Chapter 10

Surplus Lines Producer Licenses

In order to operate in a state, P/C insurance companies are generally categorized in one of two ways. An admitted company obtains a certificate of authority to operate in a given state and is fully subject to and regulated by the laws of the state. Its policyholders are protected, at least to some extent, by the state's guaranty fund.

A nonadmitted company, otherwise known as a surplus lines company, has limited authority to operate in a state. These companies may be required to be eligible in a state but are subject to significantly less regulation. States allow surplus lines companies to operate because they recognize that certain types of insurance, or insurance at certain amounts, are not available from admitted companies. Generally, surplus lines companies are not subject to rate and policy form regulation, and their policyholders are not covered by state guaranty funds.

The NAIC uniform application is to be used for application as a surplus lines producer. Under the ULS, a producer who wishes to engage in the sale of surplus lines insurance (SLI) must first obtain a surplus lines producer license. Under the ULS, this is considered a license type and not a line of authority; however, in some of the states, it is treated as a line of authority. The ULS require that a resident producer hold both property and casualty lines of authority before an SLI producer license can be issued. Under the previous reciprocity provisions of the GLBA, surplus lines producers were entitled to reciprocal licensing if they were licensed for surplus lines and in good standing in the producer's home state. ~~The NAIC uniform application is to be used for application as a surplus lines producer.~~

Some of the states also require a resident producer placing SLI to complete an examination or post a bond. However, to comply with the reciprocity provisions of Section 8 of the PLMA, these requirements cannot be imposed on nonresidents. States cannot impose an additional CE requirement on nonresident SLI producers.

The Nonadmitted and Reinsurance Reform Act

The federal Nonadmitted and Reinsurance Reform Act (NRRA) was signed into law by President Barack Obama on July 21, 2010, as part of the federal Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5301. The NRRA set federal standards for states for the collection of surplus lines premium taxes, insurer eligibility, producer licensing and commercial purchaser exemptions. Most of the provisions of the NRRA went into effect on July 21, 2011.

For licensing of surplus lines ~~brokers~~[KK1]producers, the most significant NRRA change was to limit the licensing requirements to only the home state of the insured. Specifically, currently to place a surplus lines multistate risk policy, the ~~broker~~ producer needs only to be licensed as a surplus line ~~broker~~ producer in the insured's home state on either a resident or non-resident basis as is appropriate. This was a change from prior to the NRRA when the producer had to be hold a license~~,~~ ~~not~~ in all of the states where the policy risk is located in the case of a multi-state policy. The NRRA defines the home state of the insured as "(i) the state in which an insured maintains its principal place of business or, in the case of an individual, the individual's principal residence; or (ii) if 100% of the premium of the insured risk is located out of the state referred to in clause (i), the state to which the greatest percentage of the insured's taxable premium for that insurance contract is located." The definition goes on to clarify that, with respect to affiliated groups, "[i]f more than one insured from an affiliated group are named insureds on a single non-admitted insurance contract, the term 'home state' means the home state, as determined pursuant to [clauses (i) and (ii) above], of the member of the affiliated group that has the largest percentage of premium attributed to it under such insurance contract."

The NRRA also prohibits a state from collecting fees relating to the licensing of a surplus lines broker unless the state participates in the NAIC's national insurance producer database for surplus lines broker licensure. ~~by July 21, 2012.~~ [KK2]Currently, all states accept applications and renewals for surplus lines broker licenses for individuals through the NIPR and all but one state accept applications and renewals for surplus lines broker licenses for business entities[KK3].

Surplus Lines Distribution Systems

Surplus lines insurance is generally produced through one of two distribution systems. One, generally referred to as a retail distribution system, involves a single ~~broker~~ producer accessing the surplus lines company directly to place insurance. The second, generally referred to as a wholesale distribution system, involves a surplus lines ~~broker~~ producer placing the coverage with the surplus lines market at the request of another producer. In the wholesale distribution system, the surplus lines licensee ~~that~~ operates as an intermediary between a "retail agent" and a surplus lines company. ~~In the retail distribution system, there is only one producer in a transaction, so that producer would need to conduct the diligent search of the admitted markets prior to accessing the surplus lines markets (unless there is some exception such as a large commercial purchaser or an export list). In the wholesale distribution system, the diligent search is often conducted by the retail broker, who determines there is no admitted market prior to contacting the surplus lines wholesale broker; however, some of the states have different requirements.~~ [KK4]

The vast majority of the states take the position that a broker conducting a diligent search would need a P/C agent's license because it is necessary to solicit insurance, take an application and make a submission to an admitted company. [KK5]~~Many states do not require a~~A retail producer is not required to obtain a surplus lines broker's license unless the broker is going to access the surplus lines companies directly, otherwise the wholesale broker accessing the surplus lines market should have a surplus lines license. ~~. There are a couple of states that require a retailer to have a surplus lines license before using the services of a surplus lines wholesale broker.~~[KK6]

Diligent Search Requirements

Diligent search refers to the requirement that prior to placing a risk with the surplus lines market, it can be demonstrated that an effort was made ~~The vast majority of the states require a "diligent search" of the admitted market~~ to determine if there is an admitted carrier willing to write the risk, and many of those states require that brokers search those admitted companies that are actually writing the coverages sought.~~, prior to accessing the surplus lines markets~~. ~~A couple of states have abolished the diligent search requirement. Many of the states require that brokers search those admitted companies that are actually writing the coverages sought.~~ If there is no admitted carrier willing to write the risk, the risk can be placed in the surplus lines markets. Many of the states require an affidavit to be completed documenting that the diligent effort was completed. Recently~~, a number of the~~ many states have replaced the affidavit, which was sworn under penalty of perjury, with a report from the surplus lines licensee that the diligent search was conducted. Some of the states also have replaced the requirement that the affidavit (or report) be filed with the insurance department or Surplus Line Association (SLA) with a requirement that the report of the diligent search be maintained in the office of the broker and available for audit by the insurance department.

A number of exceptions to the diligent search requirement exists in state law, and the NRRA implemented a national exception to the diligent search rules for insureds that qualify as exempt commercial purchasers. Four states have abolished their diligent search requirement (Louisiana, Mississippi, Virginia, Wisconsin), while others have eliminated diligent effort on a limited basis for specific risks, either through statutory provisions or through an export list. ~~Twenty-two~~Twenty-one [KK7]states have laws authorizing an "export list" of coverages that the insurance commissioner has determined are not generally available in the admitted markets. Coverages on the export list can be placed in the surplus lines market without a diligent search. In some of the states, the state insurance department is required to conduct an annual public hearing regarding the export list. The purpose of the hearing is to take testimony on the export list to determine whether any items should be added or removed. States with export lists include Alaska, Arizona, California, Connecticut, Idaho, Maryland, Michigan, Montana, Nevada, New Jersey, New Mexico, New York, North Dakota, Pennsylvania, Rhode Island, Utah, West Virginia and Wyoming. States that have the authority to establish an export list but have not include Colorado, Florida and Maine.

Many of the states specify that the diligent search can be conducted by the retail broker (commonly called producing broker), when a surplus lines wholesaler accesses the surplus lines markets. The retail broker has access to admitted markets. The retailer uses the services of a surplus lines wholesale broker only after the retail broker has determined that the admitted markets are not willing to underwrite the risk.

The most common diligent search standard requires declinations from three admitted carriers, but a few state require as many as five ~~are required~~. Other states simply require the producing broker to make an effort, a reasonable effort or a good faith effort to place the coverage in the admitted markets. A couple of states require that the insurance not be procurable after a diligent effort has been made to place the coverage among a majority of insurers, but this standard has been called into question as unclear and impractical. ~~A number of exceptions to the diligent search requirement exists in state law, and the NRRA implemented a national exception to the diligent search rules for insureds that qualify as exempt commercial purchasers. Twenty-two states have laws authorizing an "export list" of coverages that the insurance commissioner has determined are not generally available in the admitted markets. Coverages on the export list can be placed in the surplus lines market without a diligent search. In some of the states, the state insurance department is required to conduct an annual public hearing regarding the export list. The purpose of the hearing is to take testimony on the export list to determine whether any items should be added or removed.~~

The former NARAB (EX) Working Group updated the NAIC's standard for determining compliance with the GLBA's previous reciprocity provisions. In a report that was adopted by the NAIC in September 2009, the Working Group refined its approach to reciprocity relating to any underlying P/C licensing requirements for nonresident surplus lines producers. The Working Group determined that if a state requires the surplus lines producer to perform the diligent search of the admitted market, then the state may require the nonresident surplus lines producer to obtain an underlying nonresident P/C license in addition to a nonresident surplus lines license. However, the Working Group determined that a state may not require a nonresident surplus lines producer also to obtain a nonresident P/C license if they do not perform the diligent search. Many surplus lines producers do not perform diligent searches because the retailer has already conducted the diligent search, and the law does not require a second diligent search and the wholesaler generally does not access the admitted market. ~~In such instances, the surplus lines producer is not accessing the admitted market.~~ Consequently, the Working Group determined that it was inconsistent with the previous GLBA reciprocity requirements to require an underlying P/C license for a surplus lines wholesale broker unless they are required by law to conduct a diligent search or conduct diligent searches in their agency.

The NRRA established a single "exempt commercial purchaser" exemption from state diligent search requirements that is applicable in every state. As of July 21, 2011, a diligent search in the admitted market is not required to place a policy for an exempt commercial purchaser if: 1) the broker has disclosed to the exempt commercial purchaser that coverage may be available from the admitted market, which may provide greater protection with more regulatory oversight; and 2) the exempt commercial purchaser has requested in writing that the broker procure/place such coverage with a surplus lines insurer.

An "exempt commercial purchaser" is defined in the NRRA as a purchaser of commercial insurance that:

> 1) employs or retains a qualified risk manager to negotiate insurance coverage; 2) has paid aggregate nationwide commercial P/C insurance premiums in excess of $100,000 in the immediately preceding 12 months; and 3) meets at least one of the following criteria: (i) possesses a net worth in excess of $20 million (as adjusted for inflation); (ii) generates annual revenues in excess of $50 million (as adjusted for inflation); (iii) employs more than 500 full-time employees per individual insured or is a member of an affiliated group employing more than 1,000 employees in the aggregate; (iv) is a not-for-profit organization or public entity generating annual budgeted expenditures of at least $30 million (as adjusted for inflation); or (v) is a municipality with a population of more than 50,000.

A number of the states elected to maintain their statutory exemptions from diligent search requirements, which were sometimes known as industrial insured exemptions. If the state's industrial insured exemption was more liberal than the NRRA exempt commercial purchaser (ECP) exemption, then the state's requirements were not in conflict with the NRRA, and the exemption in the NRRA would not apply.

SLI producers are routinely subject to additional state administrative requirements that are considered to be outside the scope of licensing reciprocity considerations or the ULS. The regulations regarding the administration of surplus lines are different from other types of insurance because the states typically require the licensed surplus lines producers to perform certain compliance activities that would usually be the responsibility of the licensed insurance company in a transaction in the admitted market. In a surplus lines transaction, the compliance obligations are imposed upon the producer because the producer is the licensed party. The surplus lines insurer is unlicensed and often referred to as a "nonadmitted insurer" in some of the states or "unauthorized insurers" in other states.

There are additional administrative requirements in some of the states for licensed surplus lines producers that apply once the coverage is placed. These may include:

1. Filing reports with state insurance departments or state stamping offices of placements made.
2. Collecting and paying surplus lines premium taxes.
3. Maintaining a record of all surplus lines placements made.
4. Providing the insured with a disclosure stating that the policy he or she has purchased is being issued by an insurer that is not licensed in the state, is not subject to the financial solvency regulation and enforcement that apply to the state's licensed insurers, and does not participate in any of the insurance guarantee funds created by the state's law.
5. Using a designated stamping office.
6. Including declaration or binder pages with the surplus lines tax filings.
7. Filing a report stating that no policies were written that are known as "zero reports" (as discussed later in this section).

In order for a producer to place business in the surplus lines market, the surplus lines producer must first determine that the company is an eligible surplus lines company in a given state. Prior to the enactment of the NRRA, state eligibility standards varied widely from state to state but as.~~. Most of the states require that a surplus lines company be deemed "eligible" by meeting certain financial criteria or by having been designated as "eligible" on a state-maintained list. Prior to the enactment of the NRRA, state eligibility standards varied widely from state to state.~~

~~As~~ of July 21, 2011, a surplus lines transaction is subject only to the eligibility requirements of the NRRA. The NRRA eligibility requirements are based on two provisions from the NAIC's *Nonadmitted Insurance Model Act* (*#870*).

Specifically, the NRRA requires surplus lines carriers to comply with Section 5A(2) and Section 5C(2)(a) from *Model #870*, which require an insurer to be authorized to write the type of insurance in its domiciliary jurisdiction ~~in its domiciliary state to write the type of insurance that it writes as surplus lines coverage in the state where it is eligible~~ and to have capital and surplus, or its equivalent, under the laws of its domiciliary jurisdiction, equaling the greater of: 1) the minimum capital and surplus requirements under the law of the home state of the insured; or 2) $15 million. The insurance commissioner in the insured's home state may reduce or waive the capital and surplus requirements (down to a minimum of $4.5 million) after the insurance commissioner makes a finding of eligibility based on several factors set out in *Model #870*, such as the quality of management, the surplus of a parent company and reputation within the industry.

In addition to eligibility requirements for U.S. domiciled insurers, the NRRA requires the states to permit the placement of surplus lines coverage with surplus lines companies organized in a foreign country (alien insurers) that are listed on the NAIC *Quarterly Listing of Alien Insurers*. The states cannot prohibit a broker from making a placement with an NAIC-listed alien insurer. A state also may allow placement of coverage with alien insurers not on the NAIC list. A number of the states have authority to individually approve an alien carrier that is not listed on the *Quarterly Listing of Alien Insurers*.

The Quarterly Listing of Alien Insurers is available for reference and download on the NAIC Products – AVS, Data & Publications website at http://www.naic.org/prod_serv_alpha_listing.htm# (Quarterly Listing of Alien Insurers)

Premium Taxes

Surplus lines premium tax generally is the obligation of either the policyholder or the surplus lines producer, depending on the applicable state law. In all states, the producer or the insured, rather than the insurance company, remits the surplus lines tax. ~~If the policy covers risks that are located entirely in one state, the tax is assessed at that state's tax rate.~~

Under the NRRA, the home state of the insured has sole regulatory authority over the collection of surplus lines premium taxes. The NRRA prohibits any state other than the home state of the insured from requiring any premium tax payment for surplus lines insurance.

The NRRA permitted, but did not require, allocation of the surplus lines taxes among the states where the exposure was located through tax sharing agreements. ~~, T~~Following the passage of the NRRA, ~~states initially pursued~~ three different approaches to allocation of taxes developed including two tax sharing mechanisms: ~~following the adoption of the NRRA~~: 1) the Nonadmitted Insurance Multi-State Agreement (NIMA); and 2) the Surplus Lines Insurance Multi-State Compliance Compact (SLIMPACT); ~~and 3) taxing and keeping 100% of surplus lines premium tax on policies in the home state of insureds.~~ NIMA included six jurisdictions initially but in October 2016 announced it would disband and is no longer operational, while ~~and~~ SLIMPACT never became operational. Alternatively, a majority of states taxed and maintained 100% of multistate surplus lines premium tax on policies when they were the home state of insureds. ~~The prevailing rule is that states are taxing and keeping 100% of the premium.~~ The NRRA requires surplus lines brokers to adhere to the law of the home state of the insured to determine the amount of premium tax owed on a surplus lines transaction and for any other regulatory requirements the state may require in connection with the payment of the premium tax, such as the timing of tax payments and whether the state requires the submission of risk allocation information for multi-state transactions. The NRRA requires surplus lines brokers to submit the premium tax payment on a surplus lines transaction only to the insured's home state. In some of the states, taxes are paid to a state agency other than the insurance department, such as the department of revenue ~~In the case of a state that has joined NIMA, the payment will be made to the clearinghouse in accordance with the home state's law. Should SLIMPACT become operational, it also could elect to require multistate payments to be made to the clearinghouse.~~

~~Many~~ [KK8]~~of the states require brokers to submit documentation regarding allocation by state of the risks covered by a surplus lines transaction. If the home state of the insured is a state that has joined NIMA, the broker will be required to use~~

~~the NIMA risk-allocation formula. If the home state is a state that has joined SLIMPACT, the broker will be required to use the SLIMPACT risk-allocation formula. As of May 2013, both NIMA and SLIMPACT have adopted the same allocation formula. Other states require the broker to submit allocation data in accordance with individual state laws and regulations, but the vast majority of states do not require allocation data because there are very few states allocating premium at this time. In some of the states, taxes are paid to a state agency other than the insurance department, such as the department of revenue~~.

Guaranty Fund Warning

~~Nearly~~ A~~a~~ll but one of the states require a disclosure regarding the unavailability of guaranty fund coverage for a surplus lines policyholder~~, even if the state represents a small portion of the risk~~. Prior to the NRRA, when a multistate risk was involved, the company would be required to include several pages of guaranty fund notices, many of which had nearly the same language with minor variations. Brokers may choose to continue to use this approach following the enactment of the NRRA, but the NRRA initiated a compliance system that requires compliance only with laws of the home state of the insured.

As an example, a typical disclosure statement is as follows:

NOTICE TO POLICYHOLDER

> **This contract is issued, pursuant to Section ___ of the (State) Insurance Code, by a company not authorized and licensed to transact business in (State), and as such, is not covered by the (State) Insurance Guaranty Fund.**

After review of this and other issues by a special NAIC subgroup in 2006, the Producer Licensing (EX) Working Group adopted its recommendation that, on a multistate risk, the home state's disclosure should fulfill all other states' disclosure requirements.

Stamping Offices

Stamping offices are entities that are not governmental agencies but whose existence is authorized by law. These offices act as the liaison between the surplus lines producer and the state insurance departments. The stamping offices have varied responsibilities, which may include evaluation of insurance companies~~ for inclusion on a white list~~, review of surplus lines policies and education. Stamping offices also provide reports of premiums and taxes to the state insurance department.

Stamping offices are nonprofit and are funded by stamping fees assessed on each policy of surplus lines insurance written in the state. ~~As of April 2017, there~~There are stamping offices in 15~~4~~ states (Arizona, California, Florida, Idaho, Illinois, Mississippi, Minnesota, Nevada, New York, North Carolina, Oregon, Pennsylvania, Texas, Utah and Washington).~~.~~

Zero Reports

In some of the states, a producer is required to file a report, known as a "zero report," stating that the producer has not placed any SLI business during a specified time period.

In 2006, a special NAIC study group documented that five states require this report monthly, 12 quarterly, seven semi-annually and 27 annually. The states also use the reports for different recording purposes, so it was not determined if it would be possible to eliminate these reports altogether. However, the study group concluded and recommended to the Producer Licensing (EX) Working Group that zero reports be eliminated. The group also recommended further study to determine feasibility of any other use of a zero report. Since that report, several states have changed their requirements and as of July 2019, the following states require zero reports filings: Alabama (quarterly); Arkansas (annually); California (annually); Colorado (monthly); Delaware (annually); District of Columbia (semi-annually); Idaho (annually); Illinois (semi-annually); Indiana (annually); Kansas (annually); Louisiana (annually); Massachusetts (annually); Michigan (semi-annually); Minnesota (semi-annually); Missouri (quarterly); Nebraska (quarterly); New Hampshire (annually); New York (annually); Oklahoma (annually); Pennsylvania (annually); Rhode Island (annually); Virginia (annually), which is 14 annually, 3 quarterly, 4 semiannually, and 1 monthly. As of ~~January 2017~~July 2019, the Producer Licensing (EX) Working Group has not taken any formal action on this issue.