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THE LEGAL RELATIONSHIP AMONG A RECIPROCAL INSURER'S SUBSCRIBERS, ADVISORY COMMITTEE AND ATTORNEY-IN-FACT

*Michael A. Haskel, Esq.**

The increase in the number and importance of reciprocals or inter-insurance exchanges has led to greater regulation of this form of insurer, which was once largely exempt from government oversight in many jurisdictions.¹ Currently, jurisprudence varies among the states.² Although the National Association of Insurance Commissioners (hereinafter "NAIC") drafted the Reciprocal Attorney-in-Fact Model Act (hereinafter "Reciprocal Act") to provide uniformity in the treatment of reciprocals, the Reciprocal Act is seriously flawed in the manner it treats the relative rights and duties of the advisory committee and of the attorney-in-fact, which respectively govern and administer the reciprocal.

To achieve a greater understanding of inter-insurance exchanges, this article will discuss: (1) the nature of reciprocal insurance; (2) state regulation of reciprocals; (3) the role of subscribers, (4) the advisory committee, and (5) the attorney-in-fact; (6) practical aspects of the relationship between the attorney-in-fact and the advisory committee; and (7) conflicts between the advisory committee and the attorney in fact. This article will also advance general proposals to treat problems relating to reciprocals.

NATURE OF RECIPROCAL INSURANCE

A reciprocal is an insurer organized by individuals who aggregate resources to indemnify members against a defined risk. Each subscriber is both an insurer and an insured.³ Liability is separate and several.⁴ Each member enters into a subscriber agreement,

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¹ 43 AM.JUR.2d *Insurance* § 78 (2002)

² See, e.g., *infra* note 19 and accompanying text. See also Reciprocal Act Drafting Note to §1.

³ LEE R. RUSS & THOMAS F. SEGALLA, eds. COUCH ON INSURANCE 3d., § 39:48 (3d ed. 1995)

⁴ *Id.*

pursuant to which the subscriber separately underwrites losses, and each is issued a separate policy of insurance.⁵ A pool representing the aggregate surplus and underwriting profits of the reciprocal stands as a fund for the payment of claims and administrative expenses.⁶

At the time membership is conferred, the subscriber advances capital surplus to the reciprocal, and an individual subscriber account is established. This account is maintained throughout the period of membership, reflecting both the member's capital advance and his pro rata stake in the reciprocal's underwriting profits. The funds representing the individual's account are commingled with those of other subscribers, but each subscriber's account is calculated separately to show the individual's distinct equity interest. When the member retires from the reciprocal, the retiree receives a payment reflecting the amount shown in the individual accounting, adjusted for gains and losses attributable to underwriting, and investment performance.

The absence of a market for exchanging ownership interests in reciprocals is one of its distinguishing features.⁷ However, subscribers may periodically receive dividends during membership. A decision to pay a dividend following any given accounting interval is governed by a number of considerations, including the existence of free and indivisible surplus, which can loosely be defined as profits. As will be noted below, a subscriber may also be obligated to pay an assessment to the reciprocal if the reciprocal's financial condition becomes unstable.⁸

Reciprocals are generally not incorporated and their status as *de jure* entities vary depending upon the jurisdiction in which they are formed.⁹ Thus, it has been opined that a reciprocal may sue or be sued,¹⁰ although contrary authority holds that a reciprocal is not a separate legal entity.¹¹ In some states, a receiver in bankruptcy

⁵ *Id.* at § 39:48; see *Long v. Sakleson*, 195 A. 416, 418 (1937).

⁶ COUCH ON INSURANCE 3d., *supra* note 3, at § 39:55.

⁷ Although reciprocals most closely resemble mutual liability insurance companies, the two are distinguishable in many ways. The liability of members of a mutual is joint and several, and the equity in the mutual may be freely traded. While a member of a mutual may make a capital investment in the mutual, all members suffer losses jointly. Therefore, the member does not have a separate subscriber account although the capital investment may be treated as a loan that must be returned. See COUCH ON INSURANCE 3d., *supra* note 3, at § 39:48.

⁸ See *infra* pp. 7-8.

⁹ See COUCH ON INSURANCE 3d., *supra* note 3, at § 39:48.

¹⁰ *E.g.* *Long v. Sakleson*, 195 A. 416 (1937); *Casualty Reciprocal Exchange v. Bounds*, 88 S.W.2d 836 (1935).

¹¹ *Turner v. Henshaw*, 155 N.E. 222 (1927).

could not be appointed for a reciprocal on the grounds that a reciprocal has no distinct corporate existence.¹²

STATE REGULATION OF RECIPROCAL

In *Hoopston Canning Co. v. Cullen*,¹³ the Supreme Court held that New York could impose restrictions under its reciprocal law upon an out-of-state insurer. The Court rejected the insurer's argument that New York's requirements made it impossible for the insurer to operate in the state, and that the Equal Protection Clause of the U.S. Constitution precluded treating reciprocals and mutual liability insurance companies differently.¹⁴ It is now well settled that statutes can impose a variety of restrictions on reciprocals. In general, the regulation of insurers concerns the formation and regulation: the insurer's finances; the relationship between the insurer, the insured, and those that govern the insurer; and the relationship between the insurer and third parties, such as claimants. The nature of reciprocal insurance affects the way in which state law is applied to each of these areas and the general requirements that are applicable to other types of carriers. For example, if a reciprocal is writing life insurance and the state prescribes the language that must be contained in policies of life insurance, then the reciprocal will be required to issue policies that contain the required wording. This article will not discuss insurance regulations that have widespread applicability; instead it will concentrate upon those government controls that exclusively operate upon the reciprocal.

The extent of state regulation of reciprocals is largely dependent upon the way in which reciprocal insurance is perceived. Viewed as private ventures when groups of individuals join together to defend against a defined risk, the need for regulation does not appear compelling, particularly when the coverage afforded is not compulsory.

The opinion that reciprocals should not suffer extensive regulation is embraced by a number of states, among which is Pennsylvania, whose treatment of reciprocal insurance illustrates a relaxed approach.¹⁵ By statute, reciprocals in Pennsylvania are defined as "[i]ndividuals, partnerships and corporations [of Pennsylvania]. . . authorized to exchange reciprocal or inter-insurance

¹² See COUCH ON INSURANCE 3d., *supra* note 3, at § 39:48.

¹³ 318 U.S. 313 (1943).

¹⁴ *Id.* at 321.

¹⁵ See 40 PA. CONS. STAT. § 961 *et. seq.* (2002).

contracts with each other, or with individuals, partnerships and corporations of other States and countries, providing indemnity among themselves. . .”¹⁶ Pennsylvania requires each reciprocal to file a basic declaration of insurance.¹⁷ The statute is primarily concerned with finances. It directs that minimal reserves must be established and maintained,¹⁸ and it requires that the reciprocal’s fund be placed under the control of the attorney-in-fact for the payment of losses.¹⁹ Furthermore, a minimum capital surplus of \$1.5 million must be initially established where there are at least 100 separate policies or indemnity risks.²⁰ As in Pennsylvania, the approach to reciprocal in Texas is largely devoted to financial concerns and directs the filing of a certificate of authority, which, among other requirements, must provide for subscriber contingent liability equal to one year’s premium if surplus falls below a certain level.²¹ Texas also requires minimum unencumbered surplus, reserves at a minimum required level, and surplus meeting the requirements set by statute.²²

Because of these requirements, the financial stability, which includes the internal organization, of the reciprocal is a factor related to the payment of claims. Obviously, where the power to run the reciprocal is placed in a body that is beyond the supervision of subscribers, the possibility of investment decisions adverse to subscribers is increased, as is the likelihood of defalcation. Therefore, state regulation of a reciprocal’s organizational aspects can be defended on the basis of concern over how the reciprocal will govern its finances. In addition, such regulation may be based upon the state’s right to guard against potential fraudulent activities. In the exercise of its police powers, the state may take steps to protect subscribers from being compromised by an attorney-in-fact which runs the reciprocal for its own benefit, thereby jeopardizing the subscribers’ interests. Taking a more paternalistic approach than that of Pennsylvania or Texas, New York mandates that a number of detailed contractual provisions be incorporated into subscriber agreements or management agreements to guard against abuse of subscribers.²³ California takes a similar approach to that of New

¹⁶ 40 PA. CONS. STAT. § 961.

¹⁷ *See generally* 40 PA. CONS. STAT. § 964.

¹⁸ 40 PA. CONS. STAT. § 964(d), 968.

¹⁹ 40 PA. CONS. STAT. § 964(d).

²⁰ 40 PA. CONS. STAT. § 964(f).

²¹ TEX. INS. CODE ANN. § 942.151 (Vernon 2002).

²² TEX. INS. CODE ANN. § 942.155.

²³ N.Y. INS. LAW § 6106(a)(1) (McKinney 2002).

York, although the required statutory requirements of California are set forth in more general terms, relegating the drafting of details to the initiative of the parties. Florida has also enacted general legislation requiring provisions to be included in subscriber agreements to protect members.²⁴

The reciprocal's viability, both as an economic entity and as an organization structured in a way that promotes the interests of subscribers, is of particular importance when the insurer operates in fields where coverage is mandatory. For example, in those jurisdictions where medical malpractice insurance is required of private attending physicians practicing in a hospital setting, the state has a particular interest in having carriers act responsibly. The manner in which reciprocal medical malpractice carriers are organized warrants greater scrutiny to assure that the mandatory policies issued by such carriers are viable. By enacting a separate and distinct section to cover medical malpractice reciprocals,²⁵ California has attempted to balance the right of subscribers to enter into reciprocal contracts of insurance and the competing interest of the state to regulate the insurers that operate in a field of great concern to the general public. Other jurisdictions have recognized the special nature of reciprocals by exempting reciprocals from certain insurance laws, and by enacting specific regulations where the need is perceived. For example, in Texas, reciprocals are prohibited from writing life insurance.²⁶

The reciprocal's viability, both as an economic entity and as an organization structured in a way that promotes the interests of subscribers, is particularly important when the insurer operates in fields where coverage is mandatory. For example, in those jurisdictions where medical malpractice insurance is required of private-attending physicians practicing in a hospital setting, the state has a particular interest in having carriers act responsibly. The manner in which reciprocal medical malpractice carriers are organized warrants greater scrutiny to assure that the mandatory policies issued by such carriers are viable. By enacting a separate and distinct section to cover medical malpractice reciprocal, California has attempted to balance the right of subscribers to enter into reciprocal contracts of insurance and the competing interest of the state to regulate the insurers which operate in a field of great concern to

²⁴ FLA. STAT. ANN. § 629.101. (West 2002). Note that powers of attorney are often found in the subscriber agreement, and, as such, for the purposes of this article, references to powers of attorney and subscriber agreements are synonymous.

²⁵ CAL. INS. CODE § 1280.7 (Deering 2002).

²⁶ TEX. INS. CODE ANN. § 942.002(c).

the general public.²⁷ Other jurisdictions have recognized the special nature of reciprocals by exempting them from certain insurance laws and by enacting specific regulations where necessary.²⁸

As will be discussed below, states actively involved in regulating reciprocals may statutorily define the relative rights of subscribers, the advisory committee and the attorney-in-fact. However, the relationships among these three bodies are determined not only by state statute, but also by contracts which are written within the perimeters permitted by applicable laws. As this article turns to a discussion of the relationships, it is well to remember that both the germane state law and the contractual provisions addressing the reciprocal's governing bodies may vary significantly.

SUBSCRIBERS

The dual status of subscribers as insurers and insureds eliminates the layer of profit that would otherwise inure to the benefit of a separately owned insurer.²⁹ However, the unity of producer and product user leaves a void where it would otherwise exist in the infrastructure that is provided by the traditional insurer. It is this vacuum which necessitates the role of the committee and attorney-in-fact. The powers of the committee and the attorney-in-fact are derived from subscribers and are to be exercised for the benefit of subscribers who are true principals of the enterprise for all purposes.³⁰

As has been discussed, among the conditions of membership in a reciprocal may be the advance by new subscribers of capital surplus that stands as a reserve to pay claims and administration expenses.³¹ Part or all of this capital surplus advanced by subscribers may be lost,³² but the risk to subscribers is not limited to the advance of capital.³³ The subscriber agreement may provide for an assessment that means that each subscriber may be contractually responsible for making additional payments of capital to the reciprocal beyond the initial advance.³⁴ This contingent liability may be

²⁷ See generally CAL. INS. CODE § 1280.7.

²⁸ For example, pursuant to TEX. INS. CODE ANN. § 942.002(c), but reciprocals in Texas are prohibited from writing life insurance.

²⁹ See COUCH ON INSURANCE 3d., *supra* note 3, at § 39:48.

³⁰ In re Manufacturing Lumberman's Underwriters, 18 F.Supp. 114 (D. Mo 1936).

³¹ See COUCH ON INSURANCE 3d., *supra* note 3, at § 39:48.

³² *Id.* at § 38:56.

³³ In Pennsylvania, for example, there is contingent subscriber liability if free and indivisible surplus is less than 100% of capital surplus. See *supra* pp. 4-5.

³⁴ 43 AM.JUR.2d, *Insurance* § 80 (2002).

triggered when surplus drops below a comfort level that the state considers sufficient to maintain the reciprocal's stability.³⁵ Moreover, if surplus is insufficient to pay claims, the subscriber, as an insured, may be exposed to personal liability for any portion of a claim that is not paid through insurance. Given this potential personal liability, the financial exposure of subscribers of a reciprocal may be compared to that of members of a partnership.³⁶

In light of these potentialities, the subscribers of the reciprocal will want membership to be selective. Subscribers rely on each other's relatively low risk potential.³⁷ They also have an incentive to set the capital contribution of each member at a high level to create a sufficient reserve to satisfy claims without the need for assessments. The payment of dividends may also be restrictive.³⁸ Subscribers may be more concerned with that aspect of the reciprocal that involves insuring against risk than with the insured's potential for saving costs and generating income. The former concern deals with lack of insurance protection that may lead to significant personal liability for unpaid claims.

In light of such significant risks, subscribers have good reason to follow the reciprocal's activities, particularly its finances. Unfortunately, most subscribers have neither the time nor the expertise to become actively involved in the insurance enterprise. Instead, they rely upon their advisory committee or upon the attorney-in-fact to protect their interests.

THE ADVISORY COMMITTEE

State law determines whether reciprocals are required to have an advisory committee, and if so, to what extent such a committee must govern the affairs of the insurance enterprise.³⁹ However, any given jurisdiction will address the advisory committee's role that is determined by competing considerations. In certain jurisdictions, the advisory committee can avoid supervisory responsibility by entering into a management agreement with an agent

³⁵ *E.g.*, 40 PA. CONS. STAT. § 964(d).

³⁶ *See* *Mitchell v. Pacific Greyhound Lines, Inc.*, 91 P. 2d 176 (1939) (comparing subscribers to holders of stock in an insurance company).

³⁷ 43 AM. JUR. 2d, *Insurance* §§ 77 *et. seq.*

³⁸ *See, e.g.*, N.Y. INS. LAW § 6106(a)(3)(G).

³⁹ A distinction should be made between regulation of the reciprocal's internal organization and its interface with the public. Although these two aspects of the reciprocal differ, it is the former that is now under discussion. The latter would involve the issuance of insurance policies, and the payment of claims, such as activities which the reciprocal would have in common with other insurers would be covered under general insurance law provisions. *See* discussion *supra* note 2.

designated to perform that function, and in other jurisdictions there need not be an advisory committee at all.⁴⁰ Among the jurisdictions which do not require a committee are Pennsylvania⁴¹ and Texas.⁴²

In other jurisdictions, the protection of subscribers overrides the subscribers' right to contract freely. With this protection comes subscriber responsibility for the supervision of the reciprocal. This responsibility is exercised through the advisory committee, which may be required to govern the reciprocal by statute.⁴³ California allows the committee to exercise directly "any right reserved to the subscribers. . ."⁴⁴ In New York, an advisory committee has powers similar to those of a corporate board of directors⁴⁵ and the authority of the committee to oversee the affairs of the reciprocal is non-delegable, so that any attempts to transfer the committee's supervisory functions to the attorney-in-fact will be held void.⁴⁶

The intent of the NAIC to impose non-delegable oversight responsibilities upon the committee is apparent from the Reciprocal Act's definition of "advisory committee," which reads as follows:

a board, committee, counsel or any equivalent body made up of subscribers that oversees the operations of the attorney-in-fact to such extent as may be necessary to assure conformity with the subscriber's agreement and power of attorney for the benefit of all subscribers.⁴⁷

This definition mandates that the committee supervise the attorney-in-fact to a degree commensurate with the need to protect subscribers.⁴⁸ The Reciprocal Act's formulation permits flexibility as to the scope of authority vested in the attorney-in-fact, to whom wide-ranging operational functions may be transferred. However, as noted above, the NAIC's formulation requires that the committee retain ultimate supervisory authority.⁴⁹ By requiring the commit-

⁴⁰ As of the date the Reciprocal Act was drafted in 2000, approximately one half of the states did not require an advisory committee. See Reciprocal Attorney-in-Fact Model Act Drafting Note, Vol. II (1999).

⁴¹ 40 PA.CON.S. STAT. § 961 *et. seq.*

⁴² TEX. INS. CODE ANN. § 942.

⁴³ See, e.g., N.Y. INS. LAW § 6106(a)(3)(E); CAL. INS. CODE § 1308; FLA. STAT. ANN. § 629.201.

⁴⁴ CAL. INS. CODE § 1307(d).

⁴⁵ N.Y. INS. LAW § 107(a)(11).

⁴⁶ See *Lumberman's Underwriting Alliance v. Corcoran*, 103 A.D.2d 947 (3d Dept. 1984), *aff'd*, 65 N.Y.2d 653 (1985).

⁴⁷ Reciprocal Act § 2 (J).

⁴⁸ *Id.*

⁴⁹ *Id.*

tee to oversee the attorney-in-fact “to such extent . . . necessary”⁵⁰ to ensure compliance with the subscriber agreement and with the power of attorney, the Reciprocal Act recognizes that the committee’s supervisory function cannot be transferred. The greater the authority contractually conferred upon the attorney-in-fact under the subscriber agreement or power of attorney, the greater the need for oversight by the committee to ensure conformity.

Under the Reciprocal Act, the subscriber agreement, which must set forth certain enumerated duties of the attorney-in-fact and may include additional provisions at the discretion of the parties, is subject to approval by the committee and the Superintendent.⁵¹ The need for committee approval gives the committee veto power over the terms and conditions of the contract between each subscriber and the attorney-in-fact. In actuality, the committee’s role is even more significant. The subscriber agreement is a uniform document except for the particular subscriber’s name and address, and subscribers, as individuals, have no ability to alter its terms.⁵² The contract is likely to be drafted by the reciprocal’s attorneys in accordance with the committee’s instructions. Therefore, the committee is likely to author the subscriber agreement, and the Reciprocal Act.

Jurisdictions following the Reciprocal Act by requiring an advisory committee sometimes go no further than defining the committee’s role and providing that the committee will be established by subscribers. The instrument which is the logical source of the advisory committee’s rights and obligations is the subscriber agreement and the Reciprocal Act mandates that the committee be established in this uniform contract between the reciprocal and each of its members.⁵³ New York follows the Reciprocal Act, requiring that the subscriber agreement contain a clause establishing an advisory committee, which is charged with regulating the attorney-in-fact.⁵⁴ California’s reciprocal law provides that the advisory committee’s powers may be enumerated in a power-of-attorney and contracts made thereunder, leaving open the possibility that the advisory committee be established by instruments other than the subscriber agreement.⁵⁵

⁵⁰ *Id.*

⁵¹ The term “Superintendent” will refer to any state official who heads the state’s Department of Insurance. *See* Reciprocal Act § 5(C).

⁵² N.Y. INS. LAW § 6106(a)(2).

⁵³ Reciprocal Act § 5 (A).

⁵⁴ N.Y. INS. LAW § 6106(a)(3)(E).

⁵⁵ CAL. INS. CODE § 1307.

Where a committee is required by state law, the committee's authority may vary widely, although certain basic duties are commonly addressed. Under the Reciprocal Act, it is the committee's duty to keep itself informed and to inform subscribers concerning the reciprocal's operations.⁵⁶ To fulfill this duty, the committee itself must keep abreast of all significant developments, and is required to review material transactions concerning the reciprocal and its financial condition. The committee must meet at least annually.⁵⁷ Special meetings of the committee can also be called whenever required.⁵⁸ The committee is also required to provide guidelines for the investment of the reciprocal's assets and for monitoring the use of the reciprocal's funds. In its oversight of the attorney-in-fact, the committee may exercise significant managerial powers.⁵⁹

In those jurisdictions that follow the Reciprocal Act, the committee, acting on behalf of the reciprocal, will enter into negotiations with the attorney-in-fact over the terms of the attorney-in-fact's retention. Such negotiations include the setting of an expiration date for the attorney-in-fact's appointment, and the selection of a method for compensating the attorney-in-fact. During the course of the management agreement, the committee should review the attorney-in-fact's conduct on a frequent basis. When the reciprocal believes that the attorney-in-fact's performance is deficient, the reciprocal should take steps to remedy the problem. Ultimately, a decision may have to be made to terminate the attorney-in-fact. New York follows the Reciprocal Act by providing that the committee initiates the termination process by recommending the discharge of the attorney-in-fact for a "stated cause."⁶⁰

Where an advisory committee is required to exercise ultimate supervision over the reciprocal, the committee will play a significant role in defining the attorney-in-fact's operational duties. The independence of the committee is, therefore, of paramount importance. This importance is recognized in the Reciprocal Act, section 5B(1), which provides that at least two-thirds of the advisory

⁵⁶ As the governing body of the reciprocal, the duty of each member of the advisory committee is to become familiar with the reciprocal's operations so as to be able to properly supervise and control the attorney-in-fact. Wolcott B. Dunham, Jr., 2 *NEW YORK INSURANCE LAW*, § 23.02 [4](c) (Matthew Bender).

⁵⁷ Reciprocal Act § 5B(1).

⁵⁸ Reciprocal Act § 5B(6).

⁵⁹ Opinion Letter from Audrey M. Samers, Deputy Superintendent and General Counsel of the New York State Insurance Department, to Martin Minkowitz (November 6, 2001) (on file with the State of New York Insurance Department).

⁶⁰ N.Y. INS. LAW § 6106(a)(4)(C).

committee must be subscribers, officers, or directors of subscriber corporations, and not more than one-third of whom are to be financially interested in the attorney-in-fact. In this manner, the Reciprocal Act attempts to maintain the committee's independence from the attorney-in-fact. Additionally, the Reciprocal Act seeks to avoid the consequences of the reciprocal's domination by the attorney-in-fact, which clearly has a conflict of interest with the reciprocal concerning the terms of the attorney-in-fact's compensation and authority.⁶¹

THE ATTORNEY-IN-FACT

Section 5A of the Reciprocal Act provides that the fountainhead of the attorney-in-fact's powers is the subscriber agreement:

The authority of the attorney-in-fact to manage the affairs of the reciprocal shall be derived from the subscriber's agreement executed by each subscriber . . .

Some jurisdictions allow the attorney-in-fact's duties to be set forth in either the subscriber agreement or in a separate management agreement between the reciprocal, acting through the committee and the attorney-in-fact. Because the management agreement is easier to amend, its employment to define the attorney-in-fact's duties is more practical than the use of a subscriber agreement. Changes in the terms and conditions of the retention of the attorney-in-fact after the initial appointment would require the amendment of the subscriber agreement, which entails a process that involves a subscriber vote, and triggers a cumbersome process. In contrast, a management agreement can be modified after a vote of the majority of the committee. The use of a management agreement vests the advisory committee with the responsibility of negotiating with the attorney-in-fact – an approach that removes subscribers from the process of setting the terms of the attorney-in-fact's employment. With large reciprocals, subscriber involvement is a practical impossibility in any event. It must be presumed that even without subscriber involvement, the elected representatives of the reciprocal will act in the best interests of subscribers and will keep their constituents informed of any significant negotiations with the attorney-in-fact.⁶²

⁶¹ See also CAL. INS. CODE § 1310; N.Y. INS. LAW § 6106; FLA. STAT. ANN. § 629.201(2).

⁶² N.Y. INS. LAW § 6106(a)(4). Because the committee is the representative body of the subscribers, the former's right to retain counsel for the latter is beyond question.

The basic duties of the attorney-in-fact are set forth in Section C of the Reciprocal Act, which allows the parties to provide for additional contractual rights and safeguards.⁶³ Whether additional duties are enumerated is largely a function of the particular field in which the attorney-in-fact operates. For example, it is expected that a reciprocal which provides medical malpractice insurance in states mandating that continuing medical education courses be taken by physicians would retain the services of the attorney-in-fact to administer a program that offers accredited courses to the reciprocal's insureds.

The Reciprocal Act and some state statutes recognize the necessity of entrusting the attorney-in-fact with the reciprocal's property, which will be held by the attorney-in-fact as a fiduciary.⁶⁴ Such property includes subscriber funds that are in the name of the reciprocal but may be drawn upon by the attorney-in-fact subject to certain conditions.⁶⁵ An attorney-in-fact may service more than one reciprocal. If it does, the attorney-in-fact will be required to separate the assets of each of its principals.⁶⁶ Business information concerning each reciprocal should be maintained in confidence.

The attorney-in-fact is also required to maintain records, and to provide reports to the committee concerning the reciprocal's operations.⁶⁷ During the period of its retention, the attorney-in-fact has control over the daily activities of the reciprocal, and exercises such power on behalf of the subscribers under the supervision of the committee. However, all the records of the reciprocal in the possession of the attorney-in-fact are owned by the reciprocal and upon termination such records must be returned to the reciprocal.⁶⁸

Under common law principles, the attorney-in-fact's duty of loyalty extends beyond protecting the intangible assets of the reciprocal. The doctrine of corporate opportunities applies to the attorney-in-fact. In fact, this doctrine prevents the attorney-in-fact from taking advantage of any business information acquired in connection with its operations of the reciprocal without first affording the reciprocal the benefit of such information.⁶⁹ Under well-established agency law, an attorney-in-fact will also be barred from re-

⁶³ See also N.Y. INS. LAW § 6106(b)(1).

⁶⁴ Reciprocal Act, Drafting Note to § 5(C); N.Y. INS. LAW § 6106(a)(4)(D).

⁶⁵ *Id.*

⁶⁶ N.Y. INS. LAW § 6106(a)(4)(E).

⁶⁷ N.Y. INS. LAW § 6106(a)(4)(I).

⁶⁸ N.Y. INS. LAW § 6106(a)(4)(L).

⁶⁹ *Industrial Indem. Co. v. Goldenstate Co.*, 256 P.2d 77 (1953).

vealing confidences of its principal, or competing with the principal with the use of proprietary information.⁷⁰

The source of the attorney-in-fact's powers is the subscribers, who ordinarily appoint the attorney-in-fact through a power of attorney which may be contained in the subscriber agreement.⁷¹ In the case of a very small subscribership, who personally choose the attorney-in-fact, subscribers may have meaningful involvement in the appointment process. However, with larger reciprocals, there is typically a formative stage during which time an interim advisory committee is established, approves an interim attorney-in-fact, and proposes a management agreement with its recommended attorney-in-fact.⁷² After the reciprocal has been organized, subscribers are solicited and enter into agreements that ratify the appointment of the proposed attorney-in-fact by the interim committee.⁷³ The subscribers usually have no knowledge of the attorney-in-fact and rely upon their representatives to make an appropriate choice. Considering the inability of individual subscribers to change the terms of the subscriber agreement, their choice is limited to either becoming a member of the reciprocal with the existing attorney-in-fact, or flatly declining membership. After becoming a member, a subscriber can propose the removal of the attorney-in-fact, and may later vote on such termination.⁷⁴

Although the scope of authority of an attorney-in-fact is largely dependent upon the subscriber agreement or the management agreement, in those jurisdictions where a committee cannot delegate its duties to the attorney-in-fact, the former can be compared, as noted above, with a corporate board of directors.⁷⁵ In such cases, the attorney-in-fact's role would be somewhat analogous to that of a chief executive officer of a corporation. Under the Reciprocal Act, one of the roles of the attorney-in-fact is to "act for and bind subscribers in all transactions relating to or arising out of the operations of a reciprocal insurer."⁷⁶ This privilege allows the attorney-in-fact to enter into binding contracts with third persons,

⁷⁰ See generally AM.JUR.2d *Agency* §§ 225, 228 (2002).

⁷¹ COUCH ON INSURANCE 3d., *supra* note 3, at § 39:54, TEX. INS. CODE ANN. § 942.051(c); N.Y. INS. LAW §6106(a)(3)(A).

⁷² In those jurisdictions that require the reciprocal to be licensed, the Superintendent will require submission of documentation to assess viability. The attorney-in-fact's role will be scrutinized during this process.

⁷³ Such ratifications may take the form of the subscriber's execution of the subscriber agreement that contains the power of attorney.

⁷⁴ See *infra* p. 19.

⁷⁵ N.Y. INS. LAW § 107(a)(11).

⁷⁶ Reciprocal Act § 2(C).

thereby providing the attorney-in-fact with the authority to significantly impact upon subscribers. Typically, the attorney-in-fact acts as an administrator, issuing policies, contracting for services with third parties such as outside law firms that represent insureds, administering claims files, and purchasing and selling personal property. The necessity of the attorney-in-fact's fulfilling these functions is easily understood when one considers that the committee is unlikely to have employees, or even a location from which to operate. Ordinarily, the committee will provide the attorney-in-fact with the authority to engage in limited transactions within budgetary guidelines set by the committee. Typically, the committee will require the attorney-in-fact to obtain pre-approval of contracts which are not in the ordinary course of business or which have a material impact upon the reciprocal's future operations. Any restrictions upon the attorney-in-fact's right to bind subscribers, however, will not affect those third parties who have no notice of limitations upon the agent's authority.⁷⁷ Thus, even where the attorney-in-fact has engaged in a transaction which is beyond its actual authority, the agent's apparent authority may enable the attorney-in-fact to bind subscribers with respect to third parties.⁷⁸ Prudence, therefore, invites timely communication of any restrictions upon the attorney-in-fact to third parties, particularly in jurisdictions where no provision is made for an advisory committee and may be accomplished by limiting the power of attorney filed with the state.

Other areas of special concern are spelled out in the Reciprocal Act, as well as in the statutes of many jurisdictions.⁷⁹ Particular attention should be devoted to the manner in which the attorney-in-fact is to handle the funds of the reciprocal. Contractual limitations should be placed on the kinds of investments that the attorney-in-fact can make on behalf of the reciprocal. Where the attorney-in-fact is given some discretion in financial matters, the committee should at least set guidelines for pursuing the reciprocal's investment strategies.⁸⁰ The Reciprocal Act requires that the attorney-in-fact report to the committee on the financial condition of the reciprocal and advise the committee of any significant transactions.⁸¹

Among other basic duties that are enumerated in the Recipro-

⁷⁷ *But cf.* Hill v. Blanco Nat. Bank, 179 S.W.2d 999, 1001 (Ct. Civil App. Tex 1944).

⁷⁸ Pacific Finance Corp. v. Knox, 247 S.W.2d 154, 162 (1952).

⁷⁹ Reciprocal Act § 2 (C).

⁸⁰ Reciprocal Act § 5 (C)(4).

⁸¹ Reciprocal Act § 5 (C)(8) & 5(C)(9)(b)(ii)(11).

cal Act are the attorney-in-fact's responsibility to maintain books and records of the reciprocal,⁸² to arrange for the election of committee members, to call meetings of subscribers, and to effectuate any required amendments to the subscriber agreements.⁸³ Many duties will also follow from those enumerated in the subscriber agreement or management agreement. The attorney-in-fact's role of administering day-to-day operations of the reciprocal will doubtlessly encompass a wide range of activities that are not specifically set forth.

Earlier in this article, a comparison was made between an attorney-in-fact and a chief executive officer of a corporation,⁸⁴ but there are differences. Particularly in those states that do not permit the delegation of authority of the committee, the attorney-in-fact's powers may appear to be more ministerial than those enjoyed by many executives, who may be involved to some degree in establishing and implementing corporate policy. In such jurisdictions, setting and implementing policy is ordinarily in the exclusive province of the committee.⁸⁵ However, the *de facto* power of the attorney-in-fact appears greater than its *de jure* authority, and such actual power may exceed that of corporate executives who can ordinarily be terminated by the board of directors.⁸⁶ Under the Reciprocal Act and under certain state statutes, the attorney-in-fact may not be terminated by action of the committee alone, which circumstance also increases the actual power of the attorney-in-fact.⁸⁷ A practical consequence of this situation is readily apparent. With the resources of the reciprocal at its disposal, the attorney-in-fact can control the reciprocal in defiance of the committee until a court order forces compliance. This dilemma exposes the vulnerability of the reciprocal to a disobedient attorney-in-fact. An even more serious problem is presented by potential breaches of fiduciary duty by a dishonest attorney-in-fact.

The possible consequences of the attorney-in-fact's dishonesty

⁸² Reciprocal Act § 5(C)(8) & (9).

⁸³ Reciprocal Act § 5 (C)(1).

⁸⁴ *Supra*, p. 8.

⁸⁵ See *Lumberman's Underwriting Alliance v. Corcoran*, 103 A.D.2d 947 (3d Dept. 1984) *aff'd* 65 N.Y.2d 653 (1985).

⁸⁶ To be certain the termination of a corporate president by its board of directors may lead to a suit for breach of contract, but it is doubtful that the court will restore the chief executive to his office when the latter has lost the confidence of the board. See COUCH ON INSURANCE 3d § 39:53.

⁸⁷ *E.g.*, N.Y. INS. LAW § 6106(a)(4)(C). However, in New York, when the Superintendent has approved a subscriber agreement, statutory termination provisions will be subject to the subscriber agreement.

and dereliction of duty are treated by the Reciprocal Act, which envisions that the attorney-in-fact's transgressions will be covered by a surety bond. It would appear that in some jurisdictions there is a trade-off between the requirement that there be an advisory committee and the requirement of posting a bond. In Texas while there are no requirements that there be an advisory committee, a bond must be posted by the attorney-in-fact.⁸⁸ In New York, where an advisory committee must supervise an attorney-in-fact, there is no provision for the posting of a bond. The Reciprocal Act provides that the Superintendent may require the attorney-in-fact to post a bond and obtain an Errors & Omissions Policy of Insurance.⁸⁹

The surety bond should protect against defalcations. However, the Errors & Omissions (hereinafter "E&O") Policy will have limited utility. It is doubtful that any E&O insurer would cover claims for ordinary negligence advanced by a reciprocal against its own attorney-in-fact. The possibility of collusion between two inter-related companies would likely lead to an exclusion. Moreover, there will be no protection against potentially significant losses occasioned by an attorney-in-fact that enters into ill-advised contracts with third parties.

Clearly, the risk to subscribers posed by a substandard or disloyal attorney-in-fact is greater than the risk posed to corporate shareholders presented by similarly deficient executive officers. As has been discussed, the liability of subscribers may not be limited to the capital surplus they advanced to the reciprocal.⁹⁰ In contrast, shareholders of a corporation can lose no more than their investment. As also previously discussed, since the reciprocal provides insurance protection to subscribers, the financial health of the company has importance beyond the reciprocal's role as an investment vehicle.

PRACTICAL ASPECTS OF THE RELATIONSHIP BETWEEN THE ATTORNEY-IN-FACT AND THE ADVISORY COMMITTEE

In light of the potential consequences to subscribers of a substandard or disloyal attorney-in-fact there is a palpable need for the oversight of the attorney-in-fact by a body to which the attorney-in-fact is subordinate. It is, therefore, difficult to understand why approximately half of the states were not providing for a subscriber

⁸⁸ TEX. INS. CODE ANN. § 942.052.

⁸⁹ Reciprocal Act §4(B) & (C).

⁹⁰ *Supra*, p. 7.

advisory committee at the time the Reciprocal Act was drafted in 2000. Based upon the assumption that self-interest is the primary consideration, a committee of subscribers is more likely to protect their own concerns and those of their colleagues than the attorney-in-fact who does not have an equivalent personal stake. Indeed, an attorney-in-fact that is not wholly owned by the reciprocal may attempt to maximize profits at the expense of the reciprocal, particularly if such attorney-in-fact provides services for more than one reciprocal and is therefore less dependent upon an individual reciprocal's good will.

However, at least in those jurisdictions that confer upon the advisory committee the ultimate power to govern the reciprocal, the attorney-in-fact should not have the ability to thwart the advisory committee. While it is true that the attorney-in-fact is the appointed agent of subscribers who authorize the attorney-in-fact to enter into transactions with third parties, this function can arguably be performed by the committee, and, in any event, is an arrangement of convenience. The attorney-in-fact's appointment is certainly not meant to remove the attorney-in-fact from the ambit of the committee's oversight. Nor is there any evidence that the Reciprocal Act intends an attorney-in-fact to exercise a check upon the committee's supervisory powers through the attorney-in-fact's ability to bind subscribers. Rather, the committee is established as an extension of the subscribership, with the power to control the reciprocal's affairs as principal, through the attorney-in-fact as an agent.⁹¹ To reflect this, the authority of the committee is sometimes referred to as "ultimate."⁹²

Vesting the committee with oversight functions is meant to guard against substandard performance and intentional abuses by the attorney-in-fact, and assures, at least on paper, that the reciprocal's elected representatives will govern its affairs and shape its future. However, as touched upon earlier, the committee's right to direct the attorney-in-fact is not necessarily accompanied with the ability to effectively execute its directives. One reason that the committee may be unable to enforce its authority as set forth in statute or agreement is that the attorney-in-fact has actual control over the operations of the reciprocal. This may be true even in those states like California where the reciprocal statute provides that the subscribers' board has the right to directly perform the

⁹¹ See *Lumberman's Underwriting Alliance v. Corcoran*, 103 A.D.2d 947 (3d Dept. 1984) *aff'd* 65 N.Y.2d 653 (1985).

⁹² See N.Y. INS. LAW § 6101(a).

reciprocal's operations,⁹³ because the reciprocal may delegate extensive powers to the attorney-in-fact. Regardless of the circumstances leading to the attorney-in-fact's attainment of actual control owed to the reciprocal, such acquisition of power is impracticable and has serious consequences.

Cooperation between the committee and the attorney-in-fact is the product of the attorney-in-fact's voluntary recognition of the committee as its superior with respect to the reciprocal's operations. When such voluntary recognition is lacking, problems arise. If the attorney-in-fact defies the committee, the committee will be faced with a dilemma. As we have seen, the attorney-in-fact has possession of the reciprocal's assets, its records, its communication systems, including phones, facsimile machines, e-mail addresses. The attorney-in-fact also ordinarily controls the location where the reciprocal's affairs are conducted,⁹⁴ and employs the personnel that conduct the reciprocal's operations. If faced with a rebellious attorney-in-fact, the committee will be forced to turn to the Superintendent or the courts, and even while such a case against the attorney-in-fact is pending, the reciprocal will likely be forced to rely on the attorney-in-fact to continue to operate the reciprocal. In defending against such a suit, the attorney-in-fact may claim the committee's order is not lawful, or is not in the interests of subscribers. Though these defenses may be challenged for a variety of reasons, the issue will have to be explored to a greater or lesser degree, virtually guaranteeing some delay. Under such circumstances, an attorney-in-fact's compliance with the committee's directives is not to be expected until the Superintendent, or a court, issues the appropriate order. Administrative or judicial inquiry into the pertinent facts will occasion a substantial investment of time and energy by all involved.⁹⁵

Practical considerations may well restrain the committee in its exercise of powers over the attorney-in-fact with respect to minor issues, and minor dissatisfaction with the attorney-in-fact is likely to be suppressed. However, there may come a point at which the committee sees no alternative to discharging the attorney-in-fact. As discussed below, the Reciprocal Act provides for a process by

⁹³ CAL. INS. CODE § 1307(d).

⁹⁴ The attorney-in-fact, which is permitted to act on behalf of several reciprocals, is likely to own its own offices, or to lease space from a third party. *See supra* p.15 and accompanying footnotes.

⁹⁵ The reciprocal may be forced to seek an injunction, which would likely require a hearing.

which the committee can initiate termination, although the process is seriously flawed.

CONFLICTS BETWEEN THE ADVISORY COMMITTEE AND THE
ATTORNEY-IN-FACT

In any dispute between the committee and the attorney-in-fact, the legal authority of the advisory committee is confronted by the practical consequences of the attorney-in-fact's actual control of the reciprocal's assets and operations. As has been discussed above, an attorney-in-fact may be able to frustrate the exercise of oversight powers by the committee. For example, where the reciprocal's funds are controlled by the attorney-in-fact, the agent may refuse to make payments directed by the committee, particularly payments that relate to the supervision of the attorney-in-fact, such as fees to auditors. The attorney-in-fact may also frustrate the committee's supervisory function by obstructing the committee's access to the reciprocal's records. In all probability, the employees of the attorney-in-fact will be the only staff directly involved in the day-to-day operations of the reciprocal. Therefore, notwithstanding the common law rule that a sub-agent owes a duty to the ultimate principal, it is probable that such employees will follow the directives of their employer, rather than the directives of the committee.

Of course, incentives for the attorney-in-fact to follow the committee's directives include the committee's right both to regulate the compensation of the attorney-in-fact, and to decline to enter into a new management agreement with the attorney-in-fact when the old management agreement expires. However, even a committee that considers its attorney-in-fact's performance substandard may well desire to avoid an open conflict. Change is discouraged by the potential disruption of business inherent in any attorney-in-fact's substitution, which entails a transfer of operations. Even though the old attorney-in-fact may be obligated to cooperate during the transition period,⁹⁶ there may be little motivation for its doing so. In those jurisdictions where a new attorney-in-fact must be approved by the Department of Insurance, a process that can be somewhat involved, the problems of transition will be intensified even in those cases where the old attorney-in-fact is simply being replaced at the end of the management agreement. Since a decision to replace an attorney-in-fact has to be made well in advance of the expiration date so that arrangements can be made to trans-

⁹⁶ *Supra* note 59.

fer the numerous functions of the insurer to a new agent, the old attorney-in-fact would have significant time to create mischief.

Because employees of the attorney-in-fact carry out the reciprocal's daily functions, the appointment of a new attorney-in-fact will also result in the potential loss of employees who understand the operational details of the reciprocal. Employees of the old attorney-in-fact may be hired by the new attorney-in-fact where circumstances permit,⁹⁷ but transitional tasks are daunting. In part, these difficulties can be addressed in the subscriber agreement or in a management agreement, either of which can provide for the committee's direct access to, and right to direct, all employees of the attorney-in-fact.⁹⁸ By agreement the parties can also provide for the right to immediate possession and control of records and property, including the site of the reciprocal's operations, and the right to operate through independent third parties even before a new attorney-in-fact is in place. Subject to the superintendent's approval, an agreement can also provide for the suspension of the old attorney-in-fact with the right of the committee to operate on its own, through key employees or through the hiring of new employees before the expiration of the management agreement.⁹⁹ Another practical approach is to contractually provide for operations through certain employees of the committee who would be empowered to direct the employees of the attorney-in-fact. Applicable statutes may have to be modified to permit such agreements. At the current time, many jurisdictions do not address these issues.¹⁰⁰

These practical difficulties tend to promote an uneasy co-existence between a marginally performing attorney-in-fact and a committee that would like to replace the agent but also has evaluated its cost as outweighing the possible benefits. The question is how much inefficiency will be tolerated.

⁹⁷ In certain states, the reciprocal cannot operate without an attorney-in-fact, e.g., Texas and Pennsylvania. Because the appointment of a new attorney-in-fact and the termination of the old attorney-in-fact require Superintendent approval in such states, the existing attorney-in-fact will have substantial prior notice of any plans to terminate. Until termination is accomplished and a new attorney-in-fact installed, the existing attorney-in-fact will be in place, and the reciprocal will have to deal with the existing attorney-in-fact.

⁹⁸ However, the attorney-in-fact may refuse to enter into a management agreement allowing the reciprocal to control its employees, particularly if the attorney-in-fact operates more than one reciprocal.

⁹⁹ The issue may turn in part, on whether the employees have written agreements with the attorney-in-fact that restrict the employees from working for the reciprocal.

¹⁰⁰ There is no provision for an interim attorney-in-fact under the Reciprocal Act.

As discussed, difficulties may arise even in the simple case where a management agreement expires and a new attorney-in-fact must be appointed to take over the functions of the old. The problems are multiplied when an advisory committee decides to terminate the attorney-in-fact during the term of the management agreement. Such is true not only because serious disputes between the committee and the attorney-in-fact are the probable cause of the decision to terminate before the expiration date, but also because of the uncertainties in the termination process.

TERMINATION OF THE ATTORNEY-IN-FACT

Some jurisdictions have enacted statutes to deal with termination of the attorney-in-fact during the term of a management agreement. For example, New York largely follows the Reciprocal Act.¹⁰¹ Unfortunately, the Reciprocal Act does not provide a clear model for termination and is extremely impractical. The Reciprocal Act provides that upon a majority vote of the advisory committee, a recommendation of termination can be sent to subscribers for a "stated cause".¹⁰² At least thirty days in advance of mailing the recommendation to subscribers, a special meeting is to be held where subscribers can vote in person or by proxy on termination.¹⁰³ The attorney-in-fact is allowed to mail "appropriate" materials to subscribers in connection with the committee's recommendation of termination.¹⁰⁴ A two-thirds vote of subscribers in favor of terminating the attorney-in-fact is then required.¹⁰⁵

There are several problems with this formulation. First, it does not define "termination." If there is a management agreement between the reciprocal and the attorney-in-fact containing an expiration date, would this be a termination – e.g., would a subscriber vote be necessary to give effect to the expiration date? Logic dictates that a contractually agreed upon expiration date will not fall within the scope of the termination provision, yet the Reciprocal Act does not explicitly address this point. However, the Reciprocal Act and some states provide that statutory termination provisions are "subject to" any provision in a subscriber or management agreement approved by the Superintendent.¹⁰⁶ A Superintendent-approved management agreement with an expiration date

¹⁰¹ Compare N.Y. INS. LAW § 6106(a)(4)(C) with Reciprocal Act § 5(C)(3).

¹⁰² Reciprocal Act § 5 (C)(3).

¹⁰³ See N.Y. INS. LAW § 6106(a)(4)(C); Reciprocal Act § 5(C)(3).

¹⁰⁴ N.Y. INS. LAW § 6106(a)(4)(C); Reciprocal Act § 5 (C)(3).

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

or a description of the means of terminating the attorney-in-fact will presumably be outside the range of the Reciprocal Act's termination provision.¹⁰⁷ Therefore, prudence dictates that legal counsel for the reciprocal and the attorney-in-fact draft management agreements that deal clearly with the termination issue and follow such provisions where approved by the Superintendent.

The Reciprocal Act and the statutes that follow it are flawed in a number of other ways as well. As noted above, the termination process is initiated by a vote of the committee that recommends termination for a "stated cause." In failing to define "stated cause," the Reciprocal Act leaves open the question of the proper grounds for the recommendation. It is reasonable, then, to assume that "stated cause" is whatever reasons are set forth in the management agreement. In the event the management agreement is silent on this issue, "stated cause" is presumably whatever the committee considers a basis for termination, provided such basis is set forth in the written recommendation to subscribers. Under this interpretation of the Reciprocal Act, "cause" could be anything the committee in its discretion considers appropriate, including the committee's own inability to work with the attorney-in-fact. Had the drafters of the Reciprocal Act intended otherwise, they would have stated such. For example, the Reciprocal Act could have required that the cause for termination be of a nature and degree sufficient to cause the cancellation of a contract during its term. The Reciprocal Act's failure to set the bar this high¹⁰⁸ indicates an intention to provide greater flexibility. It must also be remembered that the parties can provide greater certainty as to what constitutes cause for termination through the wording of the subscriber agreement or the management agreement. In addition, the attorney-in-fact has an opportunity to present its case against the committee's recommendation, and two-thirds of subscribers must vote in favor of termination.¹⁰⁹ These are checks against unfair action by the committee.

Another problem under the Reciprocal Act is the need to schedule a special subscriber meeting for voting on termination at least thirty (30) days in advance. However, where the cause for termination is serious misconduct, for example, misappropriation

¹⁰⁷ Case law distinguishing between cancellations within the term of a contract on one hand and expiration date based upon an agreed end term of a contract on the other also suggest an interpretation excluding expiration dates from the ambit of statutory termination provisions.

¹⁰⁸ Reciprocal Act § 5 (C)(3).

¹⁰⁹ *Id.* See also N.Y. INS. LAW § 6106(a)(4)(C).

of funds, immediate action is required. Other causes for termination, such as a failure to properly invoice subscribers, or to maintain records, may appear less emergent but can also have fatal consequences before the termination process is over. Presumably, the Superintendent could address serious problems by appointing a receiver. However, this action is quite drastic and likely to have serious ramifications for the insurer. The confidence of subscribers, rating organizations and financial institutions is likely to be shaken if such action is taken. It would be preferable to provide that in more serious cases termination can be effectuated by a super-majority vote of the advisory committee, subject to the approval of the Superintendent.

Also troublesome is the fact that the Reciprocal Act provides that the attorney-in-fact shall conduct the mailing of the termination materials.¹¹⁰ The attorney-in-fact's incentive for cooperating in the process is not apparent. On the contrary, the potential for misconduct in connection with the mailing is obvious. It would seem far more practical to provide that a third party who is involved in the affairs of both the reciprocal and the attorney-in-fact conduct the mailing. In some states, this can be done by an auditor who by statute reviews the statements of both the attorney-in-fact and the reciprocal.

By providing the attorney-in-fact with the right to submit "appropriate" materials with the committee's recommendation to subscribers, the Reciprocal Act also presents further conflicts. What is "appropriate" will likely be a matter of significant difference of opinion. The materials submitted by the attorney-in-fact may be defamatory or misleading; yet the attorney-in-fact may insist that such materials be included in the mailing. Any materials drafted by the attorney-in-fact should therefore be sent separately by the attorney-in-fact, at its own cost and expense, along with its own proxy. The attorney-in-fact would likely delay the process by requesting additional time to draft such materials. To avoid this, the Reciprocal Act could propose that the attorney-in-fact have a specified period of time to prepare and send out its own materials, and failing to do so would be to forfeit the right.

Finally, the Reciprocal Act does not adequately address issues concerning the integrity of the process. There should be a provision authorizing a party other than the attorney-in-fact to supervise the special subscriber meeting to vote on the committee's termination recommendation and to collect and count the proxies. The

¹¹⁰ Reciprocal Act § 5 (C)(3).

integrity of the termination process should be assured by placing it under the auspices of someone who would be indifferent to its outcome or by specifically conferring upon representatives of both the committee and the attorney-in-fact the right to monitor the process.

As noted above, in those jurisdictions that follow the Reciprocal Act by providing for termination for an unspecified reason, what constitutes "cause" should be left to subscribers. In those jurisdictions that do not address the question of termination during the term of the management agreement, grounds for terminating a service contract during its term will presumably apply. Such grounds include material breach of contract, fraud and any act or omission for which rescission of contract is an appropriate remedy. This is a significant standard and any suit for termination will likely be plagued by delay. When a suit to replace the attorney-in-fact advances grounds warranting immediate action, preliminary injunctive relief may be the only means of preserving the insurer's rights.

Depending upon the surrounding circumstances, termination of the attorney-in-fact pursuant to statute or contract may leave open the contention that the power of attorney conferred by each individual subscriber upon the attorney-in-fact must be cancelled separately. This argument ignores the fact that while an attorney-in-fact can represent more than one reciprocal, only one attorney-in-fact can represent any reciprocal at a given time. By providing for the termination of the attorney-in-fact by a two-thirds subscriber vote, the Reciprocal Act recognizes that as many as one-third of subscribers might be compelled to yield to the will of two-thirds as concerns the discharge of the attorney-in-fact. Any requirement that there be an amendment of the individual subscriber agreement following a two-thirds termination vote would nullify the super-majority vote of subscribers favoring termination. This result is clearly unintended. In any event, even the colorable argument that individual powers of attorney must be cancelled can be avoided through a subscriber agreement that is subject to statutory or contractual provisions dealing with the means of terminating the attorney-in-fact. The Reciprocal Act's requirement that provisions of Section 5 be part of the subscriber agreement leads to the incorporation of the termination provision, thereby avoiding the argument that individual powers of attorney have to be terminated in order to remove an attorney-in-fact.

ADDRESSING PROBLEMS THROUGH THE SUBSCRIBER AGREEMENT AND
MANAGEMENT AGREEMENT

As noted above, the relationship among the subscribers, the advisory committee and the attorney-in-fact is often addressed in two separate contracts. The subscriber agreement is a three-party document among the subscriber, the attorney-in-fact and the reciprocal, which will ordinarily contain the provision appointing the attorney-in-fact. It is suggested that this document also be utilized to address limitations upon the type of power of attorney granted to the attorney-in-fact. For example, limitations can be placed upon the type of contracts that can be entered into by the attorney-in-fact on behalf of subscribers or the agreement can require that certain contracts be countersigned by members of the advisory committee. The degree to which the attorney-in-fact controls investments may also be limited to avoid potential defalcation. For example, the countersignatures of advisory committee members may be required for withdrawal of the reciprocal's funds.

The management agreement between the committee and the attorney-in-fact can also be employed to restrict the rights of the attorney-in-fact. Where utilized, this two-party contract between the reciprocal — acting through the advisory committee — and the attorney-in-fact will define the attorney-in-fact's authority and obligations and will contain an expiration date. The management agreement can set forth the grounds for terminating the attorney-in-fact before its expiration date. The difficulties in operating the reciprocal during a period of conflict with the existing attorney-in-fact or immediately following termination of the attorney-in-fact can also be addressed in the management agreement. Provided the jurisdiction in question permits, there can be provisions for the direct retention of employees of the attorney-in-fact, the immediate suspension of a disloyal or incompetent attorney-in-fact and the appointment of a provisional attorney-in-fact through whom operations can be temporarily conducted.

Whether contained in a subscriber agreement or management agreement, contractual provisions empowering the committee to protect the reciprocal should be drafted to provide the necessary details for implementing statutory provisions that define the role of the advisory committee to include exercising ultimate supervisory and managerial power over the reciprocal. The committee's employment of outside consultants, such as auditors and accountants, is a means by which the committee can reduce its dependency upon the attorney-in-fact. The committee may also secure a source

of funds directly under its control so that in any protracted dispute with the attorney-in-fact, the committee will be able to retain its own attorneys and pay for litigation costs without relying upon funds under the control of an adversarial attorney-in-fact. Another safeguard is found in the committee's right to immediate possession of the reciprocal's property. Minimally, the reciprocal should insist that the attorney-in-fact maintain duplicate records that may be turned over to the committee upon demand.

CONCLUSION

Subscribers, the committee and the attorney-in-fact of the reciprocal are in a relationship in which disagreements can be expected, particularly between the committee and the attorney-in-fact. To the extent possible, potential conflicts between the attorney-in-fact and the committee should be addressed in the management agreement or subscriber agreement. State statutes that do not provide for an advisory committee place too much reliance upon the fidelity of the attorney-in-fact. Other statutes, including those based on the Reciprocal Act, do not strike a proper balance between the reciprocal and the attorney-in-fact, and are impractical in certain respects, particularly on the issue of termination. Such statutes fail to recognize that although the committee oversees the attorney-in-fact, the attorney-in-fact has control over assets and records of the reciprocal, and therefore has the potential to thwart the advisory committee's exercise of oversight functions. Therefore, counsel for both the committee and the attorney-in-fact should draft carefully worded management agreements to address issues well in advance of the appointment of the attorney-in-fact.