

DIRECT PROCUREMENT: STATE OF THE LAW

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The right of an insured to directly place coverage with an insurer of his choice is constitutionally protected, although a state may legitimately assess a tax on the transaction and require it to be reported. *State Board of Insurance v. Todd Shipyards Corp.*, 370 U.S. 451 (1962); *Connecticut General Life Insurance Co. v. Johnson*, 303 U.S. 77 (1938); *St. Louis Compress Co. v. Arkansas*, 260 U.S. 346 (1922); *Allgeyer v. Louisiana*, 165 U.S. 578 (1897). Thus, constitutional protection has been codified by the insurance laws of nearly three-quarters of the states and the District of Columbia. In these jurisdictions direct procurement is explicitly recognized by statute.¹ One state, Delaware, does not have a statute recognizing direct procurement; however, the right exists in case law.²

Nearly three-quarters of the states require the payment of a direct procurement tax, calculated generally as a percentage of gross premiums, from a low of 2% of gross premiums written in Arkansas, Indiana, Iowa, Kentucky, Michigan, and Minnesota to as much as 6% of gross premiums written in Oklahoma.³ Utah exempts ocean marine insurance from the tax.⁴ Many states tax a reduced percentage for marine insurance and title insurance. In most states, written reports of direct placements are required to be filed with the Insurance Department within 30, 60 or 90 days from the placement, depending on the specific state law. The insured is generally responsible for making the filing and for remitting the tax, which is paid in addition to the premium.⁵

In direct procurement transactions the surplus lines broker (or other retail broker) must avoid involvement, and the insured, in most cases, deals directly with the market. The insured is, in most cases, required to leave the state's borders and to conduct the transaction outside the state's borders. *See, e.g., People v. British & American Casualty Co.*, 133 Misc. 2d 352, 505 N.Y.S.2d 759 (Sup. Ct. N.Y. County 1986). All elements of the transaction, including negotiation, issuance and delivery of the policy, and payment of the premium must occur wholly outside the state of the insured and the broker cannot be involved in the transaction.⁶

The direct procurement alternative is only available in limited situations and should only be relied upon where there is evidentiary documentation that all the conditions have been fulfilled. This includes proving that the alien insurer and its producers were not involved in soliciting or negotiating the business inside the United States (although, as mentioned, there are certain states which require the transaction to be "principally negotiated" outside the state). Thus, while there is some flexibility permitted by the New York Insurance Law, e.g., a proposed insured may learn about a particular insurer (such as at a trade association meeting or other gathering in the ordinary course of business) and may contact that insurer by telephone to request an application, it is necessary for the insured, or the insured's representative, to conduct the bulk of the activity of the negotiation regarding coverage terms and pricing outside the state. Please note, however, that a broker will not be able to place the insurance on behalf of the insured, as a broker is limited to dealing with the admitted market and is prohibited from placing business with an unlicensed insurer. *See, e.g.,* § 2117(a) of the N.Y. Ins. Law. Similarly, in order to comply with the requirement that the policy be "issued and delivered outside the state in a jurisdiction in which the insurer is licensed," § 1101(b)(2)(E), it would be necessary for the insured, or the insured's representative, to accept delivery of the insurance policy outside New York. *People v. British & American Casualty Co.*, 133 Misc. 2d 352, 505 N.Y.S.2d 759 (Sup. Ct. N.Y. County 1986).⁷

Another form of direct procurement transaction is the industrial insured exemption. Industrial insured exemption statutes exist in fewer states than direct procurement statutes (approximately 24 states, not including the key industrial states of Florida, Georgia, Massachusetts, Michigan, New Jersey, New York, and Texas, among others).⁸ These exemptions are generally designed to permit sophisticated commercial insureds to procure insurance from a nonadmitted insurer without the need to involve a surplus lines broker in seeking declinations from admitted carriers prior to placing the business. It is predicted on the alien insurer refraining from doing business where it is not authorized to do so. Alien insurers seeking to write business in states which have enacted the industrial insured exemption must otherwise abide by the rules restricting their activities. In essence, the limitations imposed on non-admitted insurers by the direct procurement requirements also apply to industrial insured placements. Industrial insured placements typically require that the insured:

1. Procure insurance by utilizing the services of either a full-time employee¹⁰ acting as an insurance manager or buyer or a regularly and continuously retained, qualified insurance consultant or risk manager;
2. Have an aggregate annual premium on all of its insurance totaling at least \$25,000; and
3. Have at least 25 full-time employees.

The rules prohibiting negotiation and delivery of a policy inside the state are less strict for industrial insured placements than they are for direct procurement placements.

The tax on industrial insured placements, which is required to be reported and paid by the insured, is generally levied at the same rate as the surplus lines tax, as is the case with the direct procurement laws.¹¹ The insured is responsible for filing and remitting the tax since a surplus lines broker is not involved. (A common variation among the states is whether workers' compensation insurance premiums are included in the aggregate premium dollars required in order to qualify as an industrial insured. *See, e.g.,* ALA. INS. CODE § 27-11-2(10), which excludes workers compensation insurance premiums from the formula).¹²

The following is some practical advice as to the role of U.S. brokers, based upon the New York law and the *People v. British & American Casualty* case:

Section 1101(b)(2)(E) of the New York Insurance Law provides, in relevant part, as follows:

(2) Notwithstanding the foregoing, the following acts or transactions, if effected by mail from outside this state by an unauthorized foreign or alien insurer duly licensed to transact the business of insurance in and by the laws of its domicile, shall not constitute doing an insurance business in this state . . .

(E) transactions with respect to policies of insurance on risks located or resident within or without this state . . . which policies are principally negotiated, issued, and delivered without this state in a jurisdiction in which the insurer is authorized to do an insurance business; (emphasis added)

Section 2117(a) of the New York Insurance Law provides, in relevant part, as follows:

(a) No person, firm, association or corporation shall in this state act as agent for any insurer or health maintenance organization which is not licensed or authorized to do an insurance or health maintenance organization business in this state, in the doing of any insurance or health maintenance organization business in this state or in soliciting, negotiating or effectuating any insurance, health maintenance organization or annuity contract or shall in this state act as insurance broker in soliciting, negotiating or in any way effectuating any insurance, health maintenance organization or annuity contract of, or in placing risks with, any such insurer or health maintenance organization, or shall in this state in any way or manner aid any such insurer or health maintenance organization in effecting any insurance, health maintenance organization or annuity contract. (emphasis added)

New York case law, as set forth in *People v. British & American Casualty*, and interpretations of the New York Insurance Department with regard to Sections 2117 and 1101, appear to indicate that the role of a broker in a direct procurement situation is limited to that which the insured, himself, is entitled to do. For example, if a New York insured calls a Lloyd's broker and discusses the insured's coverage requirements and the Lloyd's broker sends the insured information about the rates of an alien insurer and/or a binder from the alien insurer, this would likely be considered illegal solicitation by the alien insurer and, quite possibly, the Lloyd's broker, if he is deemed to be soliciting business inside New York. If, on the other hand, the insured calls the Lloyd's broker and indicates that he will be in London and wishes to meet the broker and/or the alien insurer to discuss coverages, and the Lloyd's broker sets up the meeting which, in fact, occurs in London, resulting in a binder mailed from the alien insurer or by the broker on a subsequent date to the insured in New York, this would appear to meet the requirement that the placement be principally solicited and negotiated outside New York. The Lloyd's broker is not violating section 2117 since he is doing no act inside New

York. The alien insurer is violating no law since it falls within the exception as well and is not soliciting or negotiating coverage inside New York.

As another example, if the insured asks its broker in New York to travel to London as its representative to sit down with a Lloyd's broker (or with the alien insurer at its U.K. head office) and negotiate a policy, and the broker returns with a binder, once again, it would appear that this placement is principally solicited and negotiated outside New York and that the New York broker is not violating New York law, provided there were no substantive telephone discussions of or correspondence regarding coverage terms or pricing involving the insured or its New York broker and the alien insurer or the Lloyd's broker prior to the New York broker's departure for London. If there were, the broker would be subject to possible fines and loss of its license. *Hammond v. Hunkele*, 170 A.D.2d 484, 566 N.Y.S.2d 69 (2d Dept. 1991); *People by Abrams v. American Motor Club, Inc.*, 133 A.D.2d 593, 520 N.Y.S.2d 383 (1st Dept. 1987).

Further, as a practical matter, there would appear to be more of a risk for the New York broker in involving itself in direct procurement transactions (which generally presuppose the absence of a broker) than there is for the alien insurer which is not transacting U.S. surplus lines business. With regard to a New York broker, its license would clearly be jeopardized if it is found to be violating New York law. With regard to an alien insurer which is not transacting U.S. surplus lines business, it would be difficult for insurance regulators to enforce the statute as against such a company, even if it is found to be violating New York law.¹³

Finally, there is no prohibition on an eligible surplus lines insurer transacting business on a direct procurement (or industrial insured) basis as well, provided the strict rules as respects direct procurement business and/or industrial insured business are observed.¹⁴

Endnotes

1. Ala. Ins. Code § 27-10-35; Alaska Ins. Code § 21.33.061; AZ. Ins. Code § 20-107(B); Ark. Ins. Code § 23-65-103; Cal. Ins. Code §§ 1760-61; Col. Ins. Code § 10-3-903(2)(d); Ct. Ins. Code § 38a-277; D.C. Ins. Code § 35-1543; Fla. Ins. Code § 626.938; Ga. Ins. Code § 33-5-33; HI. Ins. Code § 431:8-205; Idaho Ins. Code § 41-1233; IA. Ins. Code § 507A.4(9); Ky. Ins. Code § 304.11-030(1)(d); La. Ins. Code § 22:1249(8); Me. Ins. Code tit. 24.A § 2113; Md. Ins. Code § 4-210; Mich. Ins. Code § 500.402b(g); Minn. Ins. Code § 60A.19(8); Miss. Ins. Code § 83-5-61; Mo. Ins. Code § 384.051; Mt. Ins. Code § 33-2-706; Nev. Ins. Code § 680B.040; N.H. Ins. Code § 406-B:2(11)(d); N.J. Ins. Code § 17:22-6.64; N.M. Ins. Code § 59A- I 5-4(A); N.Y. Ins. Code § 1101(b)(2)(E); N.C. Ins. Code § 5 828-5(9)(7); Ohio Ins. Code § 3905.36; Okla. Ins. Code § I I 15(D)(1); Pa. Ins. Code § 1106.11 (e); S.D. Ins. Code § 58-32-47; Tx. Ins. Code Art. 1.14-1 § 2(b)(4); Utah Ins. Code §§ 31A-15-104(l) and 31A-3-301; Vt. Ins. Code § 5036; Va. Ins. Code § 38.2-1802A; Wi. Ins. Code § 618.42.
2. *Atlas Mutual Ins. Co. v. Fisheries Co.*, 22 Del. 256 (1907).
3. Puerto Rico, which is not a state but whose Commissioner of Insurance is a member of the National Association of Insurance Commissioners and whose scheme of insurance regulation closely resembles that of the 50 states, levies a 15% tax on insurance policies procured by unauthorized insurers. Otherwise the tax rates applied by the states are as follows: 2.25%, Colorado; 2.5%, South Dakota; 2.75%, Idaho, Montana; 3%, Alaska (most types of policies); Arizona, California, Maine, Maryland, Mississippi, New Jersey, New Mexico, Pennsylvania, Wisconsin; 3.5%, Nevada; 3.6%, New York; 4%, Alabama, Connecticut, Georgia, New Hampshire (most types of policies); 4.25%, Utah; 4.68%, Hawaii; 4.85%, Texas; 5%, Florida, Louisiana, North Carolina; 6%, Oklahoma.
4. Utah Ins. Code § 3 1 A-3-301.
5. The insurer is responsible in Indiana, Iowa, and Kentucky. In Wisconsin, the insurer and the policyholder are jointly and severally liable. In Tennessee, there is no clear statutory provision except for fire, marine or fire marine insurance under § 56-2-411 -- the insureds are liable for the tax on these types of policies; however, unauthorized insurers transacting business in violation of § 56-2-105 are liable for the tax.
6. Col. Ins. Code § 10-3-903(2)(d); N.H. Ins. Code § 406B:2(11)(d); Ky. Ins. Code § 304.11-030(1)(d); Mich. Ins.

Code § 500.402(b); Tx. Ins. Code Art. 1.14-1 § 2(b)(4). Other states allow the insured to remain within the state's borders and negotiate all insurance coverage with the nonadmitted insuror's representatives, who must be located outside the state. *See*, for example, N.J.S.A. 17:22-6.64; Calif Ins. Code § 1760, 1761 and § 13210 of the Revenue & Taxation Code; and Fla. Ins. Code § 626.938. Direct procurement is permitted in certain states if the placement is *principally* negotiated outside the state: N.Y. Ins. Law § 1101(b)(2)(E); Iowa Code Ann. § 507A.4(9); Utah Ins. Code § 31A-15-104(1) and 31A-3-301; Wis. Ins. Code § 618.42; and La. Ins. Code § 22:1249(8). The majority of states exempt direct placements effected with unauthorized insurers only if all elements of the transaction occur wholly outside the insured's state. Negotiations cannot be conducted by mail or phone from within the state and no brokers can be involved.

7. Once the policy has been issued and delivered outside the state, however, the sending of a premium notice or premium renewal, or the collection of premiums from a New York resident would, not likely be held to violate the New York Insurance Law.
8. Industrial insured exemptions have been enacted in Alabama, Arizona, California, Colorado, Connecticut, Illinois, Indiana, Kentucky, Maryland, Missouri, Nebraska, Nevada, New Hampshire, New Mexico, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont, Virginia, West Virginia, and Wyoming.
9. *Meadowlark Insurance Company v. Insurance Commissioner of the State of Maryland*, 101 Md. App. 379; 646 A. 2d 1087 (1994).
10. I read this language as requiring that the person who procures the insurance must be a full-time employee of the insured without reference to whether he has other duties. In those cases where a partner of the firm, rather than the firm's professional office manager or insurance supervisor, purchases the insurance, the reasonable interpretation of "employee" will include him. Read in this manner, the requirement serves its function of prohibiting the insurer from stretching the exemption and frustrating the laws relating to brokers and insurance consultants by "hiring" a broker or other person on a part-time basis.
11. In New Hampshire, the rate is 4% on directly placed policies, 3% for industrial insureds.
12. Nevada's industrial insured exemption is limited to the procurement of excess liability above underlying liability coverage or self-insured retention of at least \$25 million procured by a person whose total annual property-casualty premium is at least \$1 million and who employs 250 or more full-time employees. § 680A.070(9.)
13. However, it should be noted that soliciting insurance or any other transaction of business in New York in violation of the law constitutes an appointment of the Superintendent as agent for services of process in any proceeding arising out of any insurance contract entered into by such insurer.
14. In considering tax issues, it should also be noted that the Federal Excise Tax ("FET") may apply to the direct placement as well, depending on the type of business placed. The FET, equal to 4% of gross direct premium, is applicable to each policy of direct insurance (1% of reinsurance premium) issued by an alien insurer or reinsurer through, or for, or in the name of, a U.S. company with respect to risks, losses, or liabilities within the U.S. Internal Revenue Code § 4371. The tax is customarily paid by the insured, although under § 4374 of the Code the liability for paying the tax is on the company issuing the policy as well as the insured. § 4374 also requires the filing of a federal tax return (Form 720) to report the tax. Some countries have tax treaties with the U.S. which exempt policies issued in those countries from application of the FET.