Debevoise & Plimpton Financial Institutions Report

September 2011 | Volume 5 | Number 6

Transacting Insurance Without a License in the U.S. – The Reinsurance Exception

By John Dembeck

WHAT'S INSIDE

2 Cyber-Security Threats: A Matter of Regulatory Focus and Guidance

4 Additional Investments in U.S. Insurers – New Regulatory Filing Requirements

It is often said that reinsurance is not regulated by the states of the U.S. This may be in large part because many states do not apply product regulation rules to reinsurance contracts, exempt reinsurance from the requirement that an insurer be licensed to transact insurance in the state and only impose requirements on reinsurance agreements through the imposition of conditions to a U.S. ceding insurer obtaining credit for the reinsurance on its statutory financial statements.

The purpose of this article is to (i) examine the history and sources of the reinsurance exemptions from the requirement that an insurer be licensed to transact insurance in the state that have been developed over the years and that have been utilized in various states, and (ii) survey available case law and other interpretive materials that construe these reinsurance exemptions. A survey of the laws of the U.S. states that exempt reinsurance from the requirement that an insurer be licensed to transact insurance in the state is available by clicking here.

There may be other reasons to avoid transacting insurance in a state even if the transaction is an exempt reinsurance transaction, such as engaging in acts in a state that constitute designation of the domestic state insurance regulator as agent for service of process and that require pre-answer security in the case of litigation and being subject to U.S. federal income tax. These matters are outside the scope of this article.

The Problem – Mail Order Insurance

The problem of unauthorized insurance was mentioned in proceedings of the National Association of Insurance Commissioners (the "NAIC") as long ago as 1855. By the mid-1880's, the NAIC had appointed a committee to address the question. By the early 1900's, the problem became that of mail order insurers – unauthorized insurers, principally health insurers, that used the mails to solicit insurance in states in which they were not licensed.[1]

Legislative proposals, both federal and state, had been made over the years to address unauthorized insurers and mail order insurance. In many cases, exemptions were proposed to these proposals. One common exemption was an exemption for reinsurance. Since one or more of these reinsurance exemptions form the basis for the reinsurance exemption contained in current state insurance laws, we review the key legislative proposals and their applicable reinsurance exemptions.

Hobbs Bill (1935)

Representative R.P. Hobbs introduced H.R. 6452 in the U.S. House of Representatives on March 6, 1935 relating to regulating the use of the mails with respect to insurance contracts that sought to address the mail order insurance problem directly as a matter of federal law. The bill made it unlawful for any person to use the U.S. mails to solicit, negotiate or effect insurance, transmit insurance policies, collect insurance premiums or report insurance transactions unless the person first complied with the insurance law or respective states where the insurance contracts were solicited, negotiated or effected and the laws of the respective states where the property insured or subject matter of the insurance was located. Monetary and criminal penalties could be imposed for violation of

Continued on page 6

Cyber-Security Threats: A Matter of Regulatory Focus and Guidance

By Satish M. Kini and Thomas S. Wyler

In recent months, a wide number of institutions have been targets of high-profile cyber-security attacks. These attacks, which have breached institutional security measures to reveal a variety of confidential and proprietary data, have hit financial institutions, defense contractors and government institutions. The sophistication and frequency of the attacks has drawn the attention of U.S. financial regulators. In fact, the U.S. Financial Stability Oversight Council ("FSOC"), which is charged by the Dodd-Frank Act with responsibility for assessing potential systemic risks posed to the U.S. financial system, has made specific references to the dangers of cyber-security threats to U.S. financial services providers. To this end, in its first annual report to Congress, FSOC noted that cyber-intruders have stolen "hundreds of millions of dollars" by exploiting firms' data system vulnerabilities and noted regulatory efforts to address these vulnerabilities.

The most detailed response to the cyber-threats – which response FSOC cited favorably – was issued by the Federal Financial Institutions Examination Council (the "FFIEC"). In June 2011, the FFIEC supplemented previously issued guidance and updated regulatory expectations regarding customer identification, layered security and other responses to "an increasingly hostile online environment." We review briefly the original guidance and then examine more closely the newly revised guidance (the "Updated Guidance").

Original Guidance. In October 2005, the FFIEC published guidance entitled "Authentication in an

FINANCIAL INSTITUTIONS PARTNERS AND COUNSEL

The *Debevoise & Plimpton Financial Institutions Report* is a publication of

Debevoise & Plimpton LLP
919 Third Avenue
New York, New York 10022
+1 212 909 6000

www.debevoise.com

Washington, D.C.
+1 202 383 8000

London
+44 20 7786 9000

Paris
+33 1 40 73 12 12

Frankfurt
+49 69 2097 5000

Moscow
+7 495 956 3858

Hong Kong
+852 2160 9800

Shanghai
+86 21 5047 1800

All contents © 2011 Debevoise & Plimpton LLP. All rights reserved.

Gregory J. Lyons
Nicholas F. Potter
Editors-in-Chief

John Dembeck
David A. Luigs
Managing Editors

Michael K. McDonnell
Sean P. Neenan
Deputy Managing Editors

Gregory J. Lyons
Sean P. Neenan
Issue Editors

The articles appearing in this publication provide summary information only and are not intended as legal advice. Readers should seek specific legal advice before taking any action with respect to the matters discussed herein. Any discussion of U.S. Federal tax law contained in these articles was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. Federal tax law.

All lawyers based in New York, except where noted.

Corporate and Capital Markets
Marwan Al-Turki - London
Kenneth J. Berman - D.C.
E. Raman Bet-Mansour - London
Paul S. Bird
Michael W. Blair
Craig A. Bowman
Thomas M. Britt III - Hong Kong
Pierre Clermontel - Paris
John Dembeck
Michael D. Devins
Wolcott B. Dunham, Jr.
Edward Drew Dutton - Hong Kong
Sarah A.W. Fitts
Gregory V. Gooding
Christopher Henley - London
Stephen R. Hertz
Jeremy G. Hill - London
Emilie T. Hsu
Ethan T. James
Matthew E. Kaplan
Alan Kartashkin - Moscow
Thomas M. Kelly
James A. Kiernan III - London
Satish M. Kini - D.C.
Antoine Kirry - Paris
Patrick Laporte - Paris
Paul L. Lee
Linda Lerner
Guy Lewin-Smith - London
Byungkwon Lim
Peter J. Loughran
David A. Luigs - D.C.
Gregory J. Lyons
Marcia L. MacHarg - Frankfurt
Ivan E. Mattei
Dmitri V. Nikiforov - Moscow
Steven Ostner
Andrew M. Ostrognai - Hong Kong
Alan H. Paley
Nicholas F. Potter
Robert F. Quaintance, Jr.
William D. Regner
Paul M. Rodel
Jeffrey E. Ross
Thomas Schürrle - Frankfurt
James C. Scoville - London
Keith J. Slattery
Steven J. Slutzky
Andrew L. Sommer
John M. Vasily
Peter Wand - Frankfurt
Niping Wu - Shanghai

Employee Compensation & Benefits
Lawrence K. Cagney
Jonathan F. Lewis
Elizabeth Pagel Serebransky
Charles E. Wachsstock

Investments and Workouts
Steven M. Alden
Katherine Ashton - London
William B. Beekman
Hans Bertram-Nothnagel - Frankfurt
Colin Bogie - London
Alan J. Davies - London
Robert J. Gibbons
Steven R. Gross
Richard F. Hahn
Peter Hockless - London
M. Natasha Labovitz
George E.B. Maguire
Darius Tencza
My Chi To

Litigation
Frederick T. Davis - Paris
Eric. R. Dinallo
Donald Francis Donovan
Martin Frederic Evans
Mark W. Friedman
Lord Goldsmith QC - London
Mark P. Goodman
Robert D. Goodman
Donald W. Hawthorne
Mary Beth Hogan
John S. Kiernan
Gary W. Kubek
Carl Micarelli
John B. Missing - London
Joseph P. Moodhe
Michael B. Mukasey
David W. Rivkin
Edwin G. Schallert
Lorna G. Schofield
Colby A. Smith - D.C.
Mary Jo White
Bruce E. Yannett

Tax
Pierre-Pascal Bruneau - Paris
Peter A. Furci
Friedrich E.F. Hey - Frankfurt
Seth L. Rosen
Hugh Rowland, Jr.
Peter F.G. Schuur
Richard Ward - London

New Cyber-Security Requirements

Continued from previous page

Internet Banking Environment" ("2005 Guidance"). The 2005 Guidance was intended to provide an appropriate risk-management framework to banking firms that offer internet-based products and services. Among other things, the 2005 Guidance (i) required banking firms to use risk-based techniques to verify the identity of a customer; (ii) provided supervisory guidance for general transactions, and additional guidance for riskier transactions that access customer information or move funds to other parties; and (iii) required banking firms to perform periodic risk-based assessments of the evolving threat environment.

Updated Guidance. The Updated Guidance is intended to fill in gaps that have emerged as the threat landscape has evolved since 2005. As in the 2005 Guidance, the Updated Guidance lays out regulatory expectations relating to security programs, customer authentication and customer education.

Specific Supervisory Expectations. As with the 2005 Guidance, the Updated Guidance calls on banking firms to conduct periodic risk assessments and to adjust customer authentication measures in response to the development of new threats. Updated risk assessments should consider: general changes in the threat environment; changes in the customer base; changes in the functions customers are interested in; and incidents and patterns of security breaches.

The Updated Guidance suggests that banking firms should implement more robust controls when dealing with high-risk transactions. According to the guidance, business and commercial transactions generally pose greater risk and, thus, require an increased level of security.

Layered Security Programs. The Updated Guidance calls on a layered security approach for internet-based systems. Such an approach is characterized by the use of different controls at different points in a transaction, which compensates for weakness in any single control through strength in a different control. The Updated Guidance lists some examples of effective controls that may be used in a layered security program, including: fraud detection and monitoring systems, dual customer authorization through different access devices and techniques to appropriately limit the transactional use of an account.

The Updated Guidance also notes that, as a key element, a well-designed layered security program should include processes that are capable of detecting and responding to suspicious activities. The FFIEC notes that manual or automated monitoring for out-of-the-ordinary transactions could have detected and prevented many frauds.

The FFIEC also suggests that, for business accounts, layered security should include enhanced controls for system administrators who are granted privileges to set up or change system configurations, such as setting access privileges and application configurations and/or limitations. These enhanced controls should exceed the controls applicable to routine business customer users.

Authentication Techniques. The Updated Guidance notes that firms can no longer rely on simple device identification processes. The Updated Guidance notes that many financial institutions traditionally have used a basic cookie or internet protocol address matching process to confirm that a device is enrolled to a specific customer. The Updated Guidance suggests that such simple security measures are insufficient to address the sophisticated techniques used by fraudsters. The Updated Guidance notes that, while no single method of device authentication can mitigate all threats, a sophisticated technique that uses "one-time" cookies and creates a more complex digital "fingerprint" by looking at a variety of characteristics has proven to be effective.

The Updated Guidance also notes that many institutions continue to use "challenge questions" as a mechanism for identification. The Updated Guidance suggests that this tool can be effective but suggests using sophisticated questions, the answers to which cannot be found in a customer's wallet. As part of this process, the Updated Guidance suggests the use of "red herring" questions that will fool fraudsters but not legitimate customers, who will recognize the questions as nonsensical.

Customer Awareness and Education. Finally, the Updated Guidance touches on the importance

New Cyber-Security Requirements

Continued from previous page

of education and awareness and includes minimum elements of an effective customer education program. Those minimum elements include providing retail and commercial account holders with:

- an explanation of protections provided for electronic funds transfers under Regulation E;
- an explanation of the circumstances under which an institution may contact a customer on an unsolicited basis and request that the customer provide electronic banking credentials;
- a suggestion that commercial online banking customers periodically perform their own risk and controls assessment;
- a list of alternative risk control mechanisms that customers may consider implementing; and
- a list of institutional contacts for customer use in the event that they notice or experience something suspicious related to their account.

Conclusion

The FFIEC has said that bank examiners will begin to assess banking firm cyber-safeguards under the new standards commencing in January 2012. Banking firms and other financial institutions may do well to pay close attention to the Updated Guidance, not only to meet new regulatory expectations but also to address the growing and significant threat of cyber-threats. These threats pose substantial risks to firm and customer data and, as recent high-profile cases have shown, pose even more significant reputational risks to firms. ■

Satish M. Kini is a partner and Thomas S. Wyler is an associate in Debevoise & Plimpton LLP's Washington, D.C. office.

smkini@debevoise.com
tswyler@debevoise.com

Additional Investments in U.S. Insurers – New Regulatory Filing Requirements

By John Dembeck and Mike D. Devins

As we reported in the February 2011 Financial Institutions Report ("Recent Changes to the NAIC Insurance Holding Company Model Act and Model Regulation"), the National Association of Insurance Commissioners ("NAIC") adopted amendments to its Insurance Holding Company System Regulatory Act in December 2010. So far, the following states have enacted changes to their insurance holding company laws based on the 2010 Model Act amendments: Rhode Island (effective May 27, 2011), Texas (effective September 1, 2011) and West Virginia (effective July 1, 2012). The purpose of this article is to describe new filings that will be required in states that enact the 2010 Model Act amendments that may apply if an approved controlling person of a U.S. insurer or its parent makes an additional investment by acquiring additional voting securities from another person that is disposing of 10% or more of the voting securities of the insurer.

Form A Approval Requirement

Under the Model Act, both before and after the 2010 Model Act amendments, a person that acquires control (a person is presumed to control a U.S. insurer if it acquires 10% or more of the voting securities of the U.S. insurer or its parent) must generally file a "Form A" application to acquire control of the insurer with the insurer's domestic state insurance regulator and obtain the approval of the regulator. However, absent any commitment delivered by the acquiring person or any condition imposed on the acquiring person by the regulator as part of its approval, if the acquiring person is approved as a controlling person, no additional "Form A" filing or approval is required for the person to acquire an additional 10% or more of the voting securities of the insurer. However, in states that enact the 2010 Model Act amendments, two additional filings and one possible additional approval may be required for such an additional investment by an approved controlling person.

New Divestiture of Control Filing

The 2010 Model Act amendments added the following Section 3.A(2) to the Model Act:

For purposes of this section, any controlling person of a domestic insurer seeking to divest its controlling interest in the domestic insurer, in any manner, shall file with the

Continued from previous page

commissioner, with a copy to the insurer, confidential notice of its proposed divestiture at least 30 days prior to the cessation of control. The commissioner shall determine those instances in which the party(ies) seeking to divest or to acquire a controlling interest in an insurer, will be required to file for and obtain approval of the transaction. The information shall remain confidential until the conclusion of the transaction unless the commissioner, in his or her discretion determines that confidential treatment will interefere with enforcement of this section. If the statement referred to in Paragraph (1) [the Form A statement] is otherwise filed, this paragraph shall not apply.

This provision was designed to require possible regulatory approval by an existing controlling person that seeks to divests itself of 100% of a U.S. insurer but does so in a transaction in which no new person acquires a controlling (10% or more of voting securities) stake. This provision was recommended by the Pennsylvania Insurance Department after a Pennsylvania court rejected the Department's claim that regulatory approval was required when Kingsway Financial Services disposed of 100% of the voting securities of Lincoln General Insurance Company, a Pennsylvania domestic insurer, by gifting 5% of voting securities to each of 20 charities. See May 2010 Financial Institutions Report ("U.S. Insurance Holding Company Act Litigation").

However, this new Section 3.A(2) may have an unintended consequence. It also requires that a person that seeks to sell a controlling (10% or more of voting securities) stake in a U.S. insurer to a person that already is an approved controlling person of that insurer file a confidential notice of its proposed divestiture at least 30 days prior to the cessation of control with the insurer's domestic state insurance regulator. The regulator will then have the right to require that the divesting person file for and obtain approval of the transaction. While the last sentence of Section 3.A(2) exempts the divesting person from this filing requirement if the acquiring person is not an approved controlling person and must itself file and obtain approval for its acquisition of control of the insurer, the exemption does not apply to an already existing approved controlling person.

Therefore, if, for example, Party A and Party B are each approved controlling persons of a U.S insurer owning 40% and 30% of the voting securities of the insurer, respectively, and Party B decides to sell its 30% stake to Party A, then, if the U.S Insurer's domestic state has enacted the 2010 Model Act amendments, Party B must make this divestiture filing under Section 3.A(2). One can only hope that the domestic state insurance regulator will determine that no filing and approval for the divestiture is required by the divesting person since the acquiring person is already an approved controlling person.

Pre-Acquisition Notification

The 2010 Model Act amendments also added the following Section 3.A(3) to the Model Act:

With respect to a transaction subject to this section, the acquiring person must also file a pre-acquisition notification with the commissioner, which shall contain the information set forth in Section 3.1C(1). A failure to file the notification may be subject to penalties specified in Section 3.1E(3).

The pre-acquisition notification is a filing on "Form E" that discloses any potential anti-competitive market concentration that may result from the proposed transaction. Because this new Section 3.A(3) applies with respect to a "transaction" subject to "this section" (Section 3), it applies to a divestiture transaction under new Section 3.A(2). Therefore, Section 3.A(3) will apply to a divestiture transaction like the scenario described above – Party B selling its 30% stake to Party A, an approved controlling person with an existing 40% stake. Since Party A is already an approved controlling person, such a divesture alone should never result in additional market concentration. However, since a filing is required, consideration might be given to the acquiring person filing a letter stating as much in lieu of filing an actual Form E pre-acquisition notification. We expect that this is also an unintended consequence of Section 3.A(3) but one which imposes a technical but purposeless filing burden on the acquiring person in the above-described scenario.

Conclusion

It will be important to monitor the states that enact the 2010 Model Act amendments to be sure that any divesting and acquiring persons comply with the requirements of new Section 3.A(2) and Section 3.A(3). ■

John Dembeck and Mike Devins are counsel in Debevoise & Plimpton LLP's New York office.

jdembeck@debevoise.com
mddevins@debevoise.com

Transacting Insurance – The Reinsurance Exception

Continued from previous page 1

the bill and enforcement was to be made by the U.S. Department of Justice. However, H.R. 6452 included an exemption for "contracts of reinsurance."

In a report of the Subcommittee of the Committee on the Post Office and Post Roads on a series of hearings on H.R. 6452, Mr. Hobbs explained the reason for the reinsurance exemption as follows:

The matter of contracts of reinsurance is in a sphere by itself. . . . What I had in mind there was that a reinsurance group domiciled in New York State, for instance, has no solicitation in mind, and it has no practice similar to the practices of these fly-by-night [mail order] companies. It has correspondents who are in difficulty, or who make a general practice, because of their lack of financial ability, of not assuming all the risk incident to an insurance transaction. I did not think that should be made a violation of law to use the mails for that purpose when the original insurer had complied with the insurance laws of the various State in which it operates and where the use of the mails had not been denied to the original insuring company for the solicitation of that business from the people – I do not think it should be a violation of law, or that the use of the mails should be denied to that company which had complied, merely transmitting an order for reinsurance.[2]

Notwithstanding the hearings which were held over five days and which attracted much attention in the form of statements, letters and telegrams from many insurance trade associations and individual insurers and producers, H.R. 6452 was never reported out of committee. Nevertheless, the proposal was clearly intended to exempt contracts of reinsurance from its prohibitions. The NAIC "condemned" H.R. 6452.[3]

Uniform Unauthorized Insurers Act (1938)

A Uniform Unauthorized Insurer Act was approved by the National Conference of Commissioners on Uniform State Laws and the American Bar Association in 1938. While not a barring the transaction of business by unauthorized insurers as such, the Uniform Act prohibited persons from acting as a agent for an unauthorized insurer, aiding an unauthorized insurer or even representing or aiding an insured in effecting insurance on property or risks in another state with an unauthorized insurer in that state. However, these prohibitions did not apply to "contracts of reinsurance." The NAIC did not concur with this Uniform Act and believed it to be inadequate.

NAIC Reciprocal Licensing Law (1941)

In 1941, the NAIC adopted a resolution that acknowledged the "great injustice" caused by the transaction of unauthorized insurance business by foreign and alien insurers to those insurers and their agents that complied with state insurance laws and urged each state insurance regulator to urge their legislatures to enact a "reciprocal licensing law" – a law that provided that, if the domestic state insurance regulator determined that a domestic insurer transacted or attempted to transact or solicited business in a state in which it was not licensed, the domestic state insurance regulator would have a duty to revoke the certificate of authority of the offending domestic insurer. While there was no express reinsurance exemption in this recommended statutory proposal, "transacting business" was defined in the proposal in such a way as to indicate that it was directed to soliciting direct insurance by advertisement or "cicularization."[4]

At least one state (Mississippi – 83-19-69) still retains a reciprocal licensing law like provision.

NAIC Unauthorized Insurers Service of Process Act (1948)

The NAIC first adopted an Unauthorized Insurers Process Act in 1948, portions of which were patterned on the Uniform Unauthorized Insurers Act of 1938. Among other things, the Act defined certain acts which, if effected by mail or otherwise in the state by an unauthorized insurer, would constitute an appointment of the unauthorized insurer of that state's insurance regulator as agent for service of process on the unauthorized insurer. While there was no express reinsurance exemption in the Act, the purpose clause of the Act indicated that it was directed to acts involving direct insurance – the subject of concern was residents holding insurance policies of unauthorized insurers "thus presenting to such residents the often insuperable obstacle of resorting to distant forums for the

purpose of asserting legal rights under such policies."[5]

The essence of this Act is now contained in the NAIC Nonadmitted Insurance Model Act (1994) discussed below.

> It is in the public interest that large policies be issued quickly and efficiently. To do this requires access not only to a large number of United States companies, but to the international reinsurance market.

NAIC Draft Non-Admitted Insurance Act (1962)

The NAIC Unauthorized Insurance Committee was instructed in April 1960 to prepare a draft non-admitted insurers act. The Committee drafted a Non-Admitted Insurance Act that generally prohibited a person in the state from acting as an agent for, or representing or aiding on behalf of another, any unauthorized insurer, in the solicitation, negotiation, procurement or effectuation of an insurance contract, or delivering an insurance contract, or collecting or forwarding premiums, "or in any other manner represent or assist such an insurer in the transaction of insurance with respect to subjects of insurance resident, located or to be performed in this State." Exemptions included surplus lines insurance (which the balance of the Act regulated) and reinsurance. The first,[6] third[7] and fourth[8] drafts of the Act provided an exemption for "[r]einsurance effectuated with the insurance laws of this State." The fifth and final April 15, 1962 draft[9] of the Act provided for an exemption for "[r]einsurance." Committee minutes do not explain the reason for the change. This Act was "received" by the Committee with the understanding that the action would not be construed as a disapproval or endorsement of the draft, as its purpose was to was "to make such provisions of this Draft as may be found suitable or helpful available to those states as may wish to use them."

NAIC Unauthorized Insurers Model Act (1969)

History The NAIC again took up the regulation of unauthorized insurance in 1967. The NAIC Laws and Legislation (D) Committee appointed an Advisory Committee on Unauthorized Insurers[10] that presented three reports to the Committee. In the First Report (submitted June 4, 1968),[11] the Advisory Committee set out a history of the unauthorized insurer problem and included a discussion of areas of non-applicability. An Appendix to the First Report contains a detailed chronology of the unauthorized insurer problem. One area of non-applicability was reinsurance. The Advisory Committee recommended the following:

D. Reinsurance. The proposed model bill should not be applicable to reinsurance for two reasons.

First, it is well recognized that there is a capacity shortage in reinsurance markets for many property-casualty and liability coverages. The same problem arises in connection with the issuance of the very large policies of life insurance. Large amounts of reinsurance are available only when one uses the entire market capacity and there seems to be no need to restrict reinsurance facilities to admitted companies. Many of the professional reinsurers are admitted in most of the states, but larger risks are usually divided into parts and retroceded to a number of companies many of whom are not admitted in all of the states. It is in the public interest that large policies be issued quickly and efficiently. To do this requires access not only to a large number of United States companies, but to the international reinsurance market.

Second, reinsurance is negotiated between companies rather than members of the general public. The ceding and assuming parties do not need the benefit of additional regulatory protection. In fact they clearly need a continuance of the opportunity to exchange portfolios with as few fetters placed on the arrangements as possible. Rapidly rising insurable values require the maximum possible reinsurance capacity. Reinsurance whether supplied by admitted or unadmitted reinsurers is needed in order to maintain the largest available reinsurance market possible.

The First Report was received by the Laws and Legislation (D) Committee at its meeting on June 17, 1968.[12] The Second Report of the Advisory Committee is

Continued from previous page

largely directed to concerns about the "exemption approach" (the model provided broad prohibitions with specific exemptions) as well as certain exemptions (group insurance, educational institution and industrial insured exemptions).[13] The Third Report of the Advisory Committee observed that "The First Report also set forth the need for four exemptions which have been accepted without challenge to either concept or language: orphan business, surplus lines, reinsurance and ocean marine."[14] The Third Report then discusses the three exemptions that were subject to challenge – industrial insureds, educational institutions and group insurance. The first two of these exemptions were ultimately deleted.

> Rapidly rising insurable values require the maximum possible reinsurance capacity. Reinsurance whether supplied by admitted or unadmitted reinsurers is needed in order to maintain the largest available reinsurance market possible.

The Laws and Legislation (D) Committee adopted the Unauthorized Insurers Model Act on December 2, 1968. The Model Act was subsequently adopted by the NAIC. Model Act § 2(a) provided for an exemption for "[t]he lawful transaction of reinsurance by insurers."[15] Given the reasons presented by the Advisory Committee in its First Report, it seems clear that this reinsurance exemption, although not as simple an exemption as "contracts of reinsurance" (Uniform Unauthorized Insurers Act) or just "reinsurance" (NAIC Draft Non-Admitted Insurance Act), was still intended to allow an insurer in a state to cede risks to a reinsurer without the reinsurer having to be licensed to transact insurance in the state.

This is the most widely used reinsurance exemption in state insurance laws. Twenty states base their reinsurance exemption on this Model Act.

Interpretive Materials

Arizona. In interpreting the "lawful transaction of reinsurance by insurers" exemption in Arizona law, the Arizona Attorney General opined that an insurer need not possess a certificate of authority in Arizona if it only engages in the reinsurance of Arizona risks. As stated by the Arizona Attorney General, "[t]he language of the [reinsurance exemption] is clear and unambiguous: A certificate of authority to transact insurance business in the State of Arizona is not a prerequisite to the lawful transaction of reinsurance."[16]

Connecticut. In considering whether an unauthorized reinsurer must post security before filing a pleading, a Connecticut Appellate Court held that "The language of § 38a-271(b)(2) [the reinsurance exemption] is sweeping and unconditional. It categorically prevents any part of §§ 38a-271 to 38a-278 [the unauthorized insurance act] from being applied to all reinsurance contracts." However, the Court held that the reinsurer could not be excused from posting security since there was no comparable reinsurance exemption from the security requirement and the reinsured did not qualify for the industrial insured exemption.[17]

Hawaii. In citing the Hawaii "lawful transaction of reinsurance by insurers" exemption, the Hawaii Attorney General opined that "the applicability of the insurance laws to a transaction depends on whether that transaction is considered to be one in which insurance is provided or one in which reinsurance [for which an exemption is allowed] is provided."[18]

Illinois. In a case involving the priority of a reinsurance contract claim in an insurance insolvency proceeding, the Illinois Supreme Court reviewed other provisions of the Illinois Insurance Code to seek any differentiations between insurance and reinsurance. The Court held that "section 121-2.02 [transacting insurance], read in conjunction with section 121-2 [the reinsurance exemption], declares that the "lawful transaction of reinsurance by insurers" may be done without a certificate of authority. (Ill.Rev.Stat.1981, ch. 73, par. 733-2.02.) Consequently, if the term "insurance contract" includes a reinsurance agreement, then sections 121-2 and 121-3 would require that reinsurance agreements be made only by insurers with a certificate of authority. However, that

result would be in direct conflict with section 121-2.02. Therefore, the term "insurance contract" cannot include the separate and distinct concept of a reinsurance agreement."[19]

Kentucky. In considering whether an unauthorized reinsurer must post security before filing a pleading, a federal U.S. District Court, construing Kentucky law, contrasted the Kentucky post-answer security law, which applied to any unauthorized insurer, with the Kentucky "any lawful transaction of reinsurance by insurers" exemption to the requirement that an insurer have a certificate of authority in order to transact insurance in the state. The Court held that "While the 'lawful transaction of reinsurance by insurers' does not require a certificate of authority from the insurance commissioner, this certificate exemption does not speak to the participation in litigation by reinsurers."[20]

General. Lastly, one commentator on this Model Act had the following to say about the "lawful transaction of reinsurance by insurers" exemption:

Case law has existed for many years that holds that if a reinsurance agreement is consummated wholly outside the state in which the underlying risks are located, the reinsurer is not transacting business in the state [footnote ommitted]. The [1969] Model Statute takes this one step further and provides that the "lawful transaction of reinsurance" is exempted from the requirement that a certificate of authority be obtained. Consequently, in those states which have enacted the Model Statute, or its equivalent, a reinsurance company can through its own employees or appointed agents conduct a reinsurance business in the state without obtaining a certificate of authority.[21]

NAIC Nonadmitted Insurance Model Act (1994)

In 1992, the NAIC decided to merge three of its model laws relating to unauthorized insurers together into a single model law – the Model Surplus Lines Law, the Unauthorized Insurers Model Act (discussed above) and the Model Nonadmitted Insurance Act. The first drafts of the merged model law, finally named the Nonadmitted Insurance Model Act, provided for an exemption for "[r]einsurance." However, the reinsurance exemption was changed in the June 14, 1994 draft of the Model Act to the following:

(3) Reinsurance provided that, unless the commissioner waives the requirements of this subsection:
(a) The assuming insurer is authorized to do an insurance or reinsurance business by domiciliary jurisdiction and is authorized to write the type of reinsurance in its domiciliary jurisdiction; and
(b) The assuming insurer satisfies all legal requirements for such reinsurance in the state of domicile of the ceding insurer;[22]

This change, together with other changes, were proposed by the NAIC Unauthorized Entities (EX) Working Group and were described as "technical, non-substantive amendments which clarify the intent of the Model to protect the public from illegal transactions involving nonadmitted insurers."[23] At a meeting of the (EX) Subgroup on the Nonadmitted Insurance Model Act held on August 2, 1994, Virginia Commissioner Steven Foster, chair of the Subgroup, asked the New York Insurance Department's Stewart Kier, a Subgroup member and chair of the Nonadmitted Model Act Working Group that developed the Model Act, what was the purpose of subsection (b) of this reinsurance exemption. Mr. Keir stated that the Unauthorized Entities (EX) Working Group recommended the provision to address potential fraud loopholes and explained that one could wrongly claim an insurance transaction was a reinsurance transaction and therefore exempt from regulation, although it might actually be a fraudulent transaction with no actual cession of business.[24] The reinsurance exemption was included without additional change in the final Model Act as § 4.F(3).

Since an unauthorized reinsurer is expected to be properly authorized to do business in its domestic jurisdiction, one would think that so long the risks of a U.S. ceding insurer ceded to an unauthorized reinsurer constitutes reinsurance in the ceding insurer's domestic state, then the unauthorized reinsurer should be exempt from licensing in the ceding insurer's domestic state in order to enter into the reinsurance.

Given that this reinsurance exemption is not a model of clarity, one can be thankful that only one state (Louisiana)

Continued from previous page

exclusively uses this formulation of the reinsurance exemption.

Other State Laws

Some states have taken other approaches to the reinsurance exemption.

Reinsurance, Except as to Domestic Reinsurers (Survey Type A)

Seven states exempt "reinsurance, except as to domestic reinsurers" from the requirement that an insurer obtain a certificate of authority to transact insurance in the state. This exemption seems to broadly exclude all reinsurance involving nondomestic reinsurers but allows continued jurisdiction over activities of a domestic reinsurer in the state. The exception seems innocuous enough since it is generally expected that any domestic reinsurer will be licensed in its domestic state.

Kansas has a similar reinsurance exemption – "contracts of reinsurance issued by an insurer not organized under the laws of this state." Domestic reinsurers are similarly excepted. However, since the reinsurance need only be issued by a nondomestic reinsurer, the Kansas exemption expressly allows reinsurance to be provided by both U.S. and non-U.S. unauthorized reinsurers.

Nevada also has a similar reinsurance exemption but it includes an additional exception – the reinsurance of a domestic insurer by an unauthorized reinsurer will require the Commissioner's written approval. This means that, while an unauthorized reinsurer need not be licensed in Nevada to reinsure a domestic ceding insurer, the domestic ceding insurer must nevertheless obtain the Nevada Commissioner's prior approval for the reinsurance.

> Reinsurance is negotiated between companies rather than members of the general public. The ceding and assuming parties do not need the benefit of additional regulatory protection. In fact they clearly need a continuance of the opportunity to exchange portfolios with as few fetters placed on the arrangements as possible.

Reinsurance or "Contracts of Reinsurance" (Survey Types B and C)

Five states exempt "reinsurance" and four states exempt "contracts of reinsurance" from the requirement that an insurer obtain a certificate of authority to transact insurance in the state. Each of these exemptions seem equally broad – if the transaction constitutes reinsurance, then the reinsurer will be exempt from licensing in the state.

Reinsurance, When Transacted by an Insurer Duly Authorized by its State of Domicile to Transact the Kind of Insurance Involved (Survey Type D)

Three states exempt "reinsurance, when transacted by an insurer duly authorized by its state of domicile to transact the kind of insurance involved" (emphasis added) from the requirement that an insurer obtain a certificate of authority to transact insurance in the state. So, as long as this condition is met by the reinsurer, the reinsurer will be exempt from licensing in the state. Any interesting interpretive question is whether this exemption applies only to unauthorized insurers domiciled in a "state" as defined in the relevant state law, generally meaning a state in the U.S. That is a possible technical reading of the exemption. In that case, the reinsurance exemption may not apply to reinsurance provided by non-U.S. unauthorized reinsurers.

Transaction/Contract of Reinsurance (other than Assumption Reinsurance) (Survey Type E)

Two states exempt a transaction/contract of reinsurance, other than assumption reinsurance, from the requirement that an insurer obtain a certificate of authority to transact insurance in the state. Therefore, if the proposed reinsurance is not assumption reinsurance (a contract by which a "reinsurer" seeks to substitute itself as the obligor under the insurance policies issued by the "ceding insurer"), then so long as the transaction constitutes reinsurance, the reinsurer will be exempt from licensing in the state.

Other Exemption States (Survey Type M)

The following four states have still other variations to the reinsurance exemption.

Transacting Insurance – The Reinsurance Exception

Continued from previous page

California. For reinsurance to be exempt under California law, it must be "[r]einsurance of the liability of an admitted insurer." Hence, the California reinsurance exemption will not allow an unauthorized reinsurer to transact reinsurance in California with an unauthorized ceding insurer.

Florida. For reinsurance to be exempt under Florida law, it must be transacted as "authorized by" the Florida reinsurance credit rules. Reinsurance credit rules do not authorize reinsurance transactions as such – they merely establish conditions to the ceding insurer being allowed credit for the ceded reinsurance. Just because credit is not allowed, the reinsurance may still be reinsurance. So, it is not entirely clear what "authorized by" means in this context. A conservative reading of this condition may be that the reinsurer has the status or posts the required collateral security to allow a ceding insurer to be allowed credit for the ceded reinsurance under the Florida reinsurance credit rules.

New Jersey (Life Reinsurance). New Jersey has different reinsurance exemptions for life and non-life insurers. In the case of life insurers, reinsurance is exempted from "when transacted as authorized under" a section of New Jersey law that defines reinsurance. Since the applicable reinsurance definition is general ("Reinsurance" is a contract under which an originating insurer, called the "ceding insurer," procures insurance for itself in another insurer, called the "assuming insurer," with respect to part or all of an insurance risk of the originating insurer), the condition should be easily met to satisfy this New Jersey reinsurance exemption for life reinsurance.

> While most state laws include a reinsurance exemption to the requirement that an insurer obtain a certificate of authority to transact insurance in the state, outside of the reinsurance exemption contained in the NAIC Unauthorized Insurers Model Act adopted in 1969, there is little uniformity in the way each state approaches the reinsurance exemption.

New York. Like many states, New York law defines the kinds of acts that constitute doing an insurance business for which a license is required. What follows is a list of exemptions. The reinsurance exemption reads as follows: "the following acts or transactions, if effected by mail from outside this state by an unauthorized foreign or alien insurer duly licensed to transact the business of insurance in and by the laws of its domicile, shall not constitute doing an insurance business in this state . . . (g) transactions with respect to the reinsurance of risks of authorized insurers to the extent that such reinsurance is permitted by [the New York Insurance Law]". New York enacted this and other exemptions in 1970 shortly after the NAIC adopted its Unauthorized Insurers Model Act in 1969. Instead of choosing the Model Act reinsurance exemption, New York chose a fairly complicated and somewhat limited reinsurance exemption that has four requirements:

The reinsurance transaction must be with respect to risks of a New York authorized insurer. Reinsurance transactions involving risks of an ceding insurer that is not licensed in New York will not meet this requirement.

The reinsurance must be "permitted" by the New York Insurance Law. Like the Florida law "authorized by" condition, it is not entirely clear what "permitted" means in this context. A conservative reading of this condition may mean that reinsurer has the status or posts the required collateral security to allow a ceding insurer to be allowed credit for the ceded reinsurance under the New York reinsurance credit rules.

Only acts or transactions effected by the unauthorized reinsurer by "mail" from outside New York State are allowed. The New York Insurance Department has construed "mail" to include "email"[25] but mail does not include overnight delivery by Federal Express, United Parcel Service or even the U.S. Postal Service or fax.[26] No in-person meetings in New York or telephone calls placed to New York are allowed under this exemption.

The unauthorized reinsurer must be licensed to transact the business

of insurance in its domiciliary jurisdiction. Since domicile is not limited to a "state," the exemption would extend to both and U.S. and non-U.S. unauthorized reinsurers.

To illustrate the limited scope of this New York reinsurance exemption compared to the NAIC Model Act reinsurance exemption, the New York Insurance Department has opined that "an unauthorized alien insurer which is licensed elsewhere to do insurance of the type to be covered by the reinsurance business it seeks, may send mailings into New York State from outside the State through the United States Postal Service, regarding the placement of reinsurance policies covering risks of authorized insurers, to the extent that such reinsurance is permitted by the Insurance Law, without thereby subjecting itself to doing an insurance business in this State."[27]

Still Other States

There are a few states (District of Columbia, Georgia, Massachusetts, Mississippi and Ohio) which do not have express reinsurance exemptions from the requirement that an insurer obtain a certificate of authority to transact insurance in the state. Nevertheless, there are arguments why these laws may be interpreted as requiring licensing only for direct insurance and not reinsurance.

Conclusion

While most state laws include a reinsurance exemption to the requirement that an insurer obtain a certificate of authority to transact insurance in the state, outside of the reinsurance exemption contained in the NAIC Unauthorized Insurers Model Act adopted in 1969, there is little uniformity in the way each state approaches the reinsurance exemption. Nevertheless, outside of California and New York, the three Survey Type D states (if "state" limits the exemption to a U.S. unauthorized reinsurer) and the five states that have no express reinsurance exemption, the various reinsurance exemptions are broadly drafted and allow any unauthorized reinsurer, U.S. domiciled or not, to engage in a reinsurance transaction with a ceding insurer in the state without having to licensed to transact insurance in the state. ■

John Dembeck is counsel in Debevoise & Plimpton LLP's New York office.

jdembeck@debevoise.com

1. For additional background on mail order health insurance, see Kline, Regulation of Mail Order Accident and Health Insurance, N.Y.. State Ins. Dept. (1949) and J.S. Hanson and T.E. Obenberger, Mail Order Insurers: A Case Study in the Ability of the States to Regulate the Insurance Business, Marquette Law Review, Vol. 50, No. 2, 175 (Nov. 1966).
2. Regulating the Use of the Mails with Respect to Insurance Contracts, Hearing Before a Subcommittee of the Committee on the Post Office and Post Roads, p. 7 (1935).
3. 1941 NAIC Proc. 142.
4. 1941 NAIC Proc. 146.
5. 1949 NAIC Proc. 126.
6. 1960-2 NAIC Proc. 666.
7. 1961-4 NAIC Proc. 361.
8. 1962-4 NAIC Proc. 302.
9. 1962-2 NAIC Proc. 529.
10. 1968-4 NAIC Proc. 121.
11. 1968-2 NAIC Proc. 516.
12. 1968-2 NAIC Proc. 513.
13. 1969-1 NAIC Proc. 233.
14. 1969-1 NAIC Proc 219.
15. 1969-1 NAIC Proc. 222.
16. Az. Atty. Gen. Op. No. I80-054 (Apr. 9, 1980).
17. Hartford Acc. and Indem. Co. v. ACE American Reinsurance Co., 103 Conn. App. 319, 930 A.2d 701 (2007)
18. Ha. Atty. Gen. Op. No. 95-2 (Mar. 8, 1995).
19. In re Liquidations of Reserve Ins. Co., 122 Ill.2d 555, 524 N.E.2d 538, 120 Ill. Dec. 508 (1988). See also, Universal Bonding Ins. Co. v. Esko & Young, Inc., 749 F. Supp. 879 (N.D. Ill. 1990).
20. Stephens v. Nat. Distillers and Chemical Corp., 1994 WL 1091853 (S.D.N.Y. 1994).
21. J.C. Gurley, Regulation of Reinsurance in the United States, 19 Forum 72 (1983).
22. 1994-2 NAIC Proc. 944.
23. 1994-2 NAIC Proc. 911.
24. 1994-3 NAIC Proc. 26.
25. N.Y. State Ins. Dept., unpublished opinion, Letter from Senior Attorney Brenda M. Gibbs to Jerome DaRos (May 29, 2007).
26. N.Y. State Ins. Dept., Selected Opinions of the General Counsel, OGC Op. No. 99-69 (June 10, 1999).
27. N.Y. State Ins. Dept., Selected Opinions of the General Counsel, OGC Op. No. 99-69 (June 10, 1999).