Purchasing Insurance From Unlicensed Insurers

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Over the years, insureds in various states have procured insurance from insurers that have been unlicensed and unauthorized in the state in which the insured was resident. As a result of court decisions and state statutes, these transactions continue to be permitted although they are sometimes subjected to the imposition of a tax. The following article is designed to provide a general discussion of such transactions. (However, a discussion of all the potential variables is beyond the scope of this article as analysis of the insurance laws of all 50 states would be necessary.)

In general, state insurance laws contain provisions that define the conduct of an insurance business within the state. These laws typically address a broad spectrum of activities conducted within the state, such as solicitation of insureds and underwriting as well as the negotiation and issuance of policies. (The insurance laws of each state must be reviewed separately as the states do not define the conduct of an insurance business uniformly.)

States regulate insurers operating within their borders, i.e., conducting an insurance business within the state, through the licensing process. Insureds resident within a particular jurisdiction are free to contract with insurers licensed within such jurisdiction. Typically, insurance placed with licensed carriers is conducted through licensed agents or brokers. States tax licensed insurers on these placements by imposing premium taxes on the insurers.

The legislatures of every state have provided exceptions to the doing-business laws for the transactions of a surplus lines business. Although surplus lines insurers are unlicensed, the surplus lines industry is not unregulated. Surplus lines regulation is accomplished principally by the regulation of licensed surplus lines brokers who are required in most cases to deal only with authorized surplus lines insurers (which, in turn, are required to possess certain minimum capital and surplus) and execute an affidavit stating that the risk was placed with the surplus lines insurer only after the broker executing the affidavit had conducted a diligent search of licensed insurers (usually three to five) that had declined to underwrite the risk.

As surplus lines insurers do not conduct an insurance business within the states, states do not tax them directly. Rather, state statutes generally require surplus lines taxes to be remitted by the surplus lines broker.

Self-procurement mechanisms are distinguishable from both licensed and surplus lines placements because there is no party to the transaction (i.e., insurer or broker) that is licensed by the state in which the insured is located. Nonetheless, most states also have provided some insurance regulatory exemption for direct procurement, i.e., direct access to an unlicensed, unauthorized insurer. Unlike surplus lines laws, the thrust of self procurement laws is not to regulate the transaction but to tax the transaction after the fact.

Unlicensed, unauthorized insurers include not only traditional insurers that have neither obtained licenses in a state nor become a qualified surplus lines insurer therein, but also most captive insurance companies as they typically do not become either extensively licensed outside their domicile jurisdiction or authorized to write coverages on a surplus lines basis.

The content of self-procurement statutes varies from state to state. In general, however, they take the form of either a direct placement statute or an industrial insured statute. In most cases, these appear as exceptions to, or exemptions from, the "doing business" provisions, i.e., an unlicensed, unauthorized insurer will not be considered to be doing business within the state if there is compliance with the provisions of the exception or exemption. In addition, there is a basis for direct placement that is quasi-statutory and based on case law (which is discussed later).

Direct Placement Statutes

In general, it may be said that direct placement statutes codify a right of an insured to contract with an unlicensed insurer outside the insured's state of domicile. These statutes, however, vary from state to state and, given that strict compliance is necessary, each should be reviewed carefully. Compare, for example, the New York and Colorado statutes.

The New York statute exempts "transactions with respect to policies of insurance on risks located or resident 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...."

The Colorado statute exempts "[t]ransactions involving contracts of insurance independently procured through negotiations occurring entirely outside of this state which are reported and on which premium tax is paid...."

Although the New York Insurance Law also requires reporting and payment of appropriate taxes, it is clear that there are differences between the two statutes. Most statutes are similar to the Colorado example, and exempt transactions only if all elements (including the negotiation, issuance, delivery of the policy and the payment of premium) occur wholly outside the insured's state. Negotiations by mail or telephone from within the state are not exempted, and insurance agents or brokers licensed in the insured's domicile may not generally be involved as such.

The basis for imposing premium taxes also varies from state to state, with many states conditioning the effectiveness of the exemption upon reporting of the transaction and the payment of tax by the insured. The rate of tax is generally the same as the surplus lines tax rate.

As noted above, variations do exist. One prominent example is California, which does not couch its direct procurement provision as an exemption from, or exception to, the doing-business laws. Instead, the California statute merely states that "[a]ny person may negotiate and effect insurance to protect himself, herself, or itself against loss, damage or liability with any nonadmitted insurer." As is the case with most other states, California imposes a tax and reporting requirement on insurance procured in reliance on this provision.

Industrial Insured Statutes

Industrial insured exemptions to the doing-business laws exist in 21 states. This exemption permits corporations that meet a statutory standard of sophistication to procure insurance from unlicensed insurers.

This sophistication standard varies somewhat among the states, but typically requires that the insured: (1) must procure insurance by utilizing the services of either a full-time employee acting as an insurance manager or buyer or a regularly and continuously retained qualified insurance consultant; (2) must have aggregate annual premiums on all of its insurance totaling at least $25,000 (some states have sought to increase this amount); and (3) must have at least 25 full-time employees.

Industrial insured placements are typically made by the corporation's risk manager. Because industrial insured exemptions are complete exemptions to the doing-business laws, certain in-state activities by insurers that are prohibited in direct placements are permissible under industrial insured placements.

Insureds pay a premium tax on these placements in virtually all 21 states that have enacted industrial insured exemptions. The tax rate is generally the same as the rate applied to surplus lines placements.

Case Law

There are a number of jurisdictions that have enacted neither direct placement nor industrial insured exemptions. With regard to these jurisdictions, there is nevertheless a basis for accessing unlicensed, unauthorized carriers based on long-standing case law. However, certain recent cases appear to have somewhat contracted this basis.

In *Allgeyer v. Louisiana*, which was decided in 1897, the United States Supreme Court ruled that a citizen of a state has the inalienable right under the due process clause of the Fourteenth Amendment of the U.S. Constitution to contract for insurance with an unlicensed carrier--so long as the contract is concluded outside of the state. In that case, Louisiana had enacted a statute that fined anyone who effected insurance on property in Louisiana with an unlicensed marine insurer. The case involved the placement of coverage by a Louisiana insured on goods in transit from Louisiana to New York with an insurer domiciled and licensed in New York (but not in Louisiana) and which conducted no activities in Louisiana.

The insured, E. Allgeyer & Co., was charged by Louisiana with mailing the insurer a communication requesting coverage under an open policy of marine coverage on 100 bales of cotton payable in Paris. At the time of the communication the bales of cotton were located in Louisiana. The Supreme Court held that the insurer had not conducted the business of insurance within Louisiana and had not subjected itself to the provisions of Louisiana law.

In *St. Louis Cotton Compress Co. v. State of Arkansas*, the United States Supreme Court considered the constitutionality of an Arkansas premium tax imposed on premium paid to an unlicensed insurer. Under the facts of the case, a Missouri insured placed coverage under a multi-state policy with a known insurer that covered Arkansas property. The insurer conducted no business in the state of Arkansas. The Court held that based on the facts the statute was invalid under the due process clause of the Fourteenth Amendment.

In *Connecticut General Life Insurance Co. v. Johnson*, the Supreme Court held a California premium tax on a foreign corporation to be unconstitutional under the due process clause. In that case, California sought to impose the tax on premiums paid pursuant to reinsurance contracts entered into by a California insurer, a Connecticut reinsurer licensed in California. The contracts were entered into in Connecticut, where premiums were paid and losses were payable.

Allgeyer, St. Louis Cotton Compress and Connecticut General Life Insurance were decided before the enactment of the McCarran-Ferguson Act in 1945. This act clarified that the power to regulate and tax insurance is within the exclusive province of the states. The legislative history of the McCarran-Ferguson Act unambiguously states that this power is subject always to the limitations set by the Allgeyer, St. Louis Cotton Compress and Connecticut General Life Insurance decisions.

Relying upon this legislative history and citing these decisions as precedent, the court in *State Board of Insurance v. Todd Shipyards Corp.* invalidated a Texas premium tax levied on a wholly out-of-state transaction where the only Texas contact was that the insured property was located in the state. The insurance at issue was a multi-state policy issued by unlicensed U.K. insurers that insured the Texas property of a New York corporation that was licensed in Texas. In finding that due process, as well the McCarran-Ferguson Act, limited the state's power to tax this transaction, the Court gave great weight to the following facts: the policy was negotiated and issued outside of Texas; the premium was paid outside the state; and all losses were adjusted and paid outside of Texas. In addition, the insurers were not licensed in Texas, had no offices or agents in Texas, did not solicit business in Texas and did not investigate risks or claims in Texas.

With reference to the Allgeyer, Connecticut General and St. Louis Cotton Compress cases embodied in the legislative history of the McCarran-Ferguson Act, the last sentence of the majority opinion in Todd states: "... Congress tailored the new regulations for the insurance business with specific reference to our prior decisions. Since these earlier decisions are part of the arch on which the new structure rests, we refrain from disturbing them lest we change the design that Congress fashioned."

At least two state supreme courts have recognized the Todd Shipyards analysis as the prevailing approach to determine whether a state has the power to regulate and tax an insurance transaction. In these cases Todd Shipyards was distinguished on grounds of activities conducted in the state relating to the insurance process. *In Ministers Life & Casualty Union v. Hasse*, the Supreme Court of Wisconsin held that the state could tax a mail order life and health insurer that was not licensed in the state if there was a systematic and continuous solicitation of Wisconsin citizens by mail and the use of Wisconsin investigatory services and physicians for claims settling and underwriting purposes. Similarly, in *Howell v. Rosecliff Realty Co.*, in which premium was paid to an unlicensed insurer outside the state of New Jersey with regard to a public liability policy, the court recognized that the nature of a public liability policy obliged the insurer to investigate, settle and pay claims within New Jersey, and as such, the policy may be taxed by the State of New Jersey.

In *Associated Electric & Gas Insurance Services, Ltd. v. R. Gary Clark*, the Rhode Island Supreme Court affirmed a District Court decision holding that the insurer, which was neither a licensed insurer nor an authorized surplus lines insurer in the state, was liable for premium tax on direct placement coverage provided to several

Rhode Island insureds. The taxpayer's defense was based principally on the Todd case; and the stipulated facts provided that no representatives from the company came into Rhode Island and no agent fees were paid by the company to Rhode Island residents. The Rhode Island Court found that the tax was due. In effect, it held that, for two reasons, Todd, Allgeyer, Connecticut General, and St. Louis Cotton Compress were tacitly overruled.

First, the court referred to a series of cases, each of which had distinguished the Todd line of cases, and each of which had its appeal to the U.S. Supreme Court dismissed for lack of a federal question. The Rhode Island Supreme Court found that such a dismissal was a determination on the merits.

The Rhode Island Supreme Court also found that the Todd doctrine was superceded by *Quill Corporation v. North Dakota*. In the Quill case, the U.S. Supreme Court held that Quill Corporation, a mail order business incorporated in Delaware with no sales force and insignificant tangible property in North Dakota, was not required to collect a use tax levied by North Dakota from its North Dakota customers. The court ruled that the imposition of such duty to collect taxes did not violate the due process clause of the Fourteenth Amendment as Quill annually mailed 24 tons of catalogs and flyers into North Dakota and made annual sales approaching $1,000,000 to North Dakota customers. Notwithstanding its holding that the due process clause did not bar the imposition of the tax, the Supreme Court held that the physical presence test of *National Bellas Hess* should be followed on the basis of the Commerce Clause.

It is at least questionable whether the McCarran-Ferguson Act, which is also rooted in the Commerce Clause (and which forms a basis for the Todd decision) is consistent with the decision of the Rhode Island Supreme Court.

If the theory of the Rhode Island case were to spread throughout the country, it is likely that there would be a significant erosion of the ability of unlicensed and unauthorized insurers (and reinsurers) to provide coverage for risks located within a state with which they have no other contact without being subject to tax. Similarly, if the expansive trend of decisions regarding state tax jurisdiction were followed with reference to taxes on insurance premiums without regard to Todd or to the principles of Connecticut General and the other cases discussed in the legislative history of the McCarran-Ferguson Act, the ability of a state to tax insurance transactions would be greatly expanded.

Perhaps the broadest recent extension of tax jurisdiction is found in *Geoffrey, Inc. v. South Carolina Tax Commission*, a case decided by the South Carolina Supreme Court in 1993. The court applied the due process reasoning of the Quill case and sustained South Carolina's right to tax the royalty income of Geoffrey, Inc., a wholly-owned, second tier subsidiary of Toys R Us, Inc., which is incorporated in Delaware, had no employees or offices in South Carolina and owned no tangible property in the State. The court found that Geoffrey, Inc. purposefully directed its activities at South Carolina residents because the company owned intangible property in South Carolina--a franchise that generated revenue--and, therefore, South Carolina could tax that revenue without violating the due process clause. This reasoning is very similar to that employed by the Rhode Island Supreme Court, although the Geoffrey court was not faced with Todd/McCarran-Ferguson issues.

Application to Captives

The foregoing discussion of insurance cases applies not only to an insured dealing with an unrelated, unlicensed and unauthorized insurer but also to domestic and foreign captives. Although a number of arguments may exist as to why taxes imposed under direct placement and industrial insured statutes may not be applicable to premiums paid under certain alternative risk mechanisms (for example, premium paid to a single parent captive that is not deductible for federal income tax purposes or premiums paid under a policy where there is no risk transfer), such arguments may not be readily embraced by states seeking additional taxes in times of diminishing revenue.

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