number of services for the exclusive agent. These services may include clerical support, preparing contracts, sending of renewal notices, and handling of claims.

The insurance code makes no distinction between an independent agent and an exclusive agent. The license issued gives both types of agents the same authority to transact insurance. The agency contract between the agent and the insurer determines whether the individual is either independent or exclusive.

A **general agent or managing general agent** has a written contract with one or more admitted insurance companies. These contracts must be on file with the Commissioner. A managing general agent means any person, firm, association, partnership, or corporation who negotiates and binds ceding reinsurance contracts on behalf of an insurer or manages all or part of the insurance business of an insurer (including the management of a separate division, department or underwriting office) and acts as an agent for that insurer whether known as an MGA, manager, or other similar

term, who, with or without the authority, either separately or together with affiliates, produces, directly or indirectly, and underwrites an amount of gross direct written premium equal to or more than 5 percent of the policyholder surplus as reported in the insurer's last annual statement and either: (1) adjusts or pays claims in excess of an amount determined by the commissioner, or (2) negotiates reinsurance of behalf of the insurer. (CIC 769.81c)

A managing general agent (MGA) hires, trains, and supervises other agents. A MGA has the right to appoint as well as terminate local agents, the ability to bind coverage (only in the property and casualty field), collect premiums from producers and remit them to the insurers, and provide administrative support.

Under a **branch office system**, each sales office is managed by an agency manager who is an employee of the company and is usually compensated on a salary and bonus basis with the bonus relating to premium volume production of all the agents working in the branch office. Agency managers also are responsible for hiring and training agents.

It should be noted that a broker (a form of fire and casualty license) is the representative of the insured and does the insurance shopping for the client. Brokers do not have appointments with insurers, but place business with admitted companies that will accept the offer made by the broker. A person may hold both an agent and broker license. Such a licensee is acting as an agent when placing business with a company with whom he/she has an appointment. When transacting insurance with a company with whom the licensee is not appointed, the licensee is acting in the capacity of a broker.

OTHER DISTRIBUTION SYSTEMS

Although the majority of insurance is sold by agents, a large amount is provided to the public through mass marketing. This method is called a non-agency building system as agents do not market the products at the outset. Mass marketing is a cost effective method of distribution and may achieve efficient market penetration. Some of these methods are discussed below.

Direct response marketing is achieved by advertising through the mail, in newspapers and magazines, on television and radio and the internet. If someone is interested in the advertised products, he/she will respond to the company for more information.

Franchise marketing provides insurance coverage to employees of small firms and to members of associations. This is a way in which employers who do not meet the definition of a "true group" may offer insurance to their employees. There is no master contract issued to the employer; rather each individual will receive a contract and needs to prove insurability. However, it allows for a lower premium than for insurance purchased on an individual basis. The premiums either may be paid entirely by the employer (non-contributory policy) or paid partially by the employee (contributory policy).

Non-insurance sponsors include credit card companies and banks. They target a select group of individuals who have a history of making periodic payments. Frequently, the sponsor is responsible for the billing, adding it to the billing statement or deducting it from the checking account.

Vending machine sales involve the use of coin-operated machines found in airports. The coverage is travel accident insurance and covers the purchaser during the duration of a single trip. A large amount of coverage is available for a low premium.

THE AGENCY RELATIONSHIP

An agency can be defined as a situation where one party (the agent) has the authority to act for another (the principal) in dealing with third parties. In other words, an agent acts on behalf of an insurance company when dealing with applicants and clients. Consequently, when a licensee is empowered to act as an agent for a principal, the agent legally is assumed to be the principal in matters covered by the grant of agency. If a client discloses important information to an agent, it is assumed to be the knowledge of the principal. If a client makes a payment to an agent, it is considered payment to the principal. Any contracts made by an agent are contracts of the principal.

A presumption of agency could exist if a principal were to supply a person with signs and evidence of authority. Thus, if an insurance company were to give an unlicensed person its forms and literature, it would appear that this person represented the insurer. The insurer could then be bound by the actions of this person whether or not the person had been given such authority.

The authority of the agent is one of three types. It is **express authority**, **implied authority**, or **apparent authority**. Although it might appear that only those acts for which an agent actually is authorized could bind the insurer, in truth, the agent's authority is quite broad and the insurer may be held responsible for the unauthorized acts of its representative.

Express authority is the actual authority a principal grants the agent. This authority is spelled out in the agent's written contract with the principal. Such authority includes the right of the agent to solicit applications for insurance on behalf of the principal. If an agent does not operate within the bounds of this agreement, it is possible that the agent may place himself/herself in a position of personal liability.

Implied authority is not spelled out in writing, but it is the authority the agent is assumed to have in order to carry out the intent of the written contract. Not every single act that the agent has the right to perform can be placed in the written contract. For instance, the contract might not state that an agent may collect a premium at the time of application for a life insurance policy. However, this is a normal and desirable business practice and it is assumed the agent does possess this right.

Apparent authority is a situation in which the agent's conduct causes a client or prospective insured to believe that the agent has the authority to sell an insurance policy and contract on behalf of the principal. If an agent were to continue to use insurance company documents, such as its application forms, rate manual, literature, and emblems on the door, the client reasonably may believe that the agent continues to represent the principal. It may be that the principal has withdrawn the agent's action notice of appointment and the agent no longer represents the insurer.

FIDUCIARY RESPONSIBILITY

A **fiduciary** is a person in a position of financial trust. Because a fiduciary is in this position of trust and confidence, the law demands a higher standard of conduct than it

does of others in their business pursuits. Some people that are regarded as fiduciaries include attorneys, bank trust officers, CPAs, and insurance agents. Agents owe a fiduciary responsibility to applicants, clients, and insurers that they represent. Acting as a fiduciary requires the agent to:

- have a good business reputation
- be honest and trustworthy
- be fit and proper
- act in good faith
- be qualified to perform insurance business (hold necessary licenses)
- have knowledge of state laws and regulations and abide by them

If an agent receives premium payments in the course of transacting insurance business, these funds are held in a fiduciary capacity. The agent must submit the premiums to the insurer promptly. Failing to submit these payments to the insurer or putting these funds in his/her own account is violating one's fiduciary responsibility. The mixing of personal funds with the insurer's funds is **commingling**. To use another's funds for personal use is theft and the agent could be prosecuted for theft.

RESPONSIBILITIES OF PARTIES IN INSURANCE

As an agent represents the insurer, he/she has many responsibilities to the insurer. The responsibilities of the agent to the insurance company include:

- a fiduciary duty to the insurer
- conducting himself/herself with the degree of care of a prudent person
- remitting all money received to the principal
- disclosing all pertinent information to the insurer, particularly with regard to underwriting and risk selection
- making sure the application is accurately completed
- delivering the policy and collecting any premium due
- keeping informed and obeying all insurance laws and regulations

Although the agent does not technically represent the applicant/client, there are a number of responsibilities involved. These include:

- soliciting applications for insurance and collecting premium
- explaining the requirements for issuance of a policy
- acting in the best interest of the applicant/client
- assessing the individual's need of insurance and making sure the proper coverage is provided
- making sure the client understands the coverage including any riders or endorsements; use language the client will understand.
- providing timely service to applicants/clients
- stay in touch and conduct periodic reviews of the client's needs
- protect the confidential relationship with the client

The insurer also has responsibilities to the agent. These include:

- permitting the agent to act in accordance with the terms of the agent's contract
- recognizing all the provisions of the contract

paying the agent compensation as outlined in the contract, reimbursing for all proper expenditures, and indemnifying for all damages suffered without fault on the part of the agent but occurring on account of the agency relationship keeping the agent informed of all new products and marketing methods

POLICY RETENTION

Retention of policies is beneficial to all parties. An agent by maintaining contact with clients can make sure the insurance coverage is appropriate and can make additional sales and provide the needed protection for the client. This benefits the agent and the insurer financially. It benefits the client as he/she has the appropriate insurance coverage.

ERRORS AND OMISSIONS INSURANCE

Insurance agents can be held legally liable for the consequences of any errors or omissions they have made while conducting their business. For this reason, insurance agents need to carry professional liability insurance which is called errors and omissions insurance (E&O). E&O insurance provides coverage for an act, error, or omission the agent makes in rendering or failing to render professional services in the conduct of the his/her insurance profession.

E&O insurance does not offer protection from intentional acts, criminal acts, liability assumed under contract, or bodily and personal injury. Apart from this, E&O policies have few exclusions. Although there is no standard E&O policy, there are certain characteristics that they do have. These policies normally have high deductibles—usually \$1,000 or more. Coverage normally is written on a limit per claim basis, but aggregate limits for all claims during the policy period are available. Limits of coverage commonly range from \$100,000 to several million dollars.

The insurance company providing E&O coverage will provide a defense for the agent even if the charge is frivolous.