

FEDERATION OF REGULATORY COUNSEL, INC.

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NAIC REVIEW OF LIMITED LINES PRODUCER LICENSES

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Limited lines producer licenses run the gamut among the various states as to the type of insurance products covered and the applicable regulatory requirements. Issues with uniformity and reciprocity continue to be a source of utter confusion to regulators and trade alike. With recognition of the issues by the National Association of Insurance Commissioners, the Producer Licensing Task Force ("PLTF") and the Producer Licensing Working Group ("PLWG") have been charged with review of the limited lines issues. This article will provide an overview of limited lines licensing and discuss the review of the limited lines issues by the NAIC.

Overview of Limited Lines Licensing

A Limited Lines producer license is a license authorizing the sale, solicitation or negotiation of a line of insurance other than a major line of insurance (e.g. Life, Accident and Health or Sickness, Property, Casualty, Variable Life and Variable Annuity Products and Personal Lines). A current review of the NAIC's Compendium of State Laws On Insurance Topics¹ reveals approximately fifty-five (55) different types of limited lines licenses available in the various states. The type of limited lines producer licenses include what are referred to as the five (5) "core" limited lines: car rental, credit, crop insurance, surety, and travel. In addition to the "core" limited lines, some states authorize limited lines licenses for such things as pet, self-storage, communications equipment, pre-paid legal, and motor club among others. A number of states also include a catch-all provision for classification as limited lines as the Commissioner directs.

In addition to the variation in the type of available limited lines licenses, the regulatory requirements for issuance of a limited line license also vary widely among the states. For example - rental car limited lines variations:

1. Some states require rental car company to obtain limited lines license.
2. Some states require rental car company *and* 1 employee at each location to obtain limited lines license.
3. Some states require rental car company *and* managing employee to obtain limited lines license.
4. Some states require rental car company *and* all counter employees to obtain limited lines license.
5. Some states require rental car company *and* designated responsible producer to obtain limited lines license.
6. Some states define "car rental" as a limited line of insurance which requires licensing under said states' Producer Licensing Regulations.
7. Some states' Producer Licensing regulations require limited lines license for rental car company - not officers, directors or employees.
8. Some states do not require a limited lines insurance license where travel-related coverages are offered concurrently with the rental of a motor vehicle.

These requirements are in addition to the issues with having each officer/director of the business entity submit fingerprints² and biographical affidavits, not to mention insurer appointments and fingerprint and/or test requirements of the individuals noted above in their resident state,³ as well as in a few non-resident states.⁴

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Regulatory Response To Achieve Reciprocity/Uniformity

With passage of the federal Gramm-Leach-Bliley Act ("GLBA") in 1999, the NAIC has been working to avoid certain preemption of state producer licensing laws by complying with the provisions of Section 321 for major lines of insurance, but limited lines did not receive the same attention until recently.

For those who do not follow these issues, Section 321 required a majority of states, not later than three years after the effective date, to enact: (1) uniform laws and regulations governing the licensure of individuals and entities authorized to sell and solicit the purchase of insurance within the state; *or* (2) reciprocity laws and regulations governing the licensure of non-resident individuals and entities authorized to sell and solicit insurance within those states.

To avoid federal preemption, the NAIC elected the reciprocity route rather than the uniformity route and crafted a model law to assist with meeting the reciprocity requirement. The Producer Licensing Model Act (PLMA)⁵ was adopted by the NAIC in 2000 and was intended to serve as the primary vehicle for states to achieve reciprocity, as well as assist in the next step to reach uniformity.

Although, the PLMA established uniform definitions for the six major lines of insurance: (1) Life, (2) Accident and Health, (3) Property, (4) Casualty, (5) Variable Life and Variable Annuity, and (6) Personal Lines, the PLMA specifically addressed only one limited line - credit insurance.⁶ The PLMA did provide certain definitions relating to limited lines, including the definition for:

"Limited lines insurance"⁷ means those lines of insurance defined in [insert reference to state specific limited line statute] or any other line of insurance that the insurance commissioner deems necessary to recognize for the purposes of complying with Section 8E; and

"Limited lines producer"⁸ means a person authorized by the insurance commissioner to sell, solicit or negotiate limited lines insurance.

Subsequent to the adoption of the PLMA, in 2002 the NAIC adopted the Uniform Resident Licensing Standards which focused on certain broad areas not addressed in the PLMA: (1) licensing qualifications, (2) pre-licensing education, (3) licensing testing, (4) integrity/background check standards, (5) license application process, (6) appointment process, (7) continuing education requirements, and (8) limited lines.⁹

The NAIC's Producer Licensing (D) Working Group (PLWG) is charged with ongoing monitoring of state implementation of the Uniform Resident Licensing Standards ("URLS"). In June 2002, the Uniform Producer Licensing Initiatives Working Group, acting under the direction of the NARAB Working Group, adopted limited lines definitions which are commonly referred to as "core" limited lines - car rental, credit, crop insurance, surety and travel.¹⁰

Notwithstanding these actions, continued issues with reciprocity and application of the URLS continued to persist. As a result, the NAIC ordered an assessment as to whether states previously certified as compliant for purposes of the GLBA continued to be in compliance, as well as review of state compliance with the URLS and barriers to implementation and full compliance. The assessment was reported on February 19, 2008 in the *Producer Licensing Assessment Aggregate Report of Findings*.

The Aggregate Report acknowledged continuing issues in producer licensing and additional roadblocks to reciprocity and uniformity compliance, including recognition of issues in the area of limited lines licensing. The Aggregate Report also commented on compliance with the URLS in the companion *Uniformity Standards Compliance Report*.

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Recognition of the Issue

The Aggregate Report noted a general consensus that the lines of authority, both major and limited, are areas where achieving uniformity is critical, as well as that the standards are in need of additional interpretive guidance.

Following the Aggregate Report and numerous discussions regarding the NAIC's approach to achieve reciprocity and uniformity in standards which directed adoption of the core limited lines and reduction in the number of non-core limited lines,¹¹ the PLWG in 2009 was charged with reviewing limited line licensing issues with particular focus on the following: (1) the establishment of a limited line that encompasses several insurance products where the business of insurance is ancillary to the business of the person offering the product, (2) the licensing requirements of individuals selling limited line insurance products, and (3) the fingerprinting of individuals selling limited line insurance products.

Deliberations and Demand for Change

Throughout 2009, thoughtful information was presented to the PLWG in an effort to outline changes to the PLMA, as well as provisions of the URLS, which were necessary to address the limited lines issues. Interested parties presented additional concerns regarding the practical aspects of licensing, including particular reference to limited lines issues and best practices, in connection with comments to the revisions to the NAIC State Licensing Handbook and the Uniform Applications. Issues were noted to reflect how the URLS and the PLMA were unintentionally undermining the goal of reciprocity and increasing the compliance burdens without improving consumer protection. Provision for a limitation of fewer than nine (9) limited lines would do little to address uniformity issues and a more broadened approach would have to be taken to address real change. With fifty-five (55) different types of limited lines licenses, regulatory function and purpose should be considered to obtain a proper standard and balance for regulating limited lines licenses and provide appropriate consumer protection. The review should consider the method of distribution in order to arrive at an appropriate license standard that will address the regulatory function and provide true uniformity. Interested parties presented proposed modifications to the PLMA and revisions to the URLS to substantively change the system of licensing limited lines producers to better reflect the method of distribution.

The deliberations confirmed that consumer complaints attributable to limited lines products are nominal. Licensing the counter person at a car rental company, the counter person at the self-storage facility, or the travel agent at a travel agency does little to provide consumer protection when the substantive issues of regulatory consumer protection lie with the insurer or the MGA/MGU who developed and distributed the limited lines product. Such method of distribution and product development is demonstratively much like the service agreement and/or extended warranty which according to the Service Contracts Model Act¹² do not require licensing at the counter or retail level, not to mention those products which contain accidental damage and theft coverage in addition to product defect.

As part of the PLWG effort in 2009, an ancillary¹³ definition of insurance was developed and then tabled due to resistance of some PLWG members to establish change in the current process. Issues were presented which included whether to include "core" limited lines in the definition of "ancillary" limited lines. Some regulators expressed concern with a new ancillary line definition because of the belief that implementation would require legislative action. Some regulators also objected to any changes that would allow those who sold these products not to have to be specifically licensed. Following the discussions, the Chair and Vice Chair of the PLWG issued a Report on the Producer Licensing Working Group Limited Lines Discussion and suggested recommendations to the PLTF, which included tabling the ancillary definition until the licensing requirements and guidance on fingerprints could be established, and requested further guidance on the extent of changes the PLTF wished to implement. Specifically, should ancillary type insurance products have less rigorous licensing requirements than other limited lines (such as crop insurance or surety)? Does the Task Force wish to include

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previously defined "core" limited lines that are incidental in nature within an ancillary line? Does the Task Force wish the Working Group to pursue any changes that may require modifications to the Producer Licensing Model Act?

Next Steps

Following the PLWG Report, the PLTF has advised that the 2010 charges to the PLWG will provide the requested guidance and direction on the future of limited lines regulation. We will have to wait and see whether the necessary changes can be made to obtain true reciprocity among states and achieve uniformity that provides functional and appropriate regulation for limited lines products.

Endnotes

1. See the NAIC's Compendium of State Laws on Insurance Topics, Lists of *Producer Licensing: Limited Line*, I-PL-10-1.
2. Alaska, Arizona, Connecticut, Florida, Georgia, Idaho, Louisiana, Montana, New Jersey, Nevada, Ohio, Oregon, Pennsylvania, Tennessee, Texas, Utah and Washington require fingerprints for resident limited lines producer applicants.
3. Some states continue to require pre-license testing for limited lines producer applicants while others require an approved course of instruction to be provided by the insurer.
4. California, Florida, and Washington continue to require fingerprints from non-resident limited lines producers. California and Washington have recently advised that fingerprints for non-resident limited lines producers will no longer be required if the resident state requires fingerprints at licensure.
5. NAIC Model # 218.
6. PLMA Section 2G
7. PLMA Section 2I.
8. PLMA Section 2J.
9. The Limited Lines Subgroup was charged with developing standard definitions for the eight most common limited lines licenses. These limited lines licenses were identified at a meeting of the Uniform Producer Licensing Initiatives Working Group in August, 2001 and included Credit, Car Rental, Crop/Hail, Industrial Fire, Motor Club, PreNeed Life, Travel and Surety.
10. Originally motor club, industrial fire and funeral expense insurance was also included in the limited lines definitions proposed by the Subgroup but removed prior to adoption for various reasons, including the limited number of states having such lines in effect at the time of consideration. See March 18, 2002 Report of the Limited Lines Subgroup and Uniform Producer Licensing Initiatives Subgroup Report of June 8, 9, 10, 2002.
11. See URLs at Standard 16b.

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12. NAIC Model # 685.

13. Limited Lines Ancillary Insurance: Specific types of insurance offered, solicited, or sold to the consumer under an individual policy or enrolled in a group or master policy as an add on in connection with and incidental to non-insurance goods or services, including coverage for (i) pet, (ii) self-service storage, (iii) mobile communication, (iv) travel, (v) car rental, or any other similar coverages as designated by the insurance commissioner.

COLLATERAL FOR REINSURANCE OBLIGATIONS

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At least two factors have led cedents and reinsurers to reconsider traditional approaches to the collateralization of reinsurance obligations in the last 18 months. First, the global recession has adversely impacted the financial condition of many international financial services groups, including both reinsurers and banks which provide letters of credit to secure reinsurers' obligations. Second, after years of industry discussions, the New York State Insurance Department (the "NYID")¹ and the National Association of Insurance Commissioners (the "NAIC")² have proposed modification of the U.S. approach to credit for reinsurance that would loosen the requirement of 100% collateralization by unauthorized reinsurers. It is proposed that future collateral requirements will be based on the financial strength of the unauthorized reinsurers.

In this environment, cedents should recognize that the risk of non-performance by well-rated reinsurers and banks is not insignificant. As AIG's spectacular descent from its place astride the global insurance industry to the ignominy of government control demonstrates, it may be difficult to assess accurately reinsurer default risk. At the same time, demand for letter of credit facilities has caused the cost of reinsurers to rise significantly, as a result of which reinsurers and cedents (to whom those costs are indirectly passed on) may be well-advised to develop alternative approaches to secure reinsurance obligations. Indeed, offering security to cedents in a cost-efficient way may provide reinsurers with a relative competitive advantage over those who do not.

While the adoption of proposals similar to those advanced by the NYID and the NAIC may make reinsurance more available or less costly, U.S. cedents in such a modified landscape may well face greater challenges in structuring reinsurance programs. When negotiating reinsurance treaties with unauthorized reinsurers from whom they can no longer demand full collateral as a regulatory requirement, will U.S. cedents weigh the relative financial strength of reinsurers or overall exposure of the cedent to a particular reinsurer and seek levels of security above what would otherwise be required under U.S. insurance law?

Downgrade triggers

One approach to securing reinsurance obligations is for reinsurance contracts to include provisions that trigger collateralization in the event of reinsurer downgrades. However, experience with swap obligation collateralization triggers of the non-insurance operations of AIG and Lehman Brothers, among others, raises concerns as to whether such arrangements provide effective protection.

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Indeed, cascading collateral triggers can lead to a "death spiral" of the counterparty, as in fact occurred in the U.K. with Independent Insurance, which slumped from an "A" rating to insolvency in a period of three months in 2001. Insureds with policies which contained downgrade triggers never obtained collateral. A collateralization trigger imposed on a downgraded reinsurer may, due to its deteriorating financial condition or liquidity constraints, result in little practical benefit to a cedent.

Collateralization options

Reinsurance obligations can be secured through "funds withheld" arrangements, trust arrangements, letters of credit, pledges of cash or securities, or third party surety arrangements. This article addresses some of the issues these options raise for cedents and reinsurers.

Credit for reinsurance

Every U.S. state has adopted the NAIC Credit for Reinsurance Model Law (the "Model Law") or a version of it. Under the Model Law, a U.S. cedent will get statutory credit for reinsurance if any of the following apply:

- (1) the reinsurer is authorized to transact insurance in the cedent's domiciliary state;
- (2) the reinsurer is accredited by the cedent's domiciliary state to transact reinsurance;
- (3) the reinsurer's domiciliary state has a substantially similar credit for reinsurance law as the cedent's domiciliary state, and the reinsurer has at least \$20 million in policyholder surplus;
- (4) the reinsurer maintains a trust approved by the commissioner of the cedent's domiciliary state of not less than \$20 million in a qualified U.S. financial institution; or
- (5) the cedent maintains collateral for the reinsurer's obligation by either (a) withholding funds on deposit from the reinsurer, or (b) holding security such as a trust or a letter of credit.

Funds withheld

A funds withheld arrangement is the most favorable method of collateralizing reinsurance obligations from the perspective of a cedent. In a funds withheld arrangement there can be no lien on the assets and the cedent must have exclusive control of such assets. Such arrangements may be unattractive to reinsurers due to the risk that insolvent cedents will not transfer earned ceded premiums or investment returns on the funds withheld. Simply crediting the funds withheld to a separate account in the name of the cedent will be unlikely to provide security or priority to the reinsurer if the cedent becomes insolvent, and will require the reinsurer to establish against the liquidator that the funds are held outside the insolvent estate under an implied trust in respect of funds not required to meet claims.

Whether or not it is practical for the cedent to provide security for its obligations to transfer earned premium or income to the reinsurer after meeting claims will depend on the particular circumstances. However, a cedent must hold sufficient unrestricted assets to support the issue of a letter of credit, to pledge collateral or fund a collateral trust. To have to provide security for unpaid premium may more than offset the benefit of withholding funds for the cedent.

In some circumstances the cedent pays the premium to the reinsurer, which holds it in a separate account designated for the benefit of the cedent. That structure will not qualify for credit for reinsurance and moreover will not provide security for the cedent if the reinsurer becomes insolvent in the absence of additional documentation or circumstances establishing a security interest in, or trust over, the designated account.

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Trust arrangements

As noted above under "Credit for reinsurance" paragraph (5), reinsurance obligations can be secured through a trust arrangement. U.S. insurers are familiar with a so-called "Regulation 114 trust" (the name refers to the applicable New York regulation, but similar trusts are authorized under other U.S. state insurance laws), which must include required provisions and permit unrestricted withdrawals by the cedent.³ Such trusts are unattractive to reinsurers since, like funds withheld, they do not provide security or priority to the reinsurer for payment of premiums if the cedent becomes insolvent and withdraws funds from the trust as permitted under the regulations.⁴ The reinsurer would need to establish that the funds withdrawn from the trust, which are not required to meet claims, are subject to a constructive trust.⁵

Letters of credit

Letters of credit have been extensively used by the insurance industry to support obligations. Unauthorized reinsurers can offer them in the U.S. as alternatives to Regulation 114 trusts for credit for reinsurance purposes. However, as with Regulation 114 trusts, the form of such letters of credit is prescribed by law, and cedent rights to draw upon the letter of credit are unlimited.⁶

Letters of credit can also be effective in securing reinsurance obligations even when not required by law - they are the standard way of securing reinsurance obligations in Europe - and can be tailored to meet the specific needs of a cedent and reinsurer. However, letters of credit can generally be drawn on demand (notwithstanding the terms of the reinsurance) and are considerably more expensive than trust or pledge arrangements, since the bank is assuming personal liability for making payment to the cedent (which is not the case with a trust arrangement, where the trustee's liability would be limited to distributing the assets under its control).

In addition, over the last 18 months, banks have become reluctant to issue letters of credit on an unsecured basis and to issue multi-year or so-called "evergreen" letters of credit, unless mandated by regulation. Facilities offered by banks now are often for a maximum of 364 days, which is less than the one year minimum term of a qualifying letter of credit required by Regulation 114.⁷ On any new facility, reinsurers are now likely to be required to post collateral with the bank issuing the letter of credit and will have limited options as to eligible collateral.

As with a pledge or trust, a cedent is exposed to the insolvency risk of the bank that issues the letter of credit and would have the additional risk that the obligation of the bank under the letter of credit is an unsecured liability in relation to the cedent. Against that, the reinsurer carries the credit risk of the bank failing, since it remains liable to pay under the reinsurance.⁸

Non-qualifying collateral

Where a U.S. cedent does not require credit for reinsurance, for example because the reinsurer is authorized in the cedent's domiciliary state or following the proposed regulatory modifications which will reduce the collateralization requirements for credit for reinsurance, other types of collateral may be considered, in particular security interests in a bank account and non-regulatory trusts.

Security interests

A reinsurer may secure its reinsurance obligations through the pledge of cash or securities owned by the reinsurer in favour of the cedent. A pledge (called a "charge" in the U.K. and Bermuda) is accomplished through creating a security interest in a bank or securities account of the reinsurer, which it grants in favor of the cedent.

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If the pledged account is in the U.S., the parties will enter into an account control agreement with the bank or broker that opens the account. If the charged account is in the U.K. or Bermuda, this is normally addressed through an acknowledgement from the bank. The account control agreement or acknowledgement ensures that the cash or securities held in the pledged or charged account cannot be removed or replaced without the cedent's consent.

Additionally, the parties must negotiate their respective rights to the pledged assets and income earned on those assets, the investment criteria for acceptable securities and discounts applicable in respect of the pledged assets (referred to as "eligible collateral"). These rights will usually be contained in the reinsurance agreement. The reinsurance agreement or the pledge may contain the circumstances that trigger the right of the cedent to take control of the pledged assets, or for the reinsurer to withdraw some or all of the collateral.

Such negotiations may materially increase the time taken to negotiate the terms of the reinsurance and the frictional costs. It is probable that there will be different forms of agreement between a cedent and each of its reinsurers or a reinsurer and its cedents, since the market has no standard documentation and each agreement must be individually negotiated.

Non-regulatory trusts

Cedents and reinsurers can also negotiate trust arrangements to secure reinsurance obligations with a financial institution serving as trustee. Such a non-regulatory trust can circumscribe cedent withdrawal rights to eliminate the risk of wrongful draw down by a cedent facing bankruptcy.

Trustee fees may be relatively inexpensive and trustees can manage funds and administer distributions from the trust and substitutions of assets. As with pledged accounts, there are costs associated with negotiating the trust arrangements. Unlike a pledge, however, the distribution or release of funds is within the control of the trustee (rather than relying on the consent of the parties in accordance with the terms of the reinsurance contract). Resort to judicial intervention or commencement of enforcement proceedings is unlikely to be necessary in relation to a properly-drafted trust deed.

Bank or trustee insolvency

An advantage to collateralizing reinsurance obligations through the pledge of cash or securities or the deposit of assets in trust is that each approach eliminates reinsurer and cedent credit risk. However, cedents and reinsurers may instead be exposed to risk of the insolvency of the bank or broker that holds the pledged account and of the bank or trust company that acts as a trustee. The instability of the global banking industry and growing government control of major financial institutions suggest that parties should investigate and monitor the condition of banks, brokers or trust companies involved in collateral arrangements.

Structures may be available to mitigate the impact of insolvency of the bank, broker or trustee which holds the collateral. In particular, securities would usually be preferred to cash, since it should be possible to ensure that beneficial ownership remains outside the bankrupt entity's estate. Collateral held in cash will likely be part of the bankrupt entity's estate unless it is held in an account with a third party.

Conclusion

Cedents and reinsurers have a number of options in determining whether to secure or not to secure reinsurance obligations. Other than in the context of collateralization required by regulation, the parties have great flexibility in structuring such arrangements. As and when credit for reinsurance collateralization requirements reduce, so flexibility will increase.

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Cedents should consider the financial condition of reinsurers and the cedent's aggregate exposure as an institution to each reinsurer. Reinsurers must weigh the costs of such arrangements and evaluate whether using alternative forms of collateralization at lower cost can enable them to gain a pricing advantage over competitors. Both cedents and reinsurers must take account of the previously unconsidered risk that banks which hold collateral as custodian or trustee or issue letters of credit may themselves fail.

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Endnotes

1. "Proposed Tenth Amendment to Regulation No. 20 (11 NYCRR 125) Credit for Reinsurance from Unauthorized Reinsurers," released by the NYID on December 24, 2008.
2. NAIC press release, December 7, 2008. See "NAIC Adopts Reinsurance Modernization Proposal," December 8, 2008. A revised proposal was released on July 27, 2009.
3. See N.Y. Comp. Codes R. & Regs. tit. 11, §§ 126.1 through 126.8.
4. N.Y. Comp. Codes R. & Regs. tit. 11, §126.3(d)(1)-(5).
5. See for example *In re Serio (Commercial Risk Re-Insurance Co. v. Superintendent of Insurance of the State of New York)*, 2003 N.Y. App. Div. LEXIS 13320, 2003 WL 22953553, 2003 N.Y. Slip. Op. 19566 (1st Dep't Dec.16, 2003) (No. 2488).
6. See N.Y. Comp. Codes R. & Regs. tit. 11, §§ 79.1 through 79.9.
7. N.Y. Comp. Codes R. & Regs. tit. 11, § 125.4(c)(4)(i); N.Y. Comp. Codes R. & Regs. tit. 11, § 79.2(h).
8. N.Y. Comp. Codes R. & Regs. tit. 11, § 79.5(a).

SECURING REINSURANCE: LETTERS OF CREDIT AND REGULATION 114 TRUSTS

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Reinsurance obligations can be secured in a number of ways, including trust agreements, letters of credit, funds on deposit accounts, funds withheld arrangements and pledges. Reinsurers are not subject to direct regulation, but in order for a U.S. insurer to obtain credit for reinsurance, the assuming reinsurer must be authorized or accredited in the ceding insurer's jurisdiction, or the reinsurer must post collateral in an amount equal to 100% of gross liabilities in accordance with applicable law.

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The current global economic and credit environment has made it difficult and costly to collateralize insurance programs. At the same time, the risk of default by reinsurers and banks, which cannot always be accurately assessed, is a significant concern. As a result, insurers' interest in risk-funding methods, including the security offered by methods such as "Regulation 114 Trusts," named for Regulation 114 of the Official Compilation of Codes, Rules and Regulations of the New York State Insurance Department (NYSID),¹ has skyrocketed.

This article addresses security for reinsurance and focuses on two of the most widely accepted methods by which U.S. insurers may obtain credit for reinsurance from unauthorized reinsurers: letters of credit (LOCs) and Regulation 114 Trusts.

Letters of Credit

Historically, letters of credit have been used to support reinsurers' obligations and have been viewed as the "best" form of collateral for reinsurance. By some estimates, three out of every four funded collateral programs use LOCs. Unauthorized reinsurers may offer LOCs for credit for reinsurance purposes, so long as the LOC is compliant with state insurance law, which typically requires an LOC with an authorized commercial bank in a prescribed form. It must be "clean," "irrevocable and unconditional," and "evergreen."² Even where an LOC is not required for credit for reinsurance, it may be used to secure reinsurance obligations and can be tailored to meet the specific needs of the cedent and reinsurer in a particular transaction.

Given the continuing financial market's difficulties and the resulting consolidation of the banking industry, banks have been increasingly unwilling to issue letters of credit on an unsecured basis, or to issue multi-year, *i.e.*, evergreen, letters of credit. Reinsurers have been compelled to post collateral in order to obtain LOCs, and as banks continue to reprice risk and restrict credit, the costs of LOCs continue to increase.

Regulation 114 Trusts

In lieu of an LOC, credit for reinsurance ceded to non-admitted reinsurers also is permitted where the reinsurer's obligations are secured by a compliant trust agreement. Because many U.S. insurers are licensed to do business in New York and are required to comply with Regulation 114, this article addresses trusts under New York's Regulation 114. However, such trusts are permitted by the laws of all other U.S. states under some version of the National Association of Insurance Commissioners (NAIC) model act and regulation governing credit for reinsurance.

Regulation 114 Trusts are created under a relatively standard form of tripartite agreement involving a single ceding insurance company, *i.e.* the beneficiary; a financial institution, *i.e.*, the trustee; and a single non-admitted reinsurer, *i.e.*, the grantor, who grants the beneficiary control over the ceded premiums.³

Trust assets are held in a secure financial institution approved by the NAIC or in a state-chartered bank under applicable state law. The trust must be maintained onshore and must be structured so that eligible assets are held by the trustee to guarantee payment of the reinsurer's obligation.

The insurance buyer utilizes the assets held to collateralize the reinsurer's loss payment obligations, and the grantor delivers the assets to the trustee bank in an amount equal to 100% of the beneficiary's collateral requirements. The beneficiary then has the right to demand possession of the assets in the trust to either pay or reimburse the beneficiary for the grantor's loss payment obligations. The trustee cannot release the funds for any reason, other than the payment of approved claims, without the beneficiary's consent.

In short, under a trust agreement, the trust assets may not be used for any purpose, except the payment of authorized claims, without the cedent's approval and consent. The trust thus allows state regulators to monitor the ceded funds and to control those funds in the event of the insurer's insolvency.

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Considerations in Using a Regulation 114 Trust

Although Regulation 114 Trusts are increasing in popularity, insurers' hesitancy in accepting a trust continues. LOCs seem to remain the preferred method of collateralization because they are well-tested and allow for the immediate withdrawal of cash. Nonetheless, in today's financial environment, insurers and reinsurers must consider the alternative of using a trust to collateralize an insurance program. In evaluating whether to use a trust, the following issues should be considered.

The Form of the Trust Agreement

Grantors often seek changes to the standard form, especially with regard to withdrawal and termination provisions, or propose to enter into "side" contracts to the trust agreement in order to meet their business objectives. However, any references to conditions or terms extraneous to the trust agreement are prohibited by law.⁴

Beneficiaries also must be wary in agreeing to any changes in the trust agreement which would impact their ability to use acceptable collateral where credit for reinsurance is required. Any amendments to the agreement which impair the ability to claim the assets as acceptable collateral must be avoided.

Acceptable Trustee Banks

Similar to an LOC, the trustee bank used for a Regulation 114 Trust must be a member of the Federal Reserve System or a New York State-chartered bank or trust company. The NAIC maintains a list of acceptable bank and trustee institutions, which generally follows accepted credit ratings of bank institutions.⁵

As an aside, it should be noted that the choice of financial institution will impact the issue of the regulation of the trustee. State chartered banks are regulated on both the state and federal levels; national banking associations are regulated on the federal level by the Office of the Comptroller of the Currency.

Acceptable Trust Assets and Investments

Trust assets must be managed and invested in "permitted investments" in accordance with the terms of the trust documents and applicable law. The NYSID requires that any and all trust assets be United States dollar denominated, so that U.S. insurers are afforded unfettered access to funds which are not subject to exchange rate fluctuations or currency blockage risk.⁶

The form of permitted investments is fairly restrictive, allowing funds to be invested only in cash and equivalents, such as certificates of deposit issued by U.S. banks, U.S. government obligations, money markets and relatively short-term, fixed instruments which are subject to NAIC investment requirements.⁷ This conservative investment requirement provides more security, but results in a potentially lower rate of return on investment.

Once the assets are funded in the trust, several different investment management approaches may be selected. For example, assets can be invested in liquid money market funds without active oversight; assets also can be actively managed within the parameters of the trust agreement.

Costs and Accounting Treatment

Bank charges for LOCs typically are based on the amount of the trust and can vary, depending on the bank, the reinsurer's financial condition and credit rating, and whether the LOC is secured by cash or other collateral. Regulation 114 Trusts generally are managed on an annual, flat fee basis. Thus, the actual amount

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of the trust must be considered in deciding whether an LOC or a Regulation 114 Trust is more cost-effective. Trust fees will be lower than LOC charges as a general rule.

A Regulation 114 Trust may benefit solvency and financial ratio thresholds because it reduces the utilization of a company's line of credit and is accounted for as a restricted asset. An LOC, on the other hand, may encumber credit and is accounted for as a debt obligation on the corporate balance sheet, often disclosed in the "Notes to Financial Statements," with details on the amount pledged as collateral towards the LOC.

An insurer may have multiple Regulation 114 Trusts from several unauthorized reinsurers, or conversely, an unauthorized reinsurer may accept cessions from more than one insurer by establishing multiple trusts. The trust effectively segregates a program's ceded funds into a controlled account and allows regulators to review and monitor the funds available to meet ceded obligations.

Impact in the Event of Insolvency of the Reinsurer or the Trustee

A full discussion on U.S. insolvency laws is beyond the scope of this article. However, the insolvency of a reinsurer typically will not impact the bank's payment obligations to the beneficiary under an LOC. Similarly, assets in a Regulation 114 Trust are not part of the reinsurer's property to the extent of the beneficiary's interest, although access to trust assets may be delayed while the extent of the reinsurer's residual interest, if any, is determined by the appropriate court.

With respect to the insolvency of a bank, under an LOC, a beneficiary becomes an unsecured creditor. Under a trust, on the other hand, specifically segregated trust assets are assets of the beneficiary and do not become general assets of the trustee bank. This may not be true, however, with respect to cash or possible investment income, especially in those cases where the trust agreement allows for the creation of a separate income account which allows for the payment of the trustee's fees and expenses.

A Note About Other Types of Security for Reinsurance

Funds Withheld Arrangements

In a funds withheld arrangement, assets that normally would be paid over to a reinsurer are withheld by the cedent. As a result, from a cedent's viewpoint, this may be the best approach to collateralizing reinsurance obligations. Some U.S. jurisdictions may allow credit for reinsurance under these arrangements. However, the reinsurer bears the risk that an insolvent cedent will not transfer earned ceded premiums or investment returns on funds withheld.

Security Interests

A reinsurer may seek to secure its reinsurance obligations through a pledge or charge of cash or securities to the cedent. The parties can negotiate their rights to the pledged or charged assets and interest earned, the investment criteria and discounts applicable in respect of the pledged or charged assets, and the circumstances triggering the right of the cedent to take control of the pledged or charged assets, or for the reinsurer to withdraw some or all of the collateral. These types of arrangements are not acceptable for securing the obligations of unauthorized reinsurers under current U.S. credit for reinsurance rules.

"Downgrade Triggers"

Another approach to be considered is the inclusion of a "downgrade trigger" in the reinsurance agreement, which will trigger collateralization in the event of a reinsurer downgrade. Whether these provisions provide effective protection is of some concern because they can result in the further deterioration of the reinsurer's

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financial condition. As a result, a downgrade trigger may provide the cedent with no practical benefit.

Other Trust Agreements

Finally, because Regulation 114 Trusts must include required provisions and permit unrestricted withdrawals by the cedent, they may be unattractive to reinsurers since they do not provide any security to the reinsurer and allow cedents to withdraw funds at any time. Where credit for reinsurance is not an issue, cedents and reinsurers may negotiate other types of trust agreements to secure reinsurance obligations with a financial institution serving as trustee, agreeing upon the terms of the distribution or release of funds.

The Potential Impact of Changes to U.S. Collateral Requirements for Reinsurance

Last year, the NAIC approved the submission to Congress of the Reinsurance Regulatory Modernization Act of 2009 (the NAIC Act). The NAIC Act seeks to reduce the amount of collateral that reinsurers must post in order for U.S. ceding insurers to receive credit for reinsurance. It calls for a sliding scale of collateral requirements based on reinsurers' credit ratings. Similar proposals have been advanced in New York, Florida and Texas.

The NAIC Act contemplates the creation of a new federal agency, the Reinsurance Supervision Review Board (Review Board), which would determine, under NAIC-recommended standards, which states qualify as "Home State" supervisors for U.S. domestic insurers, or "Port of Entry" supervisors for non-U.S. insurers. Under the proposal, no state may impose different collateral standards in order for an insurer to receive credit for reinsurance ceded to a Port of Entry reinsurer or regulate the financial condition of a Port of Entry reinsurer. Nevertheless, the NAIC Act would not preempt the authority of a U.S. ceding insurer's Home State regulator to determine what constitutes adequate collateral, compliance with applicable reinsurance risk transfer rules and the ceding insurer's incurred loss reserves, or to otherwise exercise regulatory powers not inconsistent with the NAIC Act.

If adopted, collateral equal to 100% of ceded reserves no longer will be required for the ceding company to take credit for reinsurance, and assets held in Regulation 114 Trusts may be released. However, when and if the NAIC Act will be enacted into law remains far from certain, and it will take several years after adoption to see any impact on the market.

Florida, which traditionally has had some difficulties attracting capital to the market in view of the state's hurricane exposure, enacted a similar proposal into law in 2007, effective September 16, 2008, allowing credit for reinsurance from a nonadmitted reinsurer, even if the reinsurer does not maintain 100% collateral, so long as the reinsurer meets that state's financial requirements.⁸ However, the Florida statute applies only to Florida domiciled companies.

A New York proposal, seeking to treat well-capitalized, unauthorized and unaccredited reinsurers with the highest credit rating the same as authorized and accredited companies, was advanced in 2007, but it has not been adopted pending action on the federal level.⁹ A similar proposal has been discussed in Texas.

Conclusion

Economic conditions are placing increasing pressure on the purchasers of reinsurance to reduce expenses, deploy capital efficiently and manage access to credit. Insurance program collateralization requirements can represent significant costs and reduce the availability of credit to an insurer.

Cedents and reinsurers have a number of options in determining whether to secure reinsurance obligations. Parties have flexibility in structuring such arrangements, except where collateralization is required pursuant to

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U.S. law in order to obtain credit for reinsurance. In evaluating these options, cedents must consider the financial condition of reinsurers and trustee banks and the aggregate exposure to each, given today's uncertain financial environment.

Endnotes

1. N.Y.Comp. Codes R. & Regs. tit. 11, § 126.
2. *See, e.g.*, N.Y. Comp. Codes R. & Regs. tit. 11, § 79.2 (Regulation 133).
3. *See* NYSID Office of General Counsel Op., dated July 21, 2005; N.Y.Comp. Codes R. & Regs. tit. 11, §§126.2 & 126.3(d) & (e).
4. *See* N.Y. Comp. Codes R. & Regs. tit. 11, §126.3 (d)(3)&(4).
5. The NAIC's recent list includes Brown Brothers Harriman; The Bank of New York; Bank of America; Citibank, N.A.; J.P. Morgan Chase, N.A.; Mellon Bank, N.A.; Deutsche Bank Trust Company; State Street Bank and Trust; and Wells Fargo Bank, N.A., among others. The trust departments of the listed institutions can be assumed to be familiar and experienced with the reinsurance trust process.
6. *See* NYSID Office of General Counsel Op. No. 08-10-09, dated October 27, 2008; N.Y. Comp. Codes R. & Regs. tit. 11, § 126.5(a)(2).
7. *See* N.Y. Ins. Law §1404.
8. 69O-144.007, F.S.
9. *See* proposed amendment to N.Y. Comp. Codes R. & Regs. tit. 11, § 125 (Regulation No. 20).

VEBAS, ERISA, AND OTHER CLOAKING DEVICES

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Health care costs continue to rise, forcing a commensurate rise in the cost of traditional group insurance. Employers continue to seek affordable benefits for their employees in an effort to maintain a productive and competitive workforce. Inspired entrepreneurs enter the market to supply low-cost programs to meet this demand. Many of these programs qualify as insurance. Yet some program promoters seek to avoid compliance with the various state laws regulating the business of insurance, such as laws requiring that insurers obtain appropriate licensure or demonstrate exemption from licensure, submit biographical materials concerning the persons who will manage these programs, file rates and forms for approval, follow mandated benefit requirements, observe prohibitions against discriminatory underwriting, achieve statutory solvency

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levels and prescribed investment practices, and comply with other measures of consumer protection applicable to the business of insurance.

Some unauthorized insurance promoters, wary of the administrative burden and cost of insurance regulation, seek to avoid state regulation of these products as insurance. They do so by cloaking these programs as "exempt" from regulation by flawed reference to federal law, such as the Internal Revenue Code or the Employee Retirement Income Security Act. In some instances this activity may be the result of unwary or erroneous professional advice. This article will review the manner in which two frequently used federal devices fall short of achieving the desired sanctuary of total exemption. To enhance this review, this article will provide a general overview of the intended advantages and limitations of these distinct federal provisions.

VEBAS

A voluntary employees' beneficiary association (VEBA) is a tax-advantaged welfare benefits funding vehicle defined under the Internal Revenue Code (IRC). The operations of a VEBA are substantially devoted to providing for the payment of life, sickness, accident, or other benefits to the VEBA's members and their dependents and beneficiaries. When properly organized under IRC Section 501(c)(9), a VEBA will be exempt from federal income taxation.¹ The mere offering of benefits in connection with a VEBA will not, alone, cloak benefits otherwise constituting insurance from regulation as insurance. The establishment of a VEBA to fund employee benefits, thus, serves no applicable purpose for effectively exempting a program from regulation as insurance.

Indeed, the IRC neither specifically authorizes nor prohibits the funding of employee benefits through a VEBA. Employees are simply eligible to associate themselves with a VEBA. Unlike traditional retiree health care in which employers agree to provide a certain level of benefits, employers make specific contributions to the VEBA. Employees also contribute on either a voluntary or mandatory basis. Employees are entitled to participate in the VEBA because of their employment status and because they have a common employment-related bond, such as coverage by a common employer or under one or more collective bargaining agreements or by virtue of membership in a labor union.² Qualification as a VEBA is a wholly separate determination from whether a benefit program -- to which the qualification as a VEBA may attach for favorable tax treatment -- is required to hold a certificate of authority issued by a state. Whether any particular association qualifies as a VEBA is a determination to be made by the Internal Revenue Service (IRS) or a federal court, not a private party or a state agency.

A company typically will use a VEBA for the collection and disbursement of monies related to the administration of the company's self-funded health care benefits plan. A VEBA offers several tax advantages to the company. For example, contributions to the VEBA are tax-deductible, while investment income earned on those contributions is tax-free; and funds, such as for the payment of claims, can be withdrawn tax-free.³ The fact that a VEBA can be used only for the funding and payment of benefits creates accountability for the company to maintain finances to support the benefit plan which, in turn, provides security to participating employees. Thus, the VEBA helps the company manage cash flow related to its health care plan, which it self-funds. Due to the volatility of claims experience, the company may also procure a financial backup in the form of specific or aggregate stop-loss insurance from a licensed carrier.

Certain criteria apply for a VEBA to retain the tax-exempt status for which it is designed. A VEBA can be established in a number of forms, such as a trust or a corporation, organized under state law. The trust or corporation must exist independent of the member employees and their employer.⁴ The organization must be controlled by its membership, independent trustees, or trustees designated by, or on behalf of, the members.⁵ Money paid into a VEBA trust cannot revert back to the company.⁶ Withdrawals are allowed only for benefit-related expenses or to purchase insurance that provides employee benefits. These tax regulatory restrictions correlate with a central premise for exempting VEBAs from federal taxation, so that the net

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earnings of the VEBA cannot inure to any private shareholder or individual other than from the payment of benefits.⁷ Moreover, with a bona fide VEBA trust, the plan administrator is treated as a common-law trustee. Like a common-law trustee, a plan administrator is accorded a certain level of discretion and deference to the extent legally permissible under governing program documents. In return, a plan administrator assumes the fiduciary duties of care and loyalty to its beneficiaries. These characteristics further help to mitigate against certain structural conflicts which may arise with the distribution of benefits. For example, an employer likely will be interested in ensuring that benefits are paid fairly to its employees for a productive workforce. A direct distribution, though, will directly affect the employer's operating budget; thus, arguably, fostering a competing financial incentive to deny claims. As such, courts tend to be wary of according unfettered fiduciary deference when the structure of a plan gives an administrator financial incentives to act against the participants' interests. The establishment of a bona fide segregated trust helps to mitigate against the structural conflict which may arise with the direct payment of benefits out of the employer's operating budget. ⁸

A company may utilize an alternative risk transfer program, in combination with a VEBA, to further control health benefit costs. Subject to approval by the federal Department of Labor (DOL), the IRS, and other agencies with a jurisdictional interest, a company may use funds that it contributes to a VEBA trust to purchase accident and health insurance from an admitted carrier. In turn, the carrier may reinsure the policy through a captive formed by the company. Generally, captive benefits funding can reduce administrative costs while improving access to claims data. Also, investment gains on contributions made to the captive can be paid out as dividends to the parent. Such an arrangement can retain the tax advantages of funding employee benefits through a VEBA while maintaining flexibility in the manner in which those benefits are provided. Notwithstanding the manner in which VEBA funding and cost-containment occurs, the potential for regulating the underlying plan benefits as insurance remains the same.

As another example, several companies may join together to fund their group health benefits by utilizing VEBAs and a risk retention group (RRG) owned by the companies. Under the arrangement, each company sets up and funds a VEBA. Employers receive an immediate tax deduction for their VEBA contributions, while VEBA assets earn tax-free interest. In turn, VEBA assets must be used to pay for benefit-related expenses, such as health care claims. When claim payments cause VEBA assets to fall below a certain level, the employers make new contributions to their VEBAs. Then, the employers are reimbursed through policies issued by the RRG. The RRG, in turn, may be reinsured. Since the employees' health coverage is not issued by a commercial insurance company, the policies may not be required to provide coverage in line with state mandated benefits laws. The linkage of a VEBA, stop-loss insurance, and a captive insurer or RRG, may help address various issues employers face when desiring to fund their health care obligations in advance. Here again, though, the funding of employee benefits through a VEBA should not be confused with the distinct activity required for compliance with applicable state insurance regulation or an express exemption to regulation as insurance.

An example of one such exemption may be found in the Michigan Insurance Code. That Code indicates that, "This code shall not apply to: ... Voluntary associations of employees which provide death, accident, or sickness benefits to persons employed by the same employer."⁹ Thus, under Michigan law, a trust which qualifies as a "voluntary association of employees" will find exemption from regulation as insurance in Michigan. The Michigan statute is silent as to whether the exemption contemplates that the association will qualify as a VEBA under the IRC. Certainly, qualification of the association as a VEBA should demonstrate compliance. However, one must remain mindful that the Michigan exemption contemplates a narrower form of association than a VEBA, limited to associations of employees "employed by the same employer."

ERISA-COVERED PLANS

A program which qualifies as an employee welfare benefit plan under Title I of the Employee Retirement Income Security Act of 1974 (ERISA) may legally avoid state regulation as insurance by the specific manner

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in which federal ERISA preempts state law. However, the program must constitute the type of "employee welfare benefit plan" designed for ERISA preemption and cannot neglect to file the various forms and reports with the DOL required under ERISA. Simply, an ERISA-covered plan must comply with ERISA.

ERISA preemption analysis begins with the presumption that Congress did not intend for ERISA to supplant state law.¹⁰ With ERISA, Congress intended "to minimize the administrative and financial burden of complying with conflicting directives among States or between States and the Federal Government."¹¹ Thus, state laws which mandate a specific employee-benefit structure or certain plan administration, or provide alternate enforcement mechanisms, must succumb to the various provisions of ERISA reserved for ERISA-covered plans.

ERISA indicates that it "shall supersede any and all state laws insofar as they may now or hereafter relate to any employee benefit plan."¹² A state law "relates to" an employee benefit plan and is subject to preemption whenever it "purports to regulate, directly or indirectly, the terms and conditions of employee benefit plans."¹³ The central issue thus becomes whether the program constitutes an "employee benefit plan" within the meaning of ERISA. An ERISA-covered "employee welfare benefit plan" is defined as "any plan, fund, or program ... established or maintained by an employer or by an employee organization, or by both, to the extent that such plan, fund, or program was established or is maintained for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise ... benefits."¹⁴ A prerequisite of an ERISA-covered employee welfare benefit plan, therefore, is that the plan must be established or maintained by an employer, and that the employer must have a certain intent: a purpose to provide benefits to its employees. ERISA defines an "employer" as any person acting directly as an employer, or indirectly in the interests of an employer, in relation to an employee benefit plan; and includes a group or association of employers acting for an employer in such a capacity.¹⁵ A third-party likely will not act directly as an employer in relation to an employee benefit plan when no employment or economic relationship exists between the third-party who established the plan and the employees of the third-party's client companies. Second, the third-party likely will not act indirectly in the interests of its client companies; rather, it likely will tend to act for itself in relation to the plan. Regulators tend to equate these third-parties with entrepreneurial ventures formed to market benefit plans to unrelated employers, with the primary interest in profiting from such activity. Such a third-party program likely will not qualify as an "employee benefit plan" within the auspices of ERISA. A regulator will be prone to connote such a program more with the transaction of insurance than an ERISA "employee benefit plan" per se.

A VEBA may be associated with an ERISA employee welfare benefit plan. However, this coupling will not affect the fundamental regulatory analysis of whether the plan constitutes insurance or qualifies for preemption under ERISA. Indeed, VEBA tax treatment differs conceptually from the plan benefits contemplated under ERISA. This difference is more pronounced, and perhaps worthy of suspicion, when no funds are accumulated in the VEBA. With a VEBA, the "risk" which an employee bears is commensurate with the employee's employment risk: that the employee may be terminated and cease to receive wages and other compensation. The VEBA trust, therefore, is not a plan covered by ERISA. To qualify a program as an ERISA plan, one must review the intended benefits, beneficiaries, source of financing, and procedures for receiving benefits. Thus, one of the factors in determining whether ERISA preemption applies is the source from which the employees' benefits are paid. As indicated above, for a plan to constitute an "employee welfare benefit plan" under ERISA, the plan must be established or maintained by an employer or employee organization. A VEBA is not an employer association if it is not composed of related employers and does not meet other relevant criteria. A VEBA may likewise not meet the definition of an employee organization. The fact that a VEBA has been recognized under the IRC does not mean that it will be recognized as an employee organization under ERISA. It is, therefore, not surprising that IRC regulations provide that VEBAs are not coterminous with employee beneficiary associations within the meaning of ERISA.¹⁶

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Further, a VEBA that is associated with an ERISA plan will likely meet the definition of a multiple employer welfare arrangement (MEWA) unless the plan is offered by a single employer or offered pursuant to an agreement that is found to be a bona fide collectively bargained agreement.¹⁷ ERISA includes a reverse preemption clause with regard to MEWAs, indicating that, "in the case of any other employee welfare benefit plan which is a multiple employer welfare arrangement, in addition to this title, any law of any State which regulates insurance may apply to the extent not inconsistent with the preceding sections of this title."¹⁸ Various states have taken this cue and promulgated legislation requiring the licensure and regulation of MEWAs.¹⁹

CONCLUSION

A program will draw regulatory attention for review as unauthorized insurance by utilizing descriptions such as "VEBA," "ERISA exempt," and similar reference to federal nomenclature while avoiding licensure as an admitted insurer or MEWA or registration as an RRG, or causing the transfer of benefit risk to an entity unauthorized to accept such risk. A program which boasts low rates and minimal or no underwriting will invite heightened regulatory attention. An "exempt" program which employs insurance agents to transact the program will ensure regulatory attention, even when the agents are characterized as "labor consultants" or "business agents" to "enroll" or "negotiate" with potential association or union members. Legitimate ERISA plans, if properly established, may avert state insurance regulation. The funding of a benefit program through a VEBA will not, alone, evoke similar federal preemption or state exemption unless provided by state law.

Endnotes

1. 26 U.S.C. § 419(e)(3)(A); 26 U.S.C. § 501(c)(9). Section 501 of the IRC deals with organizations that are exempt from federal income taxation. VEBAs are described in IRC § 501(c)(9) as: "providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earning of such association inures (other than through such payments) to the benefit of any private shareholders or individual." **The reader is cautioned that this article is not intended to provide any form of tax advice, or method for avoiding tax penalties, insurance regulation, or any other legal requirement. It is recommended that the reader seek the advice of an independent tax advisor or other qualified professional based on a program's particular circumstances.**
2. 26 C.F.R. § 1.501(c)(9)-2(a)(1).
3. Despite its exempt status, a VEBA is still subject to taxation on its "unrelated business taxable income" pursuant to IRC sections 511 and 512. Unrelated business taxable income is defined as gross income derived from any unrelated trade or business activity regularly carried on by the entity in question. *See* 26 U.S.C. § 12(a)(1). For instance, a VEBA's investment income constitutes unrelated business taxable income that is subject to taxation. An issue which often arises concerns the rate that investment income should be taxed. A trust qualifying as a VEBA may argue that the lower "corporate" rate of taxation applies whereas the IRS may argue that the higher "trust" rate of taxation applies. *Compare* 26 U.S.C. § 11 (providing rate schedule applicable to the taxable income of corporations) *with* 26 U.S.C. § 1(e) (providing rate schedule applicable to the taxable income of trusts and estates).
4. 26 C.F.R. § 1.501(c)(9)-2(c)(1).
5. 26 C.F.R. § 1.501(c)(9)-2(c)(3).

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6. See 26 U.S.C. § 501(c)(9); Treas. Reg. § 1.501(c)(9)-1.
7. 26 C.F.R. § 1.501(c)(9)-1.
8. See, e.g., *Post v. Hartford Ins. Co.*, 501 F.3d 154, 164 n.6 (3d Cir. 2007) (indicating that "when the employer both funds and administers the plan, but pays benefits out of a fully funded and segregated ERISA trust fund rather than its operating budget, no structural conflict of interest is created"). However, even though benefits are not paid directly by the company, the company still has a financial incentive to keep claims experience under the plan as low as possible -- the less the trust pays out as benefits, the less the company will ultimately need to contribute to the trust to maintain its solvency. Thus, although the impact may be less direct, there is nonetheless a close relationship between benefits paid by the trust and the money the company must provide from its general assets to fund the trust.
9. Mich. Comp. Laws § 500.128(d).
10. The Supreme Court has opined that Congress' aim in enacting the preemption clause was "to avoid a multiplicity of regulation in order to permit the nationally uniform administration of employee benefit plans." *New York Conf. of Blue Cross & Blue Shield Plans v. Travelers Ins. Co.*, 514 U.S. 645, 657 (1995).
11. *Ingersoll-Rand Co v. McClendon*, 498 U.S. 133, 142 (1990).
12. 29 U.S.C. § 1144(a).
13. 29 U.S.C. § 1144(c)(2).
14. 29 U.S.C. § 1002(1).
15. 29 U.S.C. § 1002(5).
16. 26 C.F.R. § 1.501(c)(9)-7.
17. See 29 U.S.C. § 1002(40)(A) (defining MEWAs).
18. 29 U.S.C § 1144(6)(A)(ii).
19. See, e.g., Fla. Stat. §§ 624.436-624.446. See also NAIC Model Laws, Reg'ns & Guidelines 220-1 (model act requiring producers to make an informational filing prior to soliciting business or performing other services on behalf of specified MEWAs subject to state law).

SOCIAL MEDIA COMPLIANCE ISSUES

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Introduction

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Most of us have watched a video on YouTube, been invited to join LinkedIn and have at least heard of Twitter. FORC has a wildly active web forum, and rumor is that we will soon start posting pictures from FORC cocktail reception after-parties on FORC's FaceBook page.

Social media encompasses a variety of different mediums, but in essence it is a participatory relationship rather than simply a billboard on the web. Web 2.0 is interaction.¹ What does social media mean to the insurance industry? Is it a vehicle for advertising, solicitation or consumer services? Or is it an opportunity to publicly document certain communications that can be the foundation for regulatory violations or civil liability?

Social media lends itself more to a conversational and reactionary dialog to create community - the general public is not receptive to delayed or "over-lawyered" messages. It may be that pace of social media, not the actual laws and regulations, which make compliance difficult.

In the end, compliance concerns will still most likely focus on what is said, not where it is said in social media. However, social media may give rise to more opportunities for misinterpretation, reliance and ultimately, regulatory action or liability. Is it better to simply choose to stay out of certain web mediums, or can strategies be implemented to assure regulatory compliance?

Solicitation Issues

What activity rises to the level of solicitation, and when does it occur? This of course is elemental in determining if one must be a licensed agent. In Georgia, "[s]olicit' means attempting to sell insurance or asking or urging a person to apply for a particular kind of insurance from a particular company."² Most jurisdictions have the exact or similar language. Georgia also has specific regulations on life insurance solicitation.³

I performed a forty-eight state research project for an agency that related to the interpretation of the definition of "solicitation." The client is very savvy with regard to the capabilities of the Internet and technology and has a very unique model for solicitation and sales. Because of the unique model, it is difficult to describe exactly when the solicitation and the sale occurs. Each state varied not only in its ability and willingness to respond to my inquiries, but also in how it analyzed the solicitation issue.

Some jurisdictions take the position that simply making someone aware of the fact that certain insurance is available from a specific company does not rise to the level of "attempting to sell" or "urging a person to apply for" insurance. Other jurisdictions conclude that oral comments communicating such information require one to be licensed as an agent. Still others allow an unlicensed individual to provide a pamphlet with such information, and certain others allow pamphlets to be placed in plain view, but the unlicensed individual cannot physically give them to a potential insured.

Among the continuum of solicitation definitions, where does a "Tweet" fit in? If an unlicensed individual sends a message stating that Carrier A offers homeowners insurance, is that a solicitation? If Carrier B sponsors a blog on private passenger automobile coverage, and an employee of Carrier B answers questions about the type of coverage available from Carrier B, must the employee be licensed? If a license is required, how would Carrier B determine the jurisdiction of the poster that is a guest on the blog? If someone is an insurance agent in Second Life,⁴ do they need to be a licensed agent in order to advertise there for actual sales?

Advertising Material

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Georgia requires that direct response advertising by an insurer for individual and group accident and sickness or life insurance be approved for use by the Commissioner of Insurance.⁵ In addition, Georgia requires carriers offering variable life insurance to "file all variable life insurance sales material, advertising material, and descriptive literature thirty (30) business days prior to use with the Commissioner."⁶ A carrier that seeks to use social media to advertise for direct response or for variable life insurance products in Georgia would need to work closely with the Georgia Insurance Department before beginning any type of interactive campaign. An interactive campaign that requires a filing or month-long delay for each response will not be very engaging for consumers.

Georgia has detailed regulations concerning advertising of life insurance and annuity contracts.⁷ Such regulations define advertisement as "verbal, printed, written or other material or communication of any type from any source which is designed to create or has the effect of creating public interest in life insurance, annuities or in an insurer . . . [or] agent . . . or induces or tends to induce the public to purchase, increase, modify, reinstate, surrender or retain a policy." ⁸

The Georgia definition of advertisement appears to encompass all facets of social media. Therefore, if a life insurance company is going to use Twitter, it may be prudent to either confirm there will not be any Tweets to Georgia residents or that the Tweet is compliant with the relevant Georgia laws and regulations.

Consumer Services

A carrier that desires to operate social media for existing insureds, such as a forum or blog, must take steps to assure that privacy compliance matters are addressed. In addition, procedures for promptly taking discussions offline for direct follow-up should be established. A generic coverage or claim question should not be allowed to devolve in a public manner. Lack of a deliberative response to a general question could later be used as a basis for an allegation of a violation under unfair claims settlement practices law. ⁹

Recommended Strategy for Compliance

a. *Understand the Operation of the Social Medium.* Twitter allows one to broadcast short messages to a large group. Because there can be no more than 140 characters in a Twitter message, it does not lend itself to complex communication. Podcasts are one-way messages and can provide a vehicle for more in depth information - the President of a carrier can speak directly to policyholders.

A blog can provide for in depth discussion, but it can also result in a dialog that varies significantly from the original post topic or question. Confusion and misinformation can appear, and the lack of a consistent and frequent moderator will likely cause the blog itself to be a failure. It is important to understand the operation of the specific social media so that a responsive and complete compliance process can be created.

b. *Be Prepared - Consumers Will Participate and Expect Transparency and Responsiveness.* If the social media is interactive, participants will expect transparency and responsiveness. Responses prepared by committee will often be diluted and delayed. For certain social media, the format of information for anticipated contingencies can be vetted and ready for distribution ahead of time.

One must decide what the appropriate forum is relative to the compliance resources that will be available. Is the medium simply to be used to spread a brand name and heighten public awareness, or is it meant to be a resource for existing insureds? The amount of oversight, and process for review and response, must be calculated to be responsive to the expectations of

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the users. Compliance staff and social media staff should be involved in creating a prompt, and effective, internal compliance communication system.

For a forum to be viewed as responsive and trustworthy, a response to a post cannot take a week to prepare. It may be better not to enable certain types of communications with proposed and existing insureds if one will not have the resources to make the interaction a meaningful one.

c. Contact the Relevant Insurance Department. As we have all experienced, each state may have different interpretations of the exact same law or regulation. Social media in the universe of Web 2.0 is not likely addressed in any state insurance code. However, the analysis is still likely to be on what is said, not where it is said (i.e. FaceBook, Second Life, etc.), and Insurance Departments may provide guidance for anticipated social media projects.

Endnotes

1. Web 1.0 is a general reference for early, generally static websites. Web 2.0 is a reference to interactive websites.
 2. O.C.G.A. § 33-23-1 (a)(15)
 3. Georgia Insurance Regulations Chapter 120-2-31-.01 to 08.
 4. Second Life is a virtual world where 1.4 million "residents" have occupations, earn currency, acquire real estate and have assets. Advertisers can use the website to create brand awareness for enterprises in real life. In 2005, Wells Fargo bought "Stagecoach Island" in Second Life. www.secondlife.com
www.wellsfargo.com/stagecoachisland
 5. O.C.G.A. § 33-6-4 (b) (13) (C).
 6. Georgia Insurance Regulations Chapter 120-2-32-.04 (4).
 7. Georgia Insurance Regulations Chapters 120-2-11-.01 to 14.
 8. Georgia Insurance Regulations Chapter 120-2-11-.03 (4).
 9. O.C.G.A. §§ 33-6-30 to 37.
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MINNESOTA LEGISLATIVE AND REGULATORY UPDATE

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MINNESOTA LEGISLATURE

The second half of the 2009-2010 Minnesota legislative session began on Thursday, February 4, 2010. Traditionally, the second year of the biennium focuses on the State's bonding efforts; however, much of the focus this session has been on addressing the State's \$1.2 billion budget deficit. Nevertheless, insurance continues to be front and center. In mid-December, members of our firm, Winthrop & Weinstine, P.A., hosted a gathering at our Minneapolis office for clients to meet and discuss in-depth with Minnesota Department of Commerce ("Department") Deputy Commissioner Manny Munson-Regala the Department's plans for insurance legislation in the 2010 session of the Minnesota Legislature. Mr. Munson-Regala shared that the Department's Omnibus Market Assurance Bill will pursue a number of relatively noncontroversial measures. Included in the package will be clarification of the Department's regulation of health underwriters; clarification of a statute recently enacted providing that a Certificate of Insurance does not amend the terms of an insurance policy; a change in the statutory notice of non-renewal or cancellation from 60 to 59 days; a change in continuing legal education for insurance producers; and clarification of laws passed in prior sessions regarding electronic notices provided by insurers to their insureds.

The Department is also considering an overhaul to Minnesota's title insurance laws. Although the Department is willing to explore less sweeping changes to the laws governing title insurers and title insurance agents, it has indicated that it intends to propose the National Association of Insurance Commissioners' ("NAIC") Model Title Insurers Act and the NAIC Model Title Insurance Agents Act. The reason for these legislative initiatives is the sharp uptick in fraudulent and dishonest practices that the Department has witnessed by title insurance agents and their closers over the last handful of years. The Department has suggested that the current "supervisory" system used by title underwriters to "manage" their agents is insufficient, which puts consumers at risk and makes regulatory oversight more difficult. Possible legislative outcomes are: 1) keeping the laws as they exist; 2) making more explicit the specific supervisory responsibilities of the title underwriters; 3) adopting the NAIC model laws; or 4) adopting a "strict liability" standard like Nebraska (i.e., the underwriter is held strictly liable for its issuing agents' acts). We should know more by the end of May as the legislature is required by the Minnesota Constitution to adjourn by that time.

In addition, the Department will be examining opportunities to advance Governor Tim Pawlenty's initiative regarding sale of health insurance across state lines. The Department has taken notice of the provisions in Congressional health insurance reform bills allowing an interstate compact for approval of health insurance policies and will advance the compact should the federal legislation pass. In addition, the Department is looking at opportunities for ways which will allow Minnesota to accept unilaterally policies, forms and rates filed in other states. In particular, the Department sees an opportunity in the individual health insurance marketplace to allow Minnesota licensed insurers to offer health insurance plans approved in other jurisdictions.

ENFORCEMENT ACTIONS

The Minnesota Department of Commerce is widely regarded as one of the most "active" insurance regulators in the country, and calendar year 2009 was no exception. There were a number of significant enforcement cases that the Department commenced or resolved. In a case that received significant attention in numerous national insurance journals including, among others, *National Underwriter* and *The Insurance Forum*, the Department, on April 16, 2009, commenced enforcement action in *In the Matter of the Resident Insurance*

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Producer License of Michael J. Antonello and the Resident Insurance Agency Producer License of Wealth Management Advisors, LLC. Department File No. 2612 MBF. The case related to the purchase of stranger-originated life insurance. In its thirty-nine page Order, which summarily suspended the licenses, the Department alleged that Antonello made material misrepresentations on clients' life insurance applications by failing to disclose or significantly underreporting in-force policies. In total, the Department alleged that Antonello submitted 61 applications to 19 companies for a face amount of \$198 million on the lives of four clients. In December 2009, Antonello and the Department resolved their dispute by way of a Consent Order. Stranger-originated life insurance will continue to be an enforcement target for the Department.

The fallout continued from the real estate meltdown as the Department continued to investigate and take enforcement action against numerous title insurance producers and real estate closers. In one representative case, the Department commenced enforcement action against a title insurance agency and its three principals by summarily suspending their licenses. The Department alleged that the licensees failed to remit a significant amount of premiums to their underwriter, misappropriated or converted funds, failed to pay taxes, and failed to record numerous mortgages and other real estate instruments. In November 2009, the Administrative Law Judge found in the Department's favor, and the matter is currently pending before the Commissioner for final disposition.

The Department also concluded a five year examination of Marsh USA by entering into a Consent Order with Marsh in August 2009. The Consent Order resolved allegations relating to, among other things, Marsh's compensation disclosure activities prior to 2004, which, more than five years ago, made front page national news as a result of former New York Attorney General Eliot Spitzer's investigation.

As she has since first coming into office in 2007, the Minnesota Attorney General continues her suitability crusade against life insurers doing business in Minnesota. After suing and/or settling with numerous life insurers regarding the suitability of the sale of annuities to Minnesota seniors, it continued into 2009. As recently as December 22, 2009, the Attorney General entered into a settlement with Great American Life Insurance Company and its affiliate, Annuity Investor's Life Insurance Company. According to the settlement, the Attorney General has secured refunds for consumers of approximately 2,000 policies and will require a more rigid suitability review by the company on a prospective basis. This settlement follows on the heels of four other settlements between the Attorney General and Allianz Life, American Equity Investment Life, AmerUs Life and American Investors Life (now part of Aviva), Midland National Life. At present, there is one lawsuit brought by the Attorney General regarding the suitability of annuity sales and marketing, and other investigations are pending.

Endnotes

1. Governor Tim Pawlenty is not planning to run for re-election in 2010 and is strongly considering a run for President in 2012.