



## **2015 Insurance Symposium**

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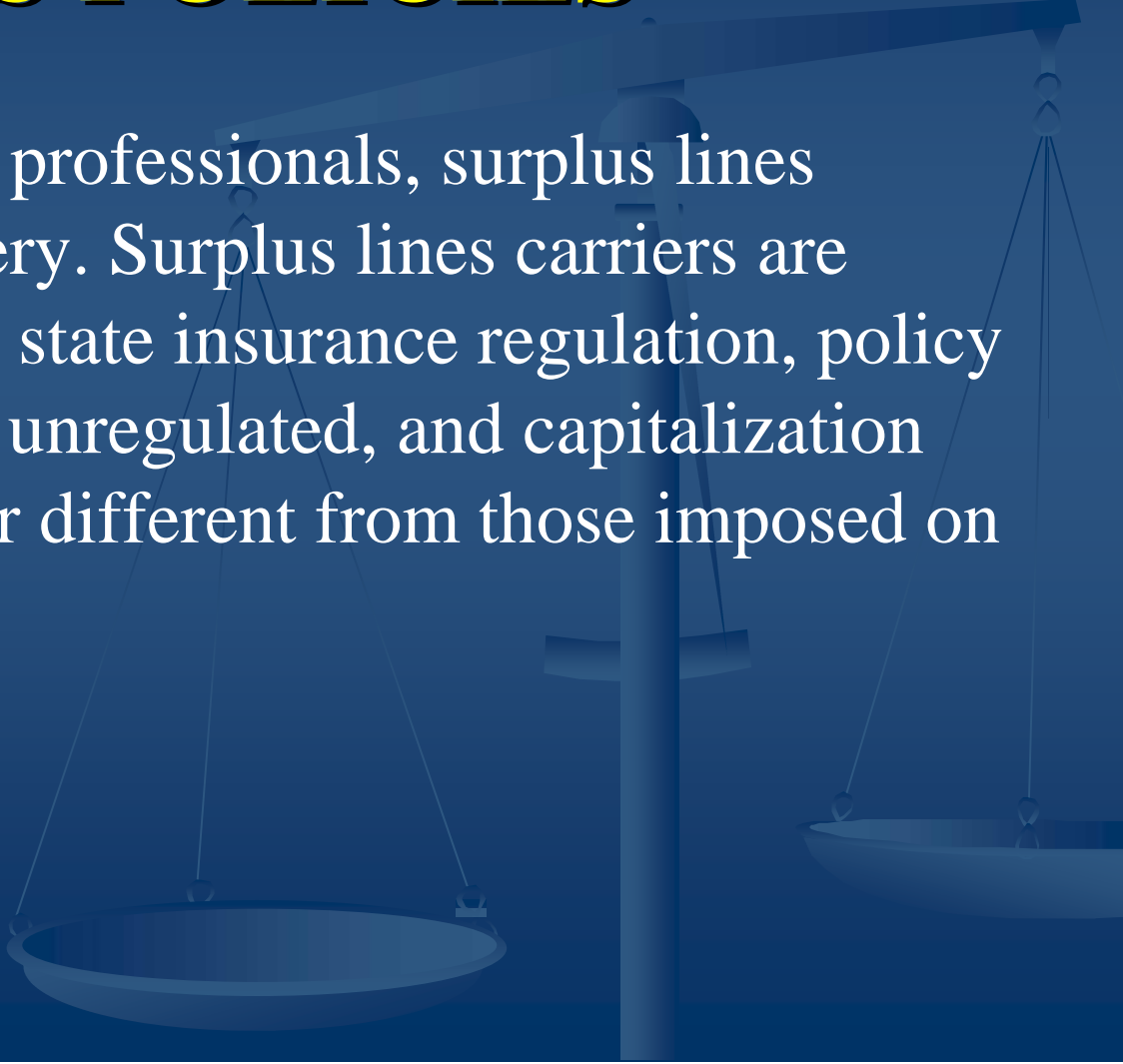
# LITIGATION ISSUES IN SURPLUS LINES COVERAGE ACTIONS



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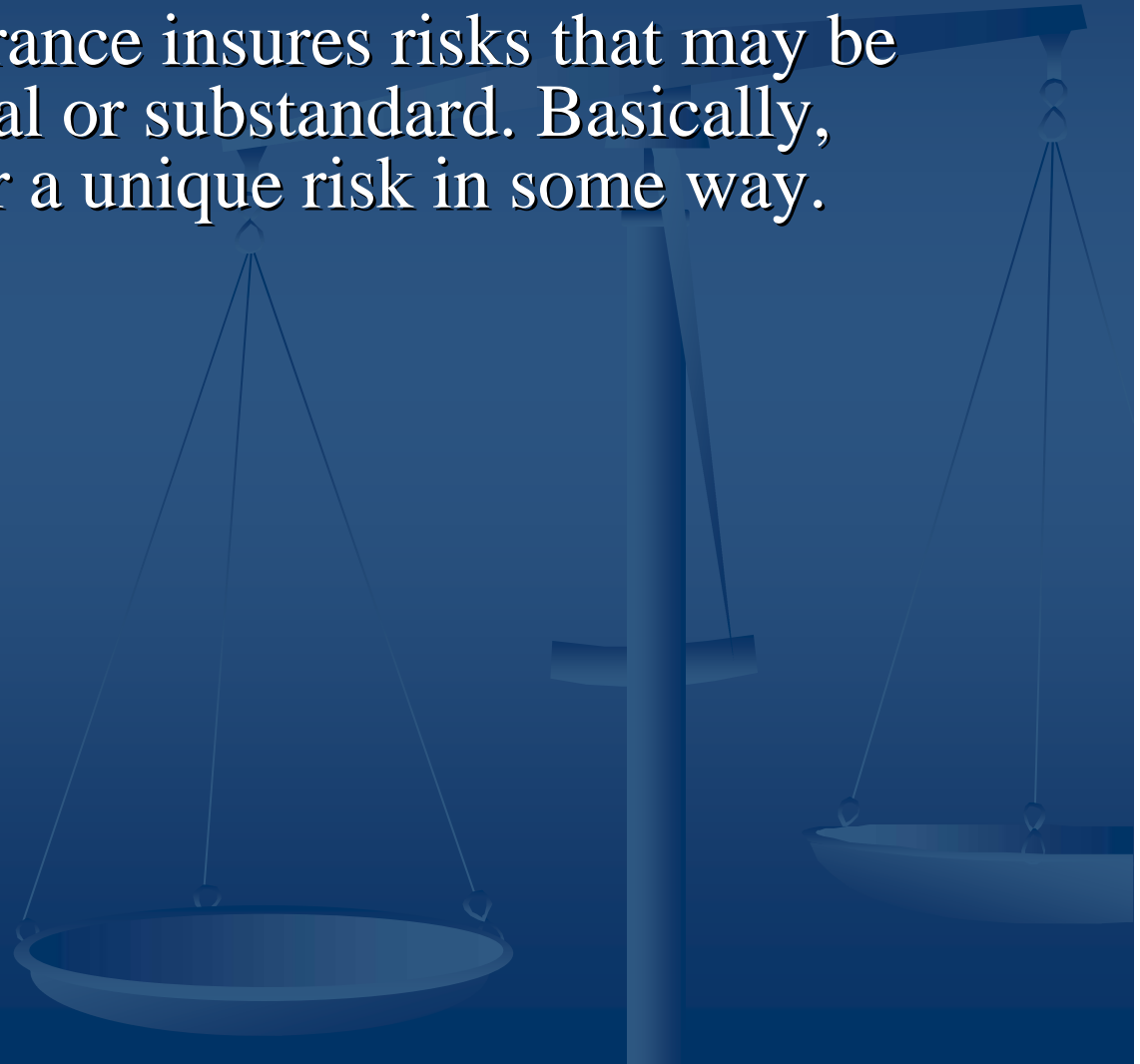
# THE MYSTERY OF SURPLUS LINES POLICIES

To many insurance professionals, surplus lines policies are a mystery. Surplus lines carriers are relatively free from state insurance regulation, policy forms and rates are unregulated, and capitalization requirements are far different from those imposed on admitted carriers.



# What is surplus lines insurance?

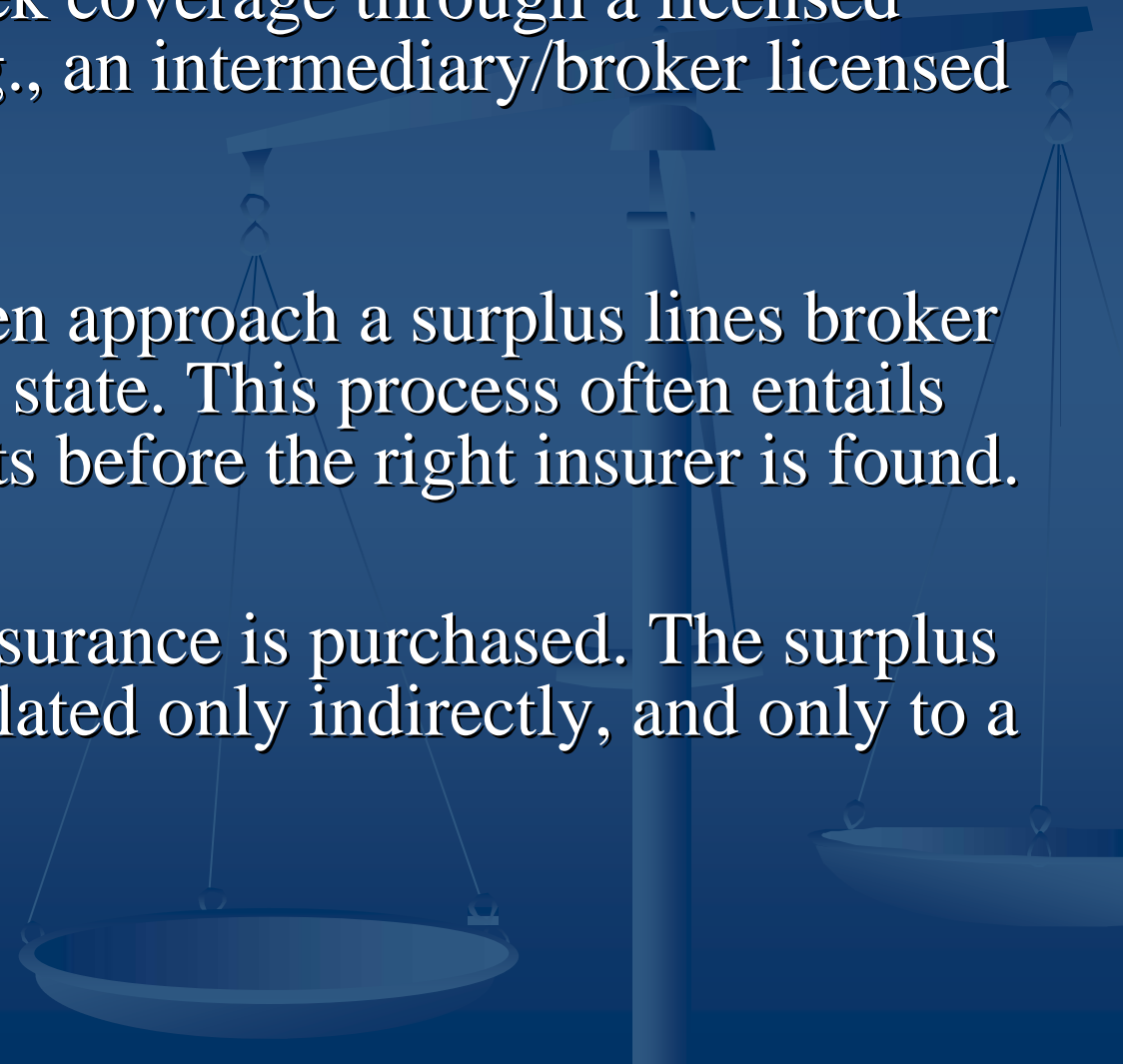
- Surplus lines insurance insures risks that may be too big, too unusual or substandard. Basically, surplus lines cover a unique risk in some way.



- <http://www.nbc.com/saturday-night-live/video/red-flag/n13192>



# How is it purchased?

- A business must seek coverage through a licensed insurance agent (e.g., an intermediary/broker licensed by the state).
  - The broker must then approach a surplus lines broker also licensed by the state. This process often entails several such contacts before the right insurer is found.
  - The surplus lines insurance is purchased. The surplus lines insurer is regulated only indirectly, and only to a limited extent.
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# How is it regulated? Part 1

- Since the surplus lines insurer is not licensed in your state, they are not regulated by the Department of Insurance in the same way licensed insurers are regulated (they *are* regulated in the state or country where they are domiciled or located).
- In many states, including Texas, the licensed agent/broker obtaining surplus lines insurance is required to make sure that the insurer meets certain financial standards before buying a policy from them.

# How is it regulated? Part 2

- In Texas, the focal point of the surplus lines market occurs through the licensing and regulation of surplus lines agents.
- A “surplus lines agent” means an agent licensed to procure an insurance contract from a surplus lines insurer. Tex. Ins. Code. § 981.002(8).
- The Department of Insurance (“TDI”) carefully regulates licensed agents.



# What is required in Texas?

1. TDI licenses and regulates surplus lines agents. A licensed surplus lines agent may place business only with eligible surplus lines carriers.
2. TDI determines whether or not the non-admitted carrier is eligible to do business in Texas.
3. TDI maintains a list of eligible surplus lines carriers.
4. TDI keeps some track of the financial condition of surplus lines carriers.
5. Insurance contracts entered into by eligible surplus lines carriers must be “stamped” so as to clearly indicate the surplus line nature of the policy.

# Issue One: Are You Licensed?

- If surplus lines insurance is not placed through a licensed Texas surplus lines agent, the transaction does not qualify as the lawful transaction of surplus lines insurance.

- *Strayhorn v. Lexington Ins. Co.*, 128 S.W.3d 772 (Tex. App.—Austin 2004), *aff'd*, 209 S.W.3d 83 (Tex. 2006); *Lexington Ins. Co. v. Strayhorn*, 209 S.W.3d 83 (Tex. 2006).
- *Yorkshire Ins. Co., Ltd. v. Seger*, 279 S.W.3d 755 (Tex. App.—Amarillo 2007, pet. denied).

## *Strayhorn v. Lexington Ins. Co.*

- In *Strayhorn*, eligible surplus lines Insurers brought an action against Comptroller of Public Accounts and Attorney General for a declaratory judgment and refund of unauthorized insurance premium tax.
- Because the Insurers did not produce evidence that the policies were issued through licensed agents, they were liable for the tax.

# Strayhorn Ctd.: Key facts for insurers

- Texas-licensed surplus lines agents must file a copy of every policy placed through them with the stamping office within sixty days of a policy's effective or issue date. Tex. Ins. Code § 981.105.
- The policies in *Strayhorn* were not reported to the surplus lines stamping office by licensed Texas surplus lines agents.
- The burden is on the Insurers to prove they fall under one of the exemptions to the unauthorized insurance premium tax: that the premiums they collected were for (1) lawfully procured surplus lines insurance on which a tax had been paid or (2) independently procured insurance on which a tax had been paid.

# *Lexington Ins. Co. v. Strayhorn*

- *Strayhorn* was affirmed by the Texas Supreme Court.
- “We recognize that whether a surplus lines policy complies with the Code is largely out of a surplus carrier's hands...Agents are responsible for getting their own licenses, as well as properly placing, reporting, and keeping records of all transactions. Agents are responsible for paying the premium tax after collecting it from insureds.

As a result, surplus lines carriers often will not know whether insurance was available from a licensed insurer, whether the policy was properly reported, whether proper records were kept, or whether the premium tax was paid.”

# Steep Consequences:

- The Texas Supreme Court also warned in *Lexington* that the consequences of treating a surplus lines policy as unauthorized insurance can be severe.
  1. Anyone who assists in procuring unauthorized insurance is individually liable for unpaid claims under the policy.
  2. Violations of the surplus lines statute may result in administrative penalties up to \$25,000, but violations of the unauthorized insurance statute are punishable by felony conviction and fines up to \$10,000 *per day*.
  3. An unauthorized insurer cannot enforce its policies, while an eligible surplus line carrier may do so except in cases of a material and intentional Code violations.
  4. Unauthorized insurers cannot even defend themselves in Texas without filing a bond, while eligible surplus lines insurers can.



# *Yorkshire Ins. Co., Ltd. v. Seger*

- *Yorkshire* was a Stowers action by an insured for negligent failure to settle within policy limits.
- Genuine issues of material fact existed as to whether a comprehensive general liability (CGL) policy was procured through a licensed surplus lines agent.
- This precluded summary judgment on the issue of whether surplus lines insurers could enforce policy defenses pursuant to surplus lines exception to general statutory restriction on unauthorized insurers.

# Yorkshire Ctd.: Key facts for insurers

- LARSI (surplus lines agent) was holding a license as a managing general agency.
- Section 981.220 restricts a surplus lines agent whose license is granted to it as a managing general agent, that is not also licensed under Article 21.14 of the Insurance Code (now Chapter 4051) to business that originates through a licensed general property and casualty agent.
- Thus, for LARSI's surplus lines agent license to meet the exception found in section 101.201(b), the transaction must have been directed through an agent that was a licensed general property and casualty agent. § 981.220.



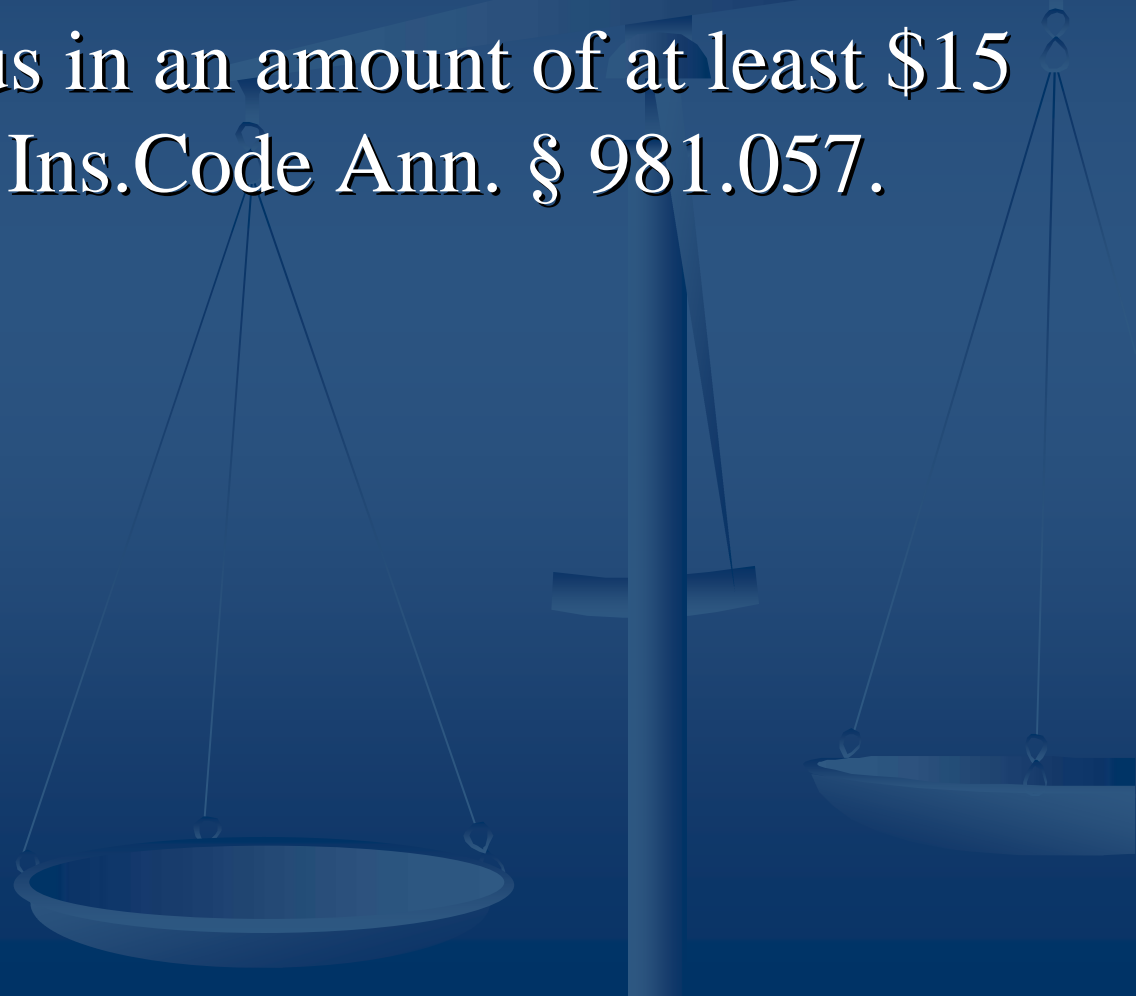
## Issue Two: Are You Eligible?

- Insurers do not have to be licensed in Texas, but instead be “eligible” to issue surplus lines insurance in the state.
- An insurer is an “eligible” surplus lines insurer if it meets certain minimum capital and surplus requirements outlined in the insurance code.  
*See Tex. Ins.Code Ann. §§ 981.002.*

■ *Mid-Am. Indem. Ins. Co. v. King*, 22 S.W.3d 321 (Tex. 1995).

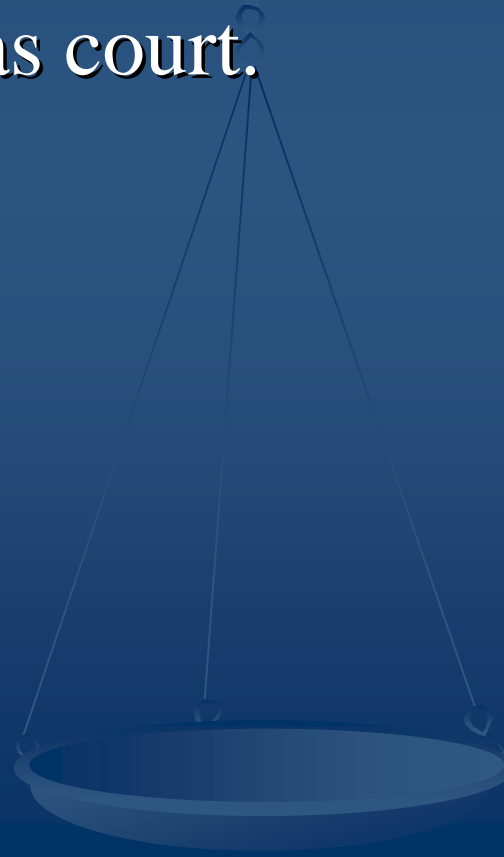
# Capital Requirements:

- An eligible surplus lines insurer must maintain capital and surplus in an amount of at least \$15 million. *See* Tex. Ins.Code Ann. § 981.057.



## *Mid-Am. Indem. Ins. Co. v. King*

- Unauthorized insurer that lost its eligibility as surplus lines insurer had to post bond to file pleadings in Texas court.



# Other interesting questions...

- Can an insured successfully sue an agent who places coverage **through an intermediary** with a surplus lines insurer?
- Probably not.
- Several cases have held that an insurer/agent who places coverage with a surplus lines insurer through an intermediary is not an agent of the insurer.
  - *Carolina Casualty Ins. Co. v. Miss Deanna's Child Care-Med Net, L.L.C.*, 869 So.2d 1169, 2003 WL 21674195, \*1-\*2 (Ala.Civ.App. July 18, 2003); *Accord, Hallas v. Boehmke and Dobosz, Inc.*, 239 Conn. 658, 686 A.2d 491, 493 (Conn.1997).

## More...

- Can an insured successfully **sue the intermediary** who places coverage with a surplus lines insurer?
- Probably not.
- Several cases have held that a **retail agent** was neither an actual nor an apparent agent of a surplus lines insurer.
  - *American Equity Insurance Co. v. Lignetics, Inc.*, 284 F. Supp. 2d 399, 409-410 (N.D.W. Va. 2003). *See also Kaselitz Family Ltd. P'ship v. Hudson & MUMA, Inc.*, No. 244382, 2004 WL 316176 (Mich. Ct. App. Feb. 19, 2004) (unpublished) (similarly finding no evidence of any "special" or "fiduciary" relationship between a retail agent and a surplus lines insurer with respect to fire insurance placed for the insured on its properties).

# Answering everything you want to know....

- Can an insured successfully sue an eligible surplus lines carrier upon theories it cannot use against an admitted carrier?
- Answer: No.
- If the surplus lines insurer is eligible, then it does not have to be licensed in your state. Thus, for purposes of legal claims and defenses, the eligible surplus lines carrier will be treated as an admitted carrier.

# About surplus lines.

- If a surplus lines carrier or surplus lines agent fails to obtain the statutorily required stamp, can this fact be used against the carrier?
- Yes: no stamp, no eligibility. *Strayhorn v. Lexington*: policies were not reported to the surplus lines stamping office by licensed Texas surplus lines agents.
- What about the agent?
- Likely yes. Example: In *Deep South Towing, Inc. v. Sedgwick of New Orleans*, 876 So. 2d 102 (La. Ct. App. 2004), *rev'd on other grounds*, 887 So. 2d 458 (La. 2004), a Louisiana appellate court clarified that surplus lines brokers are required to place surplus lines insurance with insurers who appear on the "white list."

# Sources:

## Articles:

- Martin, Brian S. "*A Short Walk Through Surplus Lines*," Insurance Journal, West Magazine. July 22, 2002. <http://www.insurancejournal.com/magazines/legalbeat/2002/07/22/21759.htm>
- Thomas B. Orlando, Rick H. Cavaliere, Leslie J. Davis, Michael J. Steinlage, & Deborah Russo, *Recent Developments in Excess Insurance, Surplus Lines Insurance, and Reinsurance Law*, 40 Tort Trial & Ins. Prac. L.J. 397, 413 (2005).

## Case List:

- *Strayhorn v. Lexington Ins. Co.*, 128 S.W.3d 772 (Tex. App.—Austin 2004), *aff'd*, 209 S.W.3d 83 (Tex. 2006).
- *Lexington Ins. Co. v. Strayhorn*, 209 S.W.3d 83 (Tex. 2006).
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- *Kaselitz Family Ltd. P'ship v. Hudson & MUMA, Inc.*, No. 244382, 2004 WL 316176 (Mich. Ct. App. Feb. 19, 2004).
- *Deep South Towing, Inc. v. Sedgwick of New Orleans*, 876 So. 2d 102 (La. Ct. App. 2004), *rev'd on other grounds*, 887 So. 2d 458 (La. 2004).



# Thank you for attending!

July 13 Cookoff in Frisco, TX

