As seen in the November 2006 issue of RISK Factor

A Case for National Reinsurance Uniformity

By Linda Dakin-Grimm, Esq. & Patricia Quilizapa, Esq.

2006 may be the year the call for uniform nationwide insurance regulation is answered. Legislation calling for federal insurance regulation can be traced as far back as 1945, with the McCarran Ferguson Act. This year, however, states such as California may have given federal legislators the push they needed to nationalize insurance regulation. Legislation introduced in the House and the Senate this year differ in the degree of federal oversight and the subjects of governance. Yet the source of inspiration for each of the pieces of legislation appears to be the same: proposed and existing inconsistent state rules and regulations.

Support for uniform nationwide insurance regulation has increased recently, citing to the patchwork of state insurance regulation. Even those who cannot agree on the degree of federal oversight necessary, agree that oversight by 50 jurisdictions stifles competition, robs the public of product and service innovation, and subjects insurers to the political whims of 50 different insurance commissioners.

On April 5, 2006, Senators John Sununu and Tim Johnson, members of the Senate Committee on Banking, Housing, and Urban Affairs, introduced Senate Bill 2509, titled as the National Insurance Act of 2006 (NIA). The NIA proposes to create an optional federal charter regulatory system for life and property/casualty insurers. It establishes a federal insurance regulator to license and supervise National Insurers, National Agencies and federally licensed insurance producers who choose to be regulated by the NIA. The NIA also addresses examinations, financial standards, regulation of "affiliates of National Insurers and National Agencies" such as directors, executives, employees, shareholders and even attorneys and actuaries, and a national guaranty fund in case of insolvency. Certain state laws such as taxes, unclaimed property and escheat would still apply to those insurers who opt for federal regulation under the NIA. However, as ambitious as the NIA appears, it may not be enough. The optional character of the bill and the collateral requirement for foreign insurers will likely become the fuel behind the opposition to the bill.

On June 19, 2006, Representatives Ginny Browne-Waite and Dennis Moore introduced H. R. 5637, titled as the Nonadmitted and Reinsurance Reform Act of 2006. The bill is part of what is expected to be a series of issue-specific legislation aimed at federal oversight, as opposed to federal regulation. This bill limits regulation of nonadmitted and surplus line insurers and reinsurers to the insured's home state.

Among other restrictions, it provides exclusive regulatory authority for placement of nonadmitted insurance to the insured's home state. Similarly, the assessment and collection of premium taxes of the nonadmitted and surplus insurance is permitted by the insured's home state, with an allowance for allocation agreements with other states.

In what appears to be a direct reaction to California's Proposed Reinsurance Oversight Regulations, H.R. 5367 prohibits the extraterritorial application of state laws governing ceding insurers, requires states to give cedent credit for reinsurance if state of domicile has given credit, and limits solvency and other regulation of reinsurers to their state of domicile, if state of domicile meets certain requirements (i.e. NAIC-accreditation or state's accreditation requirements are similar to NAIC's).

Interestingly, the apparent reaction to California's proposed draconian requirements on insurers doing business in California, came only five days after the introduction of a watered-down version of the California proposal.

On June 14, 2006, Mr. Garamendi and the California Department of Insurance announced substantial amendments to the Reinsurance Oversight Regulations, in many respects gutting

them. The Regulations, as originally proposed in November 2005, placed extraordinary burdens on cedents seeking to receive credit for reinsurance agreements – far beyond the requirements in any other state.

The amended Regulations, effective October 1, 2006, have eliminated many of these burdens, calling the question of why they were ever proposed in the first place. That Mr. Garamendi proposed these regulations on the industry – and then gutted them days after gaining the right to seek the lieutenant governor's seat – serves to highlight the need for consistent, nationwide regulation of the global business of insurance, not the hodgepodge of politically motivated and unevenly implemented regulations, which currently exists.

The Need

In September 2004, the California Department of Insurance first announced its plans to propose new regulations for reinsurance. One year later, on November 21, 2005, the Department announced revised proposed regulations. These new proposed regulations contained requirements that were stricter than both those of the National Association of Insurance Commissioners' Model Credit for Reinsurance and Life Reinsurance Regulations and the existing California reinsurance regulations found in the Department's Bulletin 97-5.

In the required section discussing the impact of new regulations on California business, the Notice of Proposed Action stated that the proposed regulations may have "a significant statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states." The Notice further concluded that the proposed regulations may "increase associated costs or reduce the universe of reinsurers willing to enter contracts or provide collateral with such terms."

Had the regulations as proposed gone into effect, the consequences for California businesses unable to obtain insurance (due to the capacity drop caused by lack of reinsurance), would have been dire. The Department never could explain how the adverse economic impact and hindering of the competitiveness of California's business could possibly have benefited Californians.

The Amendments

The proposed Regulations were controversial for two main reasons; the extra-territorial application of certain requirements and the new provisions that were to be required in reinsurance agreements in order for cedents to take credit for having reinsurance.

The Extraterritorial Reach of the Regulations

As originally proposed, section 2303.13 of the Regulations contained controversial contract requirements for statement credit. The Regulations applied to domestic insurers as well as foreign insurers classified as "volume insurers" with material insurance agreements affecting California.

"Volume Insurers" were previously defined as any foreign insurer:

- Whose direct written premium in California represented 20 percent or more if its total direct written premium as reported on its most recent annual statement; or
- Whose direct unpaid losses and unpaid loss adjustment expenses in California represented 20% or more of its total direct unpaid losses and unpaid loss adjustment expenses as reported on its most recent annual statement; or
- Whose direct written premium in California exceeded $20 Million as reported on its most recent annual statement; or
- Which assumes more than 50 percent of its total premium as reported on its most recent annual statement.

A material reinsurance agreement meant a reinsurance agreement in which the reinsurance premium or a change in the ceding insurer's liabilities equaled or exceeded 5 percent of the ceding insurer's policyholder surplus. Where the ceding insurer had more than one agreement with the same reinsurer, or more than one agreement with reinsurers within the same group of insurers, then the multiple agreements were to be considered as one agreement for the purpose of calculating the 5-percent threshold. If the threshold was met, then each of the multiple agreements was a material reinsurance agreement.

As recently amended, the Regulations now apply only to domestic insurers and to volume

insurers, without reference to material insurance agreements. The use of the term, "material insurance agreements" has been deleted from the Regulations. The definition of "volume insurer" has now changed to any foreign insurer:

- Whose average gross direct premiums written in California as reported in its three most recent annual statements, or as reported for any lesser period of time if it has been licensed in California only for such lesser period of time,
- Exceeds the average gross direct premiums written in its state of domicile for the same period, and
- Constitutes 33 percent or more of its total gross direct premiums written in the US for such three-year-or-lesser period.

The new definition of "volume insurer" appears to make Section 2303.13 applicable to a much smaller group of foreign insurers.

The Contract Requirements For Statement Credit

The originally proposed Section 2303.13 contained contract requirements allowing statement credit only if certain provisions were included in the reinsurance agreement. The Section previously applied to all ceded business with specific additional conditions for property and casualty retroactive reinsurance agreements. As amended, the Section now only applies to property and casualty business. The Section also previously contained a laundry list of burdensome requirements.

The Old Provision

The most controversial of the contract requirements under the original Regulations, included provisions aimed at the "Elliott Spitzer finite reinsurance scandal" 2005:

- The disclosing of *any* contract that could reduce, limit, mitigate or otherwise affect *any* actual or potential loss to the parties under the agreement;
- Language stating that the reinsurance agreement constitutes the entire agreement between the parties; and
- A report of premiums and losses on a quarterly basis and a requirement that payment of losses will be paid within 30 days of the date of the report.

The old section also required additional contract provisions for P & C agreements, such as:

- No guarantee of profit, directly or indirectly, from the reinsurer or from the ceding insurer;
- The report of premiums and losses is to set forth the insurer's total loss and loss expense reserves on the policy obligations subject to the agreement, so that the respective obligations of the ceding insurer and reinsurer will mirror each other; and
- In the case of a retroactive reinsurance agreement, additional conditions applied, including specific guidelines for the payment of consideration for retroactive reinsurance and compensation and adjustments.

With the exception of the requirement that the agreement contain the "entirety" language, the Department has now deleted all of these requirements, essentially ending its attempt to piggyback off of Mr. Spitzer's inquiries.

The Old Insolvency and Set-off Provision Requirements

The Section also contained a likely unlawful requirement (given past rulings from the California Supreme Court) that reinsurance contracts must contain a provision that:

- In the event of insolvency of the cedent, no provision may reduce the payment by the reinsurer to the insurer.
- List in advance of any insolvency, the specific items that would be subject to setoff;
- Precludes contract language that deems certain items to be mutual debts and credits.

The long list of requirements dealing with insolvency and set-off clauses has been deleted from the proposed regulations.

The New Slimmed-Down Requirements

The Department replaced the laundry list of provision requirements, with new language limited to:

- The agreement shall contain an acceptable insolvency clause, which for a domestic insurer means conforming to existing law, and for a foreign insurer means payment of the reinsurance to the conservator, liquidator, rehabilitator or statutory successor, without diminution because of the insolvency of the insurer or because of any failure by those representatives of the insurer to pay a claim (this language has long been standard in light of NAIC rules);
- The agreement shall contain a notice requirement to the reinsurer on the part of the ceding insurer or any of its representatives during insolvency of the pendency of a claim; and
- The reinsurer may interpose, at its own expense, in the proceeding where such claim is being adjudicated to bring forth any defense it deems available and be reimbursed for such expenses out of the estate, subject to court approval.

Choice of Forum and Law Provisions

The Reinsurance Regulations were also controversial because of their arbitration clause requirement, which required arbitrations :

- To be held in California, and
- To be subject to California law.

These provisions have now been deleted.

The last-minute moment of slight reasonableness by the California Department of Insurance to amend the Reinsurance Oversight Regulations cannot be interpreted as a movement towards uniform regulation by state regulators. The amendment is exactly the opposite.

The introduction and abrupt abandonment of the meat of the proposed Regulations were driven by the political environment in California. California is only one example of deviance from the nationally-recognized standards. Unless some type of uniform national approach is passed into law, hasty movements by state legislators will continue to threaten the insurance industry.

Linda Dakin-Grimm is a partner and Patricia Quilizapa is an associate in the Reinsurance Group at Milbank. They may be contacted at: ldakin-grimm@milbank.com & pquilizapa@milbank.com

Copyright 2006 by LDWPublishing, Valley Forge, Pa. Used by permission.
www.ldwpublishing.com

Milbank

Few firms can match Milbank's experience, knowledge and worldwide resources in resolving disputes concerning reinsurance and significant insurance issues. Our ability to service clients globally and our in-depth expertise make Milbank the choice of satisfied clients around the world.

Milbank's Reinsurance and Insurance Dispute group is headed by Linda Dakin-Grimm, a litigator with more than 17 years of experience in complex reinsurance and insurance-related dispute resolution. Milbank's lawyers are experienced in resolving high-stakes disputes impacting clients and reinsurers, and are well equipped to deal with both domestic and global issues.

They speak and publish widely on topics affecting the industry.

For more information, visit our website at www.milbank.com .

New York | Washington, D.C. | Los Angeles | London | Frankfurt | Munich | Tokyo | Hong Kong | Singapore | Beijing