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Insurance-State Regulation-Surplus Line Insurance

James C. Lockwood S.Ed.
University of Michigan Law School

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INSURANCE—STATE REGULATION—SURPLUS LINE INSURANCE—Plaintiff, a New York corporation doing business in Texas, purchased insurance covering risks located in Texas from insurers not licensed to do business in that state. The entire insurance transaction was consummated outside Texas, and any adjustment for losses was to be made outside the state. Pursuant to a Texas statute,[1] plaintiff was taxed an amount equal to five percent of its gross premiums. Plaintiff instituted the present suit in a state court in Texas to recover the tax, which had been paid under protest. The trial court's decision for plaintiff was affirmed by the court of civil appeals, and the Supreme Court of Texas denied an application for writ of error. On certiorari to the United States Supreme Court, *held*, affirmed, one Justice dissenting. Congress, in passing the McCarran Act,[2] explicitly incorporated the limitations of prior Supreme Court decisions[3] which had held that a state does not have the power to tax insurance contracts entered into outside its jurisdiction, even though such contracts covered risks located within the state, and thus a de novo consideration of such decisions is inappropriate. *State Bd. of Ins. v. Todd Shipyards Corp.*, 370 U.S. 451 (1962).

The principal case is illustrative of a troublesome area of state insurance regulation, that involving surplus line insurance. Historically, the function of surplus line insurance was to provide lines of insurance that were in excess of the lines, or amounts of a particular line, which could be absorbed by the insurance companies admitted to do business within a state. Today it has come to mean *any* insurance placed with insurance companies not admitted to do business in a particular state. Non-admitted insurers provide valuable services in addition to their historic function. First, non-admitted insurers are often responsible for the introduction of wholly new lines of insurance coverage in areas in which admitted companies have shown little interest. Moreover, they can write insurance risk by risk, whereas their admitted counterparts, because of the restrictions imposed by state regulation and the belief that actuarial tables based on extensive sampling are necessary, are confined to writing only class insurance. The ability to so individualize insurance coverage enables such insurers, through the use of non-standard forms, to tailor their policies to

1 TEX. INS. CODE art. 21.38, § 2(e) (Supp. 1962).
2 59 Stat. 33 (1945), 15 U.S.C. §§ 1011-15 (1958).
3 Connecticut Gen. Life Ins. Co. v. Johnson, 303 U.S. 77 (1938); St. Louis Cotton Compress Co. v. Arkansas, 260 U.S. 346 (1922); Allgeyer v. Louisiana, 165 U.S. 578 (1897).

the exact needs of the insured, and also to perform a valuable service in writing deductibles.[4] Finally, the existence of surplus line insurers provides an escape from the rigid rate and form regulations imposed by states on admitted insurers. On the other hand, as many admitted insurers contend, the non-admitted insurer obtains an unfair competitive advantage by not being subject to costly and burdensome state regulation and taxation. Moreover, since the non-admitted insurer is not generally required to disclose matters relating to its financial stability,[5] less protection is offered to the public.

There are three prevailing methods of writing insurance in the non-admitted market:[6] first, through local brokers licensed to deal with non-admitted companies; second, through brokers in other states who are also licensed to deal in the non-admitted market; and third, in a few instances through direct application by the insured to the insurer. The state's right to tax the purchase of insurance through brokers operating in states other than the location of the risk was the primary issue in the principal case. In defining the permissible scope of state regulatory powers, the fundamental difficulty encountered is one of balancing an individual's interest in obtaining insurance wherever he wishes with the state's interest in the effective regulation and taxation of insurance contracts. This problem becomes most acute where a large corporation, doing a multi-state business, is involved; for such a concern can shop around until it finds the most favorable contract of insurance to suit its needs irrespective of the place where such contract is made, thereby circumventing legitimate state regulation and taxation, and penalizing those insurance companies who, by virtue of the fact that they have submitted to state regulation, may find themselves unable to compete. In the principal case, the Texas statute represented an attempt to equalize burdens between companies subjected to the state regulation, and those not subject to the costs of such a program. Absent further congressional action, the decision would seem to forbid any state regulation or taxation of the direct buying of surplus line insurance. Yet, the cases which the Court refused to examine,[7] but nevertheless considered as controlling in delineating the scope of the state's taxing power,[8] are seemingly open to question in the light of events subsequent

4 See generally De Wolf, *The Proposed Surplus Line Law: Constructive or Destructive?*, 1961 INS. L.J. 259 (1961).

5 An interesting account of financial instability is that concerning the Inland Empire Insurance Co. and the International Guaranty and Insurance Co. of Tangier, Morocco. *Hearings on S. Res. 238 Before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary*, 86th Cong., 2d Sess. pt. 10, at 5709 (1960).

6 See address by Robert N. Gilmore, Jr., Panel Discussion of Zone 5 Meeting of the National Association of Insurance Commissioners, April 25, 1961.

7 Cases cited in note 3 *supra*.

8 The congressional intent as expressed by the Court in the principal case reflects the explicit intent of the House; but the Senate, with the exception of Senator McCarran's reference to the House intent, was silent as to its feelings regarding the inclusion of these cases within the framework of the McCarran Act.

to their decision, for these cases were decided on a very conceptualistic theory of the place of contract,[9] and upon an interpretation of the due process clause which has since been rejected.[10] In recent years the Court has gradually narrowed the holdings of these cases to their facts,[11] and its hesitancy in the principal case to re-examine them gives rise to the inference that, were it not for the explicit congressional intent accompanying the enactment of the McCarran Act, a different result would have been reached.

However, notwithstanding the fact that these decisions may be open to question, and that some legitimate state regulation or taxation may be circumvented, the result in the principal case is seemingly a desirable one; for the surplus line companies do serve useful purposes, and their advantage over admitted companies is not limited solely to a rate differential. The use of non-standard forms and the development of new lines of insurance are attributable to an initiative which is said to be generally lacking in admitted companies. Moreover, there is little to be gained by penalizing those individuals who seek out forms of insurance not offered by the admitted companies on the ground that the cost of the regulatory system gives the non-admitted insurer an unfair competitive advantage. The real problem lies in securing for the public the advantages offered by surplus line companies while at the same time protecting those admitted insurance companies, who, by virtue of state regulation and taxation, are placed in an unfavorable competitive position.

Several solutions to the problem of regulating the direct buying of surplus line insurance have been proposed. One possible solution is the promotion and adoption of surplus line broker laws throughout the country. Such laws might help eliminate the problems involved in those states[12] where the inefficacy of broker regulation gives non-admitted insurers an unfair advantage and denies the public adequate protection in their dealings with financially unsound companies. Recognizing this need for uniformity in surplus line broker laws, the National Association of Insurance Commissioners has attempted to work out a solution. This body has published a list of guiding principles for use in the revision of surplus line laws, which has been favorably received,[13] and subsequently, a uniform non-admitted insurance act,[14] which is now in its fifth draft. There is no sign,

9 See Hoopeston Canning Co. v. Cullen, 318 U.S. 313, 316 (1943).

10 See Lincoln Fed. Labor Union v. Northwestern Iron & Metal Co., 335 U.S. 525, 535 (1949).

11 See, *e.g.*, Hoopeston Canning Co. v. Cullen, 318 U.S. 313 (1943); Osborn v. Ozlin, 310 U.S. 53 (1940). In the *Hoopeston* case the Court said that the *Allgeyer* case could not be controlling in those cases where the policy of the state was clear, the insured interest was located in the state, and there were many points of contact between the insurer and the property within the state. 318 U.S. at 319.

12 Alabama, Delaware, Iowa, Minnesota and Wyoming have no surplus line laws.

13 See address by Raymond A. Severin, The American Management Association Spring Insurance Conference, May 8, 1961.

14 *Hearings*, *supra* note 5, at 6147.

however, that complete agreement as to its provisions will ensue. A satisfactory uniform act, if enacted and enforced in all the states, could solve the present problems to a considerable extent. However, the uniform act as presently drafted applies only to residents of the enforcing state and has no reciprocal provisions, and thus its enactment would still leave largely unsolved the problems which accompany the purchase of insurance through a broker in another state. As an alternative to its proposal of a uniform act, the N.A.I.C. is considering the establishment of a "Central Non-Admitted Insurers Information Bureau"[15]—a permanent bureau which would collect and disseminate information concerning non-admitted insurers. On the basis of such information, such as notice of an insolvency, an insurance commissioner could take appropriate action to disqualify a company. The simplicity of the proposal and the absence of elaborate qualifying formalities appear to be its chief attributes. Another solution to the problem of effective regulation would be for the admitted companies to become more competitive by exercising their ingenuity in meeting new insurance needs while the legislatures revamped those particular regulations which tend to stifle competition. One possibility would be for legislatures to enact premium limits above which no form or rate regulations would exist, thereby freeing admitted insurers from the rigid policy regulations which often prevent them from competing with the surplus line companies. As a result of an elimination of much of the need for resorting to the non-admitted market, survival would become more difficult, in light of increased competition and decreased demand, for financially unsound non-admitted companies.

A final approach would be federal intervention in the field of insurance regulation. Although this solution is generally not favored either by the states or by the insurers,[16] it is being seriously contemplated[17] because of the apparent inability of the states to protect consumers effectively from the evils attending the operation of the non-admitted insurer, and also because many of the surplus line companies are alien[18] and hence more properly a subject of federal regulation. The critical question is one of determining what kind of federal intervention is necessary to solve the surplus line problem. First, it seems improbable that the federal government would take over the regulation of all insurance activity in light of the complicated state machinery which has existed for years in this area. It would be possible merely to assume the regulation of surplus line insurance, although the imposition of additional federal requirements would certainly complicate the activities of insurance brokers and companies.

15 See The National Underwriter, June 22, 1962, p. 1, col. 1; *id.*, April 6, 1962, p. 1, col. 4.

16 See address by Julius S. Wikler, Zone 2 Meeting of the National Association of Insurance Commissioners, April 26, 1961.

17 See address by Donald P. McHugh, American Society of Insurance Management, May 8, 1961.

18 *Ibid.*

Secondly, Congress could amend the McCarran Act to provide explicitly that the states could regulate or tax insurance transactions where the risk is within the state, notwithstanding the fact that all other events and contacts take place outside the state. However, since the old cases prohibiting such state action[19] on due process grounds have never been overruled, constitutional limitations might be deemed to prevent Congress from making such an affirmative grant to the states. Indeed, some doubt exists as to whether the Court in the principal case is merely saying that Congress incorporated the due process limitations of these cases into the McCarran Act and hence is affirming the old view of economic due process, or that Congress under the commerce clause merely used these cases to delineate the boundaries of permissible state regulation and taxation. The refusal of the Court to re-examine de novo the soundness of these decisions, and Senator McCarran's conclusion, after reading the House report incorporating these decisions, that "we give to the States no more powers than those they previously had, and we take none from them,"[20] gives strong support to the view that Congress used these cases merely as an aid in establishing the limits of the regulatory powers granted to the states by Congress and did not in any way intend to place due process restrictions on the states in their regulation and taxation of insurance activities. Finally, Congress might regulate only those alien insurance companies doing an interstate business, though such an approach would leave unsolved identical problems with respect to domestic surplus line companies.

The best answer to the problem seemingly lies in some form of state regulation; but it also seems clear that, if the continuing regulation of insurance is to remain with the states, they need to act promptly. The states must be aware that non-admitted insurance companies play an important role in the insurance market, and that competition from the non-admitted segment should not be needlessly restricted. At the same time, it is imperative that adequate safeguards be provided to protect the consumers from financially unsound companies without damaging the vitality of the non-admitted market.

James C. Lockwood, S.Ed.

19 Cases cited in note 3 *supra*.
20 91 CONG. REC. 1442 (1945).