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The E&S Empire Express

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Foreign Account Tax Compliance Act (FATCA)

A number of brokers have expressed concern, surprise and consternation about this relatively new law passed in March 2010. Among other things, it will require United States taxpayers with specified foreign financial assets that exceed a certain threshold to report those assets to the IRS. It will also require foreign financial institutions to report directly to the IRS information about financial accounts held by United States taxpayers or held by foreign entities in which United States taxpayers hold a substantial ownership interest.

The act requires United States withholding agents to withhold 30% on payments of United States source fixed, determinable annual, periodic (FDAP) income made to certain foreign persons.

The regulations treat insurance brokers as withholding agents with regard to certain insurance and reinsurance contracts. This may put a burden on brokers to determine which foreign financial institutions are compliant, which are subject to withholding and which contracts are subject to withholding, not to mention setting up a withholding process.

While that is the bad news, some mitigating factors are also present. Foreign Financial Institutions which comply and register with the IRS by April 25, 2014 will be included on a list of compliant entities. Industry sources predict that insurance and reinsurance companies will comply to avoid withholding. Also, the earliest date for required withholding for certain contracts has been pushed back until July 1, 2014.

Insurer Eligibility and Broker Due Care – Connected but not Synonymous

Excess and surplus lines insurers and the associations which represent them supported passage of the Nonadmitted and Reinsurance Reform Act ("NRRA"). Perhaps the most compelling favorable provisions from the insurer perspective were the changes made or affecting state specific eligibility filing requirements. In the market, as it exists today, financial security and solvency of U.S. based E&S insurers have never been greater for the overall industry. Nevertheless, oversight to verify financial solvency will always be necessary, as the financially weakest insurers must be identified as early as possible to protect consumers and the good reputation of the marketplace.

In July, the Department of Financial Services proposed amendments to Insurance Regulation 41 to reduce the filing requirements imposed for eligibility. Eligibility constitutes the threshold an insurer must meet to receive and quote submissions from excess line brokers.

Excess line brokers, on the other hand, have a statutory duty to use "due care" in the selection of any unauthorized insurer from whom they procure insurance. This is expressly required by Insurance Law Section 2118. This obligation is important to brokers since the consequences for not complying are both regulatory trouble and potential liability for damages to one or more insureds.

Regulation 41 establishes what constitutes "due care." Under the Regulation both, as it exists and as it will exist if the proposed amendments are adopted, require more than that the broker verifies the insurer meets the minimum eligibility criteria. In fact, among other requirements, the Regulation will continue to require excess line brokers to maintain certain financial and other documents for each excess line carrier with whom it does business unless ELANY maintains a library of such information and makes it available to members.

ELANY will continue to obtain such documents to relieve broker-members of the burden and will inform broker-members to obtain such documents if necessary. ELANY will also continue to analyze insurer financials and perform other services to assist the brokers in meeting the due care standards. The good news is that today, financial information is generally available from numerous sources, at least with respect to foreign insurers.

ELANY will soon begin publishing financial summaries for eligible foreign insurers on its website to keep brokers informed.

With regard to alien insurers, ELANY has been working with other state stamping offices and NAPLSO, as well as the NAIC and the Department of Financial Services, to bolster the financial data required by the NAIC from alien insurers and to provide

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public access to it. Currently, the reporting regime is very limited, particularly when compared to the financial data foreign insurers report.

For an excess line broker to meet the due care standard, alien financial disclosure needs to be robust enough to make a reasonable determination of financial solvency. To demonstrate that a broker has used due care in selecting an insurer, a broker must establish that the insurer's management is trustworthy and competent and that its claims practices are satisfactory.

New York courts have held that an excess line broker has "… a continuing duty to apprise the insured throughout the life of each policy… of any adverse changes in the carrier's financial capability…"

Eligibility, therefore, is simply the starting point by which a broker can establish it has met the due care standard.

How Large is the New York Excess and Surplus Market by Premiums and Taxes

The volume of premium reported by ELANY year over year does not always comport with industry expectations or information from other sources such as aggregated carrier data or rating agency information. Three factors which drive premium reported by ELANY cause the data to vary from other sources from time to time.

These factors are:

1. Premiums on multiyear policies are reported 100% in the year written.
2. Major projects, such as the construction of Freedom Tower, are immense transactions driving premium in years when such projects begin with precipitous drops in years when no such project commences.
3. In some cases, the premium on very large transactions has been reported more than a year later.
4. Sometimes, all three of these factors have occurred in one or more years. These distortions were particularly acute in 2011 and 2012. The data below reflects some adjustments to reported premium in these years.

Post NRRA Tax Impact to New York

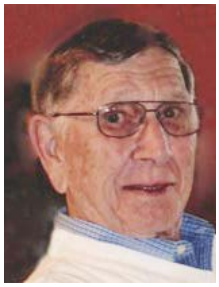
The graph below also provides some insight regarding the impact the NRRA has had on the taxation of New York excess line premium.

In the years prior to the NRRA, New York on average did not tax approximately $1 billion of gross premiums reported to it in each year. The untaxed premium came from multistate accounts, which were either home stated in New York or elsewhere. In the post NRRA era, a small number of accounts home stated elsewhere are no longer reported to New York, which reduced gross premium reported significantly but only reduced taxable premium marginally.

Conversely, New York now taxes multistate risks home stated in New York at 100% (except for international exposures). This has significantly increased New York taxable premium. Based on current trends, New York will tax approximately $3 billion of premium in 2013, which will increase total taxes collected by over $30 million per annum compared to taxes collected in 2009, 2010, 2011, and 2012. It will even increase taxes collected by about $8 million over the 2005 record year in which nearly $5 billion of gross New York premium was reported of which $2.743 million was taxed.

In Memory of Dick Smith

The loss of Dick Smith, former Executive Director of ELANY, on August 11 saddened all who knew him.



ELANY board member and Treasurer John Buckley said, "Dick was a mentor to me. He helped me become who I am, both professionally and personally. He took a young kid and pointed/led him in the right direction, without pushing/pressuring him to do any specific thing. I, on a somewhat regular basis, find myself asking "What would Dick Smith do in a situation?"–sometimes it's a business situation, sometimes a personal scenario but I've always found Dick to be a good guide on how to conduct myself and my business. Dick was someone

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NEW YORK CALENDAR YEAR EXCESS LINE PREMIUM

	2008	2009	2010	2011*	2012*	2013(5 MOS.)
GROSS PREMIUM	3.416B	3.091B	3.025B	3.087B	2.365B	1.312B
TAXABLE PREMIUM	2.430B	1.750B	1.994B	2.167B	2.189B	1.268B
UNTAXED PREMIUM ($)	.986	1.341B	1.097B	.920	.176	.044
% OF GROSS	28.9%	43.4%	36.3%	29.8%	7.4%	3.4%

**Premiums were adjusted in these years to remove transactions filed over a year late which would otherwise distort these results*

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who took pride in being professional in what he did and having that measuring stick has helped guide me in numerous situations."

Dick Bouhan recalled meeting Dick in the late 1970's when Bouhan joined the property and casualty world. He said Dick was one of the most caring individuals he had ever known. Dick Smith cared passionately about all those who touched his life, his family, his friends, and his business colleagues. He was a consummate professional and a loyal, generous friend.

Stewart Keir remembered meeting Dick at an NAIC meeting during Dick's days at Western World. When Dick became Executive Director at ELANY, we spoke regularly since I was responsible for excess line oversight at the New York Department of Insurance. When we disagreed occasionally, you could see Dick stiffen up his back and take one step back before he would lean in to make his point. That was Dick's unique way of making sure you were listening. Dick's efforts convinced me that the ELANY concept would work. He cared about the industry and insisted that things were done right. Dick was my friend, and I will miss him.

All of us at ELANY extend our condolences to Dick's wife Joan and his entire family.

NARAB II Update

On September 10th, the House of Representatives passed HR1155 by a vote of 397-6. While a version of the NARAB II Legislation has passed the House several times in the past, there is good reason to be excited this year because the bill has also been introduced in the Senate.

Industry associations are guardedly optimistic that the Senate will also take up this legislation this session.

As described in prior newsletters, this legislation will greatly streamline non-resident producer licensing. By creating an efficient system and eliminating many state specific, redundant requirements to the non-resident licensing process, producers will save a great deal of time, money and effort in obtaining non-resident licenses in the future.

The bill permits producers who qualify and join NARAB II to essentially eliminate the requirement for state-by-state applications for non-resident licenses. Each state, however, retains the right to enforce all laws regulating licensees and insurance transactions.

Will the Real Home State Please Stand Up

For the most part, determining which state is the home state of the insured for regulation and taxation purposes is easy. When the insured is a single business entity, the home state is the state where the insured maintains its "principal place of business" unless "100% of the insured risk is located out of state." This is pretty straight forward if the risk is property coverage for a building or buildings all of which are located in a state or states other than where the insured maintains its principal place of business.

However, brokers are now asking what is the home state for credit insurance, fidelity and surety, kidnap and ransom or political risk? This raises the question, what is meant by the phrase "100% of the risk is located out of the state?"

ELANY has located two forms of guidance on this issue. In an opinion of General Counsel issued by the New York Insurance Department (pre-NRRA), the opinion which interpreted an exemption from the Insurance Law said, "Insurance against loss of or damage to property having a permanent site outside of this state…" applies only to tangible forms of property".

Therefore, New York regulators view intangible property as being subject to (or located) in New York when New York is the insured's principal place of business.

In addition to the foregoing, the tax allocation formula contained in the Appendix to Regulation 41 shows that New York asserts that it is the home state when New York is the insured's principal place of business and the following criteria are met.

Credit Insurance: As long as some portion of the value of the insured's debt is in New York

Fidelity/Surety: Depending on the subclass of coverage as long as one or more insured employees are in New York or any value of the insured contract pertains to New York.

Kidnap and Ransom: As long as one or more of the insured employees is principally employed in New York.

Political Risk: Since this encompasses various types of coverage, it will depend on the subclass. For example, if the policy only covers expropriation of property all of which is overseas, it would be exempt in New York.

Coverage Dispute Arbitrations

In the last edition of this newsletter, several cases were analyzed and reviewed where insureds faced policy language requiring the insured to arbitrate a claims dispute. The concept of mandatory arbitration clauses in insurance policies conjures up different perspectives depending upon your place in the transaction. For the insurers, there is an obvious perceived advantage or the policy would not contain such a clause.

For an insured, the opposite is probably true. A plaintiff in a court of law is afforded certain benefits by a court which can level the playing field. Insurance contracts are interpreted by courts to be contracts of adhesion where a party with superior power dictates the terms and conditions. That certainly seems self-evident where the insured's right

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to bring an action to make a claim is subsumed by an insurer imposed arbitration clause.

For the broker, there are potential positives and potential negatives to such mandatory arbitration provisions. A legitimate short form, perhaps less expensive method of resolving disputes is not necessarily bad for any party. However, an insured who is denied coverage in arbitration may lay the blame for that loss at the broker's feet. This downside can be mitigated, however, by full disclosure and up front informed consent of the insured.

At least 17 states prohibit mandatory arbitration clauses in insurance contracts. ELANY summarized the Washington State case on this issue in the last newsletter. Another nine states impose some restriction or limitations on such clauses.

Perhaps what brokers should be most wary of is arbitration clauses that mandate arbitration in a remote jurisdiction.

The most startling case of this type was XL Insurance vs. Owens Corning. The insured sued in Delaware Court for declaratory relief that its policy covered certain Y2K costs. The insurer brought suit in London seeking to enjoin the insured from pursuing the Delaware action. The policy, which was apparently sold overseas, provided that New York law governed the terms of the contract but also provided for arbitration in the U.K. under its Arbitration Act.

The court granted the injunction preventing the insured from pursuing the Delaware litigation. On the facts of this case and based on the policy wording, perhaps the court was correct in its decision, but a broker would want to consider the potential negative impact such a ruling might have on it and its relationship with an insured.

Independent Procurement

The law of New York State recognizes and permits an insured to "directly" or "independently" procure insurance from an insurer, who is not authorized to do an insurance business in the state of New York. Insurance Law §1101 (b) (2) (E) establishes a narrow exception to the general requirements that an insurer be authorized (licensed) to sell insurance to New Yorkers or when insuring New York risks. The pertinent language exempts. . . "policies of insurance on risks located within or without this state . . . which policies are principally negotiated, issued and delivered without this state in a jurisdiction in which the insurer is authorized to do an insurance business."

As explained in OGC opinion number 03-06-26, it is not sufficient for an insured to make direct contact from New York by phone or by mail with a London insurer or broker, but literally must negotiate physically in the foreign location.

In addition to the requirement that the policy be principally negotiated, issued and delivered outside the state, the purchase must be "directly" or "independently" procured. The words "direct" or "independent" mean the purchase of coverage without a broker or agent's involvement. The Nonadmitted and Reinsurance Reform Act "NRRA" defines "nonadmitted insurance" as follows: "…property and casualty insurance permitted to be placed **directly** or through a surplus line broker with a nonadmitted insurer…". The NRRA defines "independently procured insurance" as "…insurance procured **directly** by an insured from a nonadmitted insurer." This federal law, therefore, reinforces the differentiation contained in most state laws that nonadmitted insurance is (with some exceptions such as exemptions for ocean marine business) either through an excess or surplus lines broker or purchased **directly** by the insured without a broker.

In New York, Article 33-A of the Tax Law is entitled "Tax on Independently Procured Insurance." It applies to premiums on contracts of insurance procured from unauthorized insurers except policies procured through excess line brokers or exempt transactions.

A question often asked is "To what extent can a broker be involved in an independent or direct procurement transaction?" The answer, based on New York's current laws and interpretations of the law by the Department of Financial Services, is a broker cannot be involved at least not as a broker.

While New York law clearly permits an insured to negotiate and acquire its own nonadmitted insurance if it does so, for example, in England or Bermuda without the services of a United States based broker, New York law requires a broker to be a licensed New York excess line broker when it sells, solicits or negotiates nonadmitted, also known as excess line insurance, when New York state is the home state of the insured. This is expressly set forth in Insurance Law §2102 (a) (1) (B). In addition to §2102, §2117 states (subject to limited exceptions not relevant to independent procurement) no person, firm, association or corporation shall in this state act as an agent for any insurer…not licensed or authorized…or shall in this state act as an insurance broker in soliciting, negotiating or in any way effectuating any insurance

…or in placing risks with any such insurer…or in this state in any way or manner aid such insurer…".

Recently issued Circular Letter #9 (2011) states "Insurance will be deemed to be independent procurement only if the insured purchased or renewed the excess line insurance policy directly from an unauthorized insurer without any assistance from an insurance producer."

In New York, a person or entity may be licensed as an insurance consultant in addition to, or in lieu of, holding licenses as a broker and excess line broker. A question often asked is: Can an insurance consultant assist an insured with a direct or independent procurement? The answer depends on what the consultant's role and services are.

A broker or an excess line broker's role includes selling, soliciting or negotiating insurance. These are defined terms in Insurance Law §2101.

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OGC opinion #04-04-04 opines that an insurance consultant not licensed as a broker or excess line broker "is precluded from engaging, in the solicitation, negotiation or procurement of insurance." So first and foremost, a consultant needs to differentiate the services provided to a client seeking coverage, particularly if the consultant is also a broker involved with placing certain coverages for that client. By way of example, if a broker, in placing a large capacity tower of property or casualty coverage exhausts the admitted and excess lines markets but has not acquired all of the coverage sought, can the broker then consult with the insured about options such as independent or direct procurement? The answer appears to be "yes", as long as the consultant is licensed as a consultant in New York and is limiting its involvement to:

1. explaining why some capacity cannot be accessed from New York,
2. informing the client that the broker cannot act as a broker but only as a consultant regarding other potential available capacity,
3. not importuning a specific transaction with a specific carrier, and
4. not selling, soliciting or negotiating coverage.

A broker, in these circumstances, would be well advised to maintain and adhere to a written protocol differentiating its broker services from consulting services. An ability to demonstrate in good faith a separation of these roles will provide the best protection from potential regulatory trouble and other liability exposures.

Independent procurements are subject to a New York tax payable by the insureds.

The Independent Procurement Tax, set forth in Article 33-A of the Tax Law, exempts certain insureds from the tax completely. The exemption applies to the following types of insureds:

- The government of the United States or any instrumentally thereof,
- New York State and its political subdivisions,
- The United Nations and any other international organizations of which the United States is a member,
- Any foreign government,
- Any taxable insurance contract of the type described under the Insurance Law in Section 2117(b), (c) and (d).

ELANY DISCLAIMER:

This is not intended to be nor should it be construed as legal advice. Consult with your own legal counsel.

ELANY

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Calendar

September	
Wednesday, **12:30 p.m.** September 18	**New York Insurance Association (NYIA)** Sponsored Disaster & Flood Preparedness Summit Doubletree Hotel, 569 Lexington Ave, NYC
Tuesday, **6:00 p.m.** September 24	**Women's Insurance Network of Long Island (WINLI)** **E&S Update** Venere Restaurant, 841 Carman Ave, Westbury, NY
Sunday–Wednesday September 29–October 2	**NAPLSO Annual Convention** San Diego, CA
October	
Wednesday, **6:00 p.m.** October 16	**New Jersey Surplus Lines Association President's Forum** Hilton East Brunswick 3 Tower Center Blvd, East Brunswick, NJ
Thursday-Friday October 17–18	**Surplus Lines Law Group** Omni Hotel at Independence Park 401 Chestnut St, Philadelphia, PA
Wednesday October 30	**Professional Insurance Agents (PIA) Hudson Valley Rap** Doubletree Hotel, 455 S. Broadway, Tarrytown, NY
Wednesday, **5:30 p.m.** October 30	**Insurance Brokers Association of New York (IBANY) Fall Reception** Tribeca Rooftop 2 Desbrosses St, New York, NY
November	
Wednesday November 6	**Professional Insurance Wholesalers Association (PIWA) Annual Dinner** Battery Garden Restaurant New York, NY
Friday, **11:30 a.m.** November 15	**Insurance Federation of New York (IFNY) Annual Luncheon** Cipriani, 55 Wall St, New York, NY
Thursday-Sunday November 21–24	**National Conference Insurance Legislators (NCOIL) Annual Meeting** Hilton Nashville Downtown, Nashville, TN
Friday, **6:30 p.m.** November 22	**Council Insurance Brokers of Greater New York Annual Dinner** El Caribe Country Club 5945 Strickland Ave, Brooklyn, NY
December	
Wednesday, **6:00 p.m.** December 11	**Insurance Industry Charitable Foundation (IICF) Gala Dinner** Waldorf Astoria Hotel 301 Park Ave, New York, NY
Sunday-Wednesday December 15–18	**NAIC National Meeting** Washington Marriott Wardman Park 2660 Woodley Rd NW, Washington D.C.