A PRIMER ON THE SURPLUS LINES "DILIGENT EFFORT" DUTY

The Second in a Series

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

Two weeks ago, you received the first in a series of articles addressing the "diligent effort" duty that applies in every surplus lines transaction (except "Exempt Commercial Purchaser" transactions). The first article focused on the legal duty itself, in the context of the public policy that produced it. This second article focuses on the question of who is to perform that statutory duty in a surplus lines transaction.

The previous article highlighted **Section 981.004(a), Texas Insurance Code,** which 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]

The article provided an oversimplified "rule-of-thumb" guideline for understanding of the effect of the statute: "If the coverage sought is obtainable from an admitted carrier, a surplus lines policy for that coverage cannot be issued." It also explained that the statutory phrases "cannot be obtained, after a diligent effort" together mean that something less than an effort to make inquiry of 100% of the admitted market is required to satisfy the duty. It also explained that the extent of the "effort" to determine "obtainability" that is required is that of "diligence."

Before turning to the question of how much "diligence" is required in the effort to determine "obtainability," this series article focuses on the question of who, in the typical surplus lines transaction, is required to make that "diligent effort."

Whose Duty is it?

You'll notice that the statute quoted above does not come right out and say specifically who is responsible for performing the "diligent effort." However, the Texas Department of Insurance and some Texas appellate courts, looking at the entirety of the surplus lines law (Chapter 981, Texas Insurance Code), have interpreted the duty as being the responsibility of the surplus lines agent, and not that of the retail or producing agent. The Texas Supreme Court noted in *Lexington v. Strayhorn,* a 2006 premium tax case, "The surplus lines statute relies heavily on *licensed surplus lines agents*. *It is the agent who determines and certifies* that coverage is unavailable from authorized insurers, thus justifying surplus lines placement." [Emphasis added]

Of course, as a practical matter, the surplus lines agent is often in no position to be able to make that determination. By virtue of their surplus lines agent and underlying P&C general agent licenses alone, many surplus lines agencies simply do not themselves have access admitted markets and thus cannot independently make the required determination. To access the admitted market, surplus lines agencies must also hold appointments with admitted carriers and many do not.

Due to the many negative considerations for retail agents inherent in a surplus lines placement, including commission

sharing, some loss of control regarding the procurement, and incomplete knowledge of coverages provided, it is often assumed by surplus lines agents that the *mere fact that the retail agent is seeking surplus lines coverage* is sufficient proof that the coverage is not obtainable by the retail agent from the admitted market, and thus the "diligent effort" duty has been satisfied. But that assumption is not correct.

It is not correct because, since a 1967 statutory change, it appears that the surplus lines agent has held this statutory responsibility. And, the surplus lines agent cannot contractually or otherwise shift this legal burden to the retail agent because rules adopted by the TDI expressly prohibit it, stating that "no surplus lines agent or agency shall shift, transfer, delegate, or assign his or her responsibility to a person or persons not licensed as a surplus lines agent. (28 TAC Sec. 15.6(d), Texas Administrative Code).

So where are we if, as a practical matter, only the retail agent has sufficient access to the admitted market to determine whether the required insurance is obtainable from that source, but the law appears to make the surplus lines agent legally responsible for such a determination? Perhaps the best way to summarize the effect of the law today is that, in most cases, the retail agent has the *practical* responsibility for actually *making* the determination, while the surplus lines agent has the *legal* responsibility for *assuring* that the determination has, in fact, been made.

Earlier in this article, it was stated that "it appears" that the surplus lines agent has held the "diligent effort" duty since a 1967 statutory change, primarily due to the interpretations of Section 981.004(a), Texas Insurance Code, by the TDI and some appellate courts. However, whether that is the correct interpretation is not yet settled law, because the Texas Supreme Court has not yet spoken directly on the question.

The *Lexington v. Strayhorn* case mentioned above suggests that the Court has not yet addressed the question head on. Although the Court observed that, "It is the [surplus lines] agent who determines and certifies that coverage is unavailable from authorized insurers," it also at least partially recognized the practicalities involved in a surplus lines transaction as they affect surplus lines *carriers*, if *not agents*, saying:

"We recognize that whether a surplus lines policy complies with the Code is largely out of a surplus carrier's hands. Surplus lines policies are initiated by insureds or local agents when they cannot procure coverage from Texas-licensed insurers. Agents are responsible for getting their own license, as well as properly placing, reporting, and keeping records of all transactions…As a result, *surplus lines carriers often will not know whether insurance was available from a licensed insurer*…." [Emphasis added]

Considering how surplus lines transactions actually function, the Court recognized in that surplus lines *insurers* "often will not know whether insurance was available from a licensed insurer…." As discussed above, surplus lines *agents* are often, as a matter of fact, similarly situated, and also "often will not know whether insurance was available from a licensed insurer." Therefore, at some future date, the Court might apply the same reasoning to interpret Code Section 981.004(a) as requiring something less than full or sole responsibility for the "diligent effort" duty.

But for now, the wisest approach is for surplus lines agents to conduct their business on the assumption that the

ultimate responsibility for satisfying the "diligent effort" duty belongs to them.

The next article in this series will address the question of, "What degree of effort is sufficiently 'diligent'?"

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.