

# ELANY ELABORATES

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## **What constitutes earned premium in New York State? It depends on what the insurance policy says and could turn upon whether the insurer writing the policy is authorized in New York or not.**

The International Risk Management Institute defines earned premium as:

That portion of a policy's premium that applies to the expired portion of the policy. Although insurance premiums are often paid in advance, insurers typically "earn" the premium at an even rate throughout the policy term. The unearned portion of the premium that has been paid is kept in the "unearned premium reserve."

The New York State Court of Appeals' recent ruling in *Gevorkyan v. Judelson* (2017 NY Slip Op 05176) states that a bail bond surety cannot retain paid premiums if a court refuses to grant bail to a criminal defendant. The Court went on to say that under New York Insurance Law, premium follows risk and therefore if the bond is not approved and the defendant is not released, no risk exists and all premiums paid are unearned premium that must be returned to the payor. As an interesting aside for producers, New York Department of Financial Services Circular Letter No. 13 (2017) states, "[T]he *Gevorkyan* decision does not address the rights of the bail agent to receive compensation or commission from the bail insurer for work performed by the agent when a defendant is not released from custody after a criminal court does not accept a bail bond as the result of a bail sufficiency hearing. Whether the bail agent may receive any compensation from the bail insurer is dependent upon the contract between those parties."

While the concept of following the risk, and therefore only recognizing premium as earned where covered risk exists, appears straightforward, what would the court have done had the insurance policy contained a minimum earned premium provision? In a situation without a minimum earned premium provision or other complexity such as premium financing or an accelerated short-rate for a seasonal boating policy, for example, an insured is entitled to a prorated share of paid premium when a policy is cancelled mid-term. However, where minimum earned premium is involved, unearned premium may not directly correlate to the time left in the coverage term.

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Minimum earned premium is the smallest amount of guaranteed premium an insurer is willing to accept to write a risk. For example, a General Liability policy may state, “[A]s a minimum earned premium, we will retain no less than 25% of the policy premium.” If the insured cancels the policy mid-term, the earned premium retained by the insurer would be the greater of the pro-rata earned premium or the minimum earned premium, which in the above example is 25% of policy premium.

If a policy is written by an authorized insurer, the amount of minimum earned premium permitted by the New York Department of Financial Services is dependent upon the insurer’s ability to prove that the minimum earned premium equals the cost associated with issuing the policy and the expense of writing the business (NY OGC Op. No. 02-03-26). The Department of Financial Services views the purpose of minimum earned premium to be the recovery of expenses incurred to write the business should the policy be cancelled prior to the expiration date, or where a premium audit results in a premium lower than the amount needed to cover the cost of writing the policy. The Department exercises this authority to approve or disapprove policies with minimum earned premiums pursuant to these standards under Article 23 of the New York Insurance Code.

However, in NY OGC Op. No. 08-09-13, the Department found that Article 23 does not apply to unauthorized insurers (such as eligible excess line insurers) and therefore an unauthorized insurer may impose whatever minimum earned premium it chooses so long as it is spelled out in the policy. The terms of the governing contract prevail. As such, the excess line market affords a great deal of flexibility in shaping minimum earned premium and/or minimum and deposit premium constructs.

Minimum earned premium is distinct from minimum and deposit premium, which is the amount of premium due at the inception of the policy and later subject to adjustment based on an audit calculation once the policy has expired or is cancelled. The annual earned premium cannot be less than the minimum earned premium. The policy therefore can generate an additional premium on audit but not a return premium, except in the event of a midterm cancellation where the minimum earned premium has been exceeded by the premium determined by the audit.

Some insurance policies contain both minimum earned and minimum and deposit premium provisions. When such a policy expires at its specified expiration date and a premium audit is conducted, the minimum earned premium has by definition been met and the potential for return premium is dependent on whether the policy language provides for return premium upon the audit calculation. However, what happens when a policy is cancelled midterm? If the minimum earned premium has been satisfied and a premium audit is conducted, does the insured receive a pro rata return premium?

Assume a policy states that minimum earned premium is \$30,000 and the insured pays a deposit premium of \$50,000, which is subject to audit at the end of the policy period or at cancellation. The audit comes back indicating \$40,000 total earned premium. Is the insured due any return premium? If the policy language is unclear, the insured may argue that \$10,000 is due since the minimum earned premium has been exceeded and their deposit premium was \$10,000 more than owed based on the audit. However, the

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insurer may contend that the deposit serves as essentially minimum earned premium and no return premium is owed. The lesson is that when constructing policy language, insurers would do well to ensure that the policy unambiguously sets out how unearned premium will be calculated under such a scenario and what return premium, if any, will be remitted to the policyholder.

In short, under New York law, earned premium can be: a prorated portion of the premium in policies that are cancelled mid-term where the policy does not contain minimum earned premium or other relevant provisions; a guaranteed amount of premium that the insurer is entitled to keep at a minimum, regardless of proration, if the insurer is an authorized carrier and the amount or percentage is designed to reimburse the insurer for the cost of writing the policy, or; whatever amount or percentage is specified by the policy if written by an unauthorized insurer. An insurance policy can structure such an arrangement as either minimum earned premium or minimum and deposit premium, or a combination of both.

