Sandra Millers Younger

Who's Out Of Trust?

Industry observers explore causes and consequences

It's the stuff of rumors and whispers. On the street. Behind the scenes. At meetings and conventions. No one wants to discuss it openly. No one wants to name names. And certainly no one wants to admit that perhaps they themselves are guilty – guilty of operating an insurance agency "out of trust."

Is there any truth to the rumors? Are certain California brokers ignoring their fiduciary responsibilities and dipping into other people's money to cover operating expenses or even personal purchases? If so, how many? And why?

The recent demise of Rocklin, California-based Finney & Brown, undone by its inability to pay some $2.4 million in premiums to 13 separate workers' compensation carriers, certainly confirms the gravity of the situation, as does the April conviction of Pasadena broker James McVay on two charges of grand theft. McVay's game of musical bank accounts cost his clients and carriers $1.5 million.

We asked a number of industry players how serious the out-of-trust problem really is. Perhaps not surprisingly, the answers varied. Most suggested that things are no worse now than ever, that some proportion of agencies has always been and will always be out of trust.

A few, however, expressed concern that this year's dramatic drop in workers' compensation premiums and accompanying loss of commission revenue is pushing more than the usual number of agencies over the line into the red.

And one respondent claimed "out of trust" has become standard operating procedure for some 85 to 90 percent of the state's brokers. It keeps their businesses going. No harm, no foul, he concluded.

So what's the bottom line? No one knows for sure. There are no hard facts, no multicolored charts and graphs. But it's clear from our discussions that people are worried. Here's a sampling of their concerns.

What's the big deal about dipping into a big, fat trust fund, especially if you intend on paying the money back as soon as possible?

Larry Marsh: In California, it's breaking the law; it's a potential felony here.

Dennis Ward: The first obligation of an agent is to maintain premiums he or she receives in a fiduciary capacity, meaning those funds the agent receives as premiums do not belong to the agent; they belong to someone else. If you use those funds as your own, it can be prosecuted as theft; there really ought not be any disagreement about that.

The law requires that when you collect those funds you deposit them into a fiduciary trust account and that those monies remain in that fiduciary account until the agent remits them to a party entitled to them, which in most cases is the insurer – or the insured in case of a return premium.

The law does allow you to withdraw your commission; that is your money. The law also allows you to put premiums from separate insureds into the same trust account. What the law prohibits an agent from doing is commingling other monies with those premiums. . . . If they do that, not only is it in violation of the law, but it's one of those things that can snowball on you. Pretty soon, you have a shortage in your trust account of such a magnitude you really can't fix it, and pretty soon it will collapse of its own weight. That's when the CDI sees it – when carriers knock on our doors saying their premiums have not been paid.

Steve Young: It's a very dangerous practice. It's only when the check doesn't come in that you're found out. Then the agent or broker must put in money from his or her own pocket so the consumer is made whole within the time limit.

Bob Taylor: I do think it's a big deal. It certainly demonstrates to me an inability to operate your business. . . . When it means premium dollars get diverted from the risk-taker, it's a big deal. The statement that it's not a big deal presumes that somewhere along the way the agent covers it before it's due the company. But the trust obligation is fairly clear. Just because you don't get caught doesn't mean it's not wrong.

In California, it's a grave concern. We have had a few [out-of-trust] companies that already are winding down; their assets are being sold off. You [the company] may or may not get your money back. The customer's in good shape: he's paid his premium. So the company eats the difference.

> **"Just because you don't get caught doesn't mean it's not wrong."**

Why do agencies fall into the "out of trust trap?"

Dennis Ward: I do think there's some misconception within the industry that it's O.K. to use Paul's premium to pay Peter's company because "I know I'm going to collect from Peter shortly and then I'll use Peter's premium to pay Paul's company. I'm not using the money; I'm just paying my companies as premiums are due." Well, that's wrong; you've got to use Peter's premium to pay Peter's company. If you never collect Paul's premium, you're in trouble. If you're not paying attention, eventually it's just going to overwhelm you. I do think there's a gross misunderstanding among agents on that point. What agents ought to be doing is paying out of their own money if they're billed for premiums they haven't collected yet; otherwise, they're going to be in violation.

> **"You can get in trouble in a hurry but never get out of the hole."**

Larry Marsh: If you look from '92 to '94 or sometime in '93 until today, you'll see there's been a big, big change in the insurance industry. Many, maybe most of the big agencies [in trouble then] did go out of busi-

ness. As a result, the average performance standards of the survivors is much better. In general, expenses are under better control; employees are more productive. Agencies are looking better than they did before, but they're still out of trust. The problem is the lack of working capital. Nobody retains what they earn. They spend it, and they need to. They're doing a good job of controlling costs, but revenues are down, and it's harder to make a living.

It's interesting because being out of trust is frankly an insurance company problem, not an agency's problem, and the companies, for whatever reason, just aren't dealing with it. Having too little working capital – that's an insurance agency problem. Half of the agencies in America have learned to be very good collectors, and now they don't think they need operating capital. They're saying this is what we have to do to survive and operate our business. We are comfortable doing it, and we have become very good at it, and the guys who weren't have gone out of business.

Has the advent of open rating in the workers' compensation market caused more agencies to misuse trust funds?

Dennis Ward: There's a soft market out there. In workers' comp in particular you're seeing a dramatic reduction in premiums, and that has a direct correlation to an agency's revenues. If an agency is heavily concentrated in workers' comp business, this can present significant cash flow problems that may cause some agents to inappropriately use their trust accounts.

Steve Young: There's no question but that what's happening in open rating right now is having a big impact on certain agencies. That is of real concern. Agents and brokers who are heavy into workers' comp are probably only feeling the impact of the dramatic and seemingly irrational price drops a little earlier than some of the companies themselves.

It probably is worse among workers' comp shops. I don't think it was a secret to anyone as we moved into open rating that revenue and commissions would drop. Smart brokers will charge fees for services above and beyond mere submission of the policy and supplement their income in that way.

Bob Taylor: I think the alteration of the workers' compensation market with drastically lower prices, resulting in lower commissions caught some people short. They were not ready to run on less money. . . . That's the agents' offered reason, and that makes perfect sense to me.

How big is the "out of trust" problem? How many California agencies currently are operating out of trust?

Dennis Ward: As a department, we're concerned there may be significant problems in the area of trust accounting.

Bob Taylor: I've heard 50 to 80 percent. They're all guesses.

Larry Marsh: From my speeches and discussions over the past couple of years, I'd estimate close to half.

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The Panel

Bob Taylor
Vice president and associate general counsel, SAFECO, Seattle, Washington

Steve Young
Senior counsel, IBA West

Dennis Ward
Chief, Enforcement Division, California Department of Insurance

Larry Marsh
President, Marsh-Berry & Company, an insurance consulting firm based in Cleveland, Ohio

"It's Different for Insurance"

Attorney says using trust funds is okay

Los Angeles-area attorney Raymond Greenberg is representing Finney & Brown in litigation related to the agency's recent failure in the face of $2.4 million of unpaid premiums owed to 13 workers' compensation carriers. The following comments were taken from an interview with him and do not represent the views of the Insurance Journal.

"Finney & Brown played the brokerage game the way it's designed to be played in this state, in this country, using the American agency system. Carriers have traditionally paid lip service to premium trust account laws in California and other states. Every carrier knows that, for a number of reasons, producers live not on the float but on the cash flow. That's why producers want to do agency billing.

"One of the situations historically with agency billing, because of the 45-to-105-day lag, under even sloppy practices, a carrier normally is giving the producer an interest-free, in-perpetuity loan equal to almost 60 days of premium. But what happens is, it's not that anyone's intentionally trying to steal, but the broker sees money coming in, and he's paying his bills every month, and nobody says, 'That's future premium.' It goes on and on and on, and at some point in time the significance of it gets lost. In that sense, it's a house of cards. But I'm not putting an amoral or immoral spin on it. It's really no big secret. It's been going on for many, many years. People have been living with it; carriers have known about it.

"In the strict trust accounting sense, 85 to 90 percent of California agencies are out of trust; this is a frequent occurrence. I've handled thousands of these cases, primarily for carriers. Basically under the insurance industry

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Who's out of trust?

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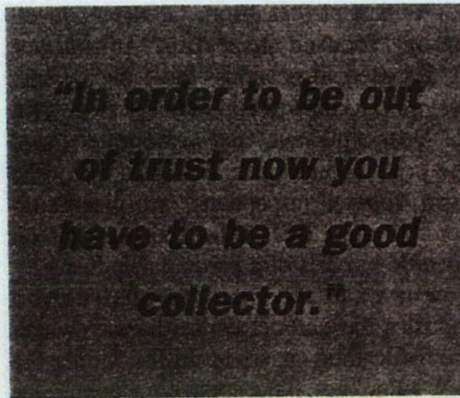
Steve Young: I have read speculation that as many as 80 percent of the state's insurance agents are out of trust, and I don't believe that for a second. It's absurd. Our stats suggest that of agents who specialize in commercial lines, maybe 40 percent of them were big in workers' compensation, so if the initial hypothesis is that comp is driving this out-of-trust problem, I don't think the numbers are there. It's a mathematical thing.

I can't give you a statistic. I've heard pundits say at any time it could be 30 [percent] or 40 percent, and even then it's a technical violation of the trust laws where they're playing with the float. I don't believe 40 to 50 percent of agents and brokers are pocketing money. I don't believe that's true except in a handful of cases, and those people should be drummed out of the industry and prosecuted criminally.

Is it any worse now than before?

Dennis Ward: I don't think we've seen any dramatic or noticeable increase, but there isn't a systematic way that information comes to us. Companies tend to try to work these things out with agencies before they come to us. As a result, a lot of potential problems are being hidden from the department, and some are fixed through buyouts, loans, whatever. And there's going to be a lag, too. It may be two years before we see the fallout from what's happening now in workers' comp.

Bob Taylor: Until this year, I'd say I see less than one a year, but I think I've seen



three this year in California, and those are cases that got to our lawyer's office. I don't know how many total we've seen at SAFECO.

Larry Marsh: It's an interesting thing. The percentage of our clients out of trust three years ago was 46 percent. Today we look at our clientele and still exactly 46 percent are out of trust. That has not changed. What has changed is that in order to be out of trust now you have to be a good collector. An agent out of trust uses [collected premiums] as operating capital.

What is the California Department of Insurance doing about this?

Dennis Ward: The numbers are pretty hard to verify; there's no standard reporting requirement agents have to make from which you could determine [whether or not they're out of trust]. Plus, there are a minimum of 60,000 people with trust obligations. We have 40 to 50 investigators. So the odds of us walking in the door for no other reason than to see how your trust account is doing is small. But we have developed a staff of five to concentrate almost totally on doing trust account audits. Some of that will involve proactive spot checks of agencies so there is some threat of a department investigator walking in a door and saying let's take a look at your trust account.

Can the CDI really determine if an agency is out of trust or not?

Dennis Ward: Sure. It's doable; it's done all the time. In 21 years, there have been hundreds of cases we've prosecuted for violations of trust accounts where we went in and did audits.

Are these cases ever prosecuted?

Dennis Ward: If the money was used for the agent's own personal benefit, yes, it's prosecuted. It depends on the amount of money stolen whether it's a misdemeanor or a felony. If the money was used for your agency, it [prosecution] depends on whether or not the DA feels he can convince a jury. Regardless, the law says if you divert or convert funds to personal use it's a crime, and you are at risk.

I saw a case once where the judge commented that he thought the case should've been prosecuted criminally because the funds effectively were used for the agent's own personal benefit, since they went into the agency, which benefitted him directly.

But if you don't get caught, what's th worry?

Larry Marsh: [Agencies out of trust] hav dug a hole for themselves, and now they'r professional hole-sitters. They're only a day away from going out of business, but tha day may not come for 20 or 30 years. It's th day they lose the big jumbo account. Or th day they make a bad acquisition. It's the da their major carrier pulls out of the state. . .

Often clients come to me because the want to know how much their insuranc agency is worth. So I appraise it. I tell ther why it's worth that and why it's not wort more. And one reason it's often not wort more is because they're out of trust. It coul be a difference of a million bucks, but if the want to sell, they have to make that up.

[My clients] tend to be larger agencie

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Probably an average would be $20 million in premium, about $3.5 million in revenue. So their trust account should be half a million to over a million dollars. But only half have a trust account over a million. The others may be close to $100,000 — for agencies of the same size! So one-third of their value is in the dumpster because they're out of trust.

The other thing we do a lot of is merger and acquisition work, and that's where we see [this problem] bigtime. In 1992 and '93, 17 percent of the agencies we helped to purchase were purchased for less than nothing because the agency still owed money. [So the owner gets] a job and a long-term note, and the guy's happy to have that because the alternative is to go to jail.

Once you're out of trust, can you put your books back in order?

A California broker: Brokers think, "I've never done it before, and I never will again. No policies are going to blow up, because I'm going to continue to sell." But you gotta replace what you borrow from the trust fund with income, which is only 10 percent. So you must sell $60,000 in premium to make up for a $6,000 loan from your trust account, really more because only about a third of the commission is really yours. So you can get in trouble in a hurry but never get out of the hole."

Larry Marsh: Most agents don't use any consultants, so they aren't even aware they're out of trust. They'd be shocked. But our clients are well aware of it, and we persuade many of them to deal with it. Some respond and some don't. Some have no hope of getting out of being out of trust. ▫

Attorney

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standard, the definition, the formula for being in trust is not cash versus payables; it's cash plus current receivables versus payables. That is a generally accepted formula, and it makes perfect sense. What's bizarre is under that definition, a brokerage can be in trust even if it has no cash.

"And if a person wanted to audit [the accounts], here is money coming in against which there are either no invoices or invoices from two months ago, so tracing is nightmare. What it means is that brokers, because they don't know where they are on a daily basis, they're working on cash flow, and usually it's no harm, no foul. You can't look at a brokerage for solvency on a month-to-month basis. If a brokerage is spending less than 10 percent of premium on expenses, it's fine.

Very few crooks

"I'm terribly, terribly concerned because I get a good part of my business from brokerage insolvencies and often, they don't know they have a problem. Finney & Brown is a great example: they didn't know they had a problem.

"My biggest problem [with media interviews] is that people will start off by asking me, "How does it feel to represent a thief?" But over the years, I have learned there are very few crooks in this business. And in the vast majority of broker insolvencies, I can't even say [the cause] was bad management. Finney & Brown I can't say was managed badly.

"I've had attorneys say to me: "You're acting like this is a bankruptcy. Don't y realize this is a breach of fiduciary duty But I don't care what you call it; they do have anything to pay you with. If they h it they'd put it back. They did not line th pockets. The tragedy of all these situatio is that people who own the businesses w up broke. If they were crooks, they would be sitting with their houses in foreclosu losing their cars.

"The vast majority of producing ag cies are not dishonest. It may be emb zlement, but a breach of fiduciary duty not in and of itself a crime; it's a tort has to be very extreme to be a crime. W would be a crime is for a producer to $10,000 come in, and, rather than pay bills, etc., he takes that money to L Vegas and blows it. That's egregious. I otherwise, if there's no intent to comm a crime, no intent to steal, it's alm impossible to prove.

"I'm putting some good solid legal pr ciples to work on the [Finney & Brown] uation that have not yet been applied to insurance situation. What I'm saying is the carriers know what's going encourage it by their conduct, and nothing to defend themselves, my argum is that's a waiver of the trust law and [the fore] consent. If the beneficiary says "co mingle the money; go ahead," it's not brea of fiduciary trust. At that point, the produ should not be at risk for what the carrier caused. I'm not excusing anything. I'r lawyer; my trust accounting is squea clean. I cannot keep my own funds in a tr account. But it's different for insura trusts."

— *Sandra Millers Youn*

Bank Bill

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sure as it now stands, that it must change if it is going to survive. "Things are very much up in the air," said Jeff Keeler, Professional Insurance Agents federal affairs representative. "It all depends on what happens in the Rules Committee and then on the House floor," he said.

In fact, it is unknown whether the bill will even take its designated path to the Rules Committee. "There is a movement underfoot to send the bill to the Commerce Committee because so many of the provisions fall under their jurisdiction," said Jeff Myers, senior public affairs representative with the IIAA. And even once in committee, "there's an open question about what will happen to it."

"Naturally, we're hoping the insurance amendment is stripped out," Keeler said. "There's so much controversy surrounding this provision, the leadership and the managers of the bill will be hard-pressed" not to reach some compromise. House Banking Chairman Jim Leach (R-Iowa) and the bill's author Doug Bereuter (R-Neb.) both opposed the affiliation amendment.

The amendment takes "a seat of the pants approach to affiliation," Myers said. "It's not as broad as other affiliation language. It exposes banks to undue financial risk and places consumers at risk," he added.

If the insurance amendment remains in the final bill, Keeler agreed, "It would be very bad for small businesses and independent insurance agents." The amendment, combined with the Financial Services Competitiveness Act (H.R. 1062), would let commercial banks, securities firms and insurance companies merge under a holdi company structure, thus jeopardizing sm banks and insurance interests.

"Whether by design or lack of und standing of the importance of this issue, Banking Committee...has forced IIAA oppose not only the banking regulatory re bill but also the Glass-Steagall reform m sure — the Financial Services Comp tiveness Act," said Paul Equale, senior v president of government affairs, and Rol Rusbuldt, vice president of federal aff with the IIAA, in a joint statement.

At presstime, no date had been set either the Commerce Committee or Rules Committee to begin hearings on bill. "Don't look for floor action until S tember," Myers advised, since the Ho has a full docket between now and summer recess.