

## **ANALYSIS OF THE NONADMITTED INSURANCE MULTI-STATE AGREEMENT (NIMA)<sup>1</sup>**

**May 11, 2011**

The National Association of Insurance Commissioners (NAIC) has proposed that the States enter into a multi-party contract – The Nonadmitted Insurance Multi-State Agreement (NIMA) – pursuant to Section 521(b)(1) of the Nonadmitted and Reinsurance Reform Act of 2010 (NRRRA). The NAIC has also released a draft “Nonadmitted Insurance Premium Tax Clearinghouse Access Agreement” (“Clearinghouse Contract”) between the “Clearinghouse” and Participating States<sup>2</sup>.

The purpose of the NRRRA is to simplify and streamline regulation and taxation of surplus lines insurance transactions. Effective July 21, 2011, the NRRRA establishes Home State taxation whereby each surplus lines transaction may be taxed and regulated only by the “Home State.” Section 521(a). The NRRRA preempts state law to eliminate the multistate taxation and regulatory system that has subjected surplus lines brokers to costly and burdensome compliance with conflicting state taxation and regulatory filing requirements for policies that insure risks in more than one state.

The purpose of NIMA, in contrast, is to replicate and preserve via a “Clearinghouse” substantially the same system of multistate taxation that Congress sought to eliminate through creation of Home State taxation under the NRRRA.

This paper reviews certain major issues presented by NIMA and the Clearinghouse Contract.<sup>3</sup>

### **A. Overview**

- The NIMA Clearinghouse venture is inherently unstable.

In any year some Participating States will be Clearinghouse winners and other States will be Clearinghouse losers. The losers will quickly give sixty days notice of termination and exit NIMA. Larger surplus lines states that believe they will benefit from Home State taxation will not join.

- NIMA is incomplete, its terms vague, and its enforceability highly doubtful. The data do not exist that would allow comparison of the premium tax revenue consequences of NIMA and the Clearinghouse with (a) historical premium tax revenues or (b) the effects of

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<sup>1</sup> This paper has been commissioned by the National Association of Professional Surplus Lines Offices (NAPSLO). The author is a recognized expert on the NRRRA who has written multiple articles about the NRRRA and related state implementing legislation. Copies of those articles can be found at [www.InsuRegulatory.com](http://www.InsuRegulatory.com) and [www.InsuranceJournal.com](http://www.InsuranceJournal.com).

<sup>2</sup> Unless otherwise noted, section references are to the NRRRA; paragraph references are to NIMA or the Clearinghouse Contract as the context indicates.

<sup>3</sup> NIMA’s “Exposure Allocation Methodology” and specific data reporting requirements are beyond the scope of this paper.

Home State taxation. NIMA's dispute resolution provisions lack standards or criteria for measuring a Participating State's right to compensation in the event of a dispute.

- The Clearinghouse has no governance structure and the NAIC's role in Clearinghouse governance is undefined. There is no timeline for the Clearinghouse to become operational, no budget, and no financial projections.
- NIMA fundamentally conflicts with the NRRRA.
- NIMA presents insurmountable compliance obstacles for surplus lines brokers. NIMA's membership and tax rates can change at any time with little or no notice. When that occurs, the surplus lines broker is forced to reprogram accounting and data processing systems to take account of extraordinary premium allocation and tax rate calculation complexities depending on (a) whether taxes are paid and filings made directly to the Home State or (b) to the Clearinghouse.
- The NAIC describes NIMA as a "multistate agreement," a legally untested approach to an interstate pact that does not satisfy the requirements of an "interstate compact" within the meaning of Article I, Section 10 of the United States Constitution.
- NIMA and its Clearinghouse are subject to inevitable challenge on numerous legal grounds that likely will engage Participating States in litigation for years.

## **B. NIMA Background**

At the NAIC Summer Annual Meeting in August 2010, the NAIC Executive Committee charged a "Surplus Lines Implementation Task Force" with development of state-based solutions for implementation of the surplus lines provisions of the NRRRA.

The Task Force determined that the best solution was to create an "interstate agreement" that provides "a means for preserving something close to the status quo where premium taxes are concerned."<sup>4</sup> The status quo is the multistate surplus lines taxation system that Congress enacted the NRRRA to eliminate.

The Task Force appointed a subgroup to be responsible for developing a Clearinghouse plan of operation and for identifying third-party vendors with the software and other capabilities to operate the Clearinghouse.

NIMA itself consists of an eight page form of contract accompanied by eight pages of "Annexes" that specify how surplus lines premium is to be allocated for multistate risks. The NAIC is not a party to NIMA or the Clearinghouse Contract, or mentioned in either document.

When the NAIC Executive Committee "approved" NIMA in December 2010, NIMA was not in final form. The Executive Committee has not yet "approved" the Clearinghouse Contract. NIMA remains a working draft in the early stages that posits only a general framework for

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<sup>4</sup> NAIC Initiatives Non-Admitted and Reinsurance Reform Act of 2010 (NRRRA): Surplus Lines ([www.naic.org](http://www.naic.org))

establishing a Clearinghouse and procedures for receipt and redistribution of surplus lines tax among Participating States.

### **C. Inherent Instability**

Each Participating State necessarily exposes its treasury to reduction by the amounts of Home State surplus lines tax revenues that the Clearinghouse may allocate to other Participating States. On sixty days notice a Participating State can terminate under NIMA to cut its losses or bank its winnings, as the case may be (§ 26(a)).

NIMA's only requirement to rejoin the Clearinghouse is "renewed execution of the Agreement."

NIMA's sixty-day termination notice provision underscores the fact that states are unwilling to make a long-term commitment to NIMA and the Clearinghouse. Once a Participating State sees that it is sending premium tax revenues to other Participating States or that its Clearinghouse allocation is less than the premium taxes it would have received as the Home State, the Participating State will terminate. That cycle will naturally repeat itself until NIMA collapses.

Larger states like New York and California that are the principal place of business for many large national and multi-national businesses, and therefore expect to benefit from Home State taxation, have declined to participate in NIMA. After the NRRA takes effect on July 21, 2011, states have no apparent incentive to share their Home State tax revenues with sister states.

Under the pre-NRRA system, there have been no uniform rules for allocation of surplus lines premium tax. Surplus lines brokers therefore have allocated premium for multistate risks based largely on the broker's professional judgment and industry convention. Accordingly, there are no data showing the premium tax effects of any given allocation methodology. It therefore is impossible to determine how NIMA's premium allocation methodologies will affect the premium tax revenues of any Participating State.

Similarly, it will be some time before there are reliable data to compare whether a Participating State's share of Clearinghouse tax collections are greater or less, after consideration of Clearinghouse transactional costs, than what a Participating State would have received under Home State taxation. Until reliable Home State taxation data are available, it is impossible for a state to measure the effects of NIMA and the Clearinghouse on its surplus lines premium tax revenues.

NIMA's dispute resolution provisions provide no standards or criteria to measure damages for a breach of NIMA and require mediation before a Participating State may initiate arbitration or litigation. Resolution of disputes between and among Participating States, the Clearinghouse, and the NAIC will be protracted and necessarily disrupt receipt of tax revenues by Participating States for years. NIMA provides no alternative dispute resolution remedies for surplus lines brokers forced to use the Clearinghouse.

Legal challenges on numerous grounds will embroil Participating States, as well as the NAIC, in protracted litigation that also can be expected to disrupt Participating States' receipt of tax revenues for years.

## **D. Uncertain Governance**

NIMA's governance provisions are Spartan.

NIMA becomes effective upon execution by two or more Participating States, two-thirds may amend it in writing (§ 25), and the Clearinghouse will operate "pursuant to a plan of operation, to be agreed by two-thirds of the Participating States" (§ 10). As a practical matter, once a plan of operation is approved by the first two Participating States, the two-thirds amendment requirement will make it difficult if not impossible for subsequent Participating States to modify NIMA.

NIMA provides that "each Participating State agrees to require, by statute or rule" that surplus lines brokers remit surplus lines premium taxes to the Clearinghouse (§ 17). NIMA therefore would bypass state legislative and administrative rulemaking requirements concerning matters such as the Clearinghouse's authority to demand data and to conduct premium audits.

The Clearinghouse Contract provides: "The State is represented by the state agency or agencies charged with enforcing State laws and regulations relating to Nonadmitted Insurance premium taxes." (Recitals, ¶ B). Many states therefore would be represented by at least two agencies, the department of insurance and the state agency responsible for premium tax collection and enforcement.

NIMA and the Clearinghouse Contract are silent regarding whether the Clearinghouse will be a corporation, a partnership, or some other form of business or nonprofit enterprise.

NIMA and the Clearinghouse Contract offer no governance or advisory role for surplus lines brokers and other affected parties.

## **E. NIRA Conflicts**

NIMA fundamentally conflicts with the NIRA.

*First*, NIMA conflicts with the NIRA's principal purpose, which is to simplify and streamline regulation and taxation of multistate surplus lines transactions.

*Second*, NIMA redefines certain NIRA's terms and adds terms that would restrict and undermine the NIRA.

### **1. Home State**

Home State is generally defined by the NIRA to mean the state of the insured's "principal place of business" or "principal residence." The NIRA, however, does not define "principal place of business." Relying on a recent U.S. Supreme Court decision, *Friend v. Hertz*, \_\_U.S. \_\_, 130 S. Ct. 1181 (2010), a case involving the "diversity-of-citizenship" jurisdiction of the federal trial courts, NIMA defines "principal place of business" in a way that leaves the term Home State open to multiple interpretations certain to confuse both licensees and premium auditors.

To determine Home State under the NIMA principal place of business definition, the surplus lines broker is required to verify (a) where the insured maintains its headquarters, (b) where the insured's "high-level officers direct, control, and coordinate its business activities,"

(c) whether they do so in more than one state, and (d) whether the headquarters are located or the “high-level officers direct, control, and coordinate its business activities” outside any State.”

“Principal place of business” is a legal term of art that has been the subject of hundreds of federal court decisions over the years. The easy cases obviously are not litigated. Those that are litigated are highly fact-sensitive. It is legal folly for NIMA to attempt a “one size fits all” definition of principal place of business, particularly in the untested arena of NIRA preemption.

## 2. Group Insurance

NIMA defines the Home State for “Group Insurance” to be each state where a group member pays any portion of the premium from his, her, or its own funds; in other words, multiple Home States. The NIRA provides that there shall be a single Home State; the term Group Insurance does not appear in the NIRA.

The Group Insurance definition of Home State under NIMA directly conflicts with the NIRA and would eviscerate many group insurance programs by making them cost-prohibitive due to the transactional costs involved with multiple state tax and regulatory filing requirements.

## 3. Surplus Lines Insurer Eligibility

Although NIMA does not address surplus lines insurer eligibility directly, it does so indirectly:

“Surplus Lines Insurer” means a Nonadmitted Insurer permitted *under the law of the Home State* to accept business from a Surplus Lines Licensee. [¶ 5.n.]

The NIRA preempts state law to set uniform national standards for surplus lines eligibility. Provided that the nonadmitted insurer satisfies Home State minimum capital and surplus requirements or is listed on the NAIC Quarterly Listing of Alien Insurers, a state *may not prohibit* a surplus lines broker from placing insurance with a nonadmitted insurer. Section 524.

## **F. Compliance Impossible**

Each time a Participating State joins or exits NIMA, surplus line broker agent management and accounting systems must be reprogrammed with new premium tax rates and premium allocation formulas to comply with NIMA or the Home State’s rules, as the case may be. Compliance and training procedures similarly must be updated.

- NIMA allows Participating States to exit on sixty days notice and re-join at any time simply by re-executing NIMA.
- Participating States must give ninety days notice of changes to their premium tax rates and statewide assessments. However, the effective date for the change need not coincide with a calendar quarter or any other normal accounting period.
- The surplus lines broker may be required in some cases to determine premium tax differently depending on whether premium allocations for non-Home State exposures involved Participating States.

- NIMA and the Clearinghouse Contract require no notice to surplus line brokers about changes in NIMA membership or changes in Clearinghouse tax rates, fees, or procedures.

There are a virtually infinite number of programming variables associated with Participating States (a) exiting NIMA on sixty days notice to rejoin whenever they wish, and (b) ever-changing tax rates and statewide assessments with inconsistent effective dates. Simultaneous compliance with Home State law for non-NIMA states introduces yet another complex set of programming variables. Combined with the NIMA/Clearinghouse lack of notice requirements, compliance is impossible.

Many surplus lines brokers contract with one of several major data processing vendors for access to an "agency management system" that tracks policy information, premium allocations, and other transactional data. Major programming changes can require a consensus of representatives of perhaps hundreds of users. Once major programming changes are agreed, it can take months or longer for the programming to be completed, tested, and implemented.

NIMA and the Clearinghouse are the antithesis of the nationwide uniformity intended by Congress. Instead of simplicity, the NIMA/Clearinghouse venture would subject surplus lines brokers to compliance requirements considerably more complex, cumbersome, and costly than the multistate taxation system in effect prior to July 21, 2011.

## G. Compact Considerations

NRRA Section 521 provides:

- (a) Home State's Exclusive Authority. – No State other than the home State of an insured may require any premium tax payment for nonadmitted insurance.
- (b) Allocation Of Nonadmitted Premium Taxes. –
  - (1) In General. – The States may enter into a compact or ***otherwise establish procedures*** to allocate among the States the ***premium taxes paid to an insured's home State*** described in subsection (a).

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- (4) Nationwide System. – The Congress intends that each State adopt ***nationwide uniform requirements***, forms, and procedures, such as an interstate compact, that provide for the reporting, payment, collection, and allocation of premium taxes for Nonadmitted insurance ***consistent with this section***.

The NRRA provides that surplus lines brokers shall pay surplus lines premium tax only to the Home State. Congress leaves to the States how to allocate such premium tax receipts among themselves. There is no suggestion in the NRRA that two or more States may ***contract*** to require surplus lines brokers to remit surplus lines premium tax ***other than to the Home State***.

The co-author of a treatise on interstate compacts and leading authority on the topic has opined that NIMA does not satisfy the requirements for an interstate compact because it (a) "fails to provide a binding agreement which pre-empts other state laws in conflict with its requirements,"

and (b) “unconstitutionally purports to vest authority in an Executive Branch official (e.g., the Insurance Commissioner) to bind the Legislature of a State which adopts it.”<sup>5</sup>

## **H. Legal Challenges**

NIMA and the Clearinghouse Contract are subject to legal challenge on a number of grounds, including:

- NIMA fundamentally conflicts with the NRRRA.
- NIMA is unenforceable due to omission of contract terms essential for a “meeting of the minds” among Participating States.
- The NAIC has failed to disclose material information such as financial projections, a plan of operation, and the NAIC’s role with the Clearinghouse and its governance.
- NIMA requires unlawful delegation of legislative authority to one or more state agencies.
- NIMA and the Clearinghouse Contract fail to comply with state government contract requirements. They also would violate state administrative procedure act and “Sunshine” laws, thereby denying Due Process to surplus lines brokers, potential bidders seeking to provide Clearinghouse services, and other affected parties.
- NIMA is subject to potential antitrust scrutiny under Section 541<sup>6</sup> in connection with the NAIC and Task Force roles in establishing and controlling the Clearinghouse, and arguably otherwise attempting to restrain trade and commerce.

## **I. Conclusion**

NIMA is incomplete and ill-conceived. The Clearinghouse is ill-defined and far from becoming operational.

NIMA is essentially a game of chance for Participating States where the losers will quickly leave the table, an inevitable recurring cycle.

Standing alone, the purported economic benefit from participation in the Clearinghouse is illusory. Absent reliable data, a Participating State cannot determine the comparative amounts of surplus lines premium tax revenues it would receive as Home State free and clear of Clearinghouse transaction costs, leaving aside exposure to unquantifiable potential liabilities.

NIMA and the Clearinghouse would impose intolerable compliance costs on surplus lines brokers and increase the cost of insurance with no benefit to surplus lines insurance buyers or measurable benefit to Participating States’ treasuries.

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<sup>5</sup> Letter from Rick Masters, Special Counsel for Interstate Compacts, to NCOIL, NCSL, and CSG (January 26, 2010). A copy can be found on the website of the Council of State Governments ([www.csg.org](http://www.csg.org)).

<sup>6</sup> “Nothing in this subtitle or the amendments made by this subtitle shall be construed to modify, impair, or supersede the application of the antitrust laws. Any implied or actual conflict between this subtitle and any amendments to this subtitle and the antitrust laws shall be resolved in favor of the operation of the antitrust laws.”

Home State taxation under the NRRA is a straightforward solution for the confusing and conflicting multistate surplus lines tax system that has burdened the surplus lines industry for decades. If and to the extent that Home State taxation should adversely affect premium tax revenues of certain states, the issue can be addressed directly with Congress or through an interstate compact.

NIMA with its inherent instability cannot solve the problem.