

FEDERAL SURPLUS LINES LEGISLATION

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Quarterbacks, stunt actors, amusement park rides and off-shore oil platforms are examples of risks that are likely covered by surplus lines insurance. The regulation of the surplus lines industry is the subject of federal legislation that is currently under consideration in the House of Representatives. While this federal legislation is an answer to the industry's clamor for change, it is far from perfect.

Overview of Surplus Lines Insurance¹

Surplus lines insurance is property and casualty insurance, which covers those nonstandard risks that are unusual and hard-to-place in the admitted market. Examples of such risks include the ones mentioned above as well as certain business risks, malpractice, hotels, mobile homes, hazardous materials, railroads, natural disasters, computer risks, etc. Surplus lines coverage may also apply to more standard risks where insureds need coverage limits that are not available in the admitted market or for those one-of-kind programs that are difficult to underwrite since there is no loss history.

Carriers that underwrite surplus lines coverage are free from most insurance regulation provided they meet certain requirements which vary depending on the state. While insurance departments claim not to regulate surplus lines insurance, this is a misnomer as surplus lines insurers and agents must comply with a variety of state laws in order to do business in each state. For example, a surplus lines insurer must meet each state's eligibility requirements, and surplus lines agents must perform due diligence searches, fulfill reporting obligations and pay taxes.

Surplus lines insurers are indirectly regulated through each state's direct regulation of surplus lines agents. Unlike the insurers, surplus lines agents must be licensed in each state. It is the surplus lines agent who is responsible for determining whether the coverage is available in the admitted market and whether the insurer is an eligible insurer. Additionally, the agent must allocate and pay taxes and file regular reports with each state. While this article addresses the regulation of surplus lines agents, there are certain situations in which an insured may directly procure surplus lines insurance from the insurer without an agent acting as an intermediary.

Administrative Nightmare

Prior to the passage of the federal Gramm-Leach-Bliley Act ("GLB"), many states issued only resident licenses for surplus lines agents. This made it difficult to service insureds with multi-state risks since the agent responsible for procuring the coverage was unable to obtain nonresident licenses and, therefore, could not comply with the filing and tax requirements of those states. Such compliance would have subjected the agent to a possible claim that he or she was illegally transacting insurance as an unlicensed agent.

Creative agents found ways around this obstacle. Some agents paid the entire amount of the surplus lines taxes to their resident state. Others paid the taxes in other states and made the filings through agents who were licensed in those states (often referred to as courtesy filings) while still others had insureds pay the taxes through self-procurement tax provisions.

GLB provided some measure of relief for these agents. As a direct result of the requirements in GLB that states become reciprocal in their licensing requirements, states passed laws creating non-resident surplus lines agent licenses. Thinking this was a solution to their problems, agents rushed out to obtain their nonresident licenses. However, they soon learned that compliance with the various requirements in each state was nearly impossible. The following hypothetical and related discussion demonstrate this difficulty.

Assume that a surplus lines agent works with the American Association of Amusement Parks ("Association") to market and sell Association-endorsed insurance products to the Association's members. The products include property and liability insurance with respect to damage and injuries related to amusement park rides. Also assume

that the agent is appropriately licensed in all states to sell surplus lines coverage, and members are located across the country.

Like many agents, the agent in this hypothetical is faced with the task of complying with each state's surplus lines laws. As discussed below, this task is an administrative nightmare which involves due diligence searches, eligibility determinations, reporting obligations and tax payments.²

Due Diligence Searches

The agent must comply with each state's due diligence search requirements which require the agent to embark on a search to determine whether the coverage may be procured in the admitted market. The problem is that some states require agents to obtain a specific number of declinations of coverage from admitted insurers, the number of which differs from state to state, while other states simply prohibit the sale of such coverage if it is available in the admitted market. The states that do require a specific number of declinations may require the agent to file proof of such declinations while other states simply require such information to be available upon request.

Insurer Eligibility

A majority of the states maintain lists of "eligible" insurers with whom the surplus lines agent may place the surplus lines coverage.³ As may be expected, however, these state lists are not uniform, and they change from year to year. Thus, it is difficult for an agent to find an insurer that is eligible to provide coverage in each state; and once this insurer is found, the agent is responsible for ensuring that the insurer remains on the eligibility lists each year. In those states that do not maintain eligibility lists, the agent must determine whether the insurer meets the state's criteria for eligibility. Such criteria may include certain financial requirements (e.g., capital and surplus requirements) and the creation of a trust fund.⁴

Reporting Requirements

The agent must also comply with each state's various reporting requirements. Such reports must include the details regarding each sale of surplus lines insurance in the state. As may be expected, each state is different with respect to the level of detail that is required. Many states have their own unique form that must be used while other states have specific formatting requirements. To add to this administrative burden, the states have different deadlines for such reports. They may be due on a monthly, quarterly or annual basis, or they may be due within a certain number of days after coverage is placed.

Tax Payments

Finally, the agent must pay taxes to each state in accordance with that state's particular allocation formula. Unfortunately, it is very difficult to determine where to pay taxes given that there is no standard allocation formula with respect to paying taxes on multi-state risks.⁵ Some states require taxes to be paid on 100% of the premiums when the insured is domiciled in that state, regardless of where the risks are located, while other states require some method of allocation depending on the location of the risks. Still, other states' laws are entirely unclear with no direction as to the allocation of taxes payable on multi-state risks. For those insureds with risks located in all states, it is easy to see how double taxation regularly occurs. Additionally, the tax due dates create another level of complexity, as some states require payment on an annual basis, others on a monthly basis and still others on a quarterly or semi-annual basis.⁶

Demand for Change

The industry, which has been clamoring for uniformity in the surplus lines area for years, has renewed hope. Representative Ginny Brown-Waite from Florida introduced the Nonadmitted and Reinsurance Reform Act of 2006 ("Reform Act") in the House of Representatives on June 19, 2006.⁷ The surplus lines provisions in the Reform Act were lifted from the State Modernization and Regulatory Transparency Act ("SMART Act"), federal legislation that was created to reform the entire insurance industry, but which has stalled due to considerable objection. The surplus

lines provisions that were taken from the SMART Act were considered by many to be the least controversial provisions, and thus, they are a test case for piece-meal passage of the SMART Act.

The Reform Act is, at least, a partial answer to the industry's call for change. The Reform Act requires premium tax payments to be made to an insured's home state regardless of where the risks are located. The payment must be accompanied by a report detailing the portion of the policy premium attributable to properties, risks or exposures located in each state.⁸ The states would be required to establish a uniform allocation formula, and the insured's home state would then have the responsibility of allocating the taxes pursuant to that formula among the states in which the risks are located.⁹

The Reform Act would subject the surplus lines transaction to the regulatory requirements "solely" in the insured's home state.¹⁰ In this regard, the agent would only be required to be licensed in the insured's home state¹¹ and would only have to comply with the home state's due diligence and filing requirements.

The Reform Act would also establish uniform standards for determining an insurer's eligibility to provide surplus lines coverage.¹² Such standards would come from the NAIC Non-Admitted Insurance Model Act.¹³

Finally, the Reform Act allows sophisticated commercial purchasers to directly access the surplus lines market¹⁴ and addresses agent licensing.¹⁵

It is interesting to note that the sponsor and some of the co-sponsors of the Reform Act are from states with aggressive insurance regulation. The sponsor is from Florida, and the co-sponsors (18 to date) are from such states as New York, Pennsylvania, and Texas. Other co-sponsors include representatives from Alabama, Arizona, Georgia, Illinois, Kansas, Louisiana, North Carolina, Ohio and Oregon.

The Reform Act was introduced on June 19, 2006 and referred to the House Committee on Financial Services ("Financial Committee") and the House Committee on the Judiciary. Hearings were held on June 21, 2006 by the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises ("Subcommittee"). Representatives from several associations appeared before the Subcommittee to testify in support of the Reform Act including the National Association of Professional Surplus Lines Offices, Ltd., the Council of Insurance Agents and Brokers, the Independent Insurance Agents and Brokers of America, the American Association of Managing General Agents and the Risk and Insurance Management Society.

On July 19, 2006, the Subcommittee approved the Reform Act by voice vote and sent it to the Financial Committee for further consideration. In a hearing held on July 26, 2006, the Reform Act was passed by voice vote in the Financial Committee. The Judiciary Committee is expected to consider the Reform Act in September. A companion bill has not yet been introduced in the Senate.

Not Quite the Entire Solution

The Reform Act is a good solution for those situations in which an agent deals with insureds who have risks located in a few states. It does not, however, help those agents who work with large groups like associations that have members across the country.

The hypothetical set forth earlier in this article demonstrates the problems that remain. In that hypothetical, the agent places individual insurance coverage for the Association's members who are located in every state. In this regard, the agent still faces many of the same administrative problems, even with the passage of the Reform Act.

Admittedly, the issue of double taxation is alleviated since taxes will only be paid to the insured's home state, even when the insured owns amusement parks in other states. Additionally, the agent would not have to determine whether the insurer is eligible in each state since all states would defer to the standards in the Non-Admitted Insurance Model Act.

Unfortunately, the more difficult administrative burdens remain. The agent must still deal with the differing due diligence search requirements, reporting obligations and tax payment laws in each state.

There are several revisions that could be made to the Reform Act to address these issues. The Reform Act centers around regulation by the insured's home state. There is no definition, however, of an "insured" in the Reform Act. Thus, the Reform Act could be amended to include a definition of "insured" which would designate the Association as the insured when the Association has endorsed the surplus lines coverage for its members. A definition of an "association" would also have to be added to include an association that has been in active existence for some time and which was formed for purposes other than to market insurance products.

With these amendments, the agent would only need to comply with the due diligence, premium tax payment and filing requirements of the state in which the Association has its principal place of business. That home state would then be responsible for allocating payments to the other states.

Unfortunately, these amendments would likely face an uphill battle. So far, the NAIC has had little to say, at least publicly, about the Reform Act. These amendments, however, would likely spark some objection, not only from the NAIC but also the state regulators who would not want to yield regulatory control over insurance issued to policyholders in their state. The states may also object due to the home state's burden in having to allocate the millions of dollars that would be paid to the home state.

The other quick fix would be to amend the legislation to require uniform due diligence, tax payment and reporting obligations. Clearly, these amendments would be even more controversial than the ones suggested above.

Conclusion

The regulatory landscape of the surplus lines industry must change. While the Reform Act is a good start, it will not stop the demand for more uniform regulation. If the states are unwilling to meet this demand, they should, at least, agree not to oppose revisions to the Reform Act that would alleviate some of the burden the agents deal with in complying with laws in a "nonregulated" industry.

Endnotes

¹ For more information regarding the history of surplus lines insurance, *see* SURPLUS LINES INSURANCE PRINCIPLES AND ISSUES (Doris Hoopes, Coordinating Editor, American Institute for Chartered Property Casualty Underwriters/Insurance Institute of America, 3rd ed. 2001) and SURPLUS LINES INSURANCE PRACTICES (William R. Feldhaus, Coordinating Editor, American Institute for Chartered Property Casualty Underwriters/Insurance Institute of America, 1st ed. 1996).

² *See* the June 21, 2006 testimony in the Subcommittee by Scott A. Sinder, Esq. on behalf of the Council of Insurance Agents and Brokers for a good discussion of the differences in the states as to due diligence search, reporting and tax requirements.

³ *See* the NAIC's Compendium of State Laws on Insurance Topics, *Lists of Approved Surplus Lines Insurers*, I-CA-70-1.

⁴ As an example of such requirements, *see* the NAIC's Compendium of State Laws on Insurance Topics, *Capital and Surplus and Deposit Requirements for Surplus Lines Companies*, I-CF-30-1.

⁵ *See* the NAIC's Compendium of State Laws on Insurance Topics, *Surplus Lines Premium Tax Allocation by State*, III-TX-53-1.

⁶ *See* the NAIC's Compendium of State Laws on Insurance Topics, *Surplus Lines Insurance Premium Taxes*, III-TX-50-1.

⁷ The Reform Act, 2006 H.R. 5637 (June 19, 2006).

⁸ The Reform Act at §§ 101(a); 101(c).

⁹ *Id.* at § 101(b).

¹⁰ *Id.* at § 102(a).

¹¹ *Id.* at § 102(b).

¹² *Id.* at § 104.

¹³ *Id.* Note that a state would not be able to prohibit an alien insurer from placing nonadmitted business if the insurer is listed on the list maintained by the International Division of the National Association of Insurance Commissioners. *Id.* at § 104(2). *See* also NAIC Nonadmitted Insurance Model Act 870-1.

¹⁴ *Id.* at § 105.

¹⁵ *Id.* at § 103.