COMPLIANCE ADVISOR

E&S INSURERS AND THE LAW BEYOND FREEDOM OF RATE & FORM

A PUBLICATION BY

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Most insurance professionals take for granted that the E&S market is completely free of rate and form regulation. In fact, there is a fairly popular belief within the industry that E&S insurers are subject to none of the laws, regulations or limitations which apply to licensed insurers. The purpose of this Compliance Advisor is to explain:

I) which New York laws, regulations and court interpretations definitively apply to E&S insurers;

II) where E&S insurers enjoy express or implied exemptions from laws and regulations; and

III) which legal provisions and interpretations are the subject of differing opinions regarding their applicability to E&S transactions.

I) LAWS WHICH DEFINITIVELY APPLY TO E&S INSURERS

A) The most important law applicable to E&S insurers is actually an express exemption. Under Insurance Law Section 1101, New York law broadly defines what constitutes “doing an insurance business” for which an insurer must be licensed. It carves out an exemption for unlicensed (“unauthorized”) insurers who transact insurance pursuant to Section 2105, the statute which authorizes excess line broker transactions.

There are three key concepts to note:

1) An unauthorized insurer must be eligible to write E&S risks or this exemption does not apply and any risks written violate the licensing requirement.

2) If an eligible E&S insurer writes insurance outside of the scope of the authority granted to an excess line broker (for example binding accounts with a producer not licensed as an excess line broker), the insurer no longer enjoys the benefit of the exemption under Section 1101 and therefore, is doing an insurance business without a license. As such, the eligible E&S insurer would be subject to any penalties the New York State Department of Financial Services (DFS) could impose for such violations. The most probable sanction would be to issue a “no stamp” order or a cease and desist order.

3) The third implication of the exemption is that the limitations imposed on excess line brokers also imposes limitations on E&S insurers. Only certain kinds of insurance, as defined in Section 1113 of the New York Insurance Law, may be placed by excess line brokers. The exemption for an E&S insurer under Section 1101 is no broader than the authority granted to excess line brokers under Section 2105. An eligible insurer, therefore, can only underwrite the kinds of insurance under Section 1113 that an excess line broker is permitted to procure under Section 2105. [There are exceptions to the limitations noted above in
B) New York Insurance Regulation 41 (11 NYCRR 27) Adds a few additional requirements:

Regulation 41 by and large sets forth specific duties and obligations owed by excess line brokers and E&S insurers. In some instances, however, the Regulation asserts that the excess line broker is not permitted to place business with an E&S insurer under certain specific circumstances. Arguably, conduct not permitted by the excess line broker could constitute “doing an insurance business” without a license by the E&S carrier(s).

Regulation 41, (11 NYCRR 27.11) for example says:

27.11 Prohibited activities

A) An excess line broker shall not procure coverage from an unauthorized insurer and the unauthorized insurer shall not provide coverage if the coverage is prohibited by law, including if such coverage:
   1) does not constitute insurance within the meaning of section 1101 or other sections of the Insurance Law;
   2) involves a kind of insurance not authorized under section 1113 or other sections of the Insurance Law;
   3) is not within the scope of section 2105 of the Insurance Law;
   4) is determined by any Appellate Division of the New York State Supreme Court or the New York State Court of Appeals to be against public policy in this State; or
   5) has been otherwise proscribed by law.

Under Regulation 41 (11 NYCRR 27.14), the following additional requirements paraphrased below are imposed on the E&S insurer.

An E&S insurer must file an EL-1 report electronically, which is a bordereaux of E&S risks written in the previous year (on every March 15th).

Also, premium payment to the E&S broker must be considered payment to the E&S insurer.

II) EXPRESS OR IMPLIED EXEMPTIONS WHICH BENEFIT E&S INSURERS

A) FREEDOM OF RATE AND FORM

In New York, rate and form filing and approval requirements are set forth in Article 23 of the Insurance Law and apply to authorized (licensed) insurers only. This is set forth in Section 2302. Since eligible E&S insurers are by definition unauthorized (not licensed), no filing or approval requirements for rate or forms apply. However,
as stated in III below, this is not a blanket exemption from the entire New York Insurance Law.

B) **STATE INCOME AND/OR FRANCHISE TAXES**

Eligible E&S insurers are not subject to New York State income or franchise taxes. Excess line brokers are legally responsible for the 3.6% excess line tax. In most states, eligible E&S insurers are not subject to state taxes. However, this is not universal. Texas, for instance, has an unauthorized insurers tax, which applies to nonadmitted transactions where no E&S or independent procurement tax was paid on such transactions. State E&S laws vary sometimes significantly state by state. This always must be kept in mind.

C) **RESIDUAL MARKET MECHANISMS**

It is beyond the scope of this Compliance Advisor to cite chapter and verse the exemptions E&S insurers have regarding various residual market mechanisms. However, below are two noteworthy takeaways. In New York, eligible E&S insurers are not subject to:

1) residual market risk assignments, (auto liability, property, nor medical malpractice), nor are they required to participate financially in any deficits for these residual market mechanisms, or
2) any state guaranty or security fund assessments.

D) **CANCELLATION/NONRENEWAL LAWS**

New York E&S transactions are expressly exempt from the cancellation/nonrenewal provisions applicable to commercial lines insurance under Section 3426. However, no such express exemption is contained in the personal lines cancellation/nonrenewal laws under Section 3425.

E) **CLAIMS MADE AND DEFENSE WITHIN LIMITS OFFSET POLICIES**

Licensed insurers are subject to Insurance Regulations 107 and 121, which provide minimum mandatory provisions for policies with defense within limits offset provisions and for claims-made policies. E&S insurers are expressly exempt from these regulations. The express exemption is set forth in Regulation 41.

F) **POLICIES FINANCED BY PREMIUM FINANCE COMPANIES**

ELANY, with the assistance of other industry associations, promoted legislation in 2004, which expressly exempted financed E&S transactions from short rate/minimum earned premium caps. The caps on short rate and minimum earned premium provisions contained in Section 3428 now clearly apply only to licensed insurers.

G) **DEPARTMENTAL OPINIONS OF COUNSEL**

The New York State Department of Financial Services (DFS) Office of General Counsel issues opinions from time to time based on questions submitted. In the
recent past, the New York State Department of Financial Services (DFS) Counsel has opined that mold damage exclusions\(^1\) and lead paint exclusions\(^2\) have not been approved for any licensed insurer (as of the date of each opinion) but that eligible E&S insurers could tailor coverage with such exclusions, provided that they were clear and unambiguous. It should be noted that these opinions cut both ways. Some have not been favorable to E&S insurers.

### III) OTHER LEGAL PROVISIONS AND INTERPRETATIONS WHOSE APPLICABILITY TO THE E&S MARKET IS UNSETTLED

A number of considerations impact what laws, regulations and legal interpretations will be applied to E&S policies. Of course, the language of the specific insurance policy, statute and / or regulation involved usually plays a major role. Beyond those considerations are court cases, which set precedent, persuasive interpretations by an insurance department or attorney general, public policy considerations and equitable legal principles such as estoppel. When it comes to the courts, it would be wise not to bet the ranch on the expectation that a court will apply one set of legal principles to licensed insurers and a different set to E&S insurers. The following discussion will highlight areas where E&S insurers ought to make deliberate strategic decisions after assessing their exposures to legal interpretations which can cause an adverse and otherwise unanticipated result.

#### A) NEW YORK INSURANCE STATUTES WHICH THE NEW YORK STATE DEPARTMENT OF FINANCIAL SERVICES (DFS) INTERPRET AS APPLICABLE TO E&S POLICIES

The flip side of statutes, which expressly apply only to “authorized” insurers, are statutes which apply to policies “issued or delivered” in New York. The New York State Department of Financial Services (DFS) generally takes the position that statutes which contain “issued or delivered” language apply to E&S policies. There is a compelling argument to the contrary, namely, these statutes do not expressly state that they apply to E&S policies. Ultimately, the courts will have the final say on which laws apply to E&S policies. To date, however, few court decisions interpret whether these statutes apply to E&S policies or not. There are cases which have interpreted “issued or delivered” language in the life insurance context\(^3\) and health insurance\(^4\) world. However, no case discusses the “issued or delivered” language where an excess line broker procured coverage. There are also cases where New York courts refuse to force a change in terms and conditions, such as where an auto liability policy on an out of state registered vehicle provided less coverage for an injured New Yorker than New York Insurance Law required. The policy in such cases were not “issued or delivered” in New York. Therefore, the court did not reform the policy language. While many of the statutory provisions noted below, if applicable, impose limited burdens on E&S insurers, it is, nevertheless, important for E&S insurers to assess their potential impact. This is particularly important because Insurance Law Section 3103 allows a court to conform a policy’s language where the language violates
any provision of the Insurance Law, and you guessed it, Section 3103 applies to policies “delivered or issued for delivery” in New York.

The provisions of Section 3103 could not be used to require filing or approval of rates and forms. However, it could be used if held to apply to E&S transactions to reform policy language specified in insurance statutes applicable to policies “issued or delivered” in New York.

The following list identifies opinions/circular letter published by the New York State Department of Financial Services (DFS) which assert specific statutes apply to E&S policies.

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
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<tbody>
<tr>
<td>Section 3404 – Standard New York Fire Policy</td>
<td>Opinion No. 02-04-23 opines that excess line insurers may not issue an exclusion for “fire following a terrorist event” as it would violate minimum fire policy requirements.</td>
</tr>
<tr>
<td>Section 3420 – Liability Insurance Standard Provisions</td>
<td>Circular Letter No. 26 (2008) interprets new provisions in the Insurance Law designed to prohibit denials of coverage where the insurer was not prejudiced by a late notice of claim. It also states Section 3420 and 3103 apply to excess line policies.</td>
</tr>
<tr>
<td>Section 3425 –Personal Lines Cancellation/ Non renewal</td>
<td>Opinion No. 06-10-07 opines excess line policies are subject to the cancellation nonrenewal statute for personal lines insurance policies.</td>
</tr>
<tr>
<td>Section 403 – Fraud Warning Statements</td>
<td>Opinion No. 05-04-02 opines that excess line insurers must comply with the fraud notice requirements in Section 403(d) and (e).</td>
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Other statutory provisions include the “issued or delivered” language. However, no written interpretations regarding applicability to the excess line market have been issued.

The New York State Department of Financial Services (DFS) has issued other interpretations of law and opined they apply to E&S policies. A recent Circular Letter No. 20 (2008) regarding “contract certainty” included E&S policies.5

B.  WILD CARDS: CASE LAW, PUBLIC POLICY CONSIDERATIONS, EQUITABLE PRINCIPLES AND JUDICIAL ENGINEERING

There are times when court decisions are solidly grounded in legal principles. There are other times when the courts are so strained to reach a certain result, the guiding legal principles learned in law school appear to be AWOL.
1) CASE LAW AND SURPLUS LINES GENERALLY

While most cases involving policy language and coverage issues are probably decided based on the policy language itself whether the policy is an admitted one or an E&S policy, some cases have reached conclusions which are hard to reconcile based on the plain meaning of the applicable law. For example, a New Jersey Appellate Division recognized that E&S policies were not subject to statutory cancellation/nonrenewal provisions, however, nevertheless construed the terms of an E&S policy based on the language mandated for admitted policies. In that case, Piermount Iron Works, Inc. vs. Evanston Insurance Company, the New Jersey Supreme Court ultimately reversed the Appellate Division, however it stands as an example of how distinctions between the admitted and nonadmitted markets are sometimes blurred.

2) PUBLIC POLICY CONSIDERATIONS

There are cases which construe public policy. Courts, in the application of public policy considerations, are not likely to say this applies to everyone except E&S insurers. A classic example of this is New York’s ban on insuring punitive damages. In a recent Opinion of Counsel from the New York State Department of Financial Services (DFS), the public policy banning insurance coverage for punitive damages was reiterated, citing the leading Court of Appeals case on the subject and specifically asserted that the ban applied to E&S insurers.

3) EQUITABLE PRINCIPLES AND CASE LAW

Another area where E&S insurers will probably be treated in the same manner as admitted insurers is when a case turns on one or more equitable principles. It would be a hard argument to make that what was/is equitable among parties to a contract is no longer equitable simply because one of those parties is an E&S insurer. For example, in most states, courts have held that insurers, which deny coverage on the basis of an exclusion or condition, must do so in a timely manner as a matter of equity so the insured is fully informed as soon as possible. The failure to so inform the insured in a timely manner will, or may, subject the insurer to the doctrine of equitable estoppel prohibiting the insurer from enforcing the exclusion or condition.

4) JUDICIAL ENGINEERING

One can knock the judiciary for result oriented decision making. It adds a dimension which all insurers need to consider in the overall context of coverage litigation and risk assessment. The most recent New York examples of this are two 2008 Courts of Appeal cases: Bi-Economy Market, Inc. and Panasia Estates Inc.
In the Bi-Economy case, the insured sued its insurer for bad faith claims handling, breach of contract and consequential damages among other causes of action. The plaintiff alleged that the unnecessary delay in adjusting and settling a business interruption loss resulted in plaintiff having to permanently close down its business. The opinion of the court by majority found that plaintiff was entitled to “consequential damages” because an insured suffers additional damages as a result of an insurer’s excessive delay or improper denial. These additional damages were reasonably foreseeable and contemplated by the parties in light of the nature and purpose of the insurance and the insurer’s duties of good faith and fair dealings. The court also found that these were not punitive damages as the award was not designed to punish. Finally, as to the policy’s consequential losses limitation, the court said the policy’s consequential losses provision did not contemplate the type of “consequential damages” at issue in this case.

The dissenting Justices did not lose their sense of humor. In response to the majority’s position that the parties would have reached this same conclusion had they contemplated the situation at the time of contract, the minority opinion wrote this tongue-in-cheek colloqui.

**Insured:** “Suppose you refuse, in bad faith, to pay a claim. Will you agree to be liable for the consequences, including lost business, without regard to the policy limits?”

**Insurer:** “Oh sure. Sorry, we forgot to put that in the policy”.

The minority also said the majority abandoned its prior position on insurance bad faith by changing labels. Unrecoverable “punitive damages” are now called “consequential damages” and are recoverable. The case involved a licensed insurer. However, it is hard to believe an E&S insurer would have enjoyed a different result or that this holding will not be applied to an E&S insurer in the future.

**CONCLUSION**

The take aways for the E&S market are these:

1) Freedom of rate and form in New York is likely to remain a safe haven for E&S insurers. Freedom of rate and form is perhaps the single most fundamental distinction between the E&S market and the admitted market.

2) E&S insurers enjoy some safe harbors under New York Insurance Law. However, they are not unlimited because the carve out in Section 1101 is not unlimited and because E&S insurers provide implied consent and sometimes express consent to certain rules of law in gaining eligibility.
3) With all due apologies to E&S insurer purists, who wish to assert that no legal precepts bind them, the New York State Department of Financial Services (DFS) and courts have created and will create parameters which constrain some terms, conditions and behaviors relating to E&S insurers.

4) While some may think the E&S industry may ultimately suffer death by a thousand regulatory cuts, the regulatory incursions are not all dire. Moreover, the progress made by the industry in reducing some of the historical regulatory burdens, while simultaneously improving the overall financial quality of the insurers which underwrite E&S insurance, must not be ignored. In the end, from this vantage point, it makes sense to pick your battles carefully. Accept the interpretations and opinions which are least likely to have a material impact on the business you underwrite, take those matters into account in your rating structure where possible, and by all means preserve the substantial distinctions and freedoms which separate the E&S market from the admitted one.

1 Office of General Counsel Opinion No. 03-04-04
2 Office of General Counsel Opinion No. 03-03-12
3 Zogg vs. Penn Mutual Life Insurance Company
   276 F.2d 861 (2nd Circuit 1960)
4 Antinora vs. Nationwide Life Insurance Company
   350 N.Y.S 2d 863 (1973)
5 Circular letter No. 20 (2008)
6 Piermount Iron Works Inc. vs. Evanston Insurance Company
7 Office of General Counsel Opinion No. 08-08-09
8 Bi-Economy Market, Inc. vs. Harleysville Insurance Co. of New York, et al
   10 N.Y. 3d 187, 856 N.Y.S. 2d 505
9 Panasia Estate Inc. vs. Hudson Insurance Company
   10 N.Y. 3d 200, 2008 WL420014 (February 19, 2008)