1. What will the NRRA mean for surplus lines regulation?

The Nonadmitted and Reinsurance Reform Act (NRRA) became law on July 21, 2011, one year after it was signed by President Barack Obama and five years after it was first introduced in Congress.

This new law ushers in a new era for surplus lines regulation by implementing a “home state” tax and compliance system. The NRRA closes the chapter on multi-state tax allocation problems that have plagued brokers since the mid 1980s. The problems brokers have experienced with multi-state compliance and multi-state licensing for the placement of a single policy will also become a thing of the past. Below are answers to frequently asked questions that have been raised in connection with the implementation of the NRRA reforms and NAPSLO’s comments about the FAQ’s. For further information and reference, the entire text of the NRRA can be accessed from the NRRA Background website page by clicking on “NRRA Law.”

2. What reforms in the NRRA impact surplus lines insurance?

The most significant reform in the act for surplus lines is the creation of a one-state system of taxation and regulation for surplus lines. As set forth in the NRRA, the “home state” of the insured now has the sole and exclusive authority to tax and regulate a surplus lines transaction. In addition, the insured’s “home state” is the only state that can require a license for conducting a surplus lines transaction, even if that transaction is a multi-state transaction.

The specific NRRA reform provisions are as follows:

A. Home State’s Exclusive Authority—No State other than the home State of an insured may require any premium tax payment for nonadmitted insurance.

B. Home State Authority—Except as otherwise provided in this section, the placement of nonadmitted insurance shall be subject to the statutory and regulatory requirements solely of the insured’s home State.

C. Broker Licensing—No State other than an insured’s “home State” may require a surplus lines broker to be licensed in order to sell, solicit, or negotiate nonadmitted insurance with respect to such insured.
D. Company Eligibility—The NRRA also establishes nationwide uniform eligibility criteria for U.S. surplus lines companies as well as clear criteria for the acceptability in all states of alien insurers.

3. What insurance is impacted by the NRRA?

The NRRA implements reforms for surplus lines insurance, independently procured insurance and reinsurance. This FAQ only discusses the surplus lines insurance reforms.

The surplus lines provisions of the NRRA apply to “nonadmitted insurance”, which means insurance transacted with a nonadmitted insurer by a properly licensed surplus lines broker. The specific definitions used in the NRRA are as follows:

- **Nonadmitted Insurance**—The term “Nonadmitted Insurance” means any property and casualty insurance permitted to be placed directly or through a surplus lines broker with a nonadmitted insurer eligible to accept such insurance.

- **Nonadmitted Insurer**—The term “Nonadmitted Insurer” means, with respect to a State, an insurer not licensed to engage in the business of insurance in such State.

- **Reinsurance**—The term “Reinsurance” means the assumption by an insurer of all or part of a risk undertaken originally by another insurer.

- **Surplus Lines Broker**—The term “Surplus Lines Broker” means an individual, firm, or corporation which is licensed in a State to sell, solicit, or negotiate insurance on properties, risks, or exposures located or to be performed in a State with nonadmitted insurers.

4. When do surplus lines provisions become effective?

Most of the provisions of the NRRA, including the requirement that only one state, the “home state” of the insured, can tax and regulate a nonadmitted/surplus lines insurance transaction became effective July 21, 2011.

However, the NRRA’s requirement that a state must be participating in the NAIC national insurance database or an equivalent database or it will be prohibited from collecting “any fees relating to surplus lines broker licensing” is effective on July 21, 2012.

The bill also provides detail regarding the effective date of a voluntary interstate compact or other tax allocation system, if adopted by the states. If the states do not implement a compact or other tax allocation system within 330 days after the adoption of the NRRA, then a single-state tax system (i.e., each state collects and retains the premium tax it assesses on non-admitted/surplus lines insurance
when it is the insured’s “home state”), becomes effective concurrent the effective date of the NRRA—July 21, 2011.

If the states implement a compact or tax allocation system after the effective date of the NRRA, the allocation system will become effective on the January 1 of the first calendar year following the year the allocation system is adopted, unless the document creating the compact or other tax allocation system sets another date.

5. What will the NRRA reforms mean for surplus lines brokers?

Under the NRRA, surplus lines brokers will return to a single-state tax payment system similar to the one that existed across the country until multi-state tax requirements started to appear in the mid-1980s. In addition, the multiple state compliance requirements that were imposed by the states on multi-state surplus lines transactions following the adoption of the Gramm–Leach–Bliley Act in the early 2000s are eliminated in favor of a one-state compliance approach. These reforms are summarized as follows:

A. Brokers will no longer be required to comply with the tax provisions of each state where a portion of the risk resides. Rather, they will make a single tax payment to the “home state” of the insured which is the only state, under the NRRA, that can require a tax to be paid on a nonadmitted/surplus lines insurance transaction.

B. Brokers will only be required to comply with the placement laws of the insured’s “home state.” Any other state compliance obligations including policyholder notices, diligent search requirements, export list searches, policy fee rules, exempt commercial purchaser provisions and eligibility list searches for a single surplus lines policy placement will no longer apply.

C. A broker will only need one producer’s license from the insured’s “home state” to write a multi-state risk.

D. Insurance placements in the surplus lines market for “exempt commercial purchasers” would be streamlined by the adoption in the NRRA of a nationwide exemption from the state diligent search laws for such purchasers.

E. Congress intends that uniform tax forms and tax procedures are to be implemented by the states.

6. What will NRRA reforms mean for surplus lines insurance companies?

Surplus lines companies receive some significant benefits from the NRRA. Under the NRRA, U.S. domiciled companies will now have their eligibility to write surplus lines insurance in each state and territory determined under uniform eligibility requirements as set forth in the NRRA.
The NRRA provides that for nonadmitted insurers domiciled in the United States, no State can impose or establish surplus lines eligibility standards except in conformance with the requirements found in sections 5A(2) and 5C(2)(a) of the *NAIC Non-Admitted Insurance Model Act*, unless the State has adopted “alternative” nationwide uniform requirements, forms and procedures through its participation in an interstate compact or other similar entity that has developed and implemented such “alternative” nationwide uniform requirements;

- Section 5A(2) of the NAIC model act requires that to be an eligible surplus lines insurer in a state, an insurer must be “authorized” to write in its domiciliary jurisdiction.

- Section 5c(2)(a) of the NAIC model act provides that an insurer must possess capital and surplus or its equivalent under the laws of its domiciliary jurisdiction which equals the greater of:

  i) a. The minimum capital and surplus requirements under the law of qualifying state, or

  b. $15,000,000, or

  ii) The requirements of subparagraph (a)(i) may be satisfied by an insurers possessing less than the minimum capital and surplus upon an affirmative finding of acceptability by the commissioner. The finding shall be based upon such factors as quality of management, capital and surplus of any parent company, company underwriting profit and investment income trends, market availability and company record and reputation within the industry, in no event shall the commissioner make an affirmative finding of acceptability when the nonadmitted insurer’s capital and surplus is less than $4,500,000.

Insurers domiciled outside the United States also known as alien insurers benefit for the NRRA in that no state can “prohibit a surplus lines broker from placing nonadmitted insurance with, or procuring nonadmitted insurance from, a nonadmitted insurer domiciled outside the United States that is listed on the Quarterly Listing of Alien Insurers maintained by the International Insurers Department of the NAIC.”

7. What will NRRA mean for “sophisticated buyers” or “exempt commercial purchasers” of surplus lines insurance?

The NRRA establishes a uniform nationwide definition of an “Exempt Commercial Purchaser.” Prior to the enactment of the NRRA, the states expected the broker to verify that the insured qualified as an “Exempt Commercial Purchaser” for every state where any portion of the risk or exposure resided. If the insured did not qualify in some of the exposure states, the broker would need to complete a diligent search to access the surplus lines market for the portion of the exposures located in those particular states. In the past, this confusing regulatory environment caused significant problems for the surplus lines broker with a multi-state risk that qualified as an exempt commercial purchaser in one or more
states, but not in other states. The NRRA nationwide uniform definition of “Exempt Commercial Purchaser” should eliminate the problems caused by conflicting or non-existent definitions of these purchasers with multi-state exposures.

The requirements for placing surplus lines insurance for an “Exempt Commercial Purchaser” can be found in Section 525 of the NRRA. The definition of “Exempt Commercial Purchasers” can be found in Section 527, paragraph (5) of the NRRA. The NRRA can be accessed from the NRRA Background website page by clicking on “NRRA Law.”

8. **Does the NRRA require an “Exempt Commercial Purchaser” to employ a qualified risk manager?**

Yes, under the NRRA an “Exempt Commercial Purchaser” must employ or retain a “qualified risk manager to negotiate insurance coverage.” The term “qualified risk manager” is a complex one and is defined in Section 527, paragraph 13 of the NRRA. The NRRA can be accessed from this website page by clicking on “NRRA Law.”

9. **Will the states establish a tax sharing arrangement such as an interstate compact or other similar procedure to share tax revenue on multi-state surplus lines risks?**

This is the biggest question that arose following the adoption of the NRRA. The NRRA contains a Congressional recognition that the states “may enter into a compact or establish other procedures” to allocate the premium taxes paid to the insured’s home state. Congress did not mandate or require the States create such a compact or tax allocation mechanism. Any sharing of nonadmitted/surplus lines tax revenue among the states is strictly voluntary.

Whether the states or a group of states can come together to form a tax sharing compact or clearinghouse remains to be seen. Two models, one called NIMA (Nonadmitted Insurance Multi-State Agreement) and the other called SLIMPACT (Surplus Lines Insurance Multi-State Compliance Compact) have been put forth as possible tax sharing mechanisms. Neither of these approaches has garnered significant support among the states and neither model has become operational. While the sharing of nonadmitted/surplus lines tax revenue remains a possibility, NRRA became effective on July 21, 2011 without any tax sharing mechanism in place and much work still needs to be done to implement such an arrangement.

10. **How would an interstate compact function as the mechanism to allocate taxes?**

An interstate compact is a contract between the states. Each participating state would be a member of the compact. A compact commission would be established by the member states to govern the compact as well as to establish uniform tax allocation formulas, payment dates and data elements for the remittance of surplus lines tax.
The compact would also operate as a clearinghouse to accept from the states tax revenue to be shared with other states and periodically distribute that revenue to the other states based upon allocation formulas and payment procedures that the governing commission adopts.

11. **Is there an enforceable procedure to allocate taxes among the states without using an interstate compact?**

Most all “agreements” that are made between or among the states fall within the definition of an “interstate compact.” Some of the “compact” arrangements may be less formal than others. However, any agreement among the states must have legislative assent from the participating states and exhibit a transparent governance structure and have clear and agreed upon rules for operating.

12. **How will the single-state payment tax system that the NRRA establishes work, if the states do not establish a tax sharing compact or other similar tax allocation procedure?**

Whether or not a tax sharing compact or procedure is in place, the first step the broker must take in remitting the surplus lines premium tax is to determine which state is the “home state” of the insured and comply with that state’s surplus lines tax and placement laws/regulations. The broker would pay all the tax due under the “home state’s” law to that state. Brokers would also remit any required assessments and fees to the insured’s “home state.”

13. **Will the brokers have to file tax allocation reports even if the states do not implement a tax allocation system?**

If the state is not part of a tax sharing or allocation arrangement or no tax sharing agreement has been established among the states, it should not be necessary for the broker to divide or allocate the premium on multi-state risks to the states where exposures exist. However, the NRRA does provide that the “home state” of the insured may require surplus lines brokers and insureds to annually file detailed tax allocation reports with the insured’s “home State.” While these reports are to facilitate the tax allocation among the states, such reports would appear to be unnecessary and inappropriate, if the state is not part of a tax sharing compact or clearinghouse.

14. **What does the term “principal place of business” mean?**

The NRRA defines “home state” to mean the principal place of business of the insured or if the insured is an individual, the state where individual’s principal residence is located.

The term “principal place of business” was recently interpreted by the U.S. Supreme Court in Hertz v. Friend (No. 08-1107 decided February 23, 2010). The Court concluded that the term “principal place of business” refers to the place were a corporation’s high level officers direct, control, and coordinate the
corporations activities (i.e., its “nerve center”), which will typically be found at its corporate headquarters.

Although the Hertz decision did not interpret the term “principal place of business” in the context of the NRRA, it did interpret the phrase as a matter of federal law. It is possible that another court interpreting the NRRA would not follow the Hertz decision. But, that is unlikely because Hertz is a U.S. Supreme Court ruling interpreting the exact same words that are found in the NRRA.

15. Does the insured’s principal place of business change if 100% of insured risk is located outside of the “home state?”

The NRRA provides that if 100% of the insured risk is located out of the state where the insured’s principal place of business or insured individual’s residence is located, then the “home state” becomes the state to which the greatest percentage of the insured’s taxable premium for the insurance contract is allocated. But, this only occurs when the risk is located completely outside of the state where the insured’s principal place of business or principal residence is located. If any portion (no matter how small) of the risk is located in the state where the insured has its principal place of business or its principal residence is situated, then that state remains the “home state.”

16. What does the term “principal residence” mean and how is that determined?

The NRRA provides that an individual’s “home state” is the state where that individual’s “principal residence” is located. It is possible that an individual insured would have more that one dwelling that is considered a “residence.” In such cases, it will be necessary to determine the individual’s “principal residence.” In general, the determination of an individual’s “principal residence” requires the consideration of “all relevant facts and circumstances.” Such items as tax returns, voting records, driver’s licenses, physical occupancy and, most important, the “good faith” of the party claiming “principal residence” are important facts to be considered in making the determination of an insured’s “principal residence.”

17. How does the NRRA deal with “affiliated groups” insured under one policy?

The NRRA provides that when members of “affiliated groups” are insured under a single policy, the entity having the largest percentage of the premium attributable to it would be the entity that controls the determination of “home state.” Therefore, when affiliated entities are insured under a single policy, the broker must first identify the controlling insured or entity. Once the controlling insured or entity is determined, the process of determining the insured’s “home state” follows the same rules that apply to determining the “home state” for policies that insure just one entity.
18. **Will there be disputes over which state is the “home state?”**

Because the NRRA does not contain an enforcement provision and leaves implementation and administration of the act to the states, there is the possibility that states will disagree, from time-to-time, over a “home state” determination. However, given the fact that the definition and process of determining “home state” under the NRRA is clear and that such terms as “principal place of business” and “principal residence” have been extensively construed by the courts, the number of these disputes should be relatively small. And such disputes should diminish over time as both the states, insureds and the industry become more familiar with the rules of determining “home state.”