All states require foreign insurers to obtain a certificate of authority before transacting insurance within the state and to pay premium taxes on the insurance business written by the insurer in the state, unless the insurer qualifies for an exemption from the requirements. Captive insurers usually only hold a certificate of authority and pay premium taxes in their domiciliary states. The ability to avoid the costs associated with multi-state licensure and the premium tax requirements in other states is often touted as an advantage to using a captive arrangement.

Frequently, however, captive insurers and their owners have not given adequate consideration to the application of premium tax and licensure requirements in each of the states where the risks underwritten by the captive insurer are located. Too often, captive insurers and their owners rely exclusively on the limit on state taxation and regulation of insurers established under the due process clause of the U.S. Constitution as interpreted by the Supreme Court in *State Bd. of Ins. v. Todd Shipyards Corp.*, 370 U.S. 451 (1962).

Before relying solely on *Todd Shipyards* as a limit on state authority, captive insurers and their owners should consider whether they may avail themselves of any existing exemptions within the state’s insurance laws. Typical examples of the exemptions that may be available include, without limitation, fronting arrangements, qualification as an industrial insured or organizing the captive as a risk retention group.

Fronting arrangements are the preferred structure for many captives because they only require the captive insurer to be licensed in one state. However, a fronting arrangement carries additional costs such as administrative fees paid to a fronting insurance carrier and the cost to obtain security backing the captive insurer’s reinsurance obligations to the fronting carrier.

Granted, the cost to comply with an exemption like the one for fronting arrangements may make a captive arrangement less attractive (continued on page 5).
Model Bulletin on Stranger-Originated Annuity Transactions

Growing concerns regarding stranger-originated annuity transactions (STOA) prompted the NAIC to develop a draft model bulletin suggesting approaches for insurance companies to identify and guard against such transactions.

The draft bulletin defines STOAs as being similar to stranger-originated life insurance transactions (STOLI) because both transactions are driven by originators who offer to pay individuals a fee for allowing the use of their identity as the annuitant or “measuring life.” The individual is typically a complete stranger to the originator, in poor health and not expected to live longer than a year. Originators may target terminally ill patients through newspaper advertisements or by approaching them in nursing homes.

Typical practices may include the originator setting up an annuity transaction in the terminally ill patient’s name and ensuring that the policy guarantees a minimum payout in the event of the patient’s death. To avoid detection by insurers, originators take precautions to ensure that the guaranteed minimum death benefit falls below specific underwriting guidelines.

At the 2010 NAIC Fall National Meeting, the Life Insurance and Annuities (A) Committee created a subgroup that developed a draft model bulletin for use by insurers. As of December 21, 2010, the exposure draft model bulletin provides the following suggestions for insurers:

• Review chargeback policies and consider reserving the right to adjust agent commissions if a policy is annuitized within the first year of the contract when it appears that the policy was used to facilitate a STOA transaction
• Establish detection methods to identify STOA transactions and the producers involved in facilitating such transactions
• Revise annuity applications to include specific questions regarding the relationship between the annuitant and contract owner and the manner in which the contract is being funded
• Ensure controls are in place to flag questionable applications that should be subject to additional review
• Report actual and potential STOA transactions to the appropriate state insurance regulator

The issue of STOA transactions will continue to be a popular topic for the NAIC in 2011.

Health Agent Task Force Created

In the wake of the decision by the U.S. Department of Health and Human Services (HHS) not to exclude producer compensation from the medical loss ratio (MLR) calculations under the Patient Protection and Affordable Care Act (ACA), the NAIC Executive/Plenary Committee formed the Professional Health Insurance Advisors (EX) Task Force in an effort to protect the role of agents and brokers in the future health insurance market.

The federal MLR rules mandate that 85 percent of large group premium revenue and 80 percent of individual and small group premium revenue go to medical care and quality improvement efforts.

Producers have argued that they provide valuable guidance and expertise to consumers and employers and are concerned that the MLR limits may put a strain on agent and broker commissions, which would ultimately lead to a diminished role for the producers and negatively impact health insurance consumers.

The task force is charged to “work in a expedient manner to identify, analyze and recommend options to the Executive Committee for addressing the negative impacts on health insurance brokers/agents, insurance consumers and insurance markets as a result of the MLR requirements of the ACA and the regulation issued by HHS.”

For additional information regarding these issues, you may contact Zach Dyer at zdyer@polsinelli.com or (816) 360-4352.
State Spotlights

Kansas Spotlight
By Jeffrey S. Bottenberg

The Kansas Insurance Department (KID) enacted K.A.R. 40-9-23, which adopts the KID’s adaptation of the NAIC Model Regulation Regarding the Use of Senior-Specific Certifications and Professional Designations in the Sale of Life Insurance and Annuities. The regulation became effective on January 14, 2011.

Recently, Commissioner Sandy Praeger announced several key personnel changes at the KID. Zachary J.C. Anshutz was appointed to serve as general counsel to the KID. Previously, Anshutz worked in the KID’s legal department, and, more recently, worked for the Kansas State Board of Healing Arts and the Kansas Association of School Boards. Anshutz fills the position vacated by John Campbell, who was appointed chief deputy attorney general by Kansas Attorney General Derek Schmidt.

Commissioner Praeger also appointed Kevin Davis as director of consumer assistance and government affairs. Before joining the KID, Davis worked for American Family Insurance Company for over 20 years. Davis takes the position formerly held by Jim Welch who was recently appointed deputy attorney general for consumer protection by Attorney General General Schmidt.

Commissioner Praeger also named current KID employee and former state legislator Cindy Hermes as the KID’s health care consumer ombudsman and director of public outreach. Hermes had formerly been the director of government and public affairs at the KID. Additionally, Linda Sheppard, director of the accident and health division, was appointed by Commissioner Praeger as the project manager for implementation of Kansas guidelines for the federal Patient Protection and Affordable Care Act.

Missouri Spotlight
By Keith A. Wenzel

Director John Huff of the Missouri Department of Insurance, Financial Institutions and Professional Registration (DIFP) has been very active in the National Association of Insurance Commissioners (NAIC) since his appointment as Director in February 2009. Recently, he was appointed by the NAIC to serve in two very prominent positions. In December 2010, Director Huff was elected Treasurer of the Interstate Insurance Product Regulation Commission. The Interstate Insurance Compact is a partnership among state insurance regulators that reviews insurance products for compliance before they are sold to the buying public. In September 2010, Director Huff was appointed by the NAIC to the U.S. Financial Stability Oversight Council. He is the only insurance regulator on the Council, which was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Council coordinates with other financial regulators to identify systematic risks to the nation’s financial stability.

The DIFP recently announced that Missouri’s federally funded high risk insurance pool is dropping its premiums by 25 percent. The high risk pool will be utilized until 2014 when federal law will require health insurance companies to offer coverage to all applicants regardless of health status.

The DIFP also announced that the number of captive insurance companies licensed in Missouri doubled in 2010, increasing from six to twelve at the end of 2009 to the end of 2010. In 2009, premiums written by captive insurance companies licensed in Missouri had reached $1 billion. Similar to self-insurance, captive insurance companies are formed to insure the risks of their owners and subsidiaries and to access reinsurance. The Missouri Captive Insurance Association was recently formed to promote the captive industry in Missouri. The Association works to augment the DIFP’s efforts to attract captive insurance companies to Missouri. Polsinelli Shughart’s Keith Wenzel serves on the Board of Directors for the Missouri Captive Insurance Association.

The DIFP issued Bulletin 11-01 to provide guidance regarding claims coding and benefit payments for the newly enacted mandated benefit to cover various treatments for autism and autism spectrum disorders. The Bulletin encourages the insurance industry to exercise flexibility during the initial implementation of the new mandated benefit, which just became effective on January 1, 2011.

Director Huff appointed a Health Insurance Advisory Committee (HIAC) to assist and advise the DIFP with
the implementation of the federal Patient Protection and Affordable Care Act (ACA). On February 4, 2011, the HIAC adopted a concept statement providing, “So long as (i) Missouri is subject to the exchange provisions of Public Law, 111-148 and (ii) federal funding is available, it is desirable for the State of Missouri to exercise authority and control over the planning, implementation and operation of any exchange or exchanges functioning within our borders.” With the adoption of the statement, Director Huff indicated that the DIFP would continue moving forward with the design of a state based exchange in Missouri.

Arizona Spotlight
By Richard M. Amoroso and Tiffany Andersen

On January 11, 2011, the Arizona Department of Insurance (ADOI) issued Regulatory Bulletin 2011-01 addressing the prohibited practice of misrepresenting the terms of an insurance policy through the issuance of a certificate of insurance that attempts to amend or alter the terms of the insurance policy.

In lieu of providing a full copy of the insurance policy, insurers and insurance producers often issue certificates of insurance to summarize the policy and to serve as proof of coverage. However, certificates of insurance are not filed with, nor approved by, the ADOI. Rather, only insurance policy forms are filed and approved. The ADOI learned that some insurers and insurance producers receive requests to issue preprinted certificates of insurance that include language attempting to amend, extend or alter the terms of the insurance policy.

The ADOI advised that an insurer or insurance producer that issues a certificate of insurance that misrepresents the terms or conditions of the insurance policy in violation of Section 20-443(1), potentially faces suspension, revocation, or non-renewal of their license as well as imposition of a civil penalty, and, if applicable, restitution. Further, the ADOI warned that a person who knowingly issues such a certificate of insurance may face prosecution for a class 5 felony.

Colorado Spotlight
By Jennifer L. Osborn

On December 1, 2010, John J. Postolowski, the former deputy commissioner of finance and administration, began serving as the interim commissioner of insurance, pending permanent appointment by the Governor.

Various regulations in Colorado have undergone recent changes including the following: 3 CCR 702 Reg. 4-1-11 has been amended, effective April 1, 2011, to require insurers to establish a system to supervise recommendations and to specify standards for transactions involving annuity products; 3 CCR 702 Reg. 4-6-9 concerning group health insurance conversion coverage was amended to allow insurers to offer other conversion coverage policies, effective February 1, 2011; 3 CCR 702 Reg. 4-6-5, which addresses small employer group health benefit plans, was amended, effective February 1, 2011, to remove lifetime maximums, to revise mandated benefits and to prohibit pre-existing condition exclusions from being applied to those under the age of 19; 3 CCR 702 Reg. 4-2-33 was adopted effective January 1, 2011, governing carriers issuing child-only policies and requiring mandatory open enrollment periods; 3 CCR 702 Reg. 4-2-11 and 3 CCR 702 Reg. 4-6-7 have been amended effective January 1, 2011, to specify additional requirements for rate filings and wellness and prevention programs (see also the Colorado Insurance Division Memorandum dated November 4, 2010 discussing the factors affecting health insurance premiums in 2010); and finally, 3 CCR 702 Reg.4-4-1 was amended effective January 1, 2011, to provide that rates for individual long-term care policies may not vary due to gender.

The Division has withdrawn Bulletin B-4.32 based on a conflicting opinion in “In the Matter of the Petition for Declaratory Judgment and Order of Cover Colorado” with respect to the purchase of coverage funded by HRAs. The Division also issued Bulletin B-4.36 on December 22, 2010, concerning the interpretation of HB 10-1021, regarding mandatory maternity benefits for individual policies issued after January 1, 2011. Policies renewed after that date are not subject to the requirements.
Foreign Captives: State Regulation and Taxation

(continued from page 1)
financially than relying exclusively on the due process limits established under Todd Shipyards. But, sole reliance on Todd Shipyards potentially subjects the captive insurer and its owners to penalties and other regulatory actions by the states for non-payment of premium taxes or the unauthorized transaction of insurance. The limits on state power established by Todd Shipyards are very narrow, as discussed below.

In Todd Shipyards, the U.S. Supreme Court held that the Texas direct procurement tax violated the due process clause under the U.S. Constitution because the unauthorized insurance company against whom the state sought to apply the tax lacked sufficient contacts with the state to warrant application of the tax. The court found that the only contact with Texas was the location of the risk within the state. Relying on three prior U.S. Supreme Court cases holding in essence that the location of the risk within a state standing alone is not sufficient for the state to exert jurisdiction, the court held that Texas could not impose the direct procurement tax on the unauthorized insurer.

In order to fall within the narrow exception to state jurisdiction under Todd Shipyards, some captive insurers expend a tremendous amount of effort to conduct all insurance activities exclusively in the captive insurer’s domiciliary state. However, such efforts may not be enough to meet the Todd Shipyards exception in all circumstances.

Subsequent state cases have commented on the meaning of Todd Shipyards. For example, in Howell v. Rosecliff Realty Co., 245 A.2d 318, 322 (N.J. 1968), the court stated that “Todd Shipyards means no more than this, that insurance transactions of the kind involved in Todd Shipyards and the three cases cited in [support] cannot be taxed or regulated if the only connection with the State is the location therein of the risk insured, but the State may deal with the insurance if activities either in the making or in the performance of the contract occur within its borders.” The Howell court also commented that “the plain inference from Todd Shipyards is that if there were activity within a State either in the making or in the performance of the contract, the State could exercise its governmental powers to further its undoubted interest in insurance risks within its borders.” Finally, the Howell court said, “Liability policies are matters of obvious State concern, not only with respect to the security of the insured but also with respect to the compensation of the injured claimants.”

Because liability insurance may result in direct compensation to third-party claimants who are residents in a state where a foreign captive insurer is not licensed, it is common for captive insurers to issue their liability policies on an indemnity basis (requiring the insured to pay the claimant before seeking reimbursement from the captive insurer) or a legal expense-only basis. Even if the captive insurer avoids making direct payments to claimants residing in states where the captive insurer is not licensed, other connections may exist between the captive insurer and the state that could negatively impact their ability to rely exclusively on the Todd Shipyards exception. Each captive insurance arrangement should be evaluated based on its own unique set of circumstances.

In addition to the principles set forth in Todd Shipyards, there are other non-statutory legal theories that should be considered when assessing the need for a captive insurer to comply with exemptions to state insurance laws outside the captive insurer’s domiciliary state. For instance, where applicable, it may be possible to advance the legal theory that the captive insurer should only be subject to regulation in the state in which the insured risk is principally located. See, e.g., Alea London, LTD v. George Maxwell and Gregory’s Roadhouse, LLC, Case No. 4:05CV1240HEA, 2006 U.S. Dist. LEXIS 18182 (E.D. Mo. May 26, 2006).

Of course, if state insurance regulators determine that state taxation and regulation of a captive insurer is not prohibited by the due process analysis under Todd Shipyards and that the captive insurer has been operating unlawfully without a license, the regulators could potentially impose a host of statutory penalties including, without limitation, emergency cease and desist orders, monetary penalties and the imposition of past due premium taxes with interest and penalties.

For additional information, contact Justin Liby at jliby@polsinelli.com or 913-234-7427.
Insurance Business and Regulatory Law

With decades of experience assisting the insurance industry with corporate transactions and various compliance and regulatory issues across the country, the Insurance Business and Regulatory Group at Polsinelli Shughart PC has the expertise to provide outstanding services to this industry. With four former state insurance department attorneys, including two who served as General Counsel, and five attorneys who were former in-house counsel to various insurance organizations, our attorneys understand the unique needs of our insurance clients on matters involving state insurance departments, state Attorneys General, and other state and federal regulatory agencies.

We routinely handle business and regulatory issues, such as:

- Serving as national outside counsel for various property and casualty insurers, workers’ compensation insurers, life and health insurers, third-party administrators and discount medical plan organizations.
- Conducting corporate mergers and acquisitions.
- Making holding company transaction and other related regulatory filings.
- Completing complex national and multi-state regulatory and compliance research.
- Filing Uniform Certificate of Authority Applications, including Primary, Expansion and Corporate Amendment Applications.
- Conducting national and multi-state licensing and compliance projects for Third Party Administrators, Agencies, Adjusters and Discount Medical Plan Organizations.
- Assisting with Market Conduct Examinations and Financial Examinations, including a Multi-State Market Conduct Examination involving 50 states.
- Assisting with insurance company corporate governance requirements, including the Model Audit Rule, and development of appropriate committee charters, conflict of interest statements, code of conduct and ethics statements, record retention and destruction policies; whistle blower policies, and others.
- Serving as the Deputy Receiver or General Counsel to the Deputy Receiver with respect to insurance company receiverships.
- Forming captive insurers and risk retention groups and assisting with their ongoing compliance and business issues.

Clients include insurance companies, insurance brokers and agencies, third-party administrators, discount medical plan organizations and associations — virtually any individual or entity subject to regulation by state insurance departments, state Attorneys General or other state agencies.

The Insurance Business and Regulatory Group has the expertise and depth to provide quality and responsive legal services to regulated entities in the insurance industry with respect to all of their business and regulatory needs.