Regulation of the Surplus Lines Industry after Gramm Leach Bliley

"The Future is Now"

Foreword

The Gramm Leach Bliley (GLBA) Act of 1999 compelled state governments to modernize a number of state laws, in particular, the laws governing the licensing of agents, brokers and surplus line brokers. The states were compelled to act under threat of federal preemption.

As a result of GLBA at least 42 states have amended their producer licensing laws to allow for reciprocal licensing of surplus lines brokers and virtually all states now provide for the issuance of full nonresident surplus line broker licenses. Historically, these nonresidents could not obtain nonresident surplus line licenses (except for producing risk purchasing group business under the Federal Liability Risk Retention Act). Since these licenses were unavailable historically, brokers have had to place their out of state nonadmitted risks through resident surplus line brokers, similar in some respects to countersignature laws, or resort to other means to complete the placement.

I. OPPORTUNITIES

There is good news for the E&S market as a result of GLBA and the availability of full nonresident surplus line broker licenses, but there are also a number of issues that need to be addressed by the states to properly implement and regulate transactions under these newly created licenses.

The good news is surplus line brokers (hereinafter E&S brokers) can obtain licenses to directly place nonadmitted business in nonresident states although as licenses they have then undertaken an obligation to comply with the E&S laws of those nonresident states where applicable.

The costs to a nonresident for using a state resident E&S broker can be eliminated.

E&S brokers with offices in several states can consolidate into one or at least fewer offices, if they choose.

E&S brokers with separate corporations for separate state operations might find it practical to operate only one corporate entity.

II. CHALLENGES

While there is good news a number of outstanding unaddressed issues need to be resolved to provide E&S brokers clarity. *E&S brokers desire to comply with applicable law in all states in which they conduct their business. It is in their interest to do so since noncompliance can jeopardize their licenses, their reputations and ultimately their ability* *to make a living.* The E&S broker's failure to follow applicable E&S laws can subject the licensee to fines, penalties and personal liability for client losses.

In order to assure compliance, however, the laws must be clear and to the greatest extent possible, uniform.

The reciprocal licensing bill passed by most states was based on the NAIC "Producer Licensing Model Act". That model provides the following safe harbor.

> "a license as an insurance producer shall not be required of….." "A person who is not a resident of this state who sells, solicits, or negotiates a contract of insurance for commercial property and casualty risks to an insured with risks located in more than one state insured under that contract, provided that that person is otherwise licensed as an insurance producer to sell, solicit or negotiate that insurance in the state where the insured maintains its principal place of business and the contract of insurance insures risks located in that state……"

No similar provision was adopted with respect to E&S licensees. Therefore it is not clear when a resident E&S broker is operating under his resident license versus a nonresident license. In fact most states have left the existing substantive law of the state alone which, in most states, implies that any transaction by an E&S licensee involving a nonadmitted insurer, is governed by the law of that state.

In most cases, the law is silent as to when you are operating under a resident versus nonresident E&S license.

For example, if a New Jersey surplus lines broker places a nonadmitted risk which is located exclusively in Colorado, the law is silent on whether this is a New Jersey surplus line transaction or a Colorado transaction under a nonresident E&S license. Many would logically assume that under the foregoing example only Colorado surplus lines law applies. If you change the scenario and 50% of the risk is in New Jersey and 50% is in Colorado, which law applies?

It is difficult, sometimes impossible for an E&S broker to comply on a single multistate account with multiple state laws which may and often do conflict. The laws of the states need to clearly state when an E&S broker is operating under a resident license versus a nonresident license. For example, the New York Senate (but not the Assembly) passed Senate bill S.6701 in 2002 which contained the following language.

(7) For purposes of this article, unless exempt under the provisions of section two thousand one hundred seventeen of this article, a policy of insurance obtained from an insurer not authorized to transact business in this state must be procured pursuant to an excess line license when the entire property or risk exposure insured or any part thereof, is located in New York state and:

(A) the insured negotiated to acquire the coverage from within New York state; or

(B) the policy was delivered to the insured in New York state.

(8) Nothing in this article shall prohibit an excess line licensee from placing risks under the excess or surplus line law of another state provided that the excess line licensee:

(A) is licensed under the applicable state law as an excess or surplus line broker or places such risk through a licensed excess or surplus line broker in such state; and

(B) either no portion of the property or risk exposure is in New York, or the insured has property or risk exposure both in New York and in another state where the insured maintains a bona fide office from which it negotiated to acquire the coverage and to which the policy is delivered.

This language gives clarity to E&S brokers. It would establish which laws apply on any given transaction. It also preserves a one state filing, approach which is critical if an E&S broker is to comply and still make a reasonable return for the effort. Attempting to meet the diligent search and other requirements by making multiple filings on each multistate risk is an unworkable, unreasonable alternative. The New York state legislation poses a reasonable alternative. The state from which the insured negotiated becomes the determining factor as to which state's E&S law applies. All parties benefit because:

1) the insured is most likely to turn to his state regulator and his state law, should coverage disputes or other trouble arise,
2) the state where coverage was negotiated is most often the state with the most substantial connection to the insured and the transaction,
3) it is a clear standard which is relatively simple to apply and enforce,
4) it is very similar in concept to the NAIC model, and
5) courts, which are often called upon to decide which state law applies to a transaction, often use the situs of a particular party as determinative.

III. SOLUTIONS

Leaving aside the tax issues involving multistate risks for the moment, one preeminent goal of the E&S industry should be to develop a system of one state filling for nonadmitted business with a consistent, uniform, compatible, uncomplicated and clear framework for reporting and regulation.

In order to achieve this goal, the first order of business is to identify existing impediments and propose workable solutions.

Most state E&S laws were not altered at all substantively to meet the requirements of GLBA. In essence, the laws were amended to authorize full, nonresident E&S broker licenses leaving intact a legal system which contemplates resident licensees procuring nonadmitted policies only for residents of that state. These laws/regulations are antiquated and need to be changed.

Each state by new legislation, regulation or by written interpretation from the insurance department needs to address:

1) which transactions are subject to a resident E&S license versus a nonresident E&S license [similar in approach to the NAIC model and New York legislation referred to above],
2) modification of recordkeeping requirements to authorize nonresident licensees to maintain all records in their resident state offices.
3) modification of premium accounting and depository bank requirements providing that nonresident licensees who are in compliance with their home state requirements, are deemed to be in compliance with the requirements of the state where they have a nonresident license [states may wish to except from this deemer resident states which do not mandate fiduciary trust accounting requirements],
4) modification of any other vestiges in the laws or regulations which contemplate only resident E&S licensees.

The framework for implementing these changes could begin with proposed modifications of the National Association of Insurance Commissioners ("NAIC") and the National Conference of Insurance Legislators ("NCOIL") Model Nonadmitted Acts, respectively. In addition, working with individual state regulators and legislators and perhaps the National Council of State Legislators ("NCSL") to highlight the need for changes is likely to help build momentum across numerous states, simultaneously. Active involvement by and among NAPSLO, state stamping offices and other state surplus line associations will also help achieve these solutions.

IV. <u>Chronic Tax Complications</u>

A workable global solution to the tax payment obligations on multistate risks has long eluded the industry. Many pine for the old pre-allocation days when payment of 100% of the tax to the "home" state or single situs approach was in vogue. Unfortunately, that view ignores the history of tax allocation. The industry has supported state by state legislation to implement tax allocation. Allocating the risk for tax purposes avoided the then existing rapacious alternative which was to pay every state where a risk was located a full tax payment on 100% of the premium. Historically, on national accounts the premium taxes, so calculated, could equal or exceed the premium. The foundation for any real solution on the tax issue must be that each state gets its fair share of the tax revenues. Would the states have it any other way?

Though complicated, a two stage solution, one for the short term and the other for the long term, should be considered.

In the short term, E&S brokers will continue, generally, on their current course. An E&S broker usually files the necessary affidavits or other documents in one state and either encourages or otherwise leaves it to the insured to pay direct/or independent procurement taxes in any other state where the risk has a presence. In some cases, the E&S broker files in more than one state when state laws clearly conflict.

While the one state filing goal is a paramount one, in the short term the foregoing approach continues to be a reasonable compromise, in light of the absence of alternative methods of compliance. Moreover, in convincing states to change their laws to allow E&S brokers to file and pay taxes to a nonresident state because the insured's office from which the transaction was negotiated is in the nonresident state, when portions of the risk are in the resident state, will require great persuasion. To avoid multiple state filing and multiple state compliance requirements, E&S brokers will have to step up efforts and agree to work with all such insureds to make sure direct/independent taxes are paid to the resident state on such accounts. Otherwise, the states will balk at the solution as proposed.

The long term solution, as proposed long ago, failed due to an inability to implement the proposal in any practical way. That solution remains a modified version of "Nitch" the, National Insurance Tax Clearinghouse project. The project failed for lack of funding, lack of a method to practically implement the proposal and the absence of any state or states willing to step up and assume a level of leadership necessary to bring the project to fruition. A practical approach exists but will require significant long term efforts and commitment to achieve success.

A legislative approach requiring adoption of an interstate compact, which is a treaty agreement among those states that adopt it, could succeed with strong, broad industry support, a well thought out and professionally drafted compact and professional presentation to various legislative bodies. (A compact on sales and use tax cooperation and coordination is currently being considered by a number of states).

The following is an outline of issues that the compact should address.

- No state would be required to change the current tax rate charged. The rate charged by any given state would be applied to the allocable premium for that state.
- All states adopting the compact would be required to adopt new, simplified formulas for tax allocation.
- The allocation formulas would be based on the insureds prior year end data which is verifiable such as prior year's payroll by state. (For ease of application, allocation at inception will apply to any further premium transactions for the year).
- Instead of a specific number of states being required to adopt the compact before it becomes effective, the effectiveness would be triggered when the compact is adopted by states which process in the aggregate 60% or more of total gross E&S premium. (An independent report such as the report by AM Best would be used for state by state gross premium calculations).
- E&S brokers would report all necessary allocation information (for instance, payroll by state), to the filing office for the state where the filing is made.

- The state or the filing (stamping) office would capture premium allocation data on each such multistate placement and report aggregate data for the reporting period by E&S broker to any other states' filing offices or to NITCH as a separate entity. Each state filing office or NITCH would then issue an aggregate report to each E&S broker for each state license held. The report would provide state by state date reflecting tax liability by state.
- Tax exempt lines would remain unchanged state by state. No tax payment nor tax allocation would be paid in states where the insurer is licensed, if any, nor paid on exempt lines.
- E&S brokers would not have to be licensed in a state merely because of an allocation. Nonresident E&S licenses would be required when an E&S broker makes placements which need to be filed in any particular nonresident state. Each E&S broker would make filings as necessary reporting data for allocation when applicable. The filing office or NITCH would assist with the calculation of all applicable taxes. The E&S broker would receive periodic reports which would provide aggregate tax data, and a tax statement for each license held.
- Initial funding could come from states currently having stamping offices and representing some 70% of the nations E&S premiums, assuming some or all of these states could be persuaded to move forward early in adopting the compact. These entities could cooperate to create software for reporting. Ultimately, states without stamping offices could assign these duties within their insurance or tax departments or contract to a stamping office or other entity to comply.
- NITCH, would become the data warehouse as a result of the compact. NITCH would consolidate the data reported by the states and or stamping offices. NITCH, the stamping offices and the states would arrange to issue one billing statement per license to each E&S broker as well as collecting and sorting the taxes paid to the appropriate states.
- For states which currently allocate taxes and have an independent or direct procurement tax, the compact would arguably be revenue neutral. Many observers however, would argue this would increase collections since the independent or direct procurement taxes are currently obscure to many policyholders and often are overlooked and go unpaid.
- Even if a state viewed the changes in allocation formula as potentially reducing revenue, they could adjust the rate after monitoring tax revenues for a year or two.
- States which do not currently allocate or have no direct/independent procurement tax (approximately 10 states) could amend their tax law and adopt a direct/independent procurement tax, gaining revenue currently lost.
- Small states which perceive that they lose tax revenues to larger states where E&S filings are more often made, should favor such a compact.
- Larger states are unlikely to lose revenues if direct procurement taxes are substantially underpaid as currently believed.

A compact would not have to be adopted by all states to be successful. If states which account for 60% of all E&S premiums were to adopt the compact, it would not only achieve success in part, it would likely persuade other states to follow.

V. CONCLUSION

If the approaches outlined above, were adopted and implemented by most states, the E&S market will have attained,

- Clarity, consistency and a level of harmonization of states laws greatly reducing the complexities in complying with E&S laws,
- Preservation of a one state filing system for affidavits or other documents,
- Interstate cooperation with states assisting each other in receiving fair shares of taxes due and in maintaining a state, not federal based system of insurance regulation.