

AGENCY FORMATION AND ENVIRONMENT (83-A1)

EO 1a. **AGENCY** exists when one party (the **principal**) delegates responsibility to another party (the **agent**) who acts under the principal's control in dealing with a third party.

Agency is a fiduciary relationship that holds both the principal and his agent to the duty of good faith and fair dealing.

AN AGENT OWES HIS PRINCIPAL THE DUTIES OF

1. **loyalty**--The agent may neither represent both parties to the contract nor receive any remuneration without his principal's approval.
He may not aid his principal's competitors, reveal trade secrets, or compete against his principal. **But**, the agent's duty of loyalty does **not** require him to protect a dishonest principal.
The agency agreement might contain a **noncompete agreement** (promise neither to compete with the principal **nor** to become employed by a competitor).
2. **obedience**--The agent must obey his principal's lawful instructions even if they don't advance either's interest.
3. **accounting**--The agent must keep the principal's property and money separate from the agent's property and money.
4. **reasonable care.**
5. **disclosure of all material facts.**

EO 1b. A PRINCIPAL'S SIX REMEDIES FOR HIS AGENT'S WRONGDOING:

1. sue for breach of the agency contract,
2. bring a tort claim,
3. terminate the agency contract and sue for damages,
4. ask a court to prevent the agent from continuing the wrongdoing,
5. sue for recovery of the property, **and/or**
4. demand an official accounting of the benefits the agent received.

EO 1c. THE PRINCIPAL OWES HIS AGENT THE FOUR DUTIES OF

1. **honoring the agency contract**--providing the chance to work for the agreed time period,
2. **compensation at the agreed rate,**
3. **reimbursement for necessarily incurred expenses, and**
4. **indemnification for judgments and defense costs arising from agency performance**--The agent may **not** recover **if** he knew performance or the method of performance was tortious or illegal.

EO 1d. AN AGENT'S REMEDIES FOR BREACH include suits for

1. compensation for services up to the date of breach,
2. damages, including the agent's compensation if the contract had been completed, **or**
3. damages arising from the breach.

An agent may exercise a lien against the principal's property.

EO 1f. THE THREE MAJOR INSURANCE MARKETING SYSTEMS:

1. **Direct writer marketing system**--The producer is employed by the insurer and places business exclusively with the insurer.
2. **Independent agency and brokerage marketing system**--The producer is a part of the **American Agency System** (ie, he represents several insurers as if he were their manufacturers' representative).
3. **Exclusive agency marketing system**--The producer is obligated to place business with only one insurer, but operates an independent office and is **not** the insurer's employee.

EO 2. **INSURANCE AGENTS VS BROKERS**--A **producer** (seller of insurance and related services) may be an **agent** (represents an insurer) or a **broker** (represents an insured).

When a person represents two parties in a transaction (known as **dual agency**), he owes the duty of fair dealing to both parties.

A producer in a dual agency represents the insurer when binding insurance, keeping records, collecting premiums, issuing policies, and/or canceling policies.

The producer in a dual agency represents the client when suggesting and selecting coverages and insurers. Courts may consider the broker an agent for the insurer in order to promote fairness and to avoid penalizing the client given the nature of the circumstances. **Example:** Most states consider the broker the legal agent of the insurer for the purposes of premium collection.

AN AGENT'S AUTHORITY MAY BE

1. **express authority**--based on the principal's specific instructions.
A general agent has authority to conduct all 'usual and customary' acts.
A special agent is restricted to only the acts 'essential' to the situation.
2. **implied authority**--based on the principal's prior conduct or on trade custom **or** as necessary to carry out express authority.
3. **apparent authority (aka agency by estoppel)**--based on a third party's reasonable belief that the agent has authority due to appearances created by the principal.
Apparent authority usually arises when either the specific agent has less authority than is usually granted **or** the principal operates his business differently from most of his competitors. A third party who knows, or should guess, of a limitation on the agent's authority yet enters into the agreement without verifying the agent's authority does so at his own risk.

EO 3. **AGENCY BY RATIFICATION** is created if the principal retroactively authorizes an act or agreement beyond the original scope of the agency. **Here are the five requirements of ratification:**

1. The agent must have indicated he was acting for his principal.
2. The principal must ratify the **entire** agreement,
3. **before** the third party withdraws.
4. The principal must know all the material facts of the transaction.
5. The transaction must be legal.

EO 4. **THREE IMPLICATIONS OF AGENCY:**

1. **Agent as independent contractor--An independent contractor** is a person hired by another but who retains the right to control his own work.
Although an employer is liable for the actions of its employees, a principal is **not** liable for the actions of an independent contractor.
Insurance agency contracts usually state that the agency is an independent contractor.
2. **Undisclosed principal**--In some agency relationships, the agent does **not** reveal the agency relationship or the principal's identity to third parties.
If the third party later learns of the existence of the principal, the third party can sue **either** the principal **or** the agent for breach of contract.
The agent remains liable **if** an undisclosed principal refuses to pay the third party's loss.
3. **Nonexistent principal**--If an agent implies the existence of a principal that does **not** exist, the agent is liable for the nonexistent principal's failure to fulfill contract terms.
The agent may **also** be prosecuted for fraud.

EO 5. **PRODUCER LICENSING REQUIREMENTS**--Producers must be licensed in each state in which they do business. State laws prohibit insurers from giving authority to unlicensed agents. State regulations state the circumstances under which a license may be revoked.

EO 6. **SEVEN MAJOR SECTIONS OF AN INSURANCE AGENCY CONTRACT:**

1. **Term of agreement/termination provision**--states the term of the contract and the grounds for termination.
The run-off provision lets the insurer renew current clients for a specified period of time following the agency's termination.
2. **Rehabilitation clause**--gives the agency a specified time to avoid termination resulting from failure to meet the insurer's requirements.
3. **Ownership of expirations provision**--indicates whether the agent (or the insurer) has the right to control sales of insurance to the agent's (or insurer's) clients.
4. **Payment provisions--define the procedures for collecting and remitting premium:**
 - a. **Agency billing (aka statement billing)**--The insurer sends the agency a bill for its share of the premiums due each month.
After the agency verifies the amounts, the agent remits the total to the insurer.
The agency retains the gross premium *minus* the net premium as its commission.
 - b. **Direct billing** is sent from the insurer to its policyholders.
The agency receives a monthly commission check from the insurer.
5. **Indemnification clause**--specifies when the insurer will indemnify and defend the agency for claims arising from the insurer's error.
6. **Contract amendments**--alter the terms of the contract.
Some agency contracts let the insurer amend the contract without the agency's consent, often with ninety days' advance notice.
Agencies prefer provisions allowing amendment only by mutual consent and/or 180 days' notice.
7. **Miscellaneous provisions--**
The arbitration clause provides that disputes between the insurer and the agency will be resolved by arbitration. Each party appoints an arbitrator. The two arbitrators appoint a third. The decision of any two arbitrators is binding on both the parties.
Another miscellaneous provision defines the procedures to follow upon sale of the agency regarding notice to the insurer and the grace period *if* the insurer does *not* appoint the new owner as an agent.

COMMISSIONS RATES are scheduled by policy type or line of business.

The commission schedule may be either part of the agency contract or a separate agreement.

CONTINGENT COMMISSION AGREEMENTS--Insurers often provide profit sharing payments to agencies that exceed certain profitability and volume thresholds.

An agency's profit sharing payment might be based on

1. profitability of the agency's business based on the **trade loss ratio** (ratio of incurred losses to earned premiums),
2. minimum volume thresholds,
3. percentage growth in premiums, *and/or*
4. average long-term profitability of its book of business.

EO 7. **LEGAL FORMS OF INSURANCE AGENCIES:**

1. **Sole proprietorship** (business owned by a single individual)--
Advantages: minimal legal formality to start the business, ability to 'be your own boss', *and* increased entrepreneurial opportunity.
Disadvantages: limited duration, unlimited personal liability, *and* difficulty raising capital.
2. **Partnership** (voluntary association of two or more people operated for a profit)--
Advantages: easy to form, shared management responsibilities, *and* easier to raise capital.
Disadvantages: limited duration *and* unlimited personal liability.

3. **Corporation** (separate legal entity)--
Advantages: unlimited duration, limited personal liability, easier capital acquisition, **and** readily transferable ownership.
Disadvantages: taxation of earnings at **both** the corporate level **and** the individual level, complicated formation, **and** ongoing documentation requirements.
4. **S corporation** (small business corporation with 100 or fewer stockholders)--
Advantages: unlimited duration, limited personal liability, easier capital acquisition, readily transferable ownership, **and** pass-through income taxation similar to that of a sole proprietorship or partnership.
Disadvantages: relatively complicated formation **and** ongoing documentation requirements.
5. **Limited liability company (LLC)** (business structure created under state law)--
Advantages: taxed as individuals without a separate tax on the business entity, limited personal liability, **and** flexibility sharing economic benefits.
Disadvantages: requires a minimum of two members.

EO 8. **OPERATING AFFILIATIONS OF AGENCIES:**

1. **Independent agency networks**--consist of independent agents or agencies who combine and pool administrative resources.
Networks are different from mergers because
 - a. the network is a separate entity owned by the network agencies **and**
 - b. the agencies retain separate ownership of their own policy expirations.
2. **Insurance company affiliations**--are formed by insurers to market specialized products.
Examples: the Fireman's Fund's Famex and CIGNA's Marketdyne.
3. **Specialty marketing groups**--are independently owned organizations with programs underwritten by more than one insurer.
Examples: ARM (Associated Risk Managers) and MMI (Marketing Management, Incorporated).
4. **General purpose groups**--provide their members with educational opportunities, preferential treatment from insurers, management assistance, and exchange of marketing and management ideas.
5. **Common identity groups**--are marketing organizations that provide individual members with national image, resources, and account servicing.

TEN ADVANTAGES OF AGENCY NETWORKS:

1. special treatment of 'significant' producers by insurers,
2. increased negotiating power,
3. greater incentives and finances to automate,
4. increased economy and efficiency for insurers,
5. expertise in more specialty areas,
6. alternative to merger or sale,
7. delegation of administrative and management responsibilities,
8. economies in physical space, staffing, and insurer relations,
9. pooled advertising costs, **and**
10. serves as a 'trial' merger.

FIVE DISADVANTAGES OF AGENCY NETWORKS:

1. difficulty sharing decision-making responsibility,
2. no financial privacy,
3. no direct, personal control of agency cash flow,
4. no control over administrative decisions, **and**
5. slow formation.

EO 9. **HOW TO EVALUATE AN INDEPENDENT AGENCY NETWORK:**

1. Draft a questionnaire profiling potential network members--including business mix, premium and commission income, number of accounts, percentage of direct-billed business, automation capabilities, staffing, plans for perpetuation, areas of expertise and interest, agency goals, loss ratios, *and* degree of commitment to the network.
2. Inventory potential members' insurers and products.
3. Decide whether to consolidate offices or to establish the network separate from member offices.
4. Appoint start-up committees that address issues such as resources, finance, management, automation, and personnel.
5. Decide how to structure the network's Board of Directors.

Unasked EO. **THE EVALUATION PROCESS FOR AGENCY AFFILIATIONS**--Producers considering affiliation should interview those offering the organization as well as both satisfied and dissatisfied participants.

The producer should consider six factors:

1. **services provided**--with emphasis on those services currently provided, rather than those planned for the future;
2. **personnel**--the qualifications of those who actually provide the services;
3. **exclusivity**--any limits on the number of local participants and the reputations of other participants;
4. **fees**--whether the franchise or association services are worth the price paid;
5. **contract**--reviewed by your attorney, *and*
6. **financial stability**--the existence and commitment of resources.