A PRIMER ON THE SURPLUS LINES "DILIGENT EFFORT" DUTY

The First in a Series

The "Diligent Effort" Duty: A Critical Surplus Lines Market Gatekeeper

"Freedom from rate and form regulation" is said to be the principal distinction between the excess or surplus lines market and the admitted market. One of the critical legal "gatekeeper" mechanisms for maintaining that distinction is the "diligent effort" duty that Texas law applies in any surplus transaction (except "Exempt Commercial Purchaser" transactions). Unless surplus lines agents and carriers, and even retail P&C agents, understand the importance of the "diligent effort" duty, and act accordingly, that "freedom" is put at risk.

Recent complaints to the Texas Department of Insurance alleging that surplus lines agents failed to perform the "diligent effort" duty have raised questions about whether surplus lines agency personnel fully understand what is required of them in order to satisfy that legal duty. As a result, the TSLA has begun an education initiative to focus the attention of its members and their staffs on the "diligent effort" duty in order to help assure that our industry maintains its historically high compliance rate in the performance of that legal duty.

This publication is the first of a series of articles addressing the "diligent effort" duty. This first article in the series focuses on the legal duty itself, in the context of the public policy that produced it. Every two weeks, another series article will address such matters as whose duty it is, what effort is sufficiently "diligent," and how performance of the duty may be proved.

What is the "Diligent Effort" Duty?

As in virtually every state, Texas public policy, as reflected in its laws, administrative rules and judicial interpretations, generally favors the admitted market over the surplus or excess lines market. This is because it is thought that the Texas-licensed and more closely-regulated segment of the property and casualty insurance marketplace provides better protections to consumers in terms of government-approved policy forms and rates, as well as the Guaranty Fund safety-net. Nevertheless, Texas public policy also acknowledges the necessity for the flexibility, innovation and additional resources provided by the less-closely-regulated surplus lines segment of the marketplace. The freedom that the surplus lines segment of the industry enjoys from form and rate regulation and the financial burdens of Guaranty Fund participation is offset by the fact that Texas law effectively prohibits surplus lines insurance from competing directly with admitted insurance. It is oversimplified, but think of it this way: "If the coverage sought is obtainable from an admitted carrier, a surplus lines policy for that coverage cannot be issued."

Complaints about the failure to perform the "diligent effort" duty may arise from disappointed retail agents who think they've inappropriately lost an account to the surplus lines market, or even from admitted carriers during significant market disruptions. Moreover, plaintiff attorneys often assert a "diligent effort" failure in claims disputes in an attempt to transform an eligible surplus lines policy into mere "unauthorized insurance," and thereby strip an agent or carrier

defendant of any of its legal defenses in the dispute.

Section 981.004(a) of the Texas Insurance Code states that surplus lines insurance can only be procured from an eligible surplus lines insurer if:

"the *full* amount of *required* insurance ***cannot be obtained, after a diligent effort,*** from an insurer *authorized* to write *and actually writing* that *kind and class* of insurance in this state." [emphasis added]

Put differently, the Code requires that a "diligent effort" be made to determine that the "full" amount of the "kind and class" of insurance "required" by the insurance consumer cannot be obtained from a Texas-licensed insurer that is "actually writing" it before any surplus lines policy is placed.

The meaning of the law's critical words italicized above, such as "full,"
"required," "actually writing," and "kind and class" introduce additional complexity in understanding the statute's requirements, but the focus of this series of articles is the key phrases **"cannot be obtained, after a diligent effort."**

It is important to note how the two phrases interact. If the phrase "after a diligent effort" were not included in the statute, it would charge a retail or surplus lines agent with the impossible task of determining that the required insurance "cannot be obtained" from any one of all of the admitted carriers doing business in the State before procuring a surplus lines policy for the consumer. But the "cannot be obtained" phrase is modified by the "after a diligent effort phrase." Therefore, taken together, the two phrases and can only mean that something less than an effort to make inquiry of 100% of the admitted market is required. The question then becomes, "what kind of effort is required of the agent to determine whether the required insurance is 'obtainable' from the admitted market?" The statute, of course, answers: "A 'diligent' effort."

The next two articles in this series will address the questions of "Whose duty is it to make that 'diligent effort?" and "What is a sufficiently 'diligent' effort?"

The contents of this article are intended for the general information of TSLA members and their agency staff members. It is not intended to constitute legal advice. Members are urged to consult their own attorneys for guidance and advice on matters relating to this important subject.