

## **A PRIMER ON THE SURPLUS LINES “DILIGENT EFFORT” DUTY**

### **The Fourth in a Series of Articles**

#### **The “Diligent Effort” Duty: A Critical Surplus Lines Market Gatekeeper**

By now, you’ve received three of a series of articles addressing the “diligent effort” duty that applies in most surplus lines transactions. The first article focused on the legal duty itself, in the context of the public policy that produced it; the second article, on the question of who is to perform that statutory duty in a surplus lines transaction; and the third, on what degree of “effort” is sufficiently “diligent.”

This series of articles discussed key issues in dealing with **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]

Briefly, the first 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.”* The second article noted although Section 981.004(a) doesn’t specifically assign the “diligent effort” to either the retail or surplus lines agent, it offered another rule-of-thumb guideline: *“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 third article addressed the degree of “effort” that is sufficiently “diligent” to satisfy the requirement and explained that Texas courts appear to consider the matter to be a “fact question” to be evaluated on the basis of the particular circumstances of each individual case. Still another “rule-of-thumb” guideline was offered: “Be aware of the duty and that the ultimate responsibility is that of the surplus lines agent; be consistent in making the effort; make the effort in a manner appropriate to the circumstances of the transaction; and systematically communicate in various ways with the retail agent regarding the marketing efforts undertaken.

#### **Documenting “Diligent Effort”**

Even when the surplus lines agent has sufficiently performed his or her “diligent effort,” the problem in responding to a complaint to TDI or to litigation alleging the failure to satisfy the “diligent effort” duty is often that of simply providing evidence of that fact. The answer, according to the Stamping Office’s former Executive Director Phil Ballinger: “document;

document; document!” Documenting the performance of the duty in a consistent and appropriate manner is the best way to prevent, or succeed in, such an unpleasant circumstance.

There are a couple of other points from the previous articles in that are important to remember. First, a surplus lines agent cannot simply assume from the mere fact that a retail agent has requested surplus lines coverage that the retail agent actually has determined that he or she cannot obtain that coverage from an authorized insurer. The surplus lines agent must take on the ultimate responsibility and, depending on the circumstances, *perform* or *confirm* the performance of that duty with the retail agent, and then *document* that fact in the surplus lines agent’s files.

Second, since 28 TAC Sec. 15.6(d), Texas Administrative Code, states 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," the ultimate responsibility for the performance of the “diligent effort” probably cannot be so transferred to the retail agent requesting surplus lines coverage, even by written agreement.

Third, because good communications between the requesting retail agent and the surplus lines agent is the most critical element of the performance of the “diligent effort” duty in the typical surplus lines transaction, the performance of the “diligent effort” duty is best viewed as a *collaborative effort* between the two classes of agents. That’s because holding a surplus lines agent license does not automatically give that agent any access to the admitted market that would permit him or her to determine whether the required insurance is obtainable from that market. Usually, only the retail agent is in a position to access the admitted market, and that access is limited to those admitted insurers with which he or she holds appointments. Therefore, in the typical surplus lines transaction the retail agent is the source of the necessary information upon which the ultimate determination regarding admitted market “obtainability” may be made.

Finally, a failure to satisfy the “diligent effort” duty may have very serious financial implications for the placing surplus lines agent. It may subject the agent to administrative sanctions by TDI under Code Chapter 82, including administrative penalties, restitution, or suspension or cancellation of the agent’s license. Moreover, Code Section 981.005 provides, in effect, that if a violation of Chapter 981 (presumably including a “diligent effort” failure) is found to be a “material and *intentional* violation,” the only “party” to the insurance contract that may enforce his or her rights under it is the *insured*. In addition, Code Section 981.004(a) states that an eligible surplus lines insurer may provide surplus lines insurance “*only if*” it satisfies certain requirements, including the “diligent effort” duty. Thus, a “diligent effort” failure could result in the surplus lines policy being rendered “unauthorized insurance.” Under either Code Section 981.005 or 981.004(a), the insurer (clearly a “party” to the insurance contract) potentially faces the loss of all of its defenses in a claim on the policy, including the benefit of any policy exclusions, definitions, conditions, etc. Ultimately, if it suffered a loss under either Code provision, the surplus lines insurer would appear to have an indemnity claim against the surplus

lines agent. In such circumstances, the surplus lines agent would effectively become the de facto insurer ultimately responsible for the amount of any claim paid by the surplus lines insurer.

One key to the successful performance of both the “not obtainable” determination and its documentation is perform of those two functions consistently through a systematic approach. Developing simple, clear, written management procedures governing those functions which are appropriate to the needs of each individual agency and its particular way of doing business, and then following those procedures, has three major benefits: 1) it should reduce the likelihood that a “diligent effort” failure could occur; 2) it would establish a “course of conduct” that also reduces the possibility that any such failure that does occur would be found to be an “intentional” violation under Code Section 981.005, and the described adverse consequences that may follow; and 3) having such procedures in place may itself provide at least some evidence that the agency is being “diligent” in its efforts to perform the duty in all of its surplus lines transactions.

The critical role played by the retail agent in the “diligent effort” process has been highlighted throughout this series of articles, and this article earlier suggested that the relationship between the surplus lines agent and the retail agent should be one that is “collaborative.” The third article in this series urged the surplus lines agent to “communicate” with the retail agents with whom he or she does business regarding their collaborative effort to satisfy the “diligent effort” duty. At best, that communication should be on-going, two-way and primarily in writing (for purposes of “documentation”).

The first priority in developing such a collaborative and mutually-productive relationship with regard to the “diligent effort” duty is for the surplus lines agent to develop a formal policy and then an on-going communications program with the retail agents with whom he or she does business. After all, the retail agent is both the surplus lines agent’s “customer” and necessary “partner” in performing the “diligent effort” duty. The goal of the communications program is to inform and frequently remind both agents of the “diligent effort” duty, to assure that each agent understands his or her respective responsibilities and expectations, and to help them perform their respective functions accordingly, in an efficient and effective manner. The surplus lines agent’s communications policy should be one that includes “diligent effort” information as a component of its overall marketing program to retail agents, and may include such information in such marketing efforts as the agent’s free continuing education programs for retailers, newsletters, bulletins or other written communications with retailers. Again, both the policy itself and the various “diligent effort” communications and information are best documented in writing.

Here are two additional observations worth noting:

- Because the TDI focuses its regulatory resources on that type of insurance that affects the most Texans – homeowner’s and auto – requests from retailers relating to those coverages should serve as a “red flag” for special care in the performance of the “diligent

effort” duty. For example, a surplus lines agent can reduce his or her risk of failure by making sure that its surplus lines homeowner’s rates are higher than one standard deviation from the average rates for homeowner’s posted on the TDI’s website, thus permitting the surplus lines market to write only accounts that do not fit the standard market, due to the higher premium rate.

- Some surplus lines agents utilize the common sense approach of seeking written documentation of the retail agent’s inability to obtain the required coverage from an admitted insurer only if the facts of the case require it, such as when the surplus lines agent does not already know that the class or group of business involved is not available from the admitted market or when that agent has already done his or her own “diligent effort” regarding the required requested.

The “diligent effort” duty of the surplus lines agent is a critical component of almost every surplus lines transaction. It must be appropriately performed and documented. The failure to do so puts the surplus lines agent at risk from serious disciplinary action and financial loss. From a larger prospective, a significant increase in the frequency of proven failure to perform the “diligent effort” duty by the industry as a whole could well encourage the imposition of costly new transactional burdens on surplus lines insurers and agents by regulators or legislators and put the industry’s “freedom of rate and form” at serious risk.

The next and final article will summarize the highlights from the series.