

ROUTE TO:

The Cost of Producer Due Diligence Versus the Cost of Litigation

by Charles F. McAleer III

Companies have the responsibility of knowing whom they contract and appoint as selling agents for their company. To facilitate the need for effective due-diligence policies and procedures, comprehensive selection criteria should be in place to protect the interests of the company and its policyholders. To an even greater degree, states insist on or even require companies to conduct character verification and detailed background investigations.

Conducting background investigations on prospective agents is necessary because they are empowered to act for and represent one or several companies, and their conduct can be imputed to those companies they represent. In other words, what the agent knows, the company knows.

That being said, the need for a comprehensive and strictly enforced due-diligence policy for agent selection is critically important.

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Companies should also be aware of how their sales forces represent themselves to the public. Titles such as agent, broker, promoter, distributor, and representative are common, as well as their purported level of expertise, such as estate planner or financial planner/consultant. If agents represent themselves as financial planners, they should have the credentials and designations to support their claims.

Distribution comes in many forms, such as agents, brokers, independent marketing organizations, marketing general agencies, or small producer groups. Because of these varying distribution channels, it becomes even more imperative that due-diligence procedures apply at all levels and depths within these organizations to ensure that all subproducers in the network are vetted appropriately.

Agent training and education are a part of the due-diligence process as well. At times it is falsely perceived that if an independent experienced agent is contracted with a new company, then there is little or no need to provide training or education. Nothing could be further from the truth. Agents, regardless of experience, still need to be trained on product, company policies and procedures, and the way the products should be sold and under what circumstances. This is particularly important if the products are sold in

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markets foreign to the agent's experience. A well-constructed and documented company training program for newly contracted producers could possibly prevent potential misrepresentation or a misstatement of a material contract fact due to lack of knowledge — the results of which could lead to serious consequences, not only for the agent but the company as well.

When an agent applies for an insurance license from the state insurance department, whether it be individually or through a sponsoring company, the process generally involves an application along with paying a fee and fingerprinting. The applicant will be asked to provide historical background information that may include financial, criminal and work history. Should the applicant answer any question that would raise a red flag, he or she will then be asked to explain the answer.

Not all insurance-department background questionnaires are identical, and insurance departments don't engage in in-depth agent background investigations; that is a responsibility expected of the insurance companies. That being said, if an agent violates any code of conduct, such as misrepresentation, rebating, or fraud, the insurance

departments or a plaintiff's representative will undoubtedly question the company's due-diligence procedures and sources of investigation. If none exist or existing policies are weak, disciplinary action is probable.

When it comes to contracting independent agents who may also be appointed with several companies, a company should not assume that just because an agent is experienced and

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has been licensed for several years, he or she should be immune from a background investigation. The possibility of appointing a problem agent is undoubtedly far greater if adequate background information is not collected.

Several companies engage in packaged background investigations that can be geared to specific insurance company concerns. Among these concerns are unsecured debit-balance

chargeoffs by other insurance companies, consumer complaints, license revocations, suspensions and fines. In addition, reports on credit, bankruptcies, tax liens, repossessions, foreclosures, felonies, misdemeanors and motor vehicle reports are very important sources to include in the due-diligence process. The cost of investigation is predicated on the number of services ordered and how they are packaged and negotiated. Even though the costs can be somewhat expensive, the overriding consideration is that the cost of a comprehensive due-diligence policy is undoubtedly less expensive than a lawsuit.

Here are a few noteworthy tips about background investigations and contract requirements:

- Before contracting an agent, make sure that the agent has documented and current errors and omissions coverage, and that the limits are consistent with company minimum requirements. In addition, make sure the coverage is renewed on each policy anniversary.
 - Debit balances are agent debts caused by annualized commissions paid on policies that were not taken during the free-look period, or lapses occurring within the first year. Companies generally charge off debit balances when an agent has no collateral against
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the debit, such as renewals. If an agent has left an unsecured debit balance with one or more companies, chances are you could be the next victim. There are investigative services that track debit balance chargeoff losses reported by companies that have taken significant losses. The cost of the service is by far less than the cost of a company's potential exposure to loss.

■ Always acquire a release from the applicant under the Fair Credit Reporting Act prior to gathering information. More important, remember that the information obtained can be used only for the requested purpose and cannot be shared with third parties.

■ When inquiring about felonies, it is recommended to be more specific. Rather than just asking if an applicant was ever convicted of a felony, ask if he or she has pled guilty or no contest to criminal charges.

■ When acquiring background information, carriers should be very cognizant of state privacy laws and the Fair Credit Reporting Act. Even though these requirements may not be covered in insurance regulations, they should be followed anyway as a precaution.

■ With regard to consumer complaints, the outcome of a hearing

conducted by an insurance department and any disciplinary action imposed on a producer can be acquired either directly from the state for a fee or from a private vendor for a charge.


I began my career in the insurance and securities business over 30 years ago and have served in several capacities, including being a career agent, an insurance company vice president of agencies, and senior vice president of sales and marketing. In each of the latter two respon-

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sibilities, I was the approving authority on all agent contracts. Over that period of time, and with my due diligence always in practice, there was never a lawsuit involving agent misconduct.

During my tenure with my last company, prior to retirement, less than five percent of the contract files submitted were denied due to issues that surfaced through a background investigation. How did this happen? I attribute this success to a comprehensive agent-selection profile and an

extensive background investigation on all agent applicants. As a result I became confident that if a contracted agent proved to be rogue, a review of that agent's file would not contain one negative issue that would have precluded that agent's appointment. I firmly believe that no implemented policy or procedure is foolproof, yet one would be a fool not to have one.

I would safely guess that 95 percent or more of agents marketing financial services products today have unquestionable business reputations and serve their companies and customers with the utmost integrity. However, it should be noted that there remains that small number of people who do not fall into that desirable category, and the results are defensive measures such as stringent due-diligence standards implemented to protect the integrity of the company, its customers, and the industry as a whole. 

Mr. McAleer has over 30 years of experience in life and health insurance sales and marketing and an extensive home office management background. Prior to entering the financial services industry, he spent 11 years in health care administration as a patient administrator. He also retired from the Army Reserve as a lieutenant colonel, Army Medical Service Corps.

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