

STATE OF CALIFORNIA
Department of Insurance
100 Van Ness Avenue
San Francisco, California 94102

Bulletin No. 81-2

May 19, 1981

To: All admitted insurers, insurance producers and other interested persons

Subject: Fiduciary Obligations of Insurance Producers with Respect to Premiums and Return Premiums - California Insurance Code Sections 1734, 1734.5

The purpose of this bulletin is to inform licensed insurance producers of their fiduciary obligations with respect to handling premiums and return premiums, and to bring attention to recent changes in the Insurance Code relating to maintenance of fiduciary funds.

1. Fiduciary Obligation

California Insurance Code §1733, which provides that premiums and return premiums are received by an insurance producer in a fiduciary capacity, remains unchanged and diversion of premiums or return premiums to the insurance producers' personal account constitutes theft. The phrase, "in a fiduciary capacity," means that the insurance producer holds premiums and return premiums as a trustee, and not as the owner of the beneficial title to said premiums or return premiums. Upon receipt, the insurance producer must treat all premiums and return premiums as trust funds and must segregate them from his own funds. The insurance producer is required to keep an accurate record of all fiduciary funds in accordance with the requirements of the regulations of the Insurance Commissioner contained in California Administrative Code, Title 10, Chapter 5, Subchapter 1, Article 7. The insurance producer shall not treat insurance premiums or return premiums as a personal asset, nor may the insurance producer's financial statement reflect fiduciary funds as a personal asset or as income, and an insurance producer may not use fiduciary funds as collateral for a personal or business loan. Insurance premiums and return premiums may be listed in producer financial statements if clearly identified as a trust asset.

California Insurance Code §1734, as amended effective January 1, 1981, specifically defines trustee bank accounts or depositories as "including but not limited to checking accounts, demand accounts or savings accounts." These accounts shall be designated as a trust account thereby segregating the fiduciary funds from the personal funds of the insurance producer and protecting the fiduciary funds from claims by creditors. As amended, §1734 does not materially change the obligations of the insurance producer toward fiduciary funds; however, it does authorize funds to be held as provided in a new section, §1734.5.

Producer Trust Accounts

Section 1734, as amended, requires that insurance producers remit premiums, less commissions, and return premiums received or held by them to the insurer or to the person entitled thereto immediately or, in the alternative, to maintain said fiduciary funds on California business at all times in a separate trustee bank account or depository. It is urged that all insurance producers establish a California trust account if the insurance producer expects to receive premiums or return premiums on California business.

Under no circumstances is an insurance producer permitted to place fiduciary funds in a personal or business operating account.

Section 1734 as amended permits an insurance producer to retain commission income or other funds in his trust account in order to advance premiums, establish reserves for paying return commissions or for such contingencies as may arise in his business of receiving and transmitting premiums or return premium funds. Insurance producers may wish to retain a portion of their unearned commissions in their trust account in order to avoid being caught short in the event of a policy cancellation or a premium check returned for insufficient funds. When a policy is canceled and the return premium is received by the insurance producer by means of a credit or otherwise, these funds must be placed in his trust account until remitted to the insured person entitled thereto.

Insurance producers are encouraged to avoid advancing premiums. By making an advance, the insurance producer is deemed to have made a loan for the insured which must have been made from his personal funds. The Department has developed and prosecuted numerous cases wherein insurance producers have been charged and disciplined for misappropriation of fiduciary funds for advances made from funds held in a fiduciary capacity.

The insurance producer holds the return premium as a fiduciary; consequently, he must retain the return premium in his trust account until remittance to the client is made. If, after a reasonable period of time, the return premium cannot be delivered to the person entitled thereto, the funds must be returned to the insurer. The funds so returned to the insurer escheat to the State of California pursuant to the California Code of Civil Procedure, §1518 and the insurer has the responsibility to report the existence of these funds to the State of California.

The Department suggests that the insurance producers' California trust or custodial account signature card contain the following notation:

"This is an insurance trust or custodial account maintained under the provisions of California Insurance Code §§1733 and 1734 or 1734.5."

Checks drawn on a trust account should bear the notation "Insurance Trust Account."

Producers Electing to Remit Directly Without a Trust Account

Insurance Code §1734, as amended, continues to require that an insurance producer electing to remit fiduciary funds directly upon receipt is required to make such premium and return premium fund remittances as soon as reasonably possible. Checks made payable to the insurance producer must be endorsed to the insurer or to the persons entitled thereto. Cash premium payments must be delivered in kind to the insurer or exchanged for a money order, cashier's check, or certified check made payable to the insurer. Cash premium payments may not be deposited into the insurance producer's personal account in order to draw a personal check in the amount of net premium payment to the insurer. The use of personal checks to transmit fiduciary funds is not permitted in any situation as it results in the commingling of the fiduciary funds with the insurance producer's personal funds.

2. Permitted Investment of Fiduciary Funds in Income-Earning Securities

Those trust accounts previously authorized by former provisions of §1734 may be continued. Although there is a possible conflict between §1734 and §1734.5(a)(2), it is the Commissioner's interpretation that the entire statute continues to allow fiduciary funds to be maintained in a certificate of deposit maintained by a savings and loan association under the provisions of §1734.

The producer must receive written authorization from each appointing insurer for which that producer is acting as an agent and for whom funds have been received in a fiduciary capacity before the interest earned from an interest bearing account may be retained. Similarly, an insurance broker must receive written authorization to retain interest from each insured whose premium is deposited into an interest bearing account until such time as coverage is placed, at which time consent of the insurer is required to retain any interest earned. If no written authorization to retain interest on premiums or return premiums is given, the insurance producer or broker must remit the interest earned to the insurer or to the persons entitled thereto. This rule is based upon provisions of §2229 of the Civil Code of the State of California which states:

"A Trustee may not use or deal with the trust property for his own profit, or for any other purpose unconnected with the trust, in any manner."

As a separate and distinct alternative to maintaining funds in a trustee bank account or depository, §1734.5 allows the investment of fiduciary funds in U.S. Government bonds and Treasury certificates or other obligations for which the full faith and credit of the United States Government are pledged for payment of principal and interest, certificates of deposit of banks licensed by any state government or the United States Government, provided the insurer or persons entitled to the fiduciary funds consents to a specific bank, or repurchase agreements collateralized by securities issued by the United States Government.

Producers are cautioned that prior to making any investment allowable under §1734.5, the producer must obtain a written agreement from each insurer or person entitled to the fiduciary funds authorizing the maintenance of the funds as securities allowed by §1734.5 and permitting the retention of any earnings thereon. Evidence of the securities purchased with fiduciary funds, i.e., the government bond, the treasury certificate, the certificate of deposit, the repurchase agreement or other properly collateralized or secured obligation must be maintained in a California bank in a custodial or trust account separate and apart from any other funds.

Summary of Permissible Investments Under Section 1734.5

1. Certificates of Deposit - Issued by any bank duly authorized by any State or the U.S. Government are permitted. However, consent to use a specific bank must be secured by the producer from the person entitled to the fiduciary funds.
2. Repurchase Agreements - Permitted where collateralized by securities issued by the United States Government, e.g., bonds and Treasury bills, debentures and participating certificates of the U.S. Government.
3. Obligations of the U.S. Government - Obligations for which the full faith and credit of the U.S. Government are pledged for payment of principal and interest, such as U.S. Government bonds, Treasury certificates, short-term United States notes, debentures and participating certificates of federally operated agencies, such as Federal Housing Administration, Government National Mortgage Association, and the Tennessee Valley Authority. The Treasury Department maintains a list of those federally operated agency issues which are eligible as collateral for treasury tax and loan accounts and other public deposits. This list identifies the agency issue as one for which the full faith and credit of the U.S. Government is pledged for payment of principal and interest.

Federally operated agency securities are to be distinguished from securities issued by government-sponsored agencies, the issues of which are not guaranteed by the federal government. Securities which are not acceptable include Federal National Mortgage Association, Federal Land Banks, Federal Intermediate Credit Banks, Banks for Cooperatives, Federal Home Banks, and Federal Home Mortgage Corporation.

Only Specified Investments are Permitted

The foregoing enumerated investments are the only investments authorized by statute and no others will be permitted. Therefore, fiduciary funds may not be invested in commercial paper, bankers acceptances, or any other investment or use whatsoever other than those specifically enumerated by §§1734 and 1734.5.

Valuation of Securities

Discounted government bonds, certificates of deposit or repurchase agreements shall be valued on the basis of their acquired cost and not at the par value or the value of the securities at maturity.

Securities Brokers

The purchase of shares of a fund maintained through an investment company, the corpus of which consists entirely of U.S. Government bonds, Treasury certificates, certificates of deposit of banks, properly collateralized repurchase agreements, or other obligations for which the full faith and credit of the U.S. Government are pledged, is permissible so long as the evidence of such shares is maintained in a California bank custodial account or trust account. The burden of insuring that the particular fund consists entirely of instruments specified in the statute is on the producer.

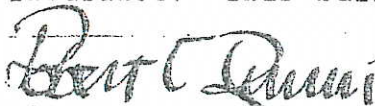
Managing General Agents

Managing general agents are reminded that their status as an agent for an insurer continues to require that all fiduciary funds received by the general agent be handled in compliance with §§1734 and 1734.5.

Duty to Report Violations of the Fiduciary Law

All insurers and insurance producers shall report any evidence of diversion of fiduciary funds to the California Insurance Commissioner. The most common indications of a diversion of fiduciary funds are manifested when the insurer's billing is not paid when due or when a check drawn on a trust account is dishonored for lack of sufficient funds. In aggravated cases involving criminal acts, the insurers are to report the diversion to the district attorney at the county in which the insurance producer is located. The Department undertakes disciplinary action against the licenses and licensing rights of an insurance producer who has diverted fiduciary funds as is warranted by the circumstances surrounding the diversion.

Questions concerning this bulletin should be directed to the nearest office of the Investigation Bureau of the Department of Insurance. This bulletin supercedes Bulletin 78-2.



ROBERT C. QUINN
Insurance Commissioner