Manual on Mutual Insurance Associations for Commercial Fishing Vessels

Washington, D.C.
September 1977

U.S. DEPARTMENT OF COMMERCE
National Oceanic and Atmospheric Administration
National Marine Fisheries Service

Manual on Mutual Insurance Associations for Commercial Fishing Vessels

Chris A. Theodore
Boston University

with the cooperation of

Gale H. Lyon
Industry Economist

and

Industry and Consumer Services Division
National Marine Fisheries Services

Washington, D.C.
September 1977

U.S. DEPARTMENT OF COMMERCE
Juanita M. Kreps, Secretary

National Oceanic and Atmospheric Administration
Richard A. Frank, Administrator

National Marine Fisheries Service
Robert W. Schoning, Director

TABLE OF CONTENTS

PREFACE

The commercial fishing industry, concerned for some time by high and rising insurance costs, asked the National Marine Fisheries Service (NMFS) to help them with insurance problems and safety improvements. NMFS responded by sponsoring the first national fishing vessel insurance conference in 1973 and publishing the conference proceedings. Then NMFS supported the work of an Ad Hoc Group that addressed itself to vessel insurance problems. A report on this group's activities was published by NMFS in 1976. At that time, NMFS reviewed the industry's existing group and mutual insurance programs and supported the research needed to publish a manual on mutual insurance associations for commercial fishing vessels. This development was encouraged by the cooperation of the insurance associations, private insurance companies, and the fishing industry.

NMFS then sponsored another conference on fishing vessel insurance and safety on May 19-20, 1977. In fulfillment of a recommendation made at the May conference, this manual is being published by NMFS. However, the views and recommendations contained in this manual are not necessarily those of NMFS.

SUMMARY

This manual shows how you, together with other vessel owners, can collectively obtain, under certain conditions, hull and protection and indemnity insurance at least cost.

Whether you are presently insured or not, you need protection because sea hazards are always present, losses may be frequent and severe, and self-insurance may be neither possible nor desirable. An insurer is a custodian of funds collected from you and other vessel owners; he assumes the risks you can ill-afford, and protects you against losses from those risks. Only an insurer can give you such protection.

A mutual insurance association or an association is a group of vessel owners who have formed an insurance club or pool for their mutual protection. Unlike group insurance where you collectively purchase insurance from a commercial insurer, an association acts as your own insurer Although there are quite a few thriving associations in the United States, they have not formed a nation-wide system as in other countries.

Under certain conditions, an association might be a viable alternative to a commercial insurer. The chances of successfully forming and operating an association are better with the following favorable conditions: a captain with proprietory interest in the vessel, an experienced and stable crew, common fishing operating characteristics, a trade association or a fishing cooperative, and group insurance. Your association has low cost in acquiring risks, accepts better-than-average risks, gets full benefits from owning its own reserves, has minimum overhead costs, enjoys tax advantages and a number of nonmonetary benefits as well. The result is low insurance costs. Of course, your association would not be free of limitations, but some of these limitations can be overcome.

To organize an association successfully, you should study this manual, consider various legal forms of organization, consult managers of on-going insurance pools, and seek professional advice on legal and insurance matters.

Although the conditions for membership may vary from one association to the next, they should be stated clearly in the by-laws. This is important for administrative as well as insurance reasons. The membership is, in a real sense, the legislative branch of your association. You, collectively, have the power to form, manage, and dissolve your association. In ordinary general meetings, you may decide on matters related to the management of the association in accordance with the approved by-laws and the insurance contract. In extraordinary meetings, you may decide to adopt or change the provisions of the by-laws and of the insurance contract as well as to dissolve or liquidate your association.

The board of directors represents the executive branch of your association. The directors are responsible for administrative and insurance operations. A seven-member rather than a five-member board has certain

advantages. Although directors are considered volunteers, most existing insurance pools provide for limited compensation for specific tasks. Day-to-day operations may be delegated to an executive committee of directors or to a business manager.

Planning the administrative set-up of your association may help you avoid making serious organizational mistakes that may be difficult or impossible to correct later. Acquiring some knowledge of sound insurance management principles and practices may help you avoid costly actuarial mistakes.

The provisions of the insurance contract provide an overview of insurance management by prescribing the rules of the insurance mechanism. Nonmonetary provisions, such as a trading warranty, the Inchmaree and war risk clauses for hull insurance, and many others for protection and indemnity insurance, define the obligations assumed by your association. Monetary provisions such as the insurance amount, deductible, franchise, or other special restrictions specify the limits of your reimbursement. In return, your commitments consist of a registration fee to meet start-up costs, annual contributions for each year's protection, and assessments in the event losses exceed contributions. If your association does as well as most, if not all, existing insurance clubs do, the net cost of insurance will be your annual contribution, less lay-up credits and refunds.

Financial management prescribes the steps and procedures which you, as a prudent insurance manager, should follow to secure the profitability of your association; it gives you a dynamic understanding of the adopted insurance mechanism. Implementation of contract provisions depends on the insurance status of the founding members prior to the establishment of your association. You may initially restrict the contract provisions as much as possible and set contributions at levels comparable to commercial premiums. Furthermore, your association may insure a small portion of the basic coverage for each member and reinsure the remaining portion with other insurers; you may increase this initial primary basic coverage and decrease the reinsurance amount accordingly as soon as accumulation of a surplus justifies it. You may continue this step-wise accumulation of surplus until your association's surplus reaches the level necessary to assume the maximum desirable basic coverage. This signals the end of the developmental stage of your association. Thereafter, any excess surplus is refunded to the members on a pro rata basis.

How do you protect your reserves during and after the developmental stage? Reserves are of three basic types. Assessments in the form of agreed sums, promissory notes, letters of credit, or legal reserves comprise your <u>initial reserves</u>; your initial reserves and annual contributions are your <u>primary reserves</u>; and retained profits represent <u>surplus reserves</u>. Your association may pass a portion of each risk to other insurers by purchasing reinsurance, as already mentioned, and coinsurance. Reinsurance, in fact, is an insurance contract of your association with another insurer where the primary basic coverage represents a deductible provision. With a coinsurance contract, on the other hand, the other insurer shares a portion of the insurance amount if a loss exceeds the primary basic coverage. In addition, your association may purchase stop-loss insurance. With this contract, the other insurer indemnifies your association up to a certain sum if losses and expenses exceed contributions during a policy year. Thus, primary reserves and surplus are protected against immediate calls.

Risk management, the third important aspect of insurance management, is concerned with rules and procedures of safety, risk acceptance, and claims adjusting. The safety rules for vessel operations and any requirements for procedures, equipment or for the safety of the crew should be stated clearly in the by-laws. Safety rules of existing insurance pools are designed to uphold high standards of maintenance and seaworthiness by either restricting the scope of fishing operations or by imposing penalties on the offending members. Also, vessel owners with the best loss experience may be rewarded with refunds while safety awards to owners and crews alike may further strengthen safety standards. Moreover, your association can become an effective education center on safety.

Risk acceptance deals with evaluations of accepted risks, contributions and lay-up credits; from the actuarial standpoint, however, risk acceptance is primarily concerned with methods for differentiating risks with respect to expected losses. Risk differentiation can be accomplished indirectly with contract provisions designed to separate good from poor risks, or directly by varying contributions according to loss experiences.

Claims adjusting is as important in risk management as safety and risk acceptance. Procedures must be explicit and should be carried out by the board of directors or their representatives. Contract provisions such as paying the expenses to inspect a vessel after hitting bottom or systematic collection of evidence on personal injuries may be effective loss prevention measures.

For many reasons, a recommended course of action for your association would be to carry primary basic insurance coverage for each member and reinsure the remaining basic coverage with commercial insurers. Also, many vessel owners may need excess coverage that can be purchased from commercial insurers either directly or indirectly through your association.

Success in the three areas of insurance management: contract provisions, financial, and risk management, may contribute to a nearly self-perpetuating closed system.

The profiles of five existing insurance pools are of interest in two very important respects. First, most of these pools, as well as others whose profiles are not available, appear to offer insurance protection at very low rates. Second, the prevailing notion that only large vessels need insurance is false because several pools underwrite exclusively small vessels.

PART I INTRODUCTION

The introduction covers some basic material: (1) need for insurance protection and an insurer; (2) difference between a mutual insurance association and group insurance; and (3) information about existing insurance pools. Subsequent parts deal with key topics: (1) why a fishermen's mutual insurance association may be the best form of insurance protection; (2) how you, together with fellow vessel owners, can organize and administer an association or insurance pool; and (3) what are the principles and procedures of sound insurance managment.

Section 1- NEED FOR INSURANCE PROTECTION

As a vessel owner, you may have to carry two types of insurance protection. Hull Insurance covers damage to or total loss of your vessel. Protection and indemnity insurance (P and I) is a personal liability insurance. P and I pays the expenses related to personal injury, illness, or death of the captain or crew members of your vessel; it also pays all legal expenses and court-awarded compensation in case an injured fisherman working for you takes you to court for damages and wins his case.

Whether you carry no insurance at all, hull insurance only, or both types of insurance, you should read this manual.

A large proportion of the 87,000 or so commercial fishing craft in the United States are operated without insurance protection of any kind. Still, of those owners who carry insurance, a considerable number carry hull insurance only. But, if so many owners do not carry insurance, why is insurance protection needed? It is important to discuss this question before we proceed to other matters.

You may be a vessel owner who does not carry insurance at the present time. Most likely, you may have a one-man operation or, at most, you may have the help of one or two persons. Besides, your helpers may be relatives or friends. You may reason: "Why do I have to carry insurance? If something happens to my boat, my crew, or me, we can take care of ourselves."

Sea hazards are always present; you never know when misfortune may strike. Someone must pay the costs arising from the sea hazards of your fishing operations. Someone must pay for the damage or total vessel loss, or for nonlegal as well as legal expenses caused by personal injury, illness, or death. The vessel owner pays the bills in one way or another. To say that you do not need insurance protection, means that you are willing to shoulder the financial burden from sea hazards. Can you really afford these costs?

If damage to your boat, personal injury, or illness are not serious and do not happen frequently, you may be able to afford any related costs on a day-to-day basis. However, this is not self-insurance because you have not provided for building up a reserve fund from which you could cover these costs.

Small accidents may happen more frequently than anticipated. Worse, total loss of your vessel, serious personal injury, illness, or even death at sea cannot be excluded. Such losses may cripple your operation, wipe out your business, or leave your family without adequate means of support In addition, injury, illness, or death of a crew member may result in a law suit against you because you are liable for their well-being. You may argue that this may not happen to you, but you cannot be 100 percent sure. Even your closest relatives or friends may turn against you when the disaster strikes.

To meet the cost of frequent small losses or a single serious loss, a large reserve fund is needed. If you are financially able to build up the required reserves for all these risks, then you are self-insured. This rarely, if ever, happens to a vessel owner. Perhaps if you own a large fleet of vessels, you may be able to build up a reserve fund. This reserve, however, may not be large enough to cover all your potential losses. So you may manage to be self-insured up to a certain limit. You may still have to carry insurance with somebody else to cover severe losses. But even if you were able to build a reserve fund for all losses, self-insurance may not be your most desirable alternative for insurance protection.

Section 2 NEED FOR AN INSURER

The best course of action to follow may be to buy the necessary protection from an insurer by paying an annual fee or premium. Insurers are custodians of the annual fees or premiums they collect from you and other insured vessel owners. In return, they provide an insurance contract that obligates them to pay you for losses caused by hazards stipulated in the contract. Such a contract may be for hull or protection and indemnity insurance, or both. Of course, the reserves the insurers accumulate must be sufficient to cover the expenses of their operation in addition to paying your claims; these expenses vary in nature depending on the type of insurer. The nature of these expenses, however, is irrelevant to why you need an insurer. Your particular interest is in knowing what an insurer can accomplish which you are unable to accomplish alone.

You may consider that obtaining insurance protection is self-contradictory. You pay an annual fee or premium to cover events that you hope will never happen. For example, you pay for protection against total loss of your boat, your automobile, or your home, and you hope your boat never sinks, your automobile never crashes; or your home never burns. If such an event happens, you recover loss, or most of it, from your insurer. If such an event does not happen, you have enjoyed a service, namely, protection against a loss you can ill-afford.

It would be wrong to think that you are a loser if the sum of the annual fees or premium paid to your insurer exceeds the payments received for your losses. You would have forgotten that you received a valuable service: protection that eliminated the disastrous consequences of frequent small losses or severe loss. Only an insurer can give you such protection.

Section 3 A MUTUAL INSURANCE ASSOCIATION AS AN INSURER

There are three major types of insurers: an insurer can be a private firm, a government agency, or a group of vessel owners who form a club or pool for their mutual protection. For convenience we may call this last type of insurer a mutual insurance association or an association. Each type of insurer has its own advantages and limitations. Government insurance is available for businesses such as in some aspects of banking and farming, but not to owners of commercial fishing vessels. Fishing vessel owners have only two alternatives; insure with a commercial insurer, or, in cooperation with other vessel owners, insure through an association of your own..

The goal of this manual is to supply you with information that may help you organize and manage such an association. As a starting point, it is necessary to explain what a mutual insurance association is and how it differs from group insurance.

In a mutual insurance association, vessel owners get together with other others, share costs arising from sea hazards, and provide a way to pay these costs no matter how great they may be. As a member of a mutual insurance association, you contribute an annual fee to a fund from which all member's claims related to accidents stipulated in a contract are paid. Protection may cover a wide range of events; furthermore, the claims for each event vary, depending on circumstances that frequently are beyond the control of the association members.

Now you can see the important difference between a mutual insurance association and group insurance. In an association, you and the other members act collectively as your own insurers. You contribute to a reserve fund out of which claims and expenses are paid. You share the gains as well as the losses of the association the same as you share the gains or losses of a fishing operation. In a group insurance plan you do not act as your own insurer. Instead of each person signing an individual contract with a commercial insurer, you sign a group insurance contract. Many trade associations or fishing cooperatives as well as fleet vessel owners in the United States carry group insurance for hull, protection and indemnity, or both types of insurance. For reasons similar to those related to mutual insurance associations, premiums for group insurance are likely to be lower than premiums for single vessel insurance.

Section 4 EXISTING INSURANCE POOLS

This manual draws heavily from the experience of the on-going insurance pools in the United States. It is further supplemented from the experience of nationwide systems of insurance cooperatives for fishing vessels in other countries.

Several fishermen's mutual insurance associations, commonly called insurance pools or clubs, operate in the United States today. There are at least five hull insurance pools and three protection and indemnity insurance pools. Most have been in business for several years while one has operated since about 1930. Brief profiles of five such insurance pools are contained in part IV of this manual.

Members of these pools are owners of commercial fishing vessels. They found it advantageous to form a mutual association to protect themselves against hazards associated with fishing. Collectively, these associations insure hundreds of vessels of all sizes. In fact, members of four associations, three for hull and one for protection and indemnity insurance, are all small vessel owners who employ none or, at most, two crew members. The combined reserves of all these associations are hundreds of thousands of dollars.

These on-going insurance pools are a small fraction of the potential number of associations that could be established in the United States. The movements toward formation of associations in this country have developed into nationwide systems. Among the leading fishing nations of the world, the Japanese and Norwegian systems deserve special attention. The two systems differ greatly in the government's role as well as their objectives, organization, and other matters. Importantly, both systems provide for a reinsurance fund that strengthens the member associations of each system in finances and actuarial stability.[1]

PART II ORGANIZATION AND ADMINISTRATION OF AN ASSOCIATION

Successfully organizing and operating an association is not easy, but neither is it impossible. If other vessel owners have been successful, so can you. Learning about the experiences and difficulties that other vessel owners have encountered may significantly enhance your ability to establish your own association. First, you should know the conditions favorable for organizing an association. Second, you should be aware of the advantages and limitations of such a cooperative venture.

Section 5 NEED FOR A MUTUAL INSURANCE ASSOCIATION

Under certain conditions, insurance associations are the most natural form of risk pooling for fishing vessel owners. But, it is important to

---

[1] For additional information about the two systems, as well as for some general discussion about insurance associations, see Chris A. Theodore, A Handbook of Mutual Insurance Systems for Commercial Fishing Vessels and Gear, Rome, Italy. Food and Agriculture Organization of the United Nations, 1966.

explain the kind of insurance risk a commercial fishing vessel represents.

If we were to classify property risks such as passenger ships, freighters, residential houses, office buildings, factories, warehouses, and other properties, starting with the highest to the lowest risk, the commercial fishing vessel is likely to be on top or near the top of such a list. This can be at least partially explained because a fishing vessel operates under the most hazardous physical conditions. Furthermore, sea hazards are subject to sudden changes more frequently than hazards affecting most land-based properties; vessels are mobile which makes proper supervision and control difficult and frequently impossible.

A. Factors favorable to organizing

The human element is a significant factor. Good maintenance and high safety standards increase the insurability of your vessel. Vessel owners know that the safety of a vessel depends greatly on the crew, especially the experience, navigational skill, and character of the captain. In addition, the human element is particularly important because existing legislation very broadly defines your personal liability for injury or death of your crew. Thus in real terms, the best constructed and equipped vessel may be only as good an insurance risk as the people who man and operate it.

Obviously, the unique sea hazards and the importance of the human factor require an exceptional degree of supervision and control over your vessel. The captain does play a very important role. Accordingly, commercial underwirters are willing to insure owner-captained vessels at lower than usual premium rates. The constitution of many existing insurance pools limits membership to owner-captained vessels. Membership of absentee owners is allowed under special circumstances and with the written approval by the board of directors of the association. This does not mean that that you cannot form an association unless all members will captain their own vessels. Not all existing insurance pools limit membership to owner-captained vessels. However, experience strongly suggests that to successfully organize a mutual insurance association vessels of potential members should have captains with proprietory interests.

Another favorable condition is careful selection of an experienced and stable crew. The captain's role in this task cannot be overemphasized. Attitudes and loyalties of crew members are important; this is found in both unionized and nonunionized ports. In fact, it should be beneficial to the self-interest of labor and union leadership to cooperate with management in establishing a stable and responsible labor force. This is the experience of some long-established insurance pools. Thus willingness of labor and union leaders to cooperate in establishing an association is important.

Similar fishing operations may provide another favorable condition. Chances for success may increase appreciably if prospective member-vessel owners operate from the same port, own a similar type of vessel, and fish in the same geographical area. The membership of the majority of insurance pools have these common operating characteristics. Yet, these are not necessary conditions. One of the largest pools insures vessels that operate from several ports along the West coast.[2]

The most important condition for organizing an association is a trade association of vessel owners or a fishing cooperative. Such organizations are formed because most, if not all, of the previously mentioned favorable conditions exist. In addition, members of these organizations recognize their common interests: they believe in group loyalty, and above all, they are convinced that mutual aid is the best way to protect and advance these common interests. Usually, these important group characteristics are present because the members of a group have a common national or cultural background. A majority of trade associations and fishing cooperatives in this country appear to have been established by such groups. Later, the membership changes as new members with different backgrounds join the organization.

Frequent personal contacts among the members of these trade associations or fishing cooperatives provide opportunities for maximum self-supervision and self-control over their vessels and their personnel. Many such organizations already carry group insurance with a commercial insurer, another important condition for forming a mutual insurance association. In fact, later discussion explains how group insurance may be used as a stepping stone for introducing an association.

Nevertheless, you and other vessel owners do not have to be already organized into a trade association or fishing cooperative with or without group insurance to form an association. Other conditions such as captain's ownership, crew's loyalties and attitudes, and common fishing operations may be a sufficient base to start a mutual insurance association. However, establishing an association is likely to be much easier and obtaining success much greater when you and other vessel owners are already organized into a group.

B. Advantages

In many respects, a mutual insurance association is like a fishing cooperative. You and the other vessel owners collectively own a cooperative. You share the profits and the losses of the venture. The purpose of a fish processing and marketing cooperative is to sell the fish caught by its members (and, sometimes, nonmembers) at the most favorable market prices with minimum costs. Similarly, the purpose of a mutual insurance association is to offer its members the most insurance protection at the lowest possible cost. How can a mutual insurance association accomplish this objective?

---

[2] See profile on Commercial Fishermen's Inter-Insurance Exchange

An insurer's annual business is reflected in a financial statement of receipts and expenditures. This statement is similar to the income and loss statement you may have for your own business. Collected premiums and income from invested reserves would be under the receipts section. The expenditures section would contain the cost of underwriting risks, also called acquisition costs, losses and expenses for the settlement of claims, administrative costs, and taxes. These are likely to be the major items of an insurer's financial statement. For a given year, an insurer realizes a surplus if receipts exceed expenditures. Now let us examine the methods an association may use to economize on each type of expenditure.

Acquisition costs are likely to be kept low. Because there are no intermediaries between the association and its members, your insurance club does not pay commissions to brokers or other insurer's representatives. In many existing insurance pools, the initial and annual inspection of each vessel is made by a committee of member-vessel owners at no, or minimum, cost to the association. Underwriting effort is minimized and paper work simplified owing to the stability of the membership and the uniformity of the risks over the years.

For reasons already explained, your association is likely to insure vessels that can be better than average risks. The greater the degree of supervision and control among the members of your association, the better the insured risks are likely to be. Whenever possible, damage to a vessel may be evaluated by a committee of member-vessel owners, leaving no room for padded repair bills. In fact, in other countries some large insurance pools manage their own repair yards, at a considerable benefit to their members. In a locally operated association for protection and indemnity insurance, injured or ill fishermen receive immediate medical care and claims are paid without delay. Quick response, coupled with the cooperative spirit of crew members, prevents frequent litigation of claims. Such closely supervised procedures for settling claims are likely to cut losses and expenses to a minimum. For similar reasons, group insurance is likely to be less costly than individual insurance.

Unlike group insurance, however, members of an insurance pool may have a third economic advantage related to reserves. Any insurer must charge premiums larger than the expected losses and expenses to realize surpluses for building the required reserves. It is important to realize that the accumulated reserves belong to the members of the insurance pool. Reserves in excess of a desirable level are refunded to the member-vessel owners in a manner that will be explained later. Refunds of accumulated excess reserves may reduce the cost of your insurance protection considerably. For several ongoing insurance pools, refunds to members are over 90 percent of the annual premiums. For example, if your initial premium is $5,000 per year, you are refunded $4,500 so that your net cost of insurance protection is only $500. In addition, income from the undistributed reserves can meet part, if not all, of the administrative costs of the association. And, in the event your association is dissolved, all remaining reserves, after payment of claims, expenses and taxes, are refunded to the members of the association.

Additional savings may be made if an existing trade association or fishing cooperative is used as a base to organize a mutual insurance association. The newly established association may share the existing office and bookkeeping facilities of the parent organization with minimum overhead costs.

With a mutual insurance association you may have tax advantages. Some of the reserves may legitimately be classified as realized but undistributed claims. Members receiving refunds after retirement may enjoy a tax advantage because they get these dividends at the time their income tax rate is likely to be reduced. Under certain conditions, refunds to surviving relatives of a deceased member are tax exempt. Furthermore, in some States it may be possible to establish an unicorporated insurance pool. According to Section 526 of the Internal Revenue Service Code, the reserves of an unincorporated insurance pool are not subject to corporate income tax if its vessels are owner-captained. Only the income earned from invested reserves is taxable.

You may take special pride in belonging to an insurance association of your own. Boards of ongoing insurance clubs are known to take care of members who are disaster victims. They may postpone payment of overdue contributions, advance payment of a pending claim, and even extend special credits and financial aid. This treatment of hardship cases is consistent with the spirit of mutual aid which prevails in cooperative ventures of this kind.

Forming a mutual insurance association has some important nonmonetary benefits. If your insurance costs have been abnormally high relative to other operating costs, an association would not only keep these costs to a minimum, but may stabilize these costs and reduce uncertainty in your business planning. Most importantly, an association can operate effectively under present as well as any future legislation for personal liability. Through your insurance association you may benefit by exerting considerable control over your insurance affairs irrespective of legislation for personal liability.

The result of these advantages is low costs. For hull insurance pools, the net contributions, i.e., initial contributions less refunds and lay-up credits, have been averaging no more than 1 percent of the insurance coverage. In other words, member-vessel owners pay no more than $1,000 per year for $100,000 hull insurance protection. Similar information for protection and indemnity insurance is not readily available, nor may such information be meaningful because of wide differences in the insurance amount, experience, and scope of coverage between insurance pools. In at least two cases, however, net contributions have been averaging less than $1,300 per year for a vessel with six or fewer crew members.

C. Operational limitations

On the other hand, remember that mutual insurance associations as insurers do have limitations. First, the vessels of an association are likely to operate in a small geographical area. The advantages related to uniform rists, as already explained, may be partially offset because the risks of the association are geographically dispersed. This limitation may be particularly important for hull insurance because one severe storm may inflict unbearable losses on the association; in fact, it may spell financial disaster. A second limitation is the inability of an association to offer its members full insurance protection. Such protection requires reserves that are usually beyond the financial resources of an association. Membership problems are a third important limitation. They may range from lack of understanding or misunderstanding of insurance principles to petty politics. No cooperative venture, let alone a mutual insurance association, can survive with serious membership problems. Finally, you may encounter legal difficulties in organizing an association.

Most of these limitations can be surmounted, at least partially. One of the objectives of this manual is to show you how to overcome some of these difficulties.

Section 6 ORGANIZATION OF AN ASSOCIATION

In addition to studying this manual, consider the alternative legal forms of organizing an association and consult the managers of existing insurance pools and other sources of information. Your initial planning should be done alone or with other influential vessel owners having similar interests. Should immediate formation of a survey committee appear justified, then planning may be done by the members of such a committee acting collectively. During this period, it might be necessary to maintain an appropriate level of confidence until all the needed organizational information is at hand. Unless reasons dictate otherwise, keep the size of your committee small, no more than three persons. The following factors should be given thorough consideration.

A. Hull or protection and indemnity insurance?

It may be unwise to start an association for both types of insurance protection. Unless conditions are extremely favorable, choose the type of insurance protection that is of greatest interest and concern to your fellow vessel owners or for which you already carry group insurance. Based on the reports of the current fishermen's insurance associations, no insurance pool in the United States at the present time carries both types of insurance protection. If interest is equally strong in both types of insurance, you may decide to start a hull insurance association at first. From the administrative as well as the actuarial standpoint, the chances of success are likely to be greater if you begin with a hull rather than a protection and indemnity insurance association. After your association is well established, you can extend coverage to both types of insurance protection or have a separate association for each type.

B. Legal forms of organization

Insurance pools presently in operation have utilized three legal forms of business organization. An association may be incorporated under the laws of your State. This association would be under the jurisdiction of the State insurance commissioner, but the conditions of incorporation may be prohibitive. According to reports, State laws require that an incorporated association must have at least 100 members and at least $250,000 in legal reserves.

Secondly, an association may be organized as an unincorporated cooperative or a risk pooling club of vessel owners. Members pay dues and assessments, not premiums. This association offers insurance protection only to its members; it does not sell insurance to outsiders; it is not under the jurisdiction of the State insurance commissioner; no legal reserves are required; and, the reserves of such as association are not subject to corporate income taxes if its vessels are owner-captained.

Thirdly, the association may be incorporated under the laws of a foreign country. Such an association may not be under the jurisdiction of the insurance commissioner of the State in which the members of the association operate. Legal reserve requirements may be met with a letter of credit. More importantly, the articles of incorporation may provide for opportunities to expand the association's business in many directions without the need to meet additional legal requirements.

Existing insurance pools have been organized under all three legal forms. Of the eight existing insurance clubs, one is incorporated under the laws of a State, six are unincorporated risk pools, and one is incorporated in a foreign country. Thus, the legal "experience" of these clubs may help your organizing effort in several respects.

C. Managers of insurance pools

Communicate with the managers of insurance pools that carry the type of insurance protection you have chosen. Ask them how they started their insurance pools; the difficulties and problems they encountered in starting and managing their venture; where and how they handle membership meetings for important matters such as contributions, coverage, and restrictions; what procedures they follow for accepting risks and settling claims; how they manage reserves, refunds, and financial matters in general. This list of topics is by no means exhaustive. You should learn a great deal from their experience.

D. Legal advice

Initially, an attorney's services are essential. Unless you have special reasons to do otherwise, consult with a lawyer who has experience in setting up and advising an existing insurance pool. The managers of existing insurance pools may be able to help you locate an experienced lawyer.

An attorney can help you choose the appropriate legal form for your association. After an agreement is reached by prospective member-vessel owners to form an association, the attorney's services may include: drafting the constitution and by-laws of the association, preparing legal documents for the association ; serving as a knowledgeable source on legal issues at general meetings of the association; drafting the insurance contract and other forms necessary for carrying out the business of the association; helping resolve disputes concerning interpretation or modification of the by-laws, the insurance contract, the settlement of claims, or the dissolution of the association; and representing the association on external legal matters.

During the first meeting with an attorney, discuss the various legal procedures necessary to organize an association: the requirements, advantages, and disadvantages of each method under the laws of your State, and which method is preferable for your group. Inquire about other services the association may need and determine the legal work needed to organize your association. Whether you act alone or as a survey committee, do not make any commitment on behalf of the group of prospective members. Discuss this information with at least one manager of an insurance pool, and, if desirable, with other attorneys.

E. Advice on insurance matters

In addition to legal assistance, you will need professional advice on insurance matters. Although an experienced attorney may be able to handle a number of tasks such as drafting of the insurance contract and other insurance forms, you may still need the assistance of an insurance consultant. Such a person may help the association to set up actuarial and administrative procedures, to determine the rate of contributions or dues, the maximum insurance amount per risk, the deductible and/or franchise clauses and other restrictions of the insurance contract; and to negotiate a reinsurance contract. After the association is established, you may need similar services during the developmental period. The duration of this period will depend on the type of insurance, actuarial considerations, and other factors related to the specific experiences of each insurance pool. After the developmental period, many insurance pools rely heavily, if not exclusively, on the insurance experience of their managers and the assistance of their legal counsel. Other insurance clubs have as their manager a former insurance underwriter or broker. At least one insurance pool employs the services of an insurance management consulting firm. Depending on the scope and extent of services, consulting fees may range from about seven and one-half to as much as twenty-five percent of the annual gross contributions of the membership.

In considering insurance services for your association, discuss your needs with more than one insurance consultant. Inquire about the services each consultant thinks your association may need and what the cost will be for these services. After the association is approved in principle, discuss the insurance services with your lawyer. Find out which of the services your lawyer can perform and identify all that are absolutely necessary. Should you employ a consultant's services, avoid committing your association to a fixed commission rate on contributions. This could result in consultant's fees that will increase proportional to the dollar volume of contributions. This arrangement could be the least advantageous to your association. If possible, negotiate a per diem fee. It allows maximum flexibility. Daily fees are not fixed costs, but depend on the needs of your association as they may arise. You have the freedom of inviting different consultants as well. If you cannot avoid a commission rate on contributions, try to introduce maximum flexibility in your contract with the consultant. Provide for renegotiation of the contract terms within a specified period, and ensure that such a period does not exceed the development years. Bargain for a small commission rate and a downward sliding scale of rates as the dollar volume of contributions increases.

Section 7 ADMINISTRATION

If successful, your efforts will be rewarded during the last organizational meeting when convening vessel owners approve the by-laws and the insurance contract and elect the first board of directors. Your attorney will be authorized to do the necessary legal work to establish your mutual insurance association. Yet, your organization exists only on paper. You must work hard to implement the membership mandate. You must make your association a viable entity serving all its members in the best possible way.

In this effort, you may need some help in two important operational aspects of your association: administration and insurance management. Administration is primarily concerned with organizational matters and focuses on the three organizational components of an association: the membership, the board of directors, and the business manager. It examines the powers, responsibilities, and functions of each component. Insurance management is discussed in part III.

The components of an association's organizational structure and their interrelationships are shown in figure 1. Solid lines indicate the direction of authority. The membership delegates power to the board of directors. In turn, the board organizes and guides the discussion groups, appoints member-vessel owners to committees and subcommittees, and recruits as well as supervises the business manager or forms an executive committee. Broken arrows indicate two-way communication lines. Although directors may communicate directly with association members during and between general meetings, their major and formal lines of communication are as indicated.

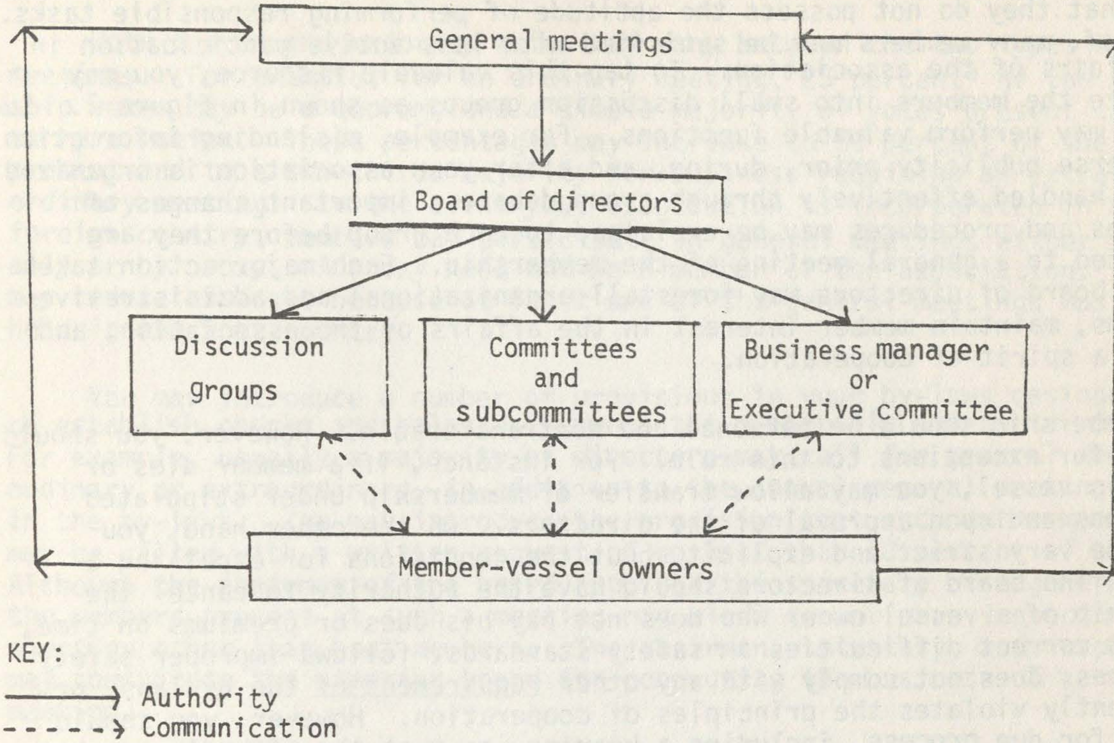
A. Membership

We discuss membership from two important administrative standpoints: membership conditions and general meetings. Some insurance aspects of membership are discussed in part III on insurance management.

- Membership conditions

Conditions for membership vary widely. In cases where your trade association or fishing cooperative has been the organizer of your mutual insurance association, you may limit, at least initially, membership to the members of the parent organization. Affiliation with a parent organization may also indirectly limit membership to a special type of fishing vessel.

Figure 1. -- A mutual insurance association: organizational components and lines of authority and communication



For a personal liability insurance pool, you may stipulate in the by-laws the type of fishing vessel, maximum crew size, and membership in a hull insurance pool as conditions for membership. Under different circumstances you may consider neither affiliation with the parent organization nor type of fishing vessel as membership conditions. In fact, you may provide for so-called special entries. Under such a provision, a vessel is insured, but the vessel owner is not a member of the association, and therefore, has no voting privileges.

Voting rights do not need to be uniform. Of course, you may provide, as nearly all existing insurance pools do, for equal voting rights, i.e., one vote for each member. On the other hand, you may consider one additional vote for each crew member. Such a voting arrangement may be more equitable, especially for a protection and indemnity insurance pool.

In addition to voting, there are many ways of maintaining cooperative democracy. For example, you may try to enlist the services of as many members as possible on at least one committee each; you may establish a rotating system of membership on the board of directors. These arrangements distribute duties and responsibilities equitably and may hinder the rise of a vested interest that may be detrimental to your association.

On the other hand, you must realize that not all member-vessel owners may wish to be placed in a position of responsibility. Still, others may feel that they do not possess the aptitude of performing responsible tasks. In brief, many members may be satisfied with less active participation in the affairs of the association. To tap this valuable resource, you may organize the members into small discussion groups as shown in figure 1. Such groups may perform valuable functions. For example, misleading information or adverse publicity prior, during, and after your association is organized can be handled effectively through group debates; important changes of policies and procedures may be explained to each group before they are presented to a general meeting of the membership. Each major action taken by the board of directors may forestall organizational and administrative problems, maintain member interest in the affairs of the association, and foster a spirit of cooperation.

Membership should be personal and nontransferable. However, you should provide for exceptions to this rule. For instance, if a member dies or sells his vessel, you may allow transfer of membership under stipulated conditions and upon approval of the directors. On the other hand, you should be very strict and explicit about the conditions for expelling a member. The board of directors should have the authority to cancel the membership of a vessel owner who does not pay his dues or premiums on time, fails to correct difficulties in safety standards, follows improper safety procedures, does not comply with any other requirement of the by-laws, or consistently violates the principles of cooperation. However, you should provide for due process, including a hearing, so that the offending member is given a chance to defend himself.

- General meetings

At the outset, you should realize that the power to form, manage, and dissolve your association rests with the membership acting collectively at a general meeting. For practical reasons and during the time the membership is not holding a general meeting, the management of your association is delegated to an elected board of directors and through them to a business manager. In a real sense, the membership represents the legislative branch; the board of directors and the business manager are the executive branch of your association.

You may find it useful to distinguish between ordinary and extraordinary general meetings. Ordinary meetings may decide on matters related to the management of the association according to approved by-laws and the insurance contract. In particular, an ordinary meeting of the membership may approve or reject the annual financial reports; determine the amounts and rates of contributions, dues, premiums, and assessments or calls; appoint or dismiss directors, managers, or auditors of the association and vote upon their discharge; reaffirm the decisions of the board on matters such as admission of new members, transfer of membership, or dismissal or members; and act on any other matters not specifically reserved to extraordinary general meetings. The latter meetings may decide to adopt or change the provisions of the by-laws and the insurance contract, except contributions, or to dissolve and liquidate the association.

Both quorum and majority rules may vary between the two types of meetings. For example, for an ordinary meeting, 25 percent[3] of the membership votes may be a quorum, and a simple majority of votes present can carry a motion. These percentages may increase to 50 percent of the votes present and to a two-thirds majority for business requiring an extraordinary meeting. In the event your association is incorporated in a foreign country, members may participate in general meetings either personally or by proxy. A proxy need not be a member of the association. This may reduce expenses because at least one of the general meetings must be held in the host country.

You may introduce a number of provisions in your by-laws designed to establish checks and balances between the membership and the directors. For example, usually a majority of directors may call for general meetings, ordinary or extraordinary, in addition to the annual general meeting provided in the by-laws. You may introduce the provision that such extra meetings may be called with a written request of no less than 10 percent of the votes. Although the chairman of the board appoints the secretary of a general meeting, the members present at such a meeting may elect two or more inspectors of election other than boat members. The chairman, secretary, and inspectors may constitute the steering board for conducting the business of a general meeting.

Other formal procedural matters are designed to meet legal requirements or to convenience the membership. These provisions may include the policy year, time and place for the annual and additional general meetings, proper notification of a general meeting, keeping appropriate minutes, and other matters related to the conduct of general meetings. Most of these provisions are standard and should be included in the by-laws.

B. Board of directors

The membership delegates the management of your association to the board of directors, sometimes called the board of trustees. The board is the executive branch of your association; it carries out the association's business in accordance with the policies, rules, and procedures approved by the membership; it is authorized to make binding decisions on behalf and in the best interests of the membership.

The board is reponsible for both administrative and insurance operations of your association. The board's involvement in insurance matters will be discussed later. From the administrative standpoint,

---

[3] Quorum requirements vary among existing insurance pools. In some cases, it is stated as a percentage and varies between 15 to 25 percent of the membership; in others, it is an absolute number of members from 5 to 17 members.

you may be interested in two operational aspects of the board: important governing rules and functions.

- Governing rules

Among reporting insurance pools, the number of directors varies from five to seven. Initially, a 5-member board may be appropriate. The membership may be small. Members who are knowledgeable and willing to work hard are likely to be in short supply. Moreover, there may be a need for more centralized authority in conducting the business of a fledgling association. However, a 7-member board may be desirable in many respects, especially after the 3-to 5-yr developmental stage. A larger board is consistent with the principles of cooperation because more people participate actively in the association's business. Additionally, this would facilitate including nonmembers of your asssociation such as your attorney or your insurance management consultant on the board; the work load for each director could be lighter; and a larger board could improve management because the directors could perform nearly all insurance-related functions themselves.

To maintain continuity in the business of the association, you may elect the first board members for different years of service. For example, one director may be elected for one year, two or three for two years, and two or three for three years. Thereafter, directors may be elected for a 3-yr term. The 3-yr term appears to be characteristic of existing hull pools. Protection and indemnity pools, however provide for a 2-yr term. The by-laws of all reporting pools provide that vacancies are filled by a majority vote of the remaining board members until the next annual general meeting.

The board of directors elects a chairman during their first meeting. Usually, the chairman calls subsequent meetings of the board; but you may provide that any two directors also have the right to call a board meeting. A simple majority of the directors present at a meeting constitutes a quorum and a majority of votes cast carries a motion. Beyond these universally accepted rules, your by-laws may include additional details, depending on circumstances. For example, if your membership is geographically dispersed or your association is incorporated in a foreign country, you may provide that any director can act by appointing another director as his proxy. You may also provide that in an emergency, the directors may cast their votes by cable, telegram, or telex. In this case, however, voting should be confirmed by a letter within a specified number of days.

Should the directors be compensated? Again, your by-laws may be as simple or as elaborate as necessary. Essentially, the directors are considered to be volunteers, in accordance with the cooperative spirit. This explains why no compensation is provided; or, if it is provided, it is usually nominal and limited to specific tasks. For example, you may specify that each director be paid a nominal fee of $10 for each meeting attended or for each vessel surveyed, plus transportation not to exceed the same sum; or you may leave compensation and expenses to the discretion of the directors. Then, too, you may require that certain items be fully reported to the next general meeting of the membership. Furthermore, you may state that a director who has a conflict of interest with any transaction of the association should disclose such interest and abstain from voting. Such conflict of interest should be reported at the next general meeting. You may further specify that the total overhead expenses, including compensation of directors, should not exceed a given percentage, for example, 5 percent, of the total annual contributions.

- Functions

Between board meetings, authority rests with the association's chairman or president whom the directors elect. He is the chief executive officer of the association who conducts the daily business of the association. Much of this authority can be delegated to an executive committee or a business manager as explained later. In preparing your by-laws, it is advisable to consider including provisions for an executive committee whose members may share certain duties and responsibilities with the president-chairman. You may state that a vice-president should be a member of the executive committee and should act for the president in his absence. If you do not plan to appoint a business manager, you may have a secretary and a treasurer as part of the executive committee. They need not be directors and may be appointed and dismissed by the directors. Whatever arrangements are made, the president-chairman, with the assistance and approval of the board, generally performs the following important functions in accordance with the rules, procedures, and authorities stipulated by the by-laws of the association:

a) Calls and conducts the general meetings of the association;

b) Submits an annual report of the business of the association, including an audit of the accounts, for discussion and approval at the annual general meeting;

c) Admits new members to the association and expels members;

d) Appoints committees and participates in their work;

e) Recruits a business manager, determines the conditions of his employment, and supervises his work;

f) Investigates, adjusts, or rejects claims;

g) Recommends changes in the contributions, refunds, and other financial matters of the association;

h) Recommends changes in the by-laws and the insurance contract;

i) Nominates a slate of new directors; or accepts an alternate slate of directors nominated by at least 10 percent of the membership;

j) Represents the association in its external social, business, and legal affairs.

C. Business manager

Earlier, we discussed the remuneration of the business manager in connection with the services of an insurance management consultant. If circumstances justify hiring a business manager, it is advisable to employ a person who has a good background in the insurance field. This may be particularly desirable for a protection and indemnity insurance association because of the complexities of managing the insurance contract. If you hire a business manager, you should remember that his remuneration is a fixed cost to the association if he works on a salary.

An alternative approach delegates daily management of your association to an executive committee of directors, including the president-chairman of your association. This alternative would be more suitable for a hull rather than a personal liability insurance association. It can be particularly desirable if your insurance club is an affiliate of a parent organization such as a trade association or a fishing cooperative. The executive committee can conduct much of the work on a voluntary basis. Daily supervision can be delegated to the manager of the parent organization who can also be a nonmember secretary of the club. Office records and other office work can be done by the personnel of the parent organization. The result would be very low overhead costs for your insurance club. Additionally, whatever fee the club pays for these services would lighten the overhead of the parent organization.

Whether your association is an affiliate or not, try to keep overhead costs to a minimum. Remember, your initial objective is to provide needed insurance at least cost through the cooperative efforts of a highly selective membership. Large initial overhead costs such as an office, a business manager, and other personnel may force you to expand membership sooner than actuarial experience justifies it.

What functions should the business manager or the executive committee perform? This depends on the particular problems the board faces and the extent to which the board members are unable to carry on the daily management of your association. If you opt for an executive committee, the board should draft a resolution that specifies the duties and responsibilities of such a committee. Of course, any member of the executive committee, acting as an officer or agent for the association, may be required to furnish a satisfactory bond for faithful performance. If you opt for a business manager, you may be more specific about duties and responsibilities. In drafting your by-laws, you may consider the following provisions. They are neither exhaustive nor exclusive. The business manager may:

a) Be custodian of all the association's funds and property;

b) Draw checks against the association's funds in payment of claims or bills approved by the board of directors;

c) Keep an accurate record of all business transactions for the association;

d) Deposit all funds in depositories approved by the board of directors;

e) Serve as secretary for both the board meetings and the general meetings of the membership;

f) Be authorized, with the approval of the board, to sign, as secretary, all documents requiring the signature of an officer of the association;

g) Prepare an annual report of the association's activities, including an audit of the accounts, and the agenda recommended by the board or the membership prior to each meeting;

h) Prepare and mail all notices required for the meetings and other procedures of the association;

i) Be required to furnish a fidelity bond in an amount determined by the board or specified in the by-laws. In either case, the association should bear the cost of such bonding.

PART III INSURANCE MANAGEMENT

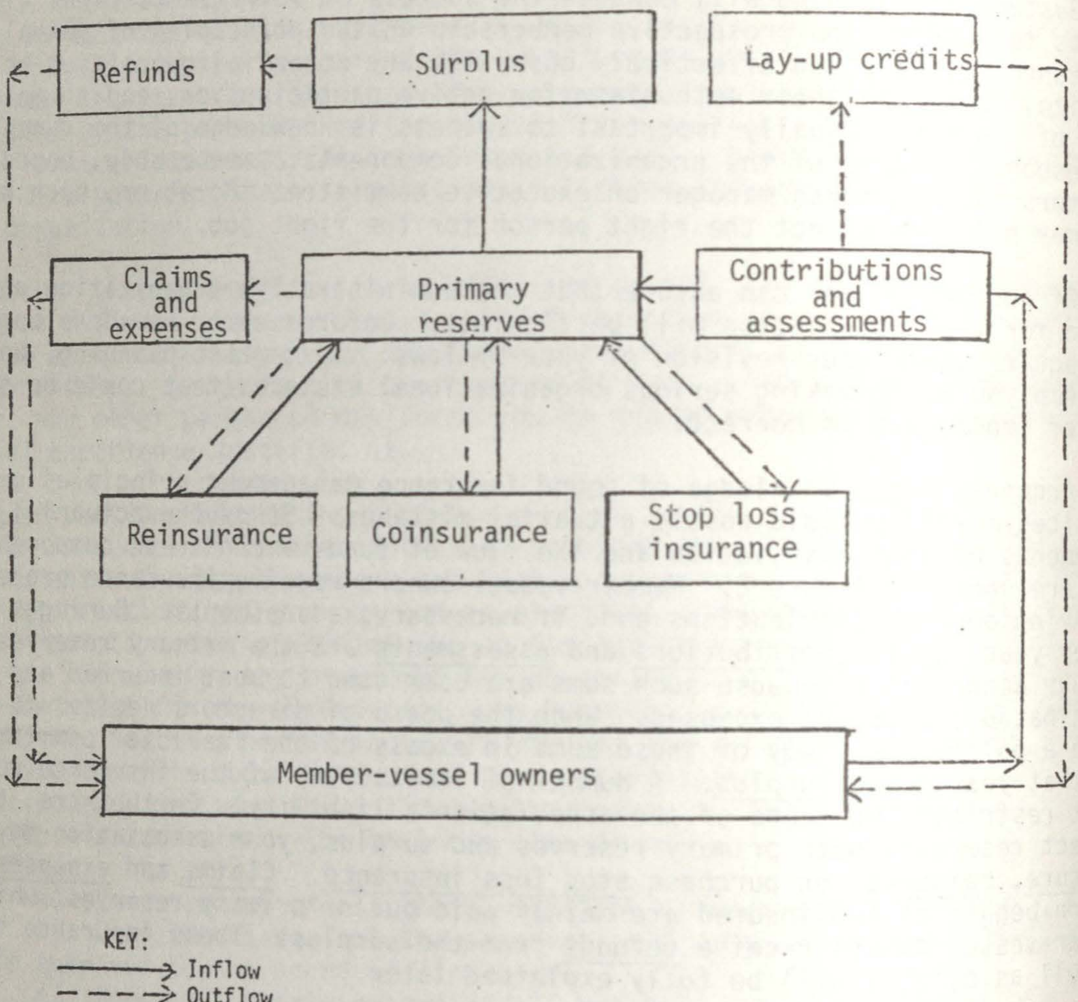
Systematic planning will enhance the success of your association. Your efforts to educate the prospective membership in the principles of mutual assistance may help you effectively cope with any potential opposition to organize, to secure their enthusiasm for active participation, and to maintain unity of purpose. Equally important to success is knowledge of the functions and responsibilities of the organizational components: membership, board of directors, and business manager or executive committee. Moreover, such knowledge may help you select the right person for the right job.

Of course, no one can assure that the administrative organization you choose for your association will be flawless. Unforeseen or new developments may require continuous revision of your by-laws. Systematic planning, however, may help you avoid making serious organizational mistakes that could be difficult or impossible to correct.

Acquiring some knowledge of sound insurance management principles and practices may help avoid costly actuarial mistakes. Study the actuarial components of your association and the flow of funds among these components; both are shown in figure 2. Member-vessel owners receive insurance protection by paying annual contributions and, if necessary, assessments. During a given policy year, total contributions and assessments are the primary reserves of of your association because such sums are committed to meet incurred and anticipated losses and expenses. When the board of directors decides to close a policy year, any of these sums in excess of the financial commitments for that year go to surplus. A number of limitations of the insurance contract restricts the scope of the association's liability. Furthermore, to protect reserves, both primary reserves and surplus, your association may reinsure, coinsure, or purchase stop loss insurance. Claims and expenses for and on behalf of the insured are mainly paid out of primary reserves, while member-vessel owners receive refunds from the surplus. These insurance terms, as well as others, will be fully explained later.

Figure 2 gives an overview of the insurance mechanism and the flow of funds for your association. This mechanism is studied from three important standpoints: contract provisions, financial management, and risk management.

Figure 2.-- A mutual insurance association: actuarial components and flow of funds



Section 8 CONTRACT PROVISIONS

Previously, we explained that your association is an insurer, providing its members collective protection against the hazards of fishing operations. What are the nonmonetary and monetary contract provisions related to this protection? This question refers to three topics that we shall examine in turn: nonmonetary and monetary obligations of your association to its members, and the financial commitments of the membership.

Most nonmonetary contract provisions are usually included in the insurance contract, but this is not a universal rule. You may elaborate and expand the initial contract provisions in your by-laws. In fact, you may desire to incorporate all nonmonetary contract rules in a separate booklet. Monetary contract provisions are usually specified in the by-laws. Our concern here is not where such provisions may appear, but which provisions are relevant to the two types of insurance protection, hull and personal liability.

A. Hull protection

The typical approach specifies that your association will indemnify any member for accidental partial or total loss according to the provisions of a specific commercial hull contract form. This appears to be the practice of existing hull insurance pools that have adopted the provisions of the American Hull Pacific form (1938). This form may then be amended to enumerate the special conditions, limitations, and exclusions designed to serve the insurance needs of your association.

Consider the following nonmonetary provisions. These provisions should be regarded as a sample rather than an exclusive or exhaustive list of major stipulations.

a) Provide that no member shall be indemnified for loss or damage to skiffs, outboard motors, poles, lines, or fishing gear.

b) Include a trading warranty that states that a member shall not be paid for losses sustained beyond specific geographical limits expressed in navigational or other identifiable terms.

c) Exclude any payment for damage or loss caused by acts of a declared or undeclared war.

d) Include electronic equipment as part of the vessel value but provide that the value of that equipment will be deducted from partial or total loss if such loss occurs while the equipment is not on board.

e) Disallow reimbursement for a loss if a vessel is assigned, pledged, chartered, or placed under new management without prior notification to, and written approval of, the board.

f) Indicate under what conditions and with what procedure a waiver limiting membership to owner-captained vessels may be permitted.

g) Provide full rights of subrogation when a claim is made by a member against any third party. Have all the rights and remedies of the member against such third party.

h) Exclude the so-called Inchmarre or negligence clause. In general, such a clause protects the insured against losses owing to breakdowns caused by negligence of the captain, engineer, or pilot.

i) Exclude loss of anchor gear unless loss occurred in an effort to save the vessel.

j) Exclude reimbursement for accidents caused by overloading.

K) Exclude losses resulting from the practice of tying vessels together while traveling.

B. Protection and indemnity

Unlike standard hull coverage, no existing personal liability insurance pool appears to refer to the coverage of a given commercial contract form. Instead, the contract provisions are stipulated in the by-laws; a contract is drafted exclusively for the pool. Thus, lack of uniformity may be partially attributed to the unpredictable outcome of legal disputes and because awards for identical injuries may vary widely.

Here are some of the most important nonmonetary coverage provisions for protection and indemnity insurance:

a) For loss of life, personal injury, or illness of crew members or their beneficiaries under any compensation act. Under certain conditions, protection may extend to claims arising from persons handling the cargo of the vessel. The latter coverage is frequently called lumper risk.

b) For hospital, medical, or other health related expenses arising in connection with the above personal liability provisions. A fixed sum may be stipulated for burial expenses.

c) For repatriation expenses and wages lost in connection with the above-mentioned coverage.

d) Costs, charges, and expenses paid for the defense of a member against any claims arising from the above personal liability provisions.

e) For damages to other vessels or property on board by collision.

f) For damages to other vessels or property on board not caused by collision.

g) For damages to docks, piers, harbors, bridges, or any other fixed or movable objects except another vessel.

h) For cost or expenses of removing the wreck of the insured vessel if such removal is required by law.

i) Under certain conditions, for property or personal effects of passengers or repairmen on an insured vessel.

j) For the cost of accidental oil spills or other pollution effects caused by an insured vessel.

k) For the so-called war risks that include damage or loss of an insured vessel caused by a drifting or abandoned mine or other marine explosive devices.

However, such protection is subject to numerous general restrictions and nonmonetary limitations. For example, if a claim is filed against your association, the involved member should not admit any liability, should aid in securing evidence, should subrogate, i.e., relinquish to the association all his claims against a third party, and should not transfer or assign any of his claims against the association. Furthermore, a member-vessel owner is not entitled to the above protection provisions if liability is the result of a social upheaval, if the vessel is engaged in unlawful trade or act; or if the vessel tows another vessel or craft, except under specified conditions. If your association limits membership to owner-captained vessels, you may stipulate that disregard of this condition without the written and annually renewed approval of the board may result in loss of protection. Finally, you may stipulate that your association's commitment does not exceed the liability that would have been legally imposed in the absence of a contract.

C. Limits of reimbursement

The above nonmonetary provisions define the coverage that your association has assumed for its members. A number of other contract provisions define the limits of reimbursement. These are provisions that limit monetary obligations of your association towards the membership. They are two types: standard such as the insurance amount, the deductible, and the franchise; and special, which may reflect the particular conditions of your association.

- Standard limitations

The insurance amount is the maximum sum of money your association would pay for any single obligation to any member. For hull insurance, the sum represents a conservative market value of the insured vessel as last assessed by the board. Closely related to the insurance amount is coinsurance. Under coinsurance, a member is free to purchase protection called insurance coverage, representing a percentage of the insurance amount. If the insurance coverage is less than the insurance amount, your association reimburses the insured for a percentage of each loss that is equal to the ratio of the insurance coverage to the insurance amount. For example, if your insurance coverage represents 75 percent of the insurance amount, the association would reimburse you for 75 percent of each loss. You are a coinsurer for 25 percent of your losses.[4]

The coinsurance provision is important in several respects. An insurance coverage representing no more than 75 to 85 percent of the insurance amount limits the monetary obligations of your association. Coinsurance protects your association against moral hazard arising from total loss of a vessel if the market value of the lost vessel has fallen below the stipulated insurance amount. Coinsurance may motivate you as a vessel owner to be more careful. Because dues are based on the insurance coverage and coinsurance is a form of self-insurance, you can tailor your contract with the association according to your finances. You can increase the portion of your self-insurance as much as you can afford, thus reducing your annual dues or vice versa. Later we shall see how coinsurance can be used to protect the reserves of your association.

---

[4] For detailed numerical examples illustrating how coinsurance works, see profile on Pacific Trollers Fund.

Coinsurance is not used for protection and indemnity insurance because the conditions justifying such practice are absent. The insurance amount is the maximum sum your association is obligated to pay for each claim of personal liability. Usually, this maximum insurance amount consists of two levels of monetary coverage; basic and excess. Basic coverage specifies the limits of your association's obligation for each claim. You must pay the stipulated annual contribution or dues for basic coverage that is mandatory for membership. If a claim exceeds the basic coverage, your association has no obligation to pay the excess amount claimed. For additional protection, you may purchase excess coverage by paying additional dues. Because rates may slide downward for excess coverage, such stratification of insurance amounts may enable you to tailor the extent of your protection according to your needs and cost considerations.

The deductible contract provision specifies the amount of money that must be subtracted from the claim. It may be a flat sum of money such as $250 or $500 per claim or it may vary, increasing with the insurance amount carried on each vessel. A deductible is designed to serve several important purposes. Because small claims are likely to occur more frequently than large ones, the association's liability may be reduced appreciably by providing for a nominal deductible. This would be consistent with the principle purpose of your association, namely, to protect you against large losses you cannot afford. While the deductible provision forces you to shoulder losses up to the deductible amount, it may also be an incentive for you to be a careful and prudent vessel operator. With respect to hull insurance, a deductible may effectively eliminate small claims that may be losses attributable, at least partially, to normal wear and tear. Thus, a deductible may discourage vessel owners from thinking that their annual contributions are mere prepayments of normal repair bills. With respect to personal liability insurance, a deductible may effectively eliminate petty claims that require as much effort to process as large claims.

Yet, circumstances may dictate a no-deductible policy for your association. Brokers or agents of competing commercial insurers in your area may follow the same policy. For hull insurance, it is also advisable to accomplish the purposes of a deductible by other means, such as a franchise or other special limitations. For protection and indemnity insurance, you may find a no-deductible policy advantageous for other reasons. Supervision to prevent accidents is closer, evaluation of claims more uniform, and payment of maintenance and cure made more promptly than otherwise might have been possible. Furthermore, you may be freed of considerable paperwork. Such arrangements allow proper collection of information and careful documentation of evidence that are important if a case is litigated.

A franchise contractual provision is a milder form of a deductible clause. Your association does not pay losses that do not exceed the franchise amount. However, if a claim exceeds the franchise amount, nothing is deducted; you get full payment of your claim. Usually, the franchise clause is applied to hull insurance and to losses caused by other than stranding, sinking, fire or collision.[5] The franchise amount may be a fixed amount, for example $10 per ft of the registered length of each vessel, or some other similar measure. Also, you may further specify that the franchise amount should not exceed a certain sum. Because a franchise clause excludes claims from certain causes, it may be combined with a deductible clause applicable to those excluded claims.

- Special limitations

Depending on the particular circumstances, monetary obligations of your association may be further limited. Here are a few suggestions to consider incorporating in the by-laws.

a) Disallow a member to carry hull insurance with another insurer which combined with your association's coverage exceeds the fair market value of his vessel.

b) Indemnify a member for only half of any loss on hull coverage that takes place in certain channels, sand bars, shoals, or other obstacles at sea, if navigational hazards justify it.

c) Disallow any member to carry the same coverage for protection and indemnity insurance with either a commercial insurer or another insurance pool.

d) Limit the obligation of your association to the unpaid mortgage balance on the vessel if a personal liability claim is the result of an unprovoked assault or unlawful act of the owner or part-owner of the vessel.

e) Limit the obligation of your association to the unpaid mortgage balance on the vessel if a claim for hull or personal liability insurance arises from failure to maintain safety standards and rules.

f) Deduct payment of a loss to a member from that member's interest in the surplus earned during the policy year in which such a loss occurred.

Such provisions on coverage and limits of reimbursement serve two important purposes. First, they reinforce the favorable selection of risks so characteristic of insurance pools by effectively controlling the non-insurable aspects of each risk. Second, they restrict the monetary obligations of your association to a level the membership can afford.

D. Members' financial commitments

In return for such protection, what financial commitments must you make? These commitments can be classified into three categories: start-up commitments, annual contributions, and assessments.

- Start-up commitments

If your association is incorporated under the laws of your State, your start-up commitments may not be as great as the membership requirements.

[5]For numerical examples illustrating how a franchise clause works, see profile on Pacific Trollers Fund.

For example, assuming a minimum of $250,000 for legal reserves, an association with a minimum of 100 founding members would require $2,500 per member. Of course, this sum is not a start-up cost. You simply tie up this sum of money to meet legal reserve requirements; the earnings from these legal reserves may be sufficient to meet the fees and expenses for establishing your association.

Your start-up commitments are likely to be minimal if you can form an unincorporated insurance pool or incorporate in a foreign country not requiring legal reserves or use the charter of an existing insurance pool incorporated in a foreign country. Then you may pay only a registration fee sufficient to meet the cost of organizing your association. This fee may be nonrefundable. Fees in excess of costs may be considered part of your primary reserves to be discussed later. The registration fee may be a flat sum per member or it may vary with the size of the vessel. For hull insurance, the fee may increase with the length or gross tonnage of each vessel. For personal liability insurance, the fee may increase with the size of the crew.

If your association is incorporated in a foreign country, you may be able to meet the reserve requirements with a <u>letter of credit</u> from a bank. In this case, the bank may accept a promissory note, which the members of your association can obtain collectively, as collateral. This letter of credit represents your reserves, until your association builds up its own surplus. It can be used to pay losses in excess of your annual contributions.

If your association is an unincorporated insurance pool, each member may sign a <u>promissory note</u> as part of your reserves until your association builds up its own surplus. Unlike a letter of credit, no banks are involved. Collectively, you may decide to have as small a promissory note as you can afford or you may decide to replace such a commitment with a provision in the by-laws for assessments, as explained later.

Unlike legal reserves, a letter of credit or a promissory note does not tie up your own money. They are pledges of money that can be called only if and when payment of losses and expenses exceed annual contributions. Later we shall explain how we can minimize or nearly eliminate the chances for calling payment of such pledges.

- <u>Annual contributions</u>

This financial commitment corresponds to the insurance premium you pay if you carry commercial insurance. It is the annual fee you must pay for the insurance protection you receive from your association. For hull insurance, it is based on a percentage or rate per thousand dollars of insurance coverage. For personal liability insurance, it is a fee per vessel or per crew member. Beyond these basic considerations, annual contributions may vary depending on other criteria. They are part of risk rating which will be discussed later.

Our purpose here is to concentrate on your financial commitments. You should know that your annual contributions are nominal commitments to your association. They are gross contributions. They are not the net contributions you make for the insurance protection you receive from your association. These net contributions are the real cost of your insurance. They depend on the loss experience of your association. If losses are small for a given policy year, your net cost would be less than your gross contributions; otherwise, you may be assessed for additional contributions or assessments as shown in figure 2.

The loss experience of your association cannot be predicted precisely, but the majority, if not all, existing insurance pools appear to be doing very well. The cost of insurance is very small because net contributions have been far below gross contributions, which is accomplished with lay-up credits and, especially, refunds. The outflow of these funds from the association to the member-vessel owners is shown with broken arrow lines in figure 2.

Lay-up credits are refunds of contributions to members whose vessels have been tied up for longer than a specified number of consecutive days during a fishing period. They are payable during or at the end of the policy year in which they occur. The rules for lay-up credits are part of a later topic on risk management. Refunds are also called dividends because they are your "earnings" from a "profitable" loss experience of your association. We will further discuss refunds later. Now, let us consider your third financial commitment to your association.

- Assessments

The third financial commitment is a pledge written in the by-laws for contributing additional money if your annual contributions are not sufficient to pay all insured losses and expenses of the current policy year. For example, if losses and expenses exceed contributions by $10,000 and the association has 50 members, each member will be called to pay $200 ($10,000 ÷ 50 = $200) to cover this deficit. For insurance associations with legal reserves or a letter of credit, these sums are normally the funds from which the $10,000 deficit is paid. If your association is an unincorporated insurance pool, you may consider the following alternatives in limiting assessments: provide for no assessments beyond the annual contributions; assess to the amount of the promissory note, if you provide for such a note; or, limit assessments to no more than a specified multiple, usually twice the annual contribution of each member. In the event of a deficit, that is, losses and expenses exceed annual contributions and stipulated assessments, you may provide for suspension of payments. Your association ceases to indemnify members. After payment of expenses, outstanding claims may be settled pro rata. For example, consider two claims, one for $50,000 and another for $100,000. Annual contributions and stipulated assessments are $75,000. A provision to suspend payments would award $25,000 to the first and $50,000 to the second claimant.

At this point, you may conclude that your association may offer you inadequate protection against heavy losses; worse, assessments are likely to be a heavy and perennial financial burden. This is simply not true. We shall demonstrate the falsity of this conclusion by discussing financial and risk management. Both aspects of insurance management are based on sound insurance policies and practices designed to protect you from being assessed and serve the ultimate objective of maximum protection at minimum cost.

Section 9 FINANCIAL MANAGEMENT

We have enumerated some of the most important contract provisions that should be considered for an association. Enumeration only gives you a static overview of obligations and commitments; it prescribes the rules of the insurance mechanism. How does this mechanism work? The question asks for steps and procedures necessary to implement these contract provisions. Implementation will give us a dynamic understanding of the adopted insurance mechanism.

Financial management is one important implementational aspect; it prescribes the steps and procedures that a prudent insurance manager should follow to secure the profitability of an association. In particular, financial management refers to three tasks: starting the wheels of the insurance mechanism to build adequate reserves, handling the acquired reserves, and protecting such reserves to maintain the solvency of your association.

A. Developmental stage

Imposing assessments during a given policy year means that your association is operating at a loss; you have had a deficit year. However, if contributions of a given policy year are just sufficient to meet losses and expenses, you neet not impose assessments, your association has broken even. And, if such contributions exceed losses and expenses, you have realized a surplus; your association made a profit. Thus, your main interest is the same as the ultimate interest of any business--to successfully manage the financial affairs of your association to avoid assessments and to maximize chances for making a profit.

Realized profits are retained as a surplus. A surplus is available to meet the deficit of unprofitable policy years. An accumulated surplus can minimize the chances of an assessment. The initial period of surplus accumulation for eligible members is the developmental stage of your association. From the financial standpoint, this stage involves two procedures of immediate concern: implementing the provisions of the adopted contract and accumulating an adequate surplus.

- Contract implementation

The profitability and, indeed, the very success of your association depend, to a large measure, on the initial steps taken to implement the association's contract. Yet, we can make only general suggestions that refer to the insurance status of the founding members as well as the contract provisions.

Prior insurance status may determine which course of action to follow. We have already explained why the presence of group insurance is one of the most favorable conditions for organizing a mutual insurance association. This holds true from the actuarial viewpoint as well. You already know the loss experience of the group. You may consider using the premium for group insurance as a measure for determining annual contributions to your association. If the premium for group insurance is sufficient for your commercial insurer to build a surplus and, hopefully, make a profit, it may be sufficient for your association as a starter.

Implementing contract provisions is likely to be more complicated if the founding members carry single contracts with commercial insurers. Then the terms of commercial contracts may largely determine the contract provisions of your association. Here are a few suggestions to consider: try to classify the candidates vessels into two or three distinct classes with respect to limits of reimbursement and, especially, the present premium rates; if possible, find out what terms, especially premiums, commercial insurers would be willing to offer for group insurance to each vessel class; then use these premiums as a guide for setting your annual contributions.

Follow a similar procedure if the founding members carry no prior insurance. If necessary, classify the candidates' vessels into two or three classes on criteria relevant to the type of desired insurance. Size and age of vessels may be sufficient criteria for hull insurance. Crew size might be an adequate criterion for personal liability insurance; determine what terms commercial insurers would be willing to offer for a group insurance package and use such an offer as a guide to determine the contract provisions of your association.

Irrespective of prior insurance status, a number of additional suggestions may be considered:

a) Unless competition dictates otherwise, restrict the contract provisions of your association as much as possible. This is especially important if the founding members carried no group insurance and, therefore, you have no prior actuarial experience with the accepted risks. You can extend these contract provisions later if loss experience justifies such a move. Restricting the initial provisions may help eliminate deficits and avoid additional assessments.

b) After providing competitive insurance terms, annual contributions may be set at levels comparable to the premiums quoted for commercial group insurance. At the same time, advertise that these contributions are gross premiums to be reduced substantially with later refunds if business is profitable.

c) Furthermore, how much insurance coverage should your association assume as a primary insurer? This is one of the most critical problems to resolve during the developmental stage. A prudent approach would be to tie up your primary insurance coverage with a step-wise accumulation of surplus as explained next.

- Surplus accumulation

Accumulation of an adequate surplus depends, of course, on the profitability of your association; the larger the profits the sooner the accumulated surplus will reach adequate levels. What is an adequate surplus level? How can surplus accumulation be tied up with insurance coverage? What is a prudent policy for surplus retention? These questions are discussed here briefly.

The length of time for surplus retention and the surplus level vary with the type of insurance. For hull insurance, the by-laws of some existing insurance pools specify a period of 3 to 4 yrs before a year's surplus is refunded to eligible members. As a rule of thumb, no less than 10 percent of the assumed basic coverage is considered an adequate surplus level. No such rule of thumb appears to have been established by existing protection and indemnity insurance pools. The by-laws of one pool provide for a 7-year surplus retention period. Since this period is nearly twice as long as the surplus retention time for hull insurance, it may be reasonable to consider 20 percent of the basic coverage as a minimum surplus level. Of course, these percentages are simple rules of thumb. We shall see later that the level of surplus retention depends also on other insurance techniques; to some degree, they may be used as alternatives to other levels of surplus retention.

In short, the length of the developmental stage depends on the profitability of your association, the level of surplus retention, and the desired basic coverage.

How profits, surplus level, and basic coverage may relate can be effectively shown with the previously mentioned step-wise accumulation of surplus. Suppose your association starts with 20 members and the maximum hull insurance coverage is \$100,000 per vessel. The total insurance coverage your association may assume is \$2 million, and the required surplus level is \$200,000 or 10 percent of the total coverage. We assume a 6-percent premium rate on the accepted total coverage; annual contributions to your association are \$120,000.

Table 1 shows step-wise accumulation of surplus. To simplify, we assume that each period is one insurance policy year.

In the first year, your association insures the first \$25,000 of basic coverage per risk, i.e., your primary insurance coverage, and reinsures the remaining \$75,000 with a commercial insurer. Thus, the reinsurer stands ready to reimburse your association if any single claim exceeds a loss of \$25,000, but not more than \$100,000. In other words, your association has purchased a contract from a reinsurer with a \$25,000 deductible. Your association assumes a \$500,000 (\$25,000 x 20 = \$500,000) primary coverage and reinsures the remaining \$1.5 (\$75,000 x 20 = \$1,500,000) million of basic coverage.

Table 1.* -- Step-wise accumulation of surplus during developmental stage: an illustration

Period	Basic insurance coverage		Contributions		Surplus accumulation
	Primary	Reinsured	Cost	Profit	
(1)	(2)	(3)	(4)	(5)	(6)
First	$ 500	$1,500	$70	$50	$ 50
Second	1,000	1,000	60	60	110
Third	1,500	500	50	70	180
Fourth	2,000	0	40	80	260

* All figures in thousands.

Remember that one way to initially reduce the limits of reimbursement for your association is to have a coinsurance provision in the contract. If such a provision stipulates a 75-percent coinsurance ratio, then a member qualifies for a maximum coverage if the fair market value of his vessel is over $133,334 ($133,334 x .75 = $100,000). Any member whose vessel has a higher fair market value can purchase excess insurance from a commercial insurer. Also, now you can appreciate the wisdom of the contract provision that disallows any member to carry insurance elsewhere if the combined coverage exceeds the fair market value of his vessel. This shows how contract provisions and financial management are interrelated.

Refer back to table 1. Assuming registration fees cover the start-up costs, the cost of $70,000 for the first year represents losses, expenses, and reinsurance premiums leaving a profit of $50,000. This sum is transferred to the surplus account. Because the surplus is 10 percent of the assumed total coverage of $500,000, your board of directors decides to increase the primary insurance coverage to $50,000 per risk and reinsure the remaining $50,000; thus total primary and reinsured insurance coverage is $1 million each. At the end of the second policy year, the realized profit of $60,000 is transferred to the surplus account. Because the accumulated surplus of $110,000 is more than 10 percent of the primary insurance coverage, the board of directors increases the primary insurance coverage to $75,000 per risk and reinsure the remaining $25,000. The cycle repeats itself until the desired surplus level of $200,000 is accumulated. At the closing of the fourth policy year, the board refunds $50,000, the surplus of the first period. The details for refunding and other procedures are discussed later. At the close of the fourth policy year, each member may receive a dividend of $2,500 on the average. During the fourth year of operation, the cost of insurance is $3,500 (gross contribution of $6,000 less dividend of $2,500 per $100,000 insurance coverage) representing a 3.5-percent net contribution rate. Dividends may continue depending on policy and the profitability of subsequent years.

Some insurance pools leave the years of surplus retention unspecified and to the discretion of the board. Unless extenuating circumstances dictate otherwise, such a policy should be followed at least until the developmental stage is over. The profitability of your association is unknown; the length of the developmental stage cannot be easily predetermined. Furthermore, the level of surplus retention depends on more than just the loss experience of your association. It must be also determined from the experience of policies and practices you adopt to protect the reserves of your association. At the end of the developmental stage, you may specify the minimum years of surplus retention in your by-laws. Of course, the board will still be given discretionary powers to postpone refunding of surplus if loss experience and other considerations justify such a decision.

- Refinements and comments

The procedure in table 1 shows a central feature of the insurance mechanism. Although in skeletal form, the illustration is a guide your association may follow in the developmental stage. A few refinements and comments may improve this approximation to reality.

The illustration is based on certain assumptions that need clarification and elaboration. Each period need not be a single policy year. This depends on your association's profitability and primary and reinsurance policies as well as other considerations. For example, a year with no profits or a deficit may compel you to lengthen a period to longer than a year. This is most likely to happen with an association for personal liability where losses are likely to fluctuate widely from year to year. You may also introduce an intermediate step between periods. Instead of increasing the primary coverage, you may reinsure for the same amount with a franchise provision. For example, for a second year of the first period, you may carry a $75,000 reinsurance contract with a $12,500 franchise. Nevertheless, the length of a policy year is not likely to be equal to a calendar year because of pending or disputed claims. This may particularly be the case with personal liability insurance where litigation may keep a policy year open long after the year during which the disputed loss occurred. Further complications may arise because finding satisfactory commercial outlets to protect the reserves of your association may be a problem. Thus, from the functional standpoint, table 1 shows a central feature of the mechanism for hull and personal liability insurance.

Furthermore, table 1 contains some significant numerical relationships of the insurance mechanism. Suppose the maximum $100,000 basic coverage was deliberately set below the protection needs of many members or membership growth, lack of satisfactory reinsurance outlets, or other factors would require a higher maximum, for example, $200,000 for basic coverage. You may repeat the cycle of surplus accumulation until surplus retention reaches desirable levels. Thus, assuming the profitability of our hypothetical association in table 1 continues, the 3-percent net contribution rate is likely to decline further after the first refunding year.

Further decline may occur for several reasons. First next year's refunding may be $3,000 per member (the profit of $60,000 in the second period divided by 20 members); this dividend will reduce your net contribution to $3,000 per member, a 3-percent rate. Second, lay-up credits, if provided, may further reduce such a rate for some members. Third, earnings from the invested surplus and primary reserves will offset at least some of your overhead costs. Fourth, as mentioned earlier, you may be able to reduce your insurance consulting costs, if any, by renegotiating your insurance consulting contract. Fifth, membership is likely to grow, thus allowing you to spread your overhead costs over a larger volume of contributions; in other words, you may be able to reduce the overhead costs per dollar of collected contributions.

For these reasons and through improvements in your financial and risk management practices, our hypotehtical association may reduce the cost of insurance to 1 percent of coverage or less. This is the rate reported by several hull insurance pools. No comparable information about existing protection and indemnity insurance pools is available. However, available information strongly suggests that both the above numerical relationships and pattern of a declining net rate of contributions are likely to hold, in general, for personal liability insurance as well.

B. Reserves

At the end of the developmental stage, the insurance mechanism of your association has reached a stable state in several important respects. From the actuarial standpoint, such stability may be evident in three significant activities: the surplus is retained at the desirable level; the net contribution rate is at or near the lowest level; and risk rating, to be discussed later, can be now based on accumulated loss experience and judgment.

Yet, the developmental stage is only one part of financial management. We are now ready to systematically discuss the second part of financial management -- reserves. In general, the reserves denote your association's assets available to meet principally incurred losses. At this point, however, we shall explain the different types of reserves at the disposal of your association. If organizing required no legal reserves, the letter of credit, the promissory notes, or the stipulated assessments will be your initial reserves. During the first policy year, your initial reserves and the annual contributions are your primary reserves. If the first policy year has a profit, the excess contributions are transferred to surplus as shown in figure 2 and explained earlier.

Reserves are associated with three financial questions that we have failed to discuss so far. The first relates to the maximum basic coverage. Because this maximum may offer only partial protection for some association members with large risks, how do you obtain full protection for them? The second refers to the initial reserves and surplus. Because they represent your assets, how do you protect them against immediate calls? The third question focuses on excess surplus. What policies and practices may you consider for refunding excess surplus.

• Full protection: reinsurance and coinsurance

The association does not act only as a commercial insurance broker, it can assume some of the functions that a commercial insurer performs as well. It may be able to protect you, the way a commercial insurer may, by passing portions of the underwritten risks to other insurers, as shown in figure 2, with reinsurance and coinsurance.

Table 1 shows how a reinsurance contract would help our hypothetical association accumulate a surplus. The cost of the same insurance coverage through your association is likely to be lower than through a commercial insurer because reinsurance rates are likely to be lower than primary insurance rates. Some of the reasons why such rates may be lower will become evident shortly.

Conceivably, you may keep increasing the maximum basic coverage through repeated cycles of step-wise surplus accumulation until such a maximum reaches the fair market value of your largest vessel or the highest requested level for personal liability. Such a policy would be unwise for several reasons. The needed level of surplus retention may require lengthening the surplus-retention period or increasing annual contributions. Either development may be against the best interest of your association. Your membership may not tolerate a long surplus-retention period. Additionally, increasing the gross contribution rate above commercially competitive levels may be disadvantageous. Moreover, the cost of reinsurance beyond a certain level may not be significantly higher than the opportunity cost of foregone profits from additional contributions even if the earnings are subtracted from the invested surplus. Furthermore, because of serious actuarial reasons, your association should reinsure a portion of each assumed risk. A reinsurer can underwrite fishing vessels from other parts of the country outside your geographical area. Thus, through reinsurance your association can become diversified.

Your association can obtain similar advantages with coinsurance, assuming a reinsurer for such a contract is available. For example, instead of reinsuring $75,000 for the first period in table 1, your association may coinsure at an 80-percent coverage ratio. Then, for any loss over $25,000 and up to $100,000, your association will be reimbursed for 80 percent of the loss. Thus, like reinsurance with a franchise provision, coinsurance may be used as an intermediate step between periods. The cost of coinsurance, of course, will be lower than the cost of reinsurance for otherwise identical contracts because your association shares in the losses of the coinsured risk.

How do you obtain a balance between all these options? Try to think of three levels of insurance protection: primary, reinsurance or coinsurance, and excess coverage. The first two levels, representing basic coverage, may be sufficient for full protection if there are no wide differences in the insurance amount among risks. This may be the case for most hull insurance associations with vessels of similar size. Excess coverage may be necessary for hull insurance associations with a few vessels much larger than most insured vessels or personal liability associations with members who need protection above the $250,000 to $400,000 range. You can handle excess coverage in two ways: either let each member purchase excess insurance from a commercial insurer or have your association purchase group excess coverage. Group insurance may be more advantageous than individual insurance.

Try to think of tradeoffs between benefits and costs of primary insurance, reinsurance or coinsurance, and surplus retention levels. An optimal point has been reached if no change among these levels is likely to improve the financial position of your association. This optimum is a theoretical ideal. Striving to reach it requires continuous monitoring of the insurance mechanism and experience and skill in insurance management.

- Stop loss insurance

You can easily see that reinsurance and coinsurance would reduce the chances for using the initial reserves or the surplus. Yet, and this is important to realize, such protection may be inadequate. On the basis of the data in table 1, our hypothetical association receives $120,000 in gross contributions. Assuming $10,000 in expenses, it takes five losses, each slightly less than $25,000 to obtain a deficit in the first policy year. In such an event, your initial reserves would be used to meet the deficit; they are the first line of financial defense against insolvency. Naturally, your initial reserves become the second line of financial defense as soon as your association realizes a surplus. In other words, the retained surplus is used to meet a deficit before your initial reserves. Thus, the chances of using your initial reserves decline as the surplus accumulates.

However, this is little consolation because a surplus represents credits to the members of the association; they are your future dividends. How do you protect both your initial reserves and the retained surplus? This is achieved with a stop loss insurance which your association may purchase from an insurer. According to such a contract, the insurer is ready to reimburse your association for any deficit up to a stipulated amount. This amount may be equal to the gross annual contributions or to the retained surplus. Thus, if a deficit occurs, the reimbursement from a stop loss insurance contract is first used to meet the deficit. If the deficit exceeds the stipulated amount, then the retained surplus and next your initial reserves are used.[6]

- Refunding

In discussing financial management, we must comment on refunding.

---

[6]For further information for stop loss insurance, read the last page of the profile on Pacific Trollers Fund.

In general, the policies and procedures of existing pools on refunding appear to be simple and uniform. Gains or profits realized at the closing of a policy year are credited to the individual member accounts in proportion to their gross contributions. Deficits in excess of reimbursements from stop loss insurance are covered with the retained surplus, starting with the latest year until the entire surplus is exhausted. If profits exceed the stipulated surplus retention level, refunds are made to the members of earliest year of the surplus retention period in proportion to the credits for that year.

Earnings from invested primary reserves and retained surplus are allocated to cover the losses, expenses, and taxes of the current policy year. Excess earnings are not transferred to surplus but are used to pay the losses, expenses, and taxes of the next policy year. The by-laws of some insurance pools provide that in the event of dissolution any earnings remaining after payment of all outstanding losses, expenses, and taxes shall be distributed to charitable, religious, educational, scientific, and literary organizations determined by the membership.[7]

- Comments

At the end of the developmental stage, the insurance mechanism of your association should have reached a stable state. Sound insurance practices may make such a mechanism as nearly a closed system as possible in three respects: except for a deductible or a franchise, the association's members can obtain full insurance protection through basic and excess coverage insurance; with reinsurance and coinsurance, your association can overcome to a large measure the limitations of reserves and risk diversification; with stop loss insurance, your retained surplus is protected, and the probability of losing your initial reserves or being burdened with stipulated excess losses is indeed small. The only important gap in describing this system is risk handling, which we will discuss next.

Section 10 RISK MANAGEMENT

The importance of risk management cannot be overemphasized. No other activity can contribute more to the success of your association than risk management. In fact, effective risk management underscores the success story of existing insurance pools. It encompasses all tasks associated with the selection, evaluation, supervision, and control of the risks your association underwrites. These tasks can be conveniently grouped into three important functions: safety, risk acceptance, and claims adjusting.

A. Safety

Safety should be the principal concern of all members of your association. It is so closely interwoven with the risk acceptance, claims adjusting and other management functions that some overlapping is inevitable.

---

[7] For additional information on relevant matters, read the last few paragraphs of the profile on United Trollers Fund.

What are the safety standards of existing insurance pools? The by-laws of at least one hull pool explicitly state that member vessels must meet the safety standards prescribed by the U.S. Coast Guard.[8] The by-laws of a personal liability pool specify that all members shall maintain their vessels in a staunch and seaworthy condition at all times and operate and equip their vessels in all manners and respects of common usage of the trade."[9] But, in the majority of cases, there are no such general pronouncements of safety standards. Rather, such standards are expressed in terms of safety equipment and safety rules.

- Safety equipment

Many safety requirements are in terms of safety equipment and appliances stipulated by hull insurance pools. No such specifications appear in the by-laws of personal liability pools. This may be partially explained because humans are a potential source of personal liability. A more plausible justification is that a vessel must be already insured for hull, and therefore, hull safety standards have been met. In fact, the by-laws of one personal liability pool stipulate membership with a hull pool as a condition of acceptance.

Hull safety requirements should be considered as minimal for personal liability pools as well. You may consider the following list for your association.

a) At least one CO_2 fire extinguisher of specified weight.
b) Anchors, chain, and sufficient length of line.
c) Suitable alarm systems for measuring low oil pressure and high water temperature.
d) A bilge alarm system to warn entry of water above a safety point.
e) One mechanical and one hand pump, both in good working condition.
f) A fire alarm over the stove.
g) Auxiliary equipment for charging batteries.
h) A radio telephone.
i) Running lights and distress signals meeting required standards.
j) A compass properly working and adjusted.
k) Fuel tanks must be fillable from the outside and must have adequate ventilation.

This is a sample. Most items in the list should be standard requirements for any vessel. A few are suitable for some vessels only. You may change or increase this list, depending on the type of fishing operations and other characteristics of the vessels in your association.

---

[8] See profile on Pacific Trollers Fund.

[9] See by-laws of United Trollers Fund.

If you plan to organize a personal liability pool, you may seriously consider some personal safety equipment and provisions in addition to the hull insurance list. For example, you may consider posting first aid and emergency procedures at suitable places on board each vessel, a skiff or a raft in good condition and equipped with survival rations, a radio homing device, life jackets or, for cold climates, survival thermosuits.

Whatever you decide, make sure that all safety equipment and appliances are explicitly stated in the by-laws. These safety provisions should not be the only conditions for accepting a vessel. Their establishment and appropriate use should be an integral part of a program on safety education, to be discussed shortly.

- Rules

Safety rules are another aspect of safety. Some rules may eliminate particular operations or practices that are considered unsafe; others may penalize member-vessel owners for failure to maintain safety standards; and still others may be designed to improve safety with appropriate rewards.

Elimination of unsafe practices may appear as nonmonetary contract provisions. A trading warranty, overloading, tying vessels together, or towing another vessel are such provisions already mentioned. Another important provision may stipulate that a vessel may remain tied up to oil scows, oil floats, or oil docks no longer than necessary for refueling, steam cleaning, or disinfecting. Other provisions may be appropriate for specific types of fishing operations. For example, boats with tuna tanks must pass a stability test. Although towing another vessel may be disallowed as a general rule, such action may be approved and, in fact, rewarded if it is done in connection with saving or salvaging another member's vessel.

Penalties for failure to maintain safety standards are one of the most prominent monetary contract provisions. We have already enumerated some stipulations for either hull or personal liability insurance where a member is reimbursed only for half of any loss or for the unpaid mortgage balance on his vessel if certain safety provisions are violated. Also, a member who fails to add recommended safety equipment or appliances or fails to maintain equipment, machinery, and gear properly forfeits his right to reimbursement for any accident arising from such safety inadequacies. Refusal to renew membership or expelling a member who consistently fails to maintain safety standards are equally universal rules among reporting insurance pools.

Provisions for rewarding the membership in maintaining and improving safety should be as prominent in the association's by-laws as penalty safety provisions. For example, giving "best crew of the year" awards to those who have demonstrably contributed to safety may be worth considering. Equally important may be a provision for rewarding vessel owners with the best safety record each year. These awards may be honorific or accompanied by a small stipend. Some well-established insurance pools in other countries make this reward system a part of their refunding policies. For example, as much as one-third of the refunds may be given as awards to 10 percent of the members with the best loss record for the past three years. Such a provision may not only motivate and educate the membership; it may be used in conjunction with risk rating as a device for differentiating between risks with varying loss records; and it may be an acceptable alternative for risk differentiation if the membership insists on uniform gross contribution rates.

- Safety education

Although maintenance of safety standards should be the responsibility of the board of directors, do not underestimate the power of education. Attitudes on safety are very important, especially for personal liability insurance; ignorance is the cousin of negligence. Unless there are reasons to justify a safety standards committee, your education committee or a subcommittee may perform many tasks on safety. Here are a few suggestions:

a) Participate in the activities of the regional safety advisory committee.

b) Develop, and periodically review, procedures for the normal operation of vessels, including navigation, fishing, and the use of machinery and gear as well as for emergencies.

c) Prepare a note showing simple examples of accident reporting procedures and loss rules.

d) Obtain films, colored slides, bulletins, billboards, and other information devices dealing with safety from government and private sources.

e) Plan for an institute or an educational program each year on safety and health standards for the entire membership.

Although educational tasks on safety may be assigned to the education committee, maintenance of safety standards should be an integral part of the other two functions of risk management, namely, risk acceptance and claims adjusting. Furthermore, these functions are too critical to be left in the hands of the rank and file membership. They should be the predominant, if not the exclusive, responsibility of the directors. In fact, this may be one of the most important responsibilities of the executive committee if your by-laws provide for such a committee.

B. Risk acceptance

This is the purest and most critical function of insurance management. Essentially, it involves risk evaluation, risk differentiation, and rules for contributions and lay-up credits.

- Evaluation

Because prospective membership is likely to come from a limited, homogeneous, and fairly known group of vessel owners, the procedures for evaluating risks are simple. Some insurance pools provide that a candidate vessel must be surveyed by an independent insurance surveyor. The report is confidential and is submitted directly to the board of directors; the insurance pool pays the survey fees, if any. However, most pools do their own surveying with the board of directors acting as a committee. An application is approved by a majority vote taken in a secret ballot.

One additional membership provision is worth mentioning. Although membership becomes effective immediately after the board's approval, some pools stipulate that the decision must be reaffirmed by the membership at the next general meeting. Thus, the membership at large is given the opportunity to discuss the quality of the newly accepted risk and control the board's decision.

o <u>Risk differentiation</u>

At the start of the developmental stage, risk rating may be a problem from both the competitive as well as the actuarial standpoint. We have already explained why it may be wise to set the gross contribution rate at competitive levels. Furthermore, the membership may insist on a uniform rate for hull insurance or on the same gross contribution for personal liability insurance. Even if the membership understands the advantages, risk differentiation may not be possible. Unless your membership carried prior group insurance, you have no loss experience on which to base rates objectively and fairly. On the other hand, failure to differentiate your risks is contrary to sound insurance management. Worse, competition may raid your association by offering attractive insurance terms to your best risks. The question is when and how you differentiate your risks.

If risk differentiation is not justified at the beginning of the developmental stage, you may start with uniform contribution rates. Loyalty of the founding members, contributions at no larger than competitive premium levels, and expected surplus refunds may be sufficient safeguards to hold the membership. More importantly, several contract provisions on limits of reimbursement may be designed to perform as indirect forms of risk differentiation.

Deducting the reimbursements from the surplus credits earned by members who experienced losses automatically penalizes poor risks. A similar effect may be achieved by a provision that members with severe losses in excess of initial reserves must bear such losses themselves. This provision may be an effective risk differentiator, especially before accumulation of a surplus and with no stop loss insurance coverage. Also, indemnifying a member for half of any loss blamed on a specified navigational hazard, provoked assault, or unlawful act, or limiting reimbursement to the unpaid mortgage because of a poor safety record automatically increases the cost of insurance for poor risks.

Thus, you can see that risk differentiating provisions such as the above are built into the insurance mechanism. It is likely that the membership may insist on uniform rates even after accumulated loss experience justifies some risk differentiation. For example, eliminating age as a criterion for determining commercial premium rates is cited by at least two existing pools as one of the reasons for organizing. Under these circumstances, the aforementioned automatic provisions may not be adequate risk differentiators. Then a number of contract provisions may be designed to indirectly have the same risk differentiating effect as age and other direct criteria. You may provide for a lower coinsurance ratio for vessels representing poor risks and a higher ratio for vessels representing good risks; a portion of the annual refunds may be distributed to vessel owners with the best loss record as explained earlier; finally, the deductible and the franchise may vary in such a way as to reflect differences in the quality of the accepted risks.

By the end of the developmental stage, you may have sufficient information to differentiate the accepted risks on the basis of loss experience as related to other operational vessel characteristics. Moreover, the membership may become increasingly aware of significant differences in the quality of the insured vessels. The result is applying several direct criteria to determine contribution rates. This appears to be the course some pools have followed. One personal liability pool, in particular, classifies its vessels into 11 risk categories using at least 13 criteria: age of vessel, repairs, whether the vessel is captain-owned or not, maximum crew size employed during the year, earnings of crew, age of crew, competence of crew, competence of master, type of fishing area, length of fishing period, whether engaged in summer or winter fishing, and loss experience.

In summary, the two basic approaches for achieving risk differentiation are the indirect and the direct. With the former, you reinforce the automatic indirect differentiators with provisions especially designed to differentiate indirectly the accepted risks. With the direct approach, you combine the automatic indirect differentiators with direct criteria based on loss experience. Although the direct approach appears to be more systematic than the indirect from the actuarial standpoint, the choice must depend, to a large degree on the particular difficulties your association encounters.

- Contributions and lay-up credits

Collection of contributions and payment of lay-up credits may appear to be a straight-forward affair. Yet, contributions may be related to the basic insurance coverage while lay-up credits are related to contributions.

The actuarial experience of an association consists of 12-month periods called policy years. These periods need not coincide with the calendar year; they should be determined on the basis of the fishing and other operational characteristics of member vessels. Contributions are due and payable before each policy year begins. If you provide for payment of contributions on an installment basis, ensure that each installment is paid prior to the period for which it is collected. To encourage prompt payment of contributions, consider imposing interest charges for a 60-day period beyond the deadline and automatic cancellation of the contract when the grace period is over.

The special relationship between contributions and basic coverage arises if the latter has increased in a step-wise manner. For example, consider table 1. Suppose your association accepts only the primary amount while the reinsured amount is treated as excess coverage. Suppose through surplus accumulation your association increases the per vessel maximum basic coverage from $25,000 for the first year to $100,000 for the fourth year, for a fixed contribution of, for example, $2,000 per year. But, how can a new member purchase the full $100,000 coverage? You may provide for back paying contributions of $2,000 per year; a new member can then have the option of purchasing any multiples of $25,000 coverage up to $100,000 by paying the corresponding multiples of yearly contributions. Back paid contributions automatically receive the same refunds as those declared for the involved years.[10]

Lay-up credits represent reduction in the gross annual contribution for a period of specified consecutive days or months during which a vessel remains idle. State clearly in your by-laws the conditions for lay-up credit, including the minimum and maximum lay-up credit period and the deadline after which no lay-up credits are granted. Lay-up credits may be stated in terms of a reduced contribution rate or an amount pro rated for the lay-up period.

Because occurrence of losses is a function of time, lay-up credit provisions may be an effective device for stratifying the risks of your association. This may be particularly advantageous if member vessels are engaged in distinctly different fishing seasons such as summer or winter, or both. Then you may provide for two sets of contribution rates, one without lay-up credit and another at lower levels with lay-up credits. Thus, your association may be able to appeal to a larger membership by offering a wider range of options.

C. Claims adjusting

We have already seen that effective controls in the selection of risks make most tasks related to risk acceptance relatively easy. By contrast, claims adjusting is more complex and requires more effort on the part of directors. Yet, it is as important as risk selection; claims adjusting determines the sums of money that must be paid for losses and expenses and, to a large measure, the profitability of your association. In particular, two aspects of claims adjusting are significant: procedures for handling claims and loss prevention measures.

---

[10] See profile on United Trollers Fund.

• Procedures

The provisions in the by-laws for reporting and evaluating accidents must be clear and explicit. Furthermore, they must be followed scrupulously to avoid later complications and misunderstandings.

The importance of accident reporting would be difficult to exaggerate. The captain, the owner, or both should be required to submit a complete report about an accident to the association as soon as possible, but not later than 30 days after it occurs. This report should describe the circumstances and conditions of an accident, and the persons involved. Collection of evidence is particularly important for personal liability associations. In fact, one existing pool considers each accident as a potential litigation case; thus, systematically collected evidence is reviewed by the attorney of the association.

Many pools provide for inspection of hull accidents by a commercial surveyor. If no surveyor is available, the vessel owner or the captain may request a committee of two disinterested but competent association members to survey the damage. However, this arrangement must, if possible, be approved by one or more directors or the business manager. If a survey committee cannot be formed, the owner or the captain must ask the business manager or the executive committee for further instructions. The findings of the survey must be promptly reported to the association.

Neither the surveyor's nor the surveying committee's recommendations are binding. The directors retain the power to approve or, if necessary, modify a claim. Many pools specify that the directors' decision is final. However, under certain conditions, claim disputes may be handled by binding arbitration.

• Loss prevention measures

Claims adjusting provides an excellent opportunity to implement safety standards by introducing the following additional loss prevention measures:

a) Captains and owners should be advised that quick action may reduce damage, facilitate salvaging, or even save a vessel. They should make arrangements for salvage and repairs as quickly as possible; and, if possible, they should supervise repairs and ensure that all work done and materials used are properly itemized in the report.

b) A wise investment of money for the association is to pay the cost of inspecting the clutch and reduction gear after the propeller has hit a submerged object. If the vessel owner does not have an inspection, he should not be reimbursed for losses caused later by clutch or reduction gear trouble.

c) A good preventive measure for the association is to pay the cost of docking a vessel that hits bottom irrespective of whether or not there is reason to believe the vessel was damaged.

d) For the same reason, the association should pay towing charges so that repairs can be made as soon as possible. Such charges, however, must be specified and towing expenses must be carefully reviewed.

e) The association should require that the engine, clutch or reduction gear be repaired without delay if they are immersed in sea water while operating.

Although these loss prevention measures refer to hull insurance, some of them may effectively control losses from protection and indemnity insurance. In addition, regular vessel inspection, the personnel safety equipment, proper emergency procedures and systematic reporting, all discussed earlier, may keep personal liability losses to a minimum.

In summary, this part contains the most substantive and significant material of the manual. Contract provisions prescribe the obligations, nonmonetary and monetary, of both your association and its members. They are a static description of the insurance mechanism. Financial management shows the dynamic functioning of that mechanism in cash flow terms. Finally, risk management shows how such insurance mechanisms can be controlled. These major functions of insurance management contribute to a nearly self-sustaining and self-perpetuating closed system.

PART IV MUTUAL INSURANCE ASSOCIATIONS IN BUSINESS

Earlier parts of this manual dealt with general information needed to form and manage a mutual insurance association. Here, we present brief profiles of five insurance clubs or pools in business today. Four of these clubs write hull insurance and one writes protection and indemnity insurance. The profiles of one hull insurance club and two additional personal liability clubs are not available. With the exception of one personal liability club, all other pools operate from the State of Washington, especially Seattle.

Who are the members of these pools? In what kind of fishing are they engaged? Why and how did they organize? What kind of organization do they have? What are some of the most important practices and experiences? Collectively, the profiles tell you how they did it and what makes these pools operate. Individually, each profile deals with general characteristics and focuses, as much as possible, on some practices and experiences that are special, and some even unique, to each club. These pools are strikingly similar in some respects and quite different in others. Yet, all of them are designed to offer their members insurance protection at very low rates. Furthermore, three hull pools and one personal liability pool underwrite exclusively small vessels. This is quite contrary to any prevailing notion that only large vessels need insurance protection.

In closing, we are grateful to the managers of the mutual insurance associations whose profiles appear in this part of the manual; also, we are thankful to the managers of pools whose profiles are not available, namely

- Harold E. Lokken, Manager, Marine Safety Reserve (P & I)
- Leif Jacobsen and Richard A. Browning, Chairman of the Board and Manager, respectively, The Neptune Association (P & I)

• Pat Hines, Manager, Fishing Vessels Reserve (Hull)

Their cooperation and valuable suggestions are greatly appreciated.

Section 11 UNITED TROLLERS FUND

(Protection and Indemnity Insurance)

Harold S. Ongstad, Manager
2400 N.W. 64th
Seattle, Washington 98107

This is the only one of the three insurance pools under my management whose purpose is to protect its members against loss from lawsuit. The other two mutual insurance associations are hull pools. The Trollers Fund was established by a group of vessel owners in 1963. Like most pooling arrangements in the Seattle area, it is not incorporated. As such, it is not under the jurisdiction of the insurance commissioner of the State of Washington. Its accumulated surpluses and reserves are not subject to federal corporate taxes. But let me talk to you briefly about the characteristics of our membership, dues or contributions, coverage, limits of liability, surpluses, and refunds.

Since its establishment, our membership increased nearly four times. Presently, the pool carries insurance for 210 boats. Our membership is limited to basic trollers under 50 to 60 ft long. They include gillnet boats, gas boats, and boats that fish crab in the winter. Boats fishing halibut are excluded. Most of our vessels are owner-captained. In most cases, relatives are crew members. Coverage is limited to no more than two crew members. Membership is not limited to the Seattle area; it includes vessels from Alaska, Oregon, and California. Part of the condition for membership is that vessels operating from California ports must belong to one of the Seattle hull pools. Our vessel owners are predominantly of Norwegian extraction.

Membership dues depend on two factors: crew and fishing during the winter. Section A protection includes public liability and property damage excluding the crew. It is mandatory for membership. The basic dues for section A protection decrease for winter lay-up credit of four consecutive months from November 15th or a 1-month leeway in either direction. Section B protection includes crew liability. It is equal to the basic dues with or without lay-up credit for each crew member. Crew coverage is limited to two persons besides a skipper nonowner. At any time when the crew size exceeds two, the vessel owner loses crew protection. Membership fees are payable January 1st. Members may pay initially 20 percent of the dues or fees and the balance on or before July 1st. After that date, a member is considered delinquent and his policy is cancelled automatically. Our policy year coincides with the calendar year.

Each member signs a promissory note of $500 as a condition for admission to the pool. In the event that losses exceed receipts and accumulated reserves during a given policy year, members may be assessed up to this sum.

Because no legal reserves were required at the time the Trollers Fund was established, the promissory notes were our initial reserves. However, our present reserves are sufficient so that chances are very small that the promissory notes will be called to cover excess losses.

We offer the broadest coverage available anywhere. It includes nearly every protection not covered by ordinary hull insurance. Here are a few examples. Suppose your crew member gets sick, injured or incapacitated in some way. Trollers Fund would pay his wages, maintenance and cure, medical, hospital, and other related expenses. If you are sued, we pay the legal fees and expenses to defend your case in court as well as damages, if the court awards any. In fact, we urge our members to carry coverage for their sons if they are crew members. In case of injury or sickness, they are entitled to wages, maintenance, and cure benefits. If your vessel runs into a dock, buoy, gridiron, or other structure and causes damage, your hull policy does not pay for such damage; Trollers Fund does. If your vessel catches fire at the dock and damages another vessel, your hull insurance covers damage to your vessel only, but we cover damages to the other vessel as well. Vessel X runs into and sinks Vessel Y. Vessel X is completely at fault. Suppose Vessel X carries a $40,000 hull insurance coverage and Vessel Y is worth $40,000, but was loaded with $10,000 worth of fish at the time of the accident. The net loss is $50,000, while Vessel X's coverage is only $40,000. If Vessel X carries insurance with Trollers Fund, we pay the excess damage over the $40,000 hull coverage. We also cover you, if your vessel runs into another vessel and someone on the other vessel is injured. Suppose your vessel sinks in a navigable channel and the government sues you to remove the wreck. Your hull policy covers the loss of your vessel <u>and</u> removal costs. Trollers Fund pays all costs related to oil spills your vessel accidentally caused. Our policy protects you if guests or salespersons on your boat, people crossing your boat, or carpenters, electricians, or other repair persons working on your boat happen to be injured. These examples illustrate the extent of protection Trollers Fund offers to its members. There is much more.

We have a $250 deductible on each claim while the limits of liability depend on the number of years a vessel owner is a member of the pool. Coverage is $10,000 for the first year and increases by $5,000 for each of the four subsequent years until it reaches $30,000 in the fifth year. This coverage is raised to $40,000 in the sixth and to $100,000 in the seventh year of membership. New members may purchase any higher coverage than the initial $10,000 coverage they wish by buying back refunds, that is, paying in their reserves. Payments are equal to the annual basic dues with winter lay-up credit per year. Suppose annual basic dues are $150. Then a new member can raise his protection to any desired level. For example, he must pay $900 in addition to the dues for a current policy year to purchase the maximum $100,000 protection.

Before 1975, the upper limit of liability was only $50,000. In 1975, we raised it to $100,000 without an increase in fees. Trollers retains the first $50,000 and reinsures the balance with commercial insurers. Of course, members, if they wish, can purchase directly additional protection in excess of $100,000 from commercial insurers.

In addition to limiting crew size, there are some additional nonmonetary limitations. The most important are: Trollers Fund is not liable for losses owing to declared or undeclared war or to atomic or fissionable material. Trading limits are from 12° North latitude to Unimak Pass. However, such limits may be restricted further considering the particular capabilities of the vessel. If a member carries no hull insurance, the market value of the vessel is agreed upon in writing between the insured vessel owner and Trollers Fund.

The final item which may be of interest to you is our policy on reserves and refunds. As mentioned earlier, the promissory notes of the members were our initial reserves. Since then, Trollers Fund built its reserves with an accumulation of a surplus. At the closing of a policy year, the surplus is credited in proportion to each member's contribution for that year. Loss payments made on behalf of a member are deducted from the member's surplus earned during the year. But loss payments in excess of a member's surplus are not deducted from surpluses that the member earned in earlier years. These surpluses are available for paying losses without regard to the distribution of credits and only when the current year's contributions have been exhausted.

Net earnings from the investment of current contributions and accumulated surpluses are used to pay claims, expenses, and taxes. If there are any excess earnings left, these are not credited to the surplus accounts of the members, but are set aside to pay future claims, expenses, and taxes.

Surpluses remain with Trollers Fund for seven years, that is, a member pays the normal annual fees for seven years before receiving refunds. Credited surpluses of a resigned or expelled member are subject in all respects to the provisions for a 7-year rollover period for refunds. On the other hand, the estate of a deceased member receives all the credited surplus in a lump sum at the end of the year in which death occurred. If the net earnings from investments, the accumulated surplus, and the promissory notes are not sufficient to pay the losses and expenses of a given year, excess loss payments are borne exclusively by the members who sustained such losses.

A two-thirds vote of the total membership at any annual meeting may decide to dissolve Trollers Fund. Any reserves after the payment of all claims will be distributed among the members in accordance with the rules mentioned earlier. Any net earnings from investments set aside after the payment of all outstanding claims, expenses, and taxes will be distributed among charitable, religious, educational, scientific, and literary organizations and in such amounts as the board of directors may decide.

We have managed to stay in business for the last 13 years and accumulate substantial reserves. Presently, our surplus of $323,000 represents a sum equal to about four times our annual receipts. More importantly, refunds to members have thus far run between 90 and 100 percent of annual contributions. What makes Trollers Fund tick? Simply said, good boats and good people.

Section 12 UNITED MARINE FUND and UNITED RESERVE FUND

(Hull Insurance)

Harold S. Ongstad, Manager
2400 N.W. 64th
Seattle, Washington 98107

These two hull insurance pools are similar to the United Trollers Fund (a protection and indemnity insurance pool) we have already discussed with respect to their policy on reserves, refunds, and their dissolution. The only important difference is that the credited surplus is kept on reserve for only four instead of seven years before it is distributed to the members. Also, like Trollers Fund, both hull pools are not incorporated; their legal status has already been explained.[11] We shall concentrate on some general characteristics, coverage, limitations, contributions, safety rules, and procedures for accepting risks and settling claims. This discussion applies to both hull pools unless otherwise specified.

United Marine Fund was established in 1930 by Seattle vessel owners of Norwegian extraction. Since then, the business of the Fund has expanded to include vessels operating from ports located in California, Oregon, and Alaska in addition to the State of Washington. Presently, our membership has more than 200 trollers, draggers, and seiners. They fish halibut principally, but also king crab.

United Reserve Fund is a much younger cooperative than the Marine Fund. It was established in 1968. Although this hull pool carries exclusively California vessels, its base of operation is in Seattle. This arrangement was necessary because the State of California considers formation of an insurance pool unlawful unless it is incorporated. Of course, incorporation requires substantial legal reserves and the organization then is under the supervision of the insurance commissioner. The more than 100 vessels of the Reserve Fund are trollers engaged in fishing salmon, albacore, and some Dungeness crab.

Basically, coverage is identical for both Funds. The terms of protection are largely specified in the American Hulls Pacific form (1938), but present maximum liability for each vessel differs, $110,000 with Marine Fund and $75,000 with Reserve Fund. Neither cooperative provides for a general deductible.

There are a number of important limitations and conditions applicable to the coverage from both Funds. Although there is no general deductible, there is a franchise clause. Any claim from a cause other than fire, collision, sinking, or stranding must amount to greater than ten dollars per foot of the registered length of a vessel. Otherwise, the claimant vessel owner is not reimbursed. Also, loss of a power seine skiff is not reimbursed unless such a skiff is of the unsinkable type. Any member installing radar

---

[11] See United Trollers Fund.

or refrigeration must inform the manager in order to raise the insurance amount accordingly. Otherwise, such equipment is not covered. Engine damage is limited to breakage of the main engine crankshaft from any cause. Reimbursement is limited to 10 percent of the insurance amount on the vessel. A member is not reimbursed for any vessel damage or loss caused by act of war, declared or undeclared. Finally, trading limits are from 12^{o} to 63^{o} North latitude. The directors of Marine Fund, however, have the authority to extend these trading limits under special circumstances. Such extension must be approved by the members at their next annual meeting.

Other limitations and conditions are applicable only to vessels of Marine Fund. Electronic equipment is covered for marine loss or fire wherever it is located. While the equipment is not on board, its value is deducted from the reimbursements for partial or total loss of the vessel. Members are not allowed to place insurance on their vessel in addition to the insurance amount agreed with the cooperative. This restriction is particularly important because the insurance amount represents 100 percent of a conservative estimate of the market value of each member vessel.

The present membership contribution rate is 6 percent for Marine Fund and 6.5 percent for Reserve Fund of the insurance amount on each member vessel. Port lay-ups are at a rate of 3 percent and 3.5 percent of the insurance amount, respectively. Members are entitled to a port lay-up if their vessel remains idle for 15 consecutive days. Marine Fund imposes additional restrictions. For both cooperatives, the policy and fiscal years coincide with the calendar year. Each member-vessel owner has one vote. Contributions are due and payable quarterly on the first of January, April, July, and October. Quarterly contributions must be paid within ninety days. Otherwise, both membership and policy are automatically canceled without notice.

Depending on the type of vessel, some safety provisions are imposed by both hull pools and for others by either one of the two hull pools. Provisions such as all vessels must be equipped with radio telephone and with a bilge alarm system and maintain a list at the office of any equipment aboard including duplicate equipment are common to both cooperatives. Marine Fund provides that: all members must obtain confirmation of the directors or the manager for hiring a skipper to run the vessel; all vessels must have auxiliary equipment for charging aboard in working order and carry at least one CO_2 fire extinguisher of no less than four pounds; vessels with tuna tanks must take stability tests or have their tanks approved by the directors. By contrast, Reserve Fund provides that all boats must have at least two means of pumping the bilge. In both hull pools, the directors have full and complete authority to expel any member who is "detrimental to or does not abide by the purposes of the organization."

Procedures for accepting risks are identical for both hull pools. The principal consideration for accepting a risk is that the vessel owner has a record of careful and able vessel operation. Applications for membership must be approved by the board of directors. Any director may request that an application be voted upon by a secret ballot. Although membership becomes effective immediately upon approval, acceptance of risks must be reaffirmed by the members at the next annual meeting. The widow or children of a deceased member may retain membership in the hull pool on the condition that the management of the vessel is in personnel acceptable to the board of directors.

Also, both hull pools have nearly identical procedures for settling claims. Any two disinterested members may be considered to represent a competent committee for surveying damages to any member vessel if they are asked to do so by either the owner or the master of the damaged vessel. If possible, such an appointment must be approved by one or more directors or the manager. If appointment of a survey committee is impractical, the master or owner of the damaged vessel should notify the manager and request instructions. In such a case, the usual procedure for the manager is to engage a professional marine surveyor. Claims must be reported as soon as feasible but no later than 30 days after the damage occurred. A claimant must submit proof of loss as the directors may require. In the case of Marine Fund, claims must be paid within 30 days after notifying the claimant of the directors' decision. On the other hand, Reserve Fund reserves the right to pay claims occurring during the first season as follows: 50 percent within 30 days, and the remainder when the season is over and all losses are ascertained.

The purpose of the two hull pools is "to create and maintain a fund for reimbursement of marine losses suffered by members occasioned by perils of the seas, or fire, or by certain collision liabilities; to work for the elimination of careless and reckless operation of fishing vessels; to maintain staunch and seaworthy vessels; and to afford assistance to fellow members' vessels in distress at a reasonable rate of compensation." Have the cooperatives lived up to their purpose? The answer is a definite "yes" if success is measured in terms of time and money. Since their establishment, both hull pools have continued their operation uninterruptedly. Our reserves for both cooperatives are sufficiently large so that we carry the full insurance amount of each risk. In other words, neither of the funds needs to purchase reinsurance. More importantly, annual refunds to the members of Marine Fund averaged 82 percent of annual contributions. Thus, net contributions, allowing for port lay-up credits, averaged less than 1.0 percent or at a yearly cost of less than $1,000 per $100,000 of insurance coverage. As you can see, self-insurance through an insurance cooperative pays.

Section 13 PACIFIC TROLLERS FUND

(Hull Insurance)

Donald E. Reinhardt, Manager
P.O. Box 1235
Bellingham, Washington 98225

Halibut Producers Cooperative, the fiscal agent for Pacific Trollers Fund, came into being in 1944. The principal reason for establishing the cooperative was that vessel owners had difficulty marketing their halibut catch at what they considered a fair price. At that time, premium rates with commercial insurers were 5 to 6 percent. Even with such high rates, insurance protection was not readily available because some insurers refused to underwrite vessels driven by gasoline engines. Neither could members of the cooperative consider it advantageous to join other insurance pools which carried mainly large vessels; they owned small vessels and had a different mode of operation. So, in 1958, thirty members of the cooperative got together to organize a hull insurance pool. The next year, Pacific Trollers Fund started its business.

Only vessel owners who are members of Halibut Producers Cooperative can join the hull pool. But not all cooperative members carry insurance with the Fund because of careful selection by the directors. Yet, the initial membership of 30 grew steadily over the years. Presently, the Fund has over 135 members and carries insurance for an equal number of vessels. Each member has one vote. All our vessels are owner operated and most of them are one-person operations. The great majority of the members are primarily engaged in trolling for salmon, whereas initial members owned halibut vessels.

Like most insurance pools in the State of Washington, our Fund is not incorporated. Also, our general policy on reserves, refunds, and dissolution are quite similar to those already explained.[12] However, some of our charter provisions on coverage, limitations, risk acceptance, safety rules, and settlement of claims might be of interest to you.

Over the years, the Fund's insurance coverage and related provisions have changed considerably. From 1959 to 1967, maximum insurance coverage for any one accident increased from \$10,000 to \$20,000. This sum represented 85 percent of the market value of the vessel as last assessed by the board of directors. Since 1968, maximum coverage increased from \$30,000 to \$45,000 to date. Now, this insurance amount can represent up to 100 percent of the assessed market value of the vessel. There are no deductibles, but a franchise clause applicable under specified conditions is included. However, a member who receives money for a claim loses his right to participate in the refund for that year by the amount of the claim. Also, coverage includes the running-down clause. Both clauses will be explained later.

The Fund accepts risks on terms provided in the American Hulls Pacific form (1938) subject to several modifications specified in the by-laws. In this respect, there are a number of important exceptions, limitations, and conditions. Members are not reimbursed for loss of or damage to skiffs, outboard motors, poles, lines, or fishing gear. Also, members are not indemnified for loss or damage sustained south of 11° North latitude or in or beyond Unimak Pass. However, the board of directors may approve in writing and prior to April 1 extension of the coverage beyond Unimak Pass. Any reimbursement is reduced to 50 percent for any loss occurring inside of or on the following sand bars: Italio, Dry Bay, Dangerous River, Situck-Ahrnklin, Kaliakh, Silhoo, Okalee Channel, Copper River, and Bering River.

Each member warrants that the vessel does not carry insurance with any commercial insurer or other hull pool for an amount which, if added to the

---

[12]See United Trollers Fund.

maximum coverage carried by our Fund, exceeds 100 percent of the last assessed value of the vessel. Any member who breaches this warranty automatically loses all rights of indemnification by the Fund. For example, if the directors assess the value of your vessel at $50,000, as a member, you are entitled to carry the maximum of $45,000 coverage with the Fund. You are also entitled to purchase additional coverage up to $5,000 from another pool or a commercial insurer. However, if you purchase more than $5,000 additional coverage, you will have breached your warranty.

Annual contributions to the Fund are proportional to each member's insurance coverage. There are two rates, one for gasoline and a lower rate for diesel-operated vessels. No lay-up credit is available. The Fund's fiscal and policy years coincide with the calendar year, so contributions are payable in advance on January 1 at the beginning of each policy year. If a claim arises before the member's full annual contribution has been paid, the unpaid balance of the contribution is deducted from the reimbursement. No member is liable for more than this annual contribution. If losses in any policy year exceed reimbursements from stop loss insurance (to be explained later) and accumulated reserves, the board of directors is authorized to do the following: a) notify all members that no claims arising more than five days after the date of notice will be accepted; b) suspend payment of all outstanding claims; and c) reimburse outstanding claims on a pro-rated basis, after payment of all outstanding expenses. Neither are heirs of the deceased member entitled to payment of the member's surplus credit at the end of the year in which death occurred. Such surplus credits are paid out in accordance with a 4-year rollover refunding policy of the Fund.

We maintain high safety standards. The Fund does not accept or renew the insurance policy of a vessel without a certificate of safety standards prescribed by the U.S. Coast Guard. Each member must maintain on board the vessel a radio telephone, bilge alarm system to warn entry of water above a safety point, and a deck pump in workable condition. If a member's failure to maintain equipment or to correct deficiencies results in or contributed to an accident, this member forfeits his right for indemnification for the accident. Each member must maintain a list at the office of any duplicate equipment on board their vessel. The directors, at their discretion, may raise the insurance amount to cover duplicate equipment.

In case of an accident, the member owner of the vessel must notify the office of the Fund immediately, obtain written statements from witnesses, if any, as to the cause(s) of the accident, and call for a commerical surveyor, if in the owner's opinion, the damage amounts to at least $1,000. If appointment of a commercial surveyor is not feasible or necessary, the owner or master of a damaged vessel may appoint any two disinterested members of the Fund to survey the damage and promptly report their findings. If possible, appointment of the two-member committee must be made with the consent of one or more directors, or of the manager of the Fund. No reimbursement of losses is made until the claimant has submitted satisfactory proof of the loss and the board of directors has reached a decision.

One provision of our by-laws which may be of interest to you is assistance rules. Each member is obligated to assist, if possible, a fellow member in distress. A member who gives towage or salvage to a fellow member is entitled to reasonable compensation for any loss, damage, or expense attributable to such assistance. In case of dispute, the board of directors decides the amount of compensation; this decision is binding.

We follow commercial practice in settling claims. Each member is a coinsurer of his vessel to the extent that his coverage is less than the market value as last assessed by the directors. For example, suppose your vessel is assessed for $40,000 and you have purchased a $30,000 insurance coverage. You are a coinsurer for $10,000 ($40,000 - $30,000 = $10,000) of the market value of your vessel and the Fund covers 75 percent of your losses. Your vessel is stranded and the damage is $10,000. The Fund pays you $7,500 ($10,000 x .75 = $7,500). You must pay the difference of $2,500 to repair the damage.

The franchise clause, or the so-called "free from particular average" warranty, works as follows. The Fund pays you for damages from causes other than stranding, sinking, fire,or collision, if such damages are more than 3 percent of the assessed market value of your vessel; otherwise, you get nothing. For example, you have a 75-percent coverage as before and your vessel is damaged in heavy seas. The damage is $1,000. The Fund pays you nothing because the sum is below the franchise amount of $1,200 ($40,000 x .03 = $1,200). However, if the same damage from heavy seas requires $2,000 for repairs, this sum is above the franchise of $1,200, so the Fund pays you $1,500 ($2,000 x .75 = $1,500). If fire has caused the $2,000 damage, you get full payment because the franchise does not apply to claims caused by fire.

Under the running-down clause, the Fund pays for a member's liability to another vessel for collision damages up to the full amount of the member's coverage. Suppose your vessel is assessed at $40,000 and you carry a $35,000 coverage with the Fund. Now the Fund covers 87.5 percent (35,000 ÷ 40,000 = 87.5) of your losses. Your vessel collides with another vessel causing damages of $50,000. Your vessel also has damages of $20,000. You are held at fault; therefore, your liability is not limited to the damage of your vessel only. You are also liable for the losses of the other vessel. The Fund pays the owner of the other vessel your coverage of $35,000 and you receive $17,500 ($20,000 x .875 = $17,500) for your vessel damage.

I hope these examples clearly illustrate how we settle claims of members against the Fund. The net result is that the Fund is financially healthy and growing. Presently, our 4-year reserves are more than 10 percent of the total insurance amount the Fund carries for its members. Although these reserves may be considered adequate for normal operation, we carry stop loss insurance with a commercial insurer. In the event that losses exceed contributions during any policy year, the insurer pays the Fund a sum nearly equal to our present reserves. The premium is a very small percentage of the total insurance amount the Fund carries. In return, we protect our own reserves against excessive losses by nearly doubling the reserves of the Fund. So far, our refunds have averaged better than 80 percent of annual contributions; the net annual rate of contributions has averaged less than 1 percent. In present terms, a member can purchase a maximum coverage of $45,000 at an annual cost of less than $450. I believe that a mutual insurance association can offer a better insurance policy to a group of vessel owners than any other arrangement. This is true because member vessels are better than average risks through careful screening of applications. Also, this type of operation lends itself to low overhead costs that can be met, to a large degree, by earnings from the invested contributions and surplus.

Section 14 COMMERCIAL FISHERMEN'S INTER-INSURANCE EXCHANGE (Hull Insurance)

Paul L. Anderson, Agent in Seattle
1111 N.W. 45th Street
Seattle, Washington 98107

During the 1930's, the advent of diesel-engined vessels prompted commercial underwriters to refuse accepting gasoline-engined boats. In addition, the age of vessels became an important factor in underwriting. In response to these developments, a group of 50 vessel owners from San Pedro, California and 50 from Seattle, Washington met and established the Exchange.

This is an insurance cooperative incorporated in California, Oregon, and Washington. As such, it is under the supervision of the insurance commissioners of these States. At the time the Exchange was organized, the legal reserve requirements were $100,000. Now we must maintain $400,000 legal reserves.

The founders of the Exchange were of Yugoslavian descent. Today, the membership includes a considerable number of others, especially of Scandinavian origin. The Exchange carries at least 250 vessels located in Eureka, San Pedro, and Fort Bragg, Calif; Astoria, Ore; and Seattle, Wash. Most vessels are about 70 ft in length, but several vessels are 100 ft long. During the time the exchange was organized, the majority of our vessels were fishing sardines. Now they are engaged in salmon and tuna fishing.

Many operational aspects of the Exchange are similar to those found in other hull pools. So I will briefly discuss our procedure for accepting and rating risks, coverage, limitations, and the way we handle protection and indemnity insurance.

A review board, with members in each key port, is responsible for processing applications of membership to the Exchange. The United States Salvage Service is invited to survey the vessel. The Exchange pays the fee. If the vessel fails to meet acceptable standards of safety and seaworthiness, a list of recommendations is prepared for correcting deficiencies. Also, board members consider the kind of risk the owner, crew members, and the captain of the surveyed vessel represent. All this information is included in a confidential report submitted to the board of directors of the Exchange.

If the vessel is accepted, premium rates are determined on criteria other than age of the vessel. After all, commercial underwriting based on age was one of the reasons prompting vessel owners to establish their insurance cooperative. What counts, in their opinion, is safety standards, seaworthiness, and competence, as well as the character of those who run a vessel. In addition to these factors, determining premium rates is based on whether a vessel's hull is made of wood or steel, location of the fisheries, and fishing season.

As a matter of policy, the Exchange may assume up to $100,000 insurance protection for a vessel. However, the insurance amount may be larger than this sum, but not more than $500,000. Coverage can be up to 100 percent of the last assessed market value of the vessel. Screening and the surveyor's conservative assessment of vessel values are considered sufficient safeguards against the presence of moral hazard. If coverage is less than 100 percent, the vessel owner is a coinsurer. The coinsurance, collision, and franchise provisions of our contract are similar to those applied elsewhere.[13] Only the franchise amount differs somewhat. It is 3 percent of the assessed market value of a vessel but not more than $3,000. The deductible increases with the insurance amount.

Also, several of the limitations, restrictions, and conditions are similar to those provided in the American Hulls Pacific form (1938). They may differ with respect to specifications. In particular, no king crab fishing is allowed. There are different types of trading warranties with some vessels allowed to fish in Puget Sound only and others as far as the Southern side of the Aleutian Islands, but not in the Bering Sea. Furthermore, port lay-up credits require a period of 20 rather than 15 consecutive days of idleness.

The Exchange does not carry protection and indemnity insurance. Members of the Exchange carry such insurance protection with commercial insurers, either individually or as a group through their local trade association. In Seattle, we carry group insurance for the members of the Seiners Association. Annual premiums depend on the trading warranty. Vessels operating in the Puget Sound area pay an annual premium on a per-vessel basis because crew size varies. Annual premiums for vessels operating in Alaska waters depend on crew size in general. Presently, the average annual premium per vessel is less than $1,000. How do we manage to obtain protection with such low rates?--because our vessel owners are selective and they work as a group, a carry-over of ideas from the Exchange.

---

[13] See Pacific Trollers Fund.