

### COMPLIANCE ADVISOR

# E&S Insurers and The Law Beyond Freedom of Rate & Form

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Many insurance professionals take it as an article of faith that the Excess & Surplus (E&S) line market is completely free of rate and form regulation. In fact, there is a common misconception that E&S insurers are subject to none of the laws, regulations or limitations that 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) NEW YORK LAWS THAT DEFINITIVELY APPLY TO E&S INSURERS

A) The most important law applicable to E&S insurers is actually an express exemption. Insurance Law §1101 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 Insurance Law §2105, the statute that authorizes excess line broker transactions.

There are three key concepts to note:

- 1) An unauthorized insurer must be eligible pursuant to New York law to write E&S risks for this exemption to apply, and if it is not, any risks written violate the licensing requirement contained in Insurance Law §1102.
- 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 Insurance Law §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 (instructing ELANY not to stamp insurance documents issued by the insurer), a cease-and-desist order and/or to impose fines.
- 3) The third implication of the exemption is that the limitations imposed on excess line brokers also impose limitations on E&S insurers. Only certain kinds of insurance, as defined in Insurance Law §1113, may be placed by excess line brokers. The exemption for an E&S insurer under Insurance Law §1101 is no broader than the authority granted to excess line brokers under Insurance Law §2105. Therefore, an eligible excess line insurer can only underwrite the kinds of insurance under Insurance Law §1113 that an excess line broker is permitted to procure under Insurance Law §2105.

Note that there are exceptions to the limitations noted above in Insurance Laws §1101 and §2117 regarding transactions for certain coverages exempt from the excess line law.

#### B) 11 CRR-NY Part 27 adds a few additional requirements:1

11 CRR-NY Part 27 sets forth specific duties and obligations owed by excess line brokers and E&S insurers. However, in some instances the regulation asserts that the excess line broker is not permitted to place business with an E&S insurer under specific circumstances. Arguably, conduct not permitted by the excess line broker could constitute "doing an insurance business" without a license by an E&S carrier.

For example, <u>11 CRR-NY 27.11</u> states, in part:

#### 27.11 Prohibited activities.

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 §1101 or other sections of the Insurance Law;
- 2) involves a kind of insurance not authorized under §1113 or other sections of the Insurance Law;
- 3) is not within the scope of §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 11 CRR-NY 27.14, the following additional requirements paraphrased below are imposed on the E&S insurer:

- An E&S insurer must file annually an EL-1 report electronically, which is a bordereau of E&S risks written in the previous year, by March 15.
- Premium payments to an E&S broker constitute payments to the E&S insurer.

#### II) EXPRESS OR IMPLIED EXEMPTIONS THAT 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 under Insurance Law §2302(a). 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.

<sup>1 11</sup> CRR-NY Part 27 is also commonly referred to as Regulation 41.

#### B) State Income and/or Franchise Taxes

Eligible E&S insurers historically have not been subject to New York State income or franchise taxes. However, since June 2016, the New York State Department of Taxation and Finance has asserted that E&S insurers are subject to a franchise tax under §1501 and §1502 of the Tax Law. There are challenges to the state's position pending an Administrative Agency hearing and appeal. Excess line brokers are legally responsible for payment of the 3.6% excess line premium tax.<sup>2</sup>

#### 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 pools or risk assignments (auto liability, property, medical malpractice), nor are they required to participate financially in any deficits for these residual market mechanisms
- 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 line insurance under Insurance Law §3426.<sup>3</sup> However, no such express exemption is contained in the personal lines cancellation/nonrenewal laws under Insurance Law §3425 and, by implication, those requirements apply to excess line personal line policies.

#### E) Claims Made and Defense Within Limits Offset Policies

Licensed insurers are subject to <u>11 CRR-NY Part 71</u> (Regulation 107) and <u>11 CRR-NY Part 73</u> (Regulation 121), which respectively 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 except as noted below. The express exemption is set forth in <u>11 CRR-NY 27.10</u>.

When legislation was passed in 2017, transportation network companies (TNC) were first permitted to legally operate in New York. The 11 CRR-NY 27.10 exemption was modified to make both 11 CRR-NY Part 71 (Regulation 107) and 11 CRR-NY Part 73 (Regulation 121) applicable to TNC automobile liability coverages.

<sup>2</sup> In most states, eligible E&S insurers are not subject to state taxes. However, this is not universal. Texas, for instance, has an unauthorized insurer's tax that 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 should always be kept in mind.

<sup>3</sup> However, the notice of cancellation requirements applicable to commercial fire insurance policies and automobile liability insurance policies under the state financial responsibility laws do apply to excess line transactions.

#### F) Policies Financed By Premium Finance Companies

ELANY, with the assistance of other industry associations, promoted legislation in 2004 that 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 Insurance Law §3428 now clearly apply only to licensed insurers.

#### G) The DFS Opinions of Counsel

The DFS' Office of General Counsel formerly issued opinions based on questions submitted. These opinions cut both ways. Some were not 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. In addition to those considerations are judicial opinions; interpretations by the DFS, other executive departments, agencies and the attorney general; public policy considerations; and equitable legal principles such as estoppel. When it comes to the courts, it should not be assumed 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 should make deliberate strategic decisions after assessing their exposures to legal interpretations that can cause an adverse and otherwise unanticipated result.

#### A) New York Insurance Statutes That DFS Interprets as Applicable to E&S Policies

Certain statutes expressly apply only to "authorized" insurers while others apply to policies "issued or delivered" in New York. The DFS generally takes the position that statutes that contain "issued or delivered" language apply to E&S policies. The New York State Court of Appeals has rendered a broad interpretation of what "issued or delivered" means. *See* Welcome to New York ... Whether You Like It or Not. However, no case explicitly discusses the "issued or delivered" language where an excess line broker procured coverage. 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 §3103 allows a court to conform a policy's language where the language violates any provision of the Insurance Law, and Insurance Law §3103 applies to policies "delivered or issued for delivery" in New York.

The provisions of Insurance Law §3103 could not be used to require filing or approval of rates and forms. However, they could be used to conform an excess line policy to statutorily required policy language applicable to policies "issued or delivered" in New York.

The following DFS opinions/circular letters assert that specific statutes apply to E&S policies.

§3404 – Standard New York Fire Policy	OGC Opinion of April 19, 2002, opines that "no policy of fire insurance made, issued or delivered on any property in this state may contain a terrorism exclusion with respect to the peril of fire" and that this prohibition applies to insurance procured by an excess line broker, as it would violate minimum requirements of the Standard New York Fire Policy.
§3420 – Liability Insurance Standard Provisions	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 Insurance Law §3420 and §3103 apply to excess line policies.
§3425 – Personal Lines Cancellation/ Nonrenewal	OGC Opinion of October 25, 2006, opines excess line policies are subject to the cancellation nonrenewal statute for personal lines insurance policies.
§403 – Fraud Warning Statements	OGC Opinion of April 4, 2005, opines that excess line insurers must comply with the fraud notice requirements in Insurance Law §403(d) and (e).

The DFS has issued other, broader interpretations of law and opined that they apply to E&S policies. For example, <u>Circular Letter No. 20 (2008)</u> explicitly applied "contract certainty" requirements to E&S policies.

#### B) Public Policy Considerations and Equitable Principles

#### 1) Public Policy Considerations

There are cases that construe public policy. Courts, in the application of public policy considerations, are not likely to rule that public policy imperatives apply to everyone except E&S insurers. A classic example of this is New York's ban on insuring punitive damages. In the DFS' OGC Opinion of August 27, 2008, the public policy banning insurance coverage for punitive damages was reiterated, citing the leading Court of Appeals case on the subject and specifically asserting that the ban applies to E&S placements.

#### 2) Equitable Principles and Case Law

E&S insurers will probably be treated in the same manner as admitted insurers when a case turns on one or more equitable principles. For example, in most states, courts have held that insurers denying 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 may subject the insurer to the doctrine of equitable estoppel, prohibiting the insurer from enforcing the exclusion or condition.

#### **CONCLUSION**

The takeaways 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 Insurance Law §1101 is not unlimited, and E&S insurers implicitly consent to both express and implied legal requirements when gaining eligibility to write E&S business in New York.
- 3) The DFS and the courts have created, and will continue to create, parameters that constrain some terms, conditions and behaviors relating to E&S insurers.



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