

Presentation to The Surplus Line Association of California

**Catastrophes Impacting
Upon the Insurance Industry:
Natural and Man-Made**



January 24 & 26, 2006

LEBOEUF, LAMB, GREENE & MACRAE LLP
A LIMITED LIABILITY PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

- **Spitzer's Crusade and Its Effect on the Insurance Industry**
- **Federal Initiatives: The SMART Act, TRIA & the Model Audit Rule**
- **Insurance Issues Arising From Hurricane Katrina**
- **California's Proposed Credit for Reinsurance Regulations**
- **Significant Legislative Developments in 2005 and the Outlook for 2006**

Spitzer's Crusade and Its Effect on the Insurance Industry



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Spitzer's Crusade

- **History**

- **February 2004 – Washington Legal Foundation sends letter calling on regulators to investigate alleged conflicts of interest caused by placement service agreements**
- **April 2004 – Spitzer begins investigation into contingent commissions among allegations of “kickbacks”**
- **September 9, 2004 – First email describing alleged bid rigging schemes discovered**
- **September 17, 2004 – First major wave of subpoenas issued under the Donnelly Act**
- **October 14, 2004 – Complaint against Marsh filed**

Spitzer's Crusade...con't



PACKED AND LOADED:
Spitzer and deputy David
Brown, overwhelmed (well,
almost) with boxed evidence

Fortune Magazine, November 15, 2004

Targeted Practices

- 1. Contingent Commissions**
- 2. Fictitious Quotes [Bid Rigging]**
- 3. Reinsurance Tying/Leveraging**
- 4. Floats, Loans and Perks**
- 5. Financial Engineering [Finite Reinsurance]**
- 6. Pay to Play**
- 7. Inappropriate Use of Wholesalers and Vertical Integration**

Spitzer – Act II

- **End of Year-Two: 6 months to go**
- **Focus:**
 - **Same three AG cases**
 - **Bid Rigging**
 - **Finite Reinsurance**
 - **Contingent Commissions and Special Bonuses**
- **Goals:**
 - **Settle with AIG on accounting inaccuracies; thereafter settle with GenRe, Hartford, ACE and 4 to 6 other insurers**
 - **Review other brokers re: contingent commissions**
 - **“We’re not convinced that all problematic behavior surrounding contingent commissions has ceased and we’re concerned about that.” - lawyer close to Spitzer’s office quoted by Financial Times, October 14, 2005, p. 28.**

Other State Investigations

- **33 State Insurance Departments and 11 State Attorneys General have taken action**
- **In total, at least 108 insurance companies and 22 brokerages have been publicly named as targets for investigation**
- **States that have implemented statutes and/or regulations to mandate disclosure of broker compensation:**
 - **Washington Insurance Code s. 48.17.270 (1994)**
 - **Nevada Administrative Code 686A.1-12**
 - **Oregon Administrative Rules s. 836-071-0263**
 - **Rhode Island H. 6233**
 - **Since October 2004, 17 states have introduced 32 laws or regulations on broker disclosure issues, and 3 state insurance departments have issued bulletins on the subject**

State Investigations...con't

- **California Department of Insurance**
 - **October 18, 2004 – Issued a proposed regulation requiring the full disclosure of all broker compensation**
 - Required full disclosure of “all material facts” surrounding a broker’s receipt of compensation
 - Required broker’s selection of the “best available insurer”
 - **December 21, 2004 – Issued producer compensation letters of inquiry, containing 10 interrogatories and 7 document requests, to all CA brokers**
 - Retained a plaintiff’s law firm
 - **April 12, 2005 – Issued revisions to proposed regulation**
 - Deleted “best available insurer” standard – now focused solely on disclosure
 - Required disclosure of who producer represents, the compensation producer will receive in consideration for placing client’s insurance, and the details of any quotes producer solicits on client’s behalf from insurers

State Investigations...con't

- **California Department of Insurance (con't)**
 - **Commissioner Garamendi also sponsored broker compensation disclosure legislation (S.B. 938), which would have imposed a statutory duty of reasonable care, skill and diligence upon brokers, as well as required various compensation- and representation-related disclosures**
 - **S.B. 938 was defeated on April 27, 2005 in the Senate Banking, Finance and Insurance Committee**
 - **Amid strong opposition from the industry, the Department appeared to have abandoned its attempt to implement new regulations governing the fiduciary duties and compensation disclosure obligations of brokers**
 - **In addition, the Department gave indications that it might use the information obtained through the formal letters of inquiry to initiate enforcement actions against California brokers under existing legal rules**

State Investigations...con't

- **California Department of Insurance (con't)**
 - **November 2, 2005 – Department commends IBA West’s new “Guide to Agent-Broker Compensation Disclosure”**
 - **IBA West’s “Guide” provides a cafeteria line of options of disclosure language for producers to consider if such producers wish to voluntarily provide information to their customers, including:**
 - **Disclosing the sources and types of compensation they will receive, including whether they are eligible for any contingent compensation, and if so, the criteria for determining whether such contingent compensation will be received;**
 - **Disclosing whether they will seek quotes from more than one insurer;**
 - **Telling their customers about all quotes obtained; and**
 - **Disclosing whether the compensation they would receive from any of the insurers providing quotes is significantly greater than what they would receive from the others.**
 - **The Department noted it will hold off on issuing its revised Agent-Broker Compensation Disclosure Regulations in order to give various voluntary disclosure initiatives coming from the industry, including the Guide, an opportunity to take root.**
 - **The Department’s investigation continues, however, and it will bring enforcement actions against producers that have engaged in bid-rigging or steering or have failed to disclose material information to customers.**
 - **The Department has also indicated that it may propose regulations that would immunize insurers from administrative action if they require their producers to follow certain compensation disclosure protocols**

State Investigations...con't

- **Nevada Department of Insurance**
 - **Promulgated regulation (effective 10/31/05) requiring a documented acknowledgment, signed annually by the insured, disclosing the broker's total compensation to be received, the form and nature of the compensation, the identity of any third parties that may also receive compensation, and the details of all quotes sought by the broker on behalf of the insured**
- **Oregon Division of Insurance**
 - **Promulgated regulation (effective 8/1/05) requiring a documented acknowledgement, signed by the insured, disclosing the fact that the broker will receive additional compensation from the insurer or some other third party**
- **Washington Department of Insurance**
 - **On October 21, 2004, issued a Technical Assistance Advisory (T 04-05) offer guidance to brokers and insurers for complying with Washington Law – the guidance is generally aimed at the disclosure of compensation arrangements by brokers and the consideration of such compensation arrangements by insurers when establishing premium rates**

Other Developments

- **National Association of Insurance Commissioners (NAIC)**
 - **Executive Task Force on Insurance Broker Activities**
 - **Proposed Amendment to the Producer Licensing Model Act**
 - **Two states: Rhode Island and Arkansas have adopted the amendment**
 - **Approved enhanced disclosure and attestation requirements obligating P&C insurers to regularly disclose and attest to their use of nontraditional reinsurance contracts (*i.e.*, finite reinsurance) and to provide details of all reinsurance contracts for which the insurer is taking statement credit**
 - **Incorporated in California's proposed credit for reinsurance regulations**
- **National Conference of Insurance Legislators (NCOIL)**
 - **Proposed Insurance Broker Fiduciary Duty and Conflict of Interest Model Act**

Other Developments...con't

- **Europe**
 - **Head of European Commission's insurance unit has said he is watching developments in the U.S. closely**
 - **UK Financial Services Administration (FSA)**
 - **In January 2005, the FSA implemented rules requiring brokers to disclose their commissions only if they are specifically requested to do so by corporate insurance buyers**
 - **In December 2005, the FSA announced that it will continue to investigate the sufficiency of broker practices and may consider rules requiring the compulsory disclosure of commissions to commercial customers by brokers, intermediaries and/or insurers.**
 - **Two weeks later, the FSA took its first regulatory action against individual brokers, banning two former Benfield brokers for two years from working within the FSA's jurisdiction for improper conduct.**

Likely Impact on Industry

- **Fines, Settlements, Class Actions and/or Guilty Pleas**
 - **Marsh (\$850 million), Aon (\$190 million) and Gallagher (\$27 million) settlements**
 - **On September 21, 2005, Marsh entered into a joint settlement agreement with 30 state regulators, which recognizes the \$850 million settlement with New York (and does not impose any further monetary penalties) and calls for similar business reforms**
 - **Only half of Marsh's clients have accepted the settlement**
 - **Spitzer filed lawsuit against AIG and its executives on May 26, 2005**
 - **17 total executives (from 5 insurers) have plead guilty to various charges relating to bid-rigging and price-fixing since Spitzer launched his investigation**
 - **Spitzer recently indicted 8 Marsh executives on charges of felony price-fixing and bid-rigging**
- **Restatement of Financial Statements**
 - **AIG restated financial reports to reduce profits by nearly \$4 billion over five years**
 - **On November 9, 2005, AIG announced it would restate its financial results for the last 5 years, making an additional adjustment of \$500 million**

Likely Impact on Industry...con't

- **Industry Reshuffling – M&A Activity**
 - *Wall Street Journal* (1/20/05) reports that Marsh is considering the sale or closing of its investment subsidiary, MMC Capital
 - **Business model challenges**
 - Willis Group Holdings, Inc. to sell its U.S. wholesale unit, Stewart Smith Group
 - Marsh is looking into future options for its wholesale-brokerage operations, including Crump Insurance Services
 - Aon has sold Swett & Crawford to an investment group
 - The commercial market has begun to shift to regional and independent brokers
 - Potential investigations into the vertical integration of insurers and reinsurers
- **Federal Oversight**
 - Antitrust Modernization Commission, SMART Act, etc.
- **Implementation of Standards of Conduct and Training**

Likely Impact on Industry...con't

- **Disclosure of Contingent Commissions**
 - **According to A.M. Best, insurers in the U.S. property/casualty market paid out nearly \$3.7 billion in contingent commissions in 2003**
 - **Guy Carpenter Global Disclosure Doctrine; Marsh's Commitment to Transparency**
 - **Under its settlement agreement, Gallagher has agreed to not accept, directly or indirectly, anything worth more than \$500 from an insurer. Aon has issued internal memo prohibiting its brokers from accepting anything worth over \$100 from insurers.**
- **Mandated Disclosures of All Compensation By Some Insurers**
 - **Irrespective of potential new laws or regulations mandating disclosure, some insurers have begun including language in their incentive agreements contractually mandating that brokers fully disclose the terms of such incentive agreements to the brokers' respective clients**



Broker Compensation Disclosures

Broker Compensation Disclosures

- **Likely Key Elements to Required Disclosures:**
 - **Identify the Producer and the Client**
 - **What services will be provided by the producer?**
 - **How will the Producer be compensated for those services?**
 - **Name/identity of the source of compensation**
 - **Nature and form of the compensation**
 - **Amount or value of the compensation (or reasonable estimate thereof and method of calculation therefor)**
 - **The details of all quotes obtained by the producer on the client's behalf**

Broker Compensation Disclosures

- **NOTE: Producer disclosures and other representations to Clients MAY establish Producer duties to Client irrespective of whether the Producer is acting as an independent agent or a broker**
 - Duties generally include loyalty, honesty, integrity, good faith, avoiding self-dealing (steering), and full disclosure (*see* 9/30/05 CDI Letter to IBA West re: fiduciary duties)
- **Broker Fees in California**
 - Agents may not charge brokerage fees on personal lines policies.
 - Brokers may only charge a broker fee in limited circumstances and subject to mandated disclosures (*see* tit. 10 CCR s. 2189.3 and next slide).
 - A “broker fee” is defined as any fee charged by an insurance broker to provide services that constitute the transaction of insurance, but excludes fees charged for services not constituting or arising out of the transaction of insurance.

Tit. 10 CCR § 2189 App. B

STANDARD BROKER FEE AGREEMENT

1. The parties to this agreement are _____ ("CLIENT") and _____ California Department of Insurance license #XXXXXXX, ("BROKER").
2. CLIENT appoints BROKER as CLIENT'S insurance broker of record.
3. This agreement shall become operative on _____ (date), and shall continue in full force until terminated by either party.
4. BROKER agrees to represent CLIENT honestly and competently.
5. CLIENT agrees to pay BROKER a broker fee for BROKER'S services. The broker fee is \$ _____. The broker fee IS/IS NOT refundable (circle one).
6. BROKER may charge CLIENT, and CLIENT agrees to pay, additional fee(s) for the services listed below. The additional fees and services are:

Service Amount

7. Following are the nature and amount of all fees known to BROKER that will be charged by persons other than BROKER or the insurance company in connection with current placement of CLIENT's insurance. These fees are not retained by BROKER.

_____ Client signature Date

_____ Broker signature Date

In case of any questions or problems concerning broker fees or insurance, contact the Department of Insurance at 1-(800) 927-HELP.

Template Service and Compensation Disclosure

Term and Services To Be Performed

The insurance, financial and risk management services to be provided by PRODUCER to Client (the “Services”) are set forth in Client’s Insurance Proposal. The term of this Agreement shall be from _____ to _____, or upon 30 days advance written notice of termination to the other party, whichever occurs first (the “Service Period”).

PRODUCER as Client’s Insurance Producer

PRODUCER transacts insurance as a licensed insurance producer. As such, by nature of the relevant insurance transactions and applicable state law, PRODUCER will perform the Services under this Agreement based upon the insurance sought by a client and the relationships PRODUCER has with those insurers that may provide appropriate insurance for a client. In connection with this Agreement, Client has appointed PRODUCER as its Producer of Record for the property casualty or employee benefits insurance coverages specified in Client’s Insurance Proposal.

Template Service and Compensation Disclosure

Quotes

Whether PRODUCER acted as a broker or agent in connection with the Services provided hereunder, PRODUCER has sought quotes reasonably designed to meet Client's specifications from one insurance company or group of insurance companies under common ownership or multiple insurers with whom PRODUCER has established relationships.

In the event that PRODUCER has sought quotes on Client's behalf from multiple insurers, prior to binding coverage on behalf of Client, PRODUCER shall disclose to the Client, in a letter substantially in the form attached hereto as Exhibit A, the name of each insurer or any other source that supplied a quote or declined to supply a quote.

Upon the renewal of the coverage placed hereunder on Client's behalf, unless Client otherwise directs PRODUCER or PRODUCER otherwise notifies Client, PRODUCER intends to renew Client's coverage with the insurer that, at the time of such renewal, underwrites Client's coverage. Accordingly, Client hereby acknowledges that, in such circumstances, PRODUCER will not solicit any quotes or proposals from insurers in connection with the renewal of Client's coverage.

Template Service and Compensation Disclosure

Compensation

It is a long-standing practice in the insurance industry for insurers to compensate insurance producers based on factors including aggregate volume, persistency and profitability of the business. These arrangements are typically referred to as contingent commissions or overrides. PRODUCER has entered into a variety of these compensation arrangements with insurers and intermediaries that are not client-specific. PRODUCER's business model seeks to ensure that these compensation arrangements do not in any way prejudice PRODUCER's judgment as an insurance producer nor diminish PRODUCER's ability to serve appropriately the needs of clients with whom PRODUCER transacts insurance.

PRODUCER may be compensated for the Services performed under this Agreement principally through commissions paid by the insurer it represents. The details of all compensation to be received by PRODUCER from a person other than Client in connection with the placement of Client's insurance are set forth in Exhibit B. In some cases, PRODUCER may also be compensated for the Services performed under this Agreement through fees paid by the Client as set forth in Exhibit C.

Client hereby acknowledges that PRODUCER may receive compensation from parties other than Client in connection with this Agreement, including premium financiers as referenced in Paragraph E hereof. Client hereby consents to PRODUCER's receipt of such additional compensation and consents to any conflict of interest that may arise as a result of the receipt of such additional compensation. Should Client desire further details with respect to the compensation that PRODUCER may receive in connection with this Agreement, PRODUCER encourages Client to contact Client's PRODUCER representative.

Template Service and Compensation Disclosure

Wholesale Intermediaries/Managing General Agents (“MGAs”)

PRODUCER will utilize the services of other intermediaries, sometimes called “wholesalers,” or MGAs to assist in accessing insurance coverages for Client when, in PRODUCER’s professional judgment, it is necessary to do so. Such wholesale intermediaries or MGAs may or may not be affiliates of PRODUCER and will be compensated by the insurer out of paid premiums. PRODUCER may receive contingent commissions or overrides as described in Paragraph D hereof with respect to insurance transacted with some wholesale intermediaries and MGAs. In the event that PRODUCER utilizes the services of other intermediaries in connection with the placement of Client’s insurance, the compensation that such intermediaries reasonably known to PRODUCER may receive from the insurer in connection with the placement of Client’s insurance shall be set forth on Exhibit C.

Surplus Lines or Other Premium Taxes and/or Fees

In some instances, insurance placements made by PRODUCER on behalf of Client may require the payment of state surplus lines or other premium taxes and fees in addition to the premium itself. PRODUCER will attempt to identify any such taxes and fees in advance, but in all instances the payment of these taxes and fees will remain the sole responsibility of Client.

Template Service and Compensation Disclosure

[ADDITIONAL PROVISIONS]

Premium Finance

General Duties

Audit

Successors and Assigns

Governing law

Notices

Confidentiality

[Signature page follows.]

Template Service and Compensation Disclosure

EXHIBIT A

Quotes and Proposals

Dear _____:

As stated in the Service and Fee Agreement (the “Agreement”) entered into by and between _____ (“Client”) and _____ (“PRODUCER”), upon the renewal of the coverage placed on Client’s behalf, unless Client otherwise directs PRODUCER or PRODUCER otherwise notifies Client, PRODUCER intends to renew Client’s insurance with the insurer that, at the time of such renewal, underwrites Client’s coverage.

By this letter, PRODUCER hereby notifies Client that, in connection with PRODUCER’s placement of [type of coverage sought] pursuant to the Agreement, PRODUCER has obtained the following quotes or proposals on Client’s behalf:

Carrier	Coverages Requested	Quote Response

If Client would like further information or details pertaining to any quote obtained by PRODUCER, including a description of any proposed compensation or commission PRODUCER may receive if such quote is selected, please contact your PRODUCER representative.

In addition, PRODUCER sought quotes or proposals from the following insurers, each of whom declined to provide a quote or proposal or provided a quote or proposal which did not, in PRODUCER’s judgment, reasonably meet Client’s specifications:

Carrier	Coverages Requested	Quote Response

This letter is being provided solely as a disclosure of the quotes or proposals sought or obtained by PRODUCER on Client’s behalf. This letter is not meant to provide a thorough evaluation of the merits of each such quote or proposal and PRODUCER strongly encourages each of its clients to consult with their PRODUCER representative before binding coverage.

Very truly yours

Template Service and Compensation Disclosure

EXHIBIT B

Source of Compensation

<u>Source of Compensation</u>	<u>Coverage</u>	<u>Standard¹ Compensation/ Commission</u>	<u>Nonstandard² Compensation (i.e., contingent commissions or overrides)</u>	<u>Does PRODUCER Have Any Ownship Interest in Compensation Source?</u>

In addition, the following business entities reasonably known to PRODUCER may receive compensation from the insurer for assisting PRODUCER in the placement of Client’s insurance:

[None]

OR

[List the entities, including the source, nature and amount or value of the compensation to be received by such entities]

¹ “Standard Compensation” means a payment received by a producer from an insurer which is paid pursuant to a set compensation schedule offered to all producers for services provided in connection with the placement of insurance coverage.

² “Nonstandard Compensation” means consideration in any form for the production of insurance received by some producers from an insurer or other source which is paid in addition to or in lieu of the standard compensation and paid pursuant to a separate agreement for additional services or other consideration provided in connection with the placement of insurance coverage, including, but not limited to, contingent commissions or overrides based upon factors such as aggregate volume, persistency and profitability.


Template Service and Compensation Disclosure

Exhibit C

- Client Fee Schedule to be attached.

Exhibit D

- Premium Finance Statement required by California Insurance Code section 778.2.



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Federal Initiatives:

The SMART Act, TRIA & the Model Audit Rule



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The SMART Act

Prospects for Federal Insurance Regulation

- **S.1373—Insurance Consumer Protection Act**
 - **Hollings Proposal**
- **Optional Federal Charter**
 - **Similar to National Bank/State Bank Model**
 - **But no FDIC – Reliance upon State Guaranty Funds**
 - **Several potential sponsors in the Senate**
 - **Lack of consensus among industry players**
- **Federal Standards—SMART Act**
 - **Oxley/Baker “Roadmap” Proposal**
 - **State Modernization and Regulatory Transparency Act**

SMART Act

(State Modernization and Regulatory Transparency Act)

THE BASICS / 17 TITLES • 308 PAGES Subjects

- **Market Conduct and Uniform Standards**
- **Insurer Licensing**
- **Producer Licensing**
- **Life Insurance**
- **Commercial Property and Casualty Insurance**
- **Personal Lines Property and Casualty Insurance**
- **Surplus Lines and Independently Procured Insurance**
- **Reinsurance**
- **Anti-Fraud Network**
- **Viaticals**
- **Miscellaneous Insurance (Health Insurance)**
- **Receivership**
- **Financial Surveillance**
- **State-National Insurance Coordination Partnership**
- **Creating Competitive Insurance Markets**
- **Retain McCarran Ferguson**

SMART Act - Major Features

- **National uniformity standards for state-based regulation**
 - **Sets standards and establishes processes for setting standards for state regulation**
- **Requires states to update their insurance regulatory laws to specific standards or model laws**
- **Allows standards to be set by majority of states adopting model laws**
- **Deregulates commercial lines**
 - **Market forces for rates**
 - **File and use/use and file for forms**
- **Deregulates personal lines—Illinois is model**
 - **Open rating for rates**
 - **Self-certification based on file and use/use and file for forms**
 - **Modernize surplus lines**
- **No Federal Charter or License**

SMART Act - Major Features

- **Designed to address perceived weaknesses of the state systems through preemptive imposition of state-developed standards**
 - **Product Speed-to-Market**
 - **Multi-State Licensing**
 - **Market Conduct**
 - **Price Controls**
 - **Surplus Lines Simplification**

SMART Act - Surplus Lines & Independent Procurement

- **Premium Tax**
 - National electronic filing system within three years
 - Based on a uniform tax allocation
 - One point of payment
- **Automatic Export (No Diligent Search)**
 - For sophisticated buyers
- **One State Compliance**
 - For sophisticated buyers
- **National Eligibility Standards**
 - For surplus lines carriers and IID listing for alien insurers
- **Broker Licensing**
 - States participate in national insurance producer database for licensing surplus lines brokers

Outlook for Reform in 2006

- **SMART Act (Standards) more probable than Optional Federal Charter**
- **Negative impact of Spitzer/Katrina allegations on insurance agenda (TRIA, SMART/OFC, etc.)**



Terrorism Risk Insurance Act (“TRIA”)

Terrorism Risk Insurance Act

- **After 9/11, TRIA was enacted as a federal backstop for insurance losses attributable to terrorist acts to ensure that adequate resources are available for businesses to recover and rebuild if they become the victims of a terrorist attack**
- **It is a temporary public/private risk-sharing partnership between the federal government and the insurance industry that was due to expire on December 31, 2005**
- **Under TRIA, owners of commercial property must be offered the opportunity to purchase terrorism coverage (TRIA does not extend to auto or homeowners insurance companies or reinsurers)**

Terrorism Risk Insurance Act

- **Specific provisions:**
 - **An event must cause at least \$5 million in aggregate P/C losses to be certified as an act of terrorism**
 - **TRIA is limited to international terrorism committed on behalf of any foreign person or foreign interest on U.S. soil (though damage to an air carrier or vessel outside the U.S. is covered)**
 - **Each participating insurer is responsible for paying out a certain amount in claims (a deductible) before federal assistance becomes available**
 - **For losses above the company's deductible, the federal government will cover 90%, while the insurer contributes 10%**
 - **The aggregate insurance industry deductible or retention is \$15 billion in 2005**
 - **Losses covered by the program are capped at \$100 billion**
 - **Lines excluded from the program are: personal lines (home and auto), assumed reinsurance, federal crop, mortgage guaranty, financial guaranty, medical malpractice, flood, and life and health insurance**
 - **TRIA sunsets after three years on December 31, 2005**

Terrorism Risk Insurance Act

- **TRIA Extension**
 - **Throughout 2005, the extension of TRIA beyond its sunset date was a hotly debated political issue**
 - **Both the House and the Senate introduced bills regarding TRIA's extension or revision**
 - **Senate Bill 467 – The Terrorism Risk Insurance Extension Act of 2005**
 - **House Bill 4314 – The Terrorism Risk Insurance Revision Act of 2005**
 - **The Bush Administration had expressed opposition to the House bill, claiming it did not reduce the scope of the program or taxpayer exposure under it. Although the White House stopped short of threatening a veto, its support for the simpler Senate TRIA extension meant that Senate text had a stronger position in the joint conference (though the overwhelming majority by which the House bill passed gave the House conferees some strength)**
 - **On December 18, 2005, Congress passed the Terrorism Risk Insurance Extension Act of 2005 (“TRIEA”) (s. 467) to extend the TRIA Program for an additional two years. The President signed the Bill into law on December 22, 2005.**

Terrorism Risk Insurance Act

- **Key New Features of TRIEA**
 - **Program Extension** – new sunset date is **December 31, 2007**
 - **Covered Lines** – TRIEA excludes commercial auto, professional liability (other than D&O) and certain miscellaneous lines currently covered by the Program
 - **Program Trigger** – Federal compensation will become available only if aggregate insured losses sustained by all insurers terrorism exceed \$50 million from a certified act of terrorism occurring after March 31, 2006 and \$100 million for losses resulting from a certified act that occurs on or after January 1, 2007
 - **Program Cap** – the \$100 billion annual program cap for combined Federal and industry shared insured losses will not change

Terrorism Risk Insurance Act

- **Key New Features of TRIEA (con't)**
 - **Insurer Deductibles** – insurer deductibles will continue to be calculated as a percentage of the insurer's direct earned premium (DEP) in all covered lines for the previous year (in 2005, the deductible is 15% of 2004 DEP; under TRIEA, the insurer deductible will increase in 17.5% in 2006 and 20% in 2007)
 - **Federal Share of Insured Losses Exceeding Deductible** – the Federal share of compensation, above the insurer deductible, is presently 90% and will remain 90% in 2006, but will decrease to 85% in 2007
 - **Post-Event Recoupment of Federal Share Via Policyholder Surplus** – TRIEA increases the threshold beyond which insurers may “recoup” government payments under the Program from \$15 billion to \$25 billion in 2006 and \$27.5 billion in 2007
 - **Long-Term Availability** – TRIEA requires the President's Working Group on Financial Markets to report to the Senate and House on the long-term availability and affordability of terrorism insurance




Model Audit Rule

NAIC's Model Audit Rule

- **NAIC's Model Regulation Requiring Annual Audited Financial Reports (the "Model Audit Rule")**
 - **The revisions seek to incorporate certain best practices contained in Title IV: Enhanced Financial Disclosures of the Sarbanes-Oxley Act of 2002**
 - **The adopted revisions will be further discussed prior to and during the 2006 Spring National Meeting**

NAIC's Model Audit Rule

- **As presently drafted, the adopted amendments address, among other things, the following:**
 - **Governance** – the amendments clarify that the Audit Committee of the Board of Directors (as opposed to management) has direct oversight responsibilities for hiring and firing external auditors
 - **Auditor Independence** – independence rules have been expanded to more explicitly prohibit external auditors from providing services that might impair their ability or the perception of a fair and objective audit
 - Generally summarized, these rules are (i) the auditor should not audit or attest to his or her own work; (ii) the auditor should not act as if he or she is management; and (iii) the auditor should not act as an advocate for the client
 - **Internal Control Opinion** – the adopted revisions require that management of an insurance company with more than \$500 million in direct and assumed premiums perform an annual assessment of its internal controls over financial reporting and report the same to its domiciliary state insurance department



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Insurance Issues Arising from Hurricane Katrina



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Hurricane Katrina

- Remember the ~~Alamo~~ Superdome!
- Hurricane Katrina proved that we **CANNOT** rely upon the Government to assist us for at least three days
 - Complete failure at every level of Government
- We must be prepared to care for ourselves
 - Are you?
- The Astrodome Experience
- From Walmart Greeter to Claims Facilitator

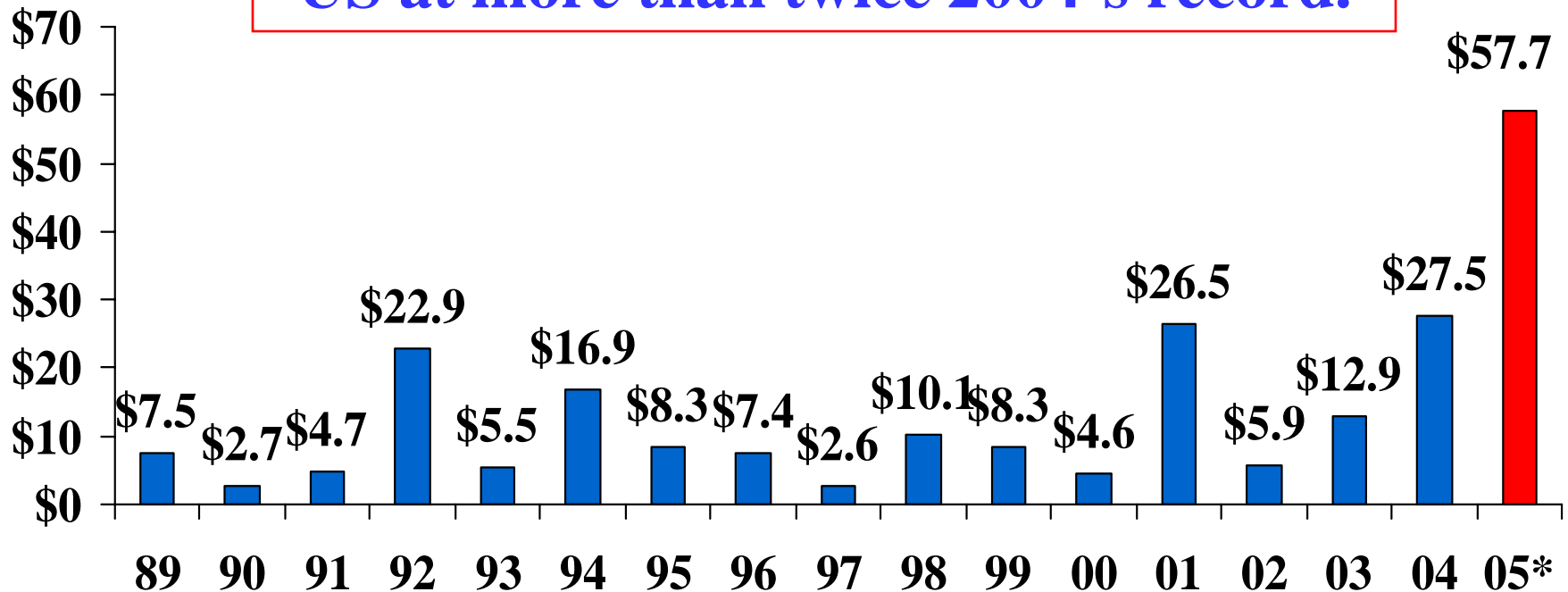
Hurricanes Katrina, Rita & Wilma:

Their Place in History

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U.S. Insured Catastrophe Losses (\$ Billions)

2005 will be by far the worst year ever for insured catastrophe losses in the US at more than twice 2004's record.

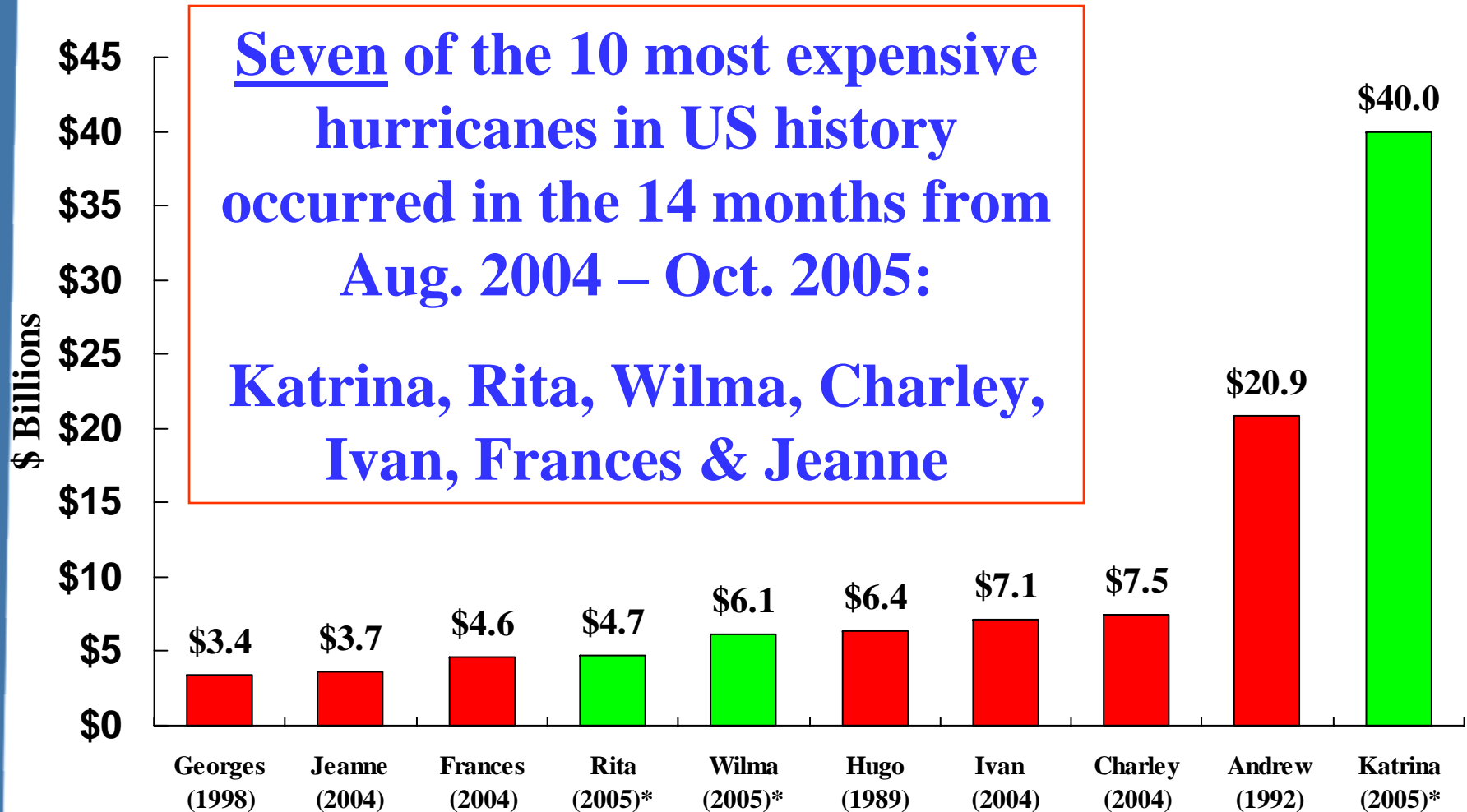


*Includes \$53.7 billion per ISO/PCS plus \$4B offshore energy losses from Hurricanes Katrina & Rita.

Note: 2001 figure includes \$20.3B for 9/11 losses reported through 12/31/01. Includes only business and personal property claims, business interruption and auto claims. Non-prop/BI losses = \$12.2B.

Source: Property Claims Service/ISO; Insurance Information Institute

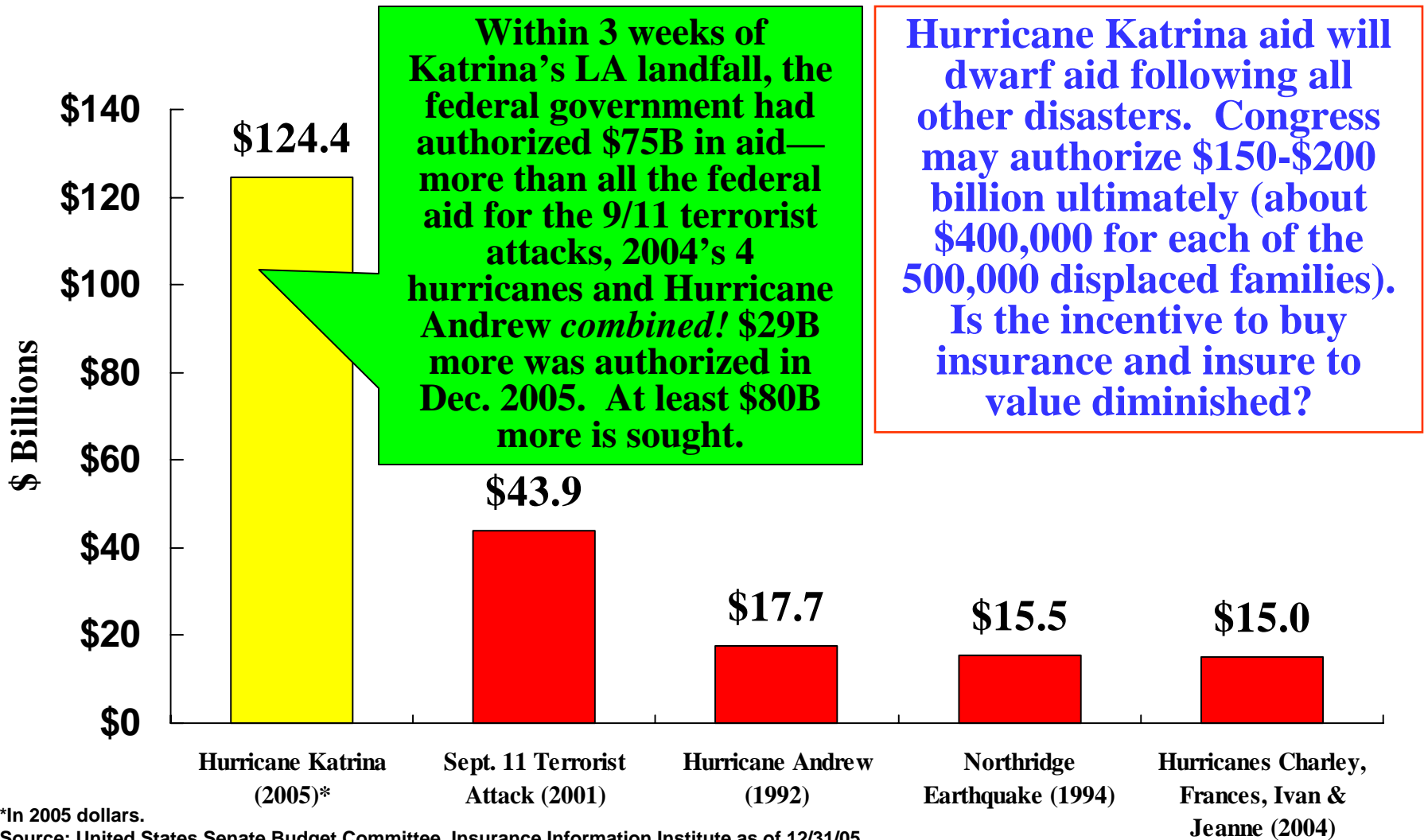
Top 10 Most Costly Hurricanes in US History, (Insured Losses, \$2004)



*Hurricanes Katrina, Rita and Wilma stated in 2005 dollars.

Sources: ISO/PCS; Insurance Information Institute.

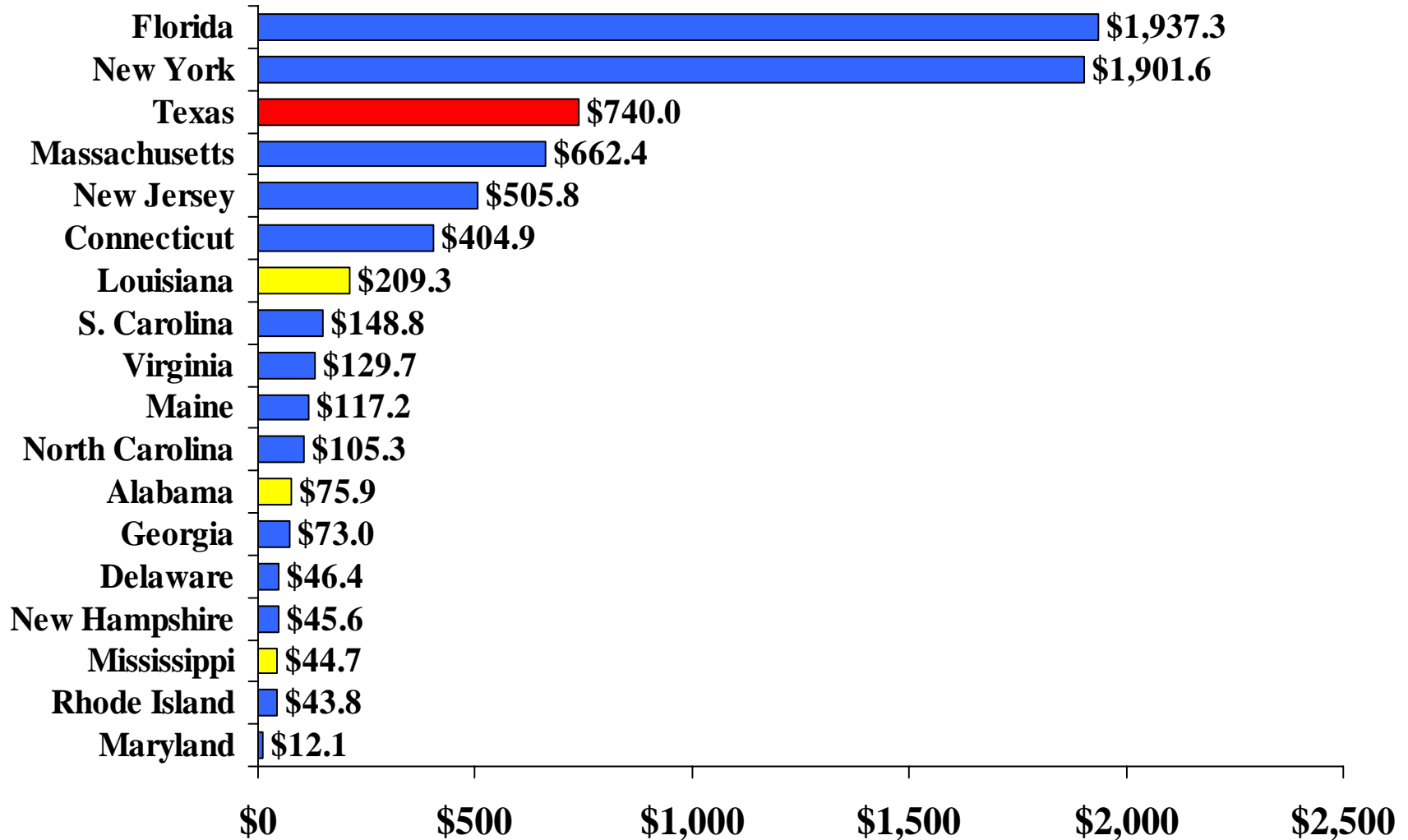
Government Aid After Major Disasters (Billions)*



*In 2005 dollars.

Source: United States Senate Budget Committee, Insurance Information Institute as of 12/31/05.

Total Value of Insured Coastal Exposure (2004, \$ Billions)



Source: AIR Worldwide

Distribution of Katrina Losses by Market (\$Billions)

Market	Percentage	Amount
Insurers	47% - 53%	\$18.8 - \$28.9
Reinsurers	52% - 44%	\$20.7 - \$24.0
Capital Markets	1% - 3%	\$0.4 - \$1.6
TOTAL	100%	\$39.9 - \$54.6

Source: *Hurricane Katrina: Analysis of the Impact on the Insurance Industry*, Tillinghast, October 2005.

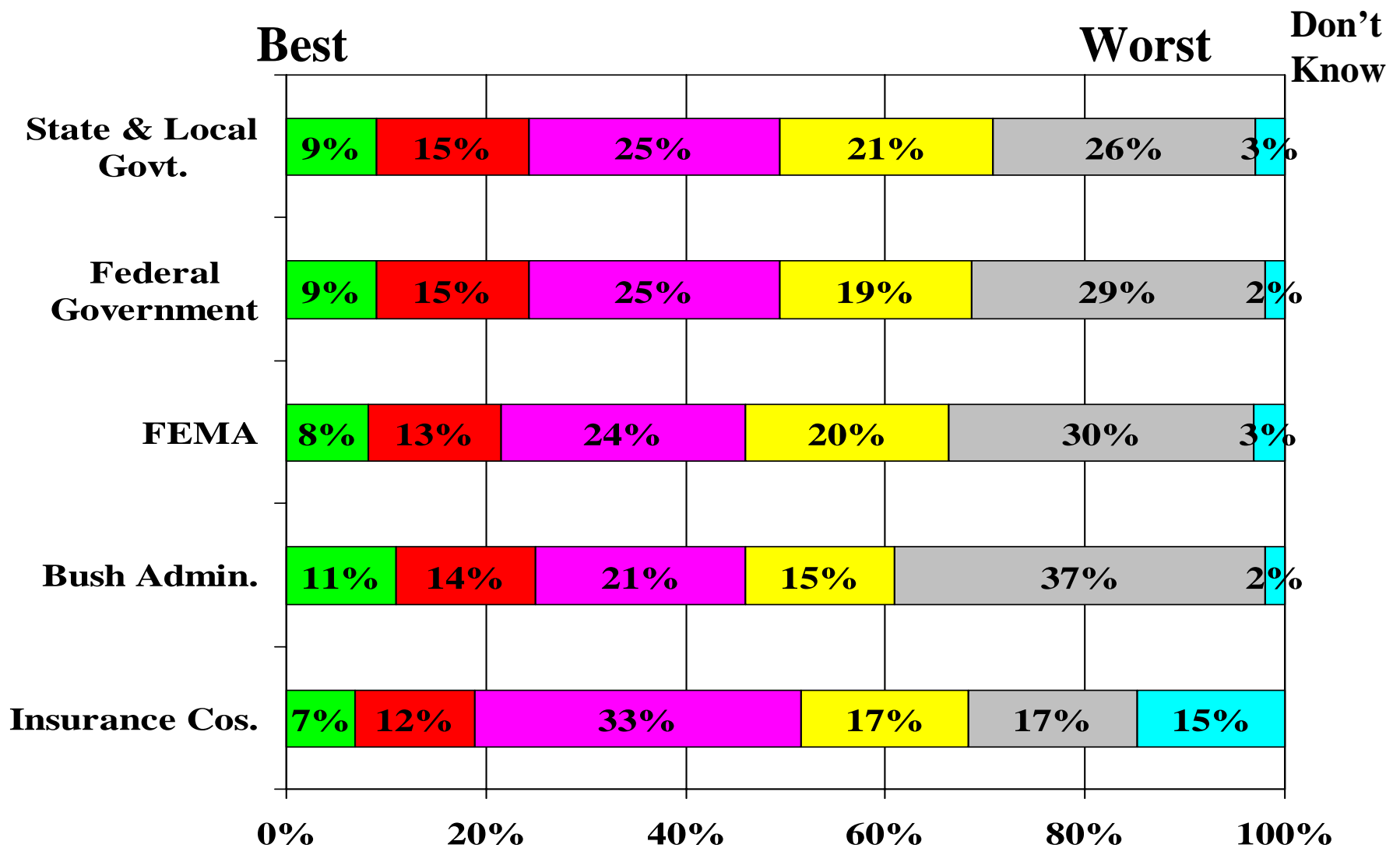
Hurricane Katrina

- **S&P has put the ratings of at least 10 insurance groups on watch for possible downgrade, including State Farm, Allstate, Allmerica Financial, Montpelier Re, PXRE Group, and Swiss Re**
- **Significant capital raising has occurred (15%-20% surplus loss to industry)**
 - **PX Re, a catastrophe specialist in Bermuda, was the first reinsurer to issue a catastrophe bond after the recent hurricanes, placing \$300 million in notes through Goldman Sachs**
 - **Munich Re has followed suit, placing 110 million euros of cat bonds to provide immediate coverage for the risk of severe windstorms in Western Europe**
 - **Private equity firms are quickly forming new reinsurance companies – according to A.M. Best, more than 10 reinsurance start ups are planned or already licensed in Bermuda**
 - **Stock sales → the losses caused by Hurricanes Katrina, Rita and Wilma have spurred billions of dollars of follow-on stock sales from publicly traded property and casualty insurers and reinsurers, which need to shore up their balance sheets as claims come in**
 - **In 2005, 35 publicly traded insurance companies have sold new shares in the US valued at \$17.23 billion**
 - **The number of follow-on stock sales in the insurance sector in 2005 is expected to exceed the level in 2001 when 9/11 drove an earlier wave of insurers to the public markets, resulting in 27 deals raising \$7.19 billion**

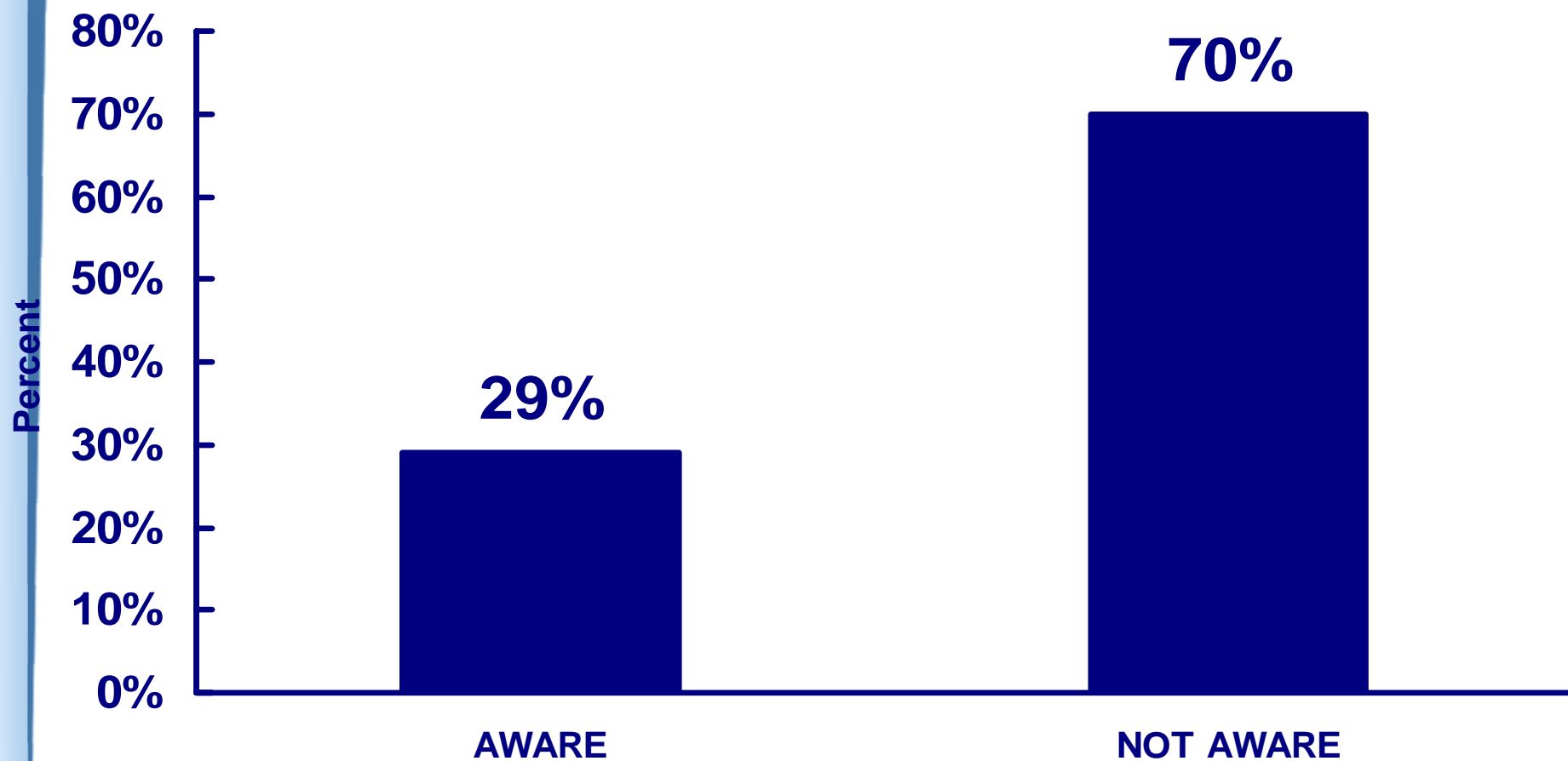
Hurricane Katrina

- **Allstate, which had no reinsurance coverage in Louisiana, lost nearly \$3.7 billion from Hurricane Katrina and has indicated that such losses could result in changes in deductibles and other aspects of the company's policies**
 - **Allstate is also pulling out of the homeowners insurance market in New York City, Westchester County and Long Island, seeking to limit its exposure to the intense storms that are predicted for coastal regions in coming years**
 - **In response, two members of regions' Congressional delegation has said that they will support federal legislation to back up insurance companies that are hit with high natural catastrophe losses**
- **Underwriting capacity in the worldwide property catastrophe retrocessional reinsurance market is down 35% following Katrina, according to the chief executive of Aon's reinsurance division**

Public Perceptions of Hurricane Katrina Response Adequacy



Awareness of Insurance Investigations



Source: Insurance Information Institute Annual *Pulse* Survey, June 2005.

Coverage Issues – Personal Lines

- **Wind-driven rain damage vs. flood damage**
 - **Standard homeowners’ policies specifically exclude flood coverage – Standard HO-3 policy defines flood damage to mean “flood, surface water, tidal water, overflow of a body of water, or spray from any of these, whether or not driven by wind”**
 - **Standard homeowners’ policies DO cover damage caused by wind**
 - **Coverage for flood is provided separately under the National Flood Insurance Act of 1968, which created the National Flood Insurance Program (NFIP), managed by FEMA.**
 - **Private insurers acting as fiscal agents issue flood insurance policies, while claims are paid from the U.S. Treasury National Flood Insurance Fund**
 - **Policy limits: \$250,000 residential property
\$500,000 commercial property**
 - **5 million property owners participate in the NFIP for a total NFIP insured property value equal to \$756 billion (in 2004)**
 - **The NFIP takes in over \$2 billion in annual premium, but FEMA expects payouts for flood claims to total between \$10-\$30 billion**
 - **By mid-October, 199,850 home and business owners had filed claims**
 - **State-backed insurers have grown to provide more than \$400 billion in coverage on 1.9 million policies**

Coverage Issues – Personal Lines

- **Wind-Driven Rain or Flood Damage?**
 - **Only 2 in 5 homes in New Orleans have flood coverage, while less than 1 in 5 Mississippi homes and businesses have flood coverage, which is sold by the National Flood Insurance Program administered by FEMA**
 - **As few as 4% of property owners in some coastal counties hard hit by Katrina carried any kind of flood insurance**
 - **Each year, about 10%-15% of flood policies lapse because property owners don't keep up the premiums**
 - **Engineers claim that they can determine the source of the damage, noting that wind damage is “top-down” (damaging roofs, etc), while flood damages is “bottom-up” (and often leaves a still-water line in the building)**
 - **In New Orleans, is the damage from the hurricane a separate event from the flooding caused by the levees breaking? (Two Events or One Event?)**

Coverage Issues – Personal Lines

- **Wind-driven rain damage vs. flood damage**
 - **Aside from wind or flood damage, some damage may have been caused by STORM SURGE (water that is pushed toward the shore by the force of the winds swirling around a storm)**
 - **FEMA defines flood as including what amounts to storm surge**
 - **Mississippi Attorney General Jim Hood asserts in litigation against five big insurers that wind-driven storm surge is not flood and is not excluded, and is thus covered**
- **Proportionality**
 - **Concurrent causation principles state:**
 - **If two causes combine to produce loss or damage, and one of the two causes is excluded (e.g., flood) and the other cause (e.g., wind) is covered, the claim should be paid**
 - **But this can be undercut by an “anti-concurrent causation lead-in clause” in a policy form, which precludes coverage for a certain peril, even if caused by an otherwise covered peril**

Coverage Issues – Personal Lines

- **Proportionality (con't)**
 - **Value Policy Laws (FL, LA and MS) generally require an insurer, absent certain narrow exceptions, to pay out the full face value of a policy in the event of a total loss of the insured property as long as one peril was covered**
 - **The allocation of damage between causes is very fact-intensive and thus investigations can take years**
 - **The method of allocation is dependent on state law**
- **The industry is still litigating insurance claims from the 1994 Northridge earthquake**

Coverage Issues – Commercial Lines

- **Business interruption coverage**
 - **Not limited to the impacted regions, but also affects those businesses that rely heavily on suppliers or customers in the Gulf Coast**
 - **But where the business premises are not physically damaged or rendered physically inaccessible, most business interruption insurance coverage does not apply**
 - *E.g., business interruption damages caused by the post-9/11 airline grounding were not covered*
 - **Forced evacuation order of New Orleans may, depending on the terms of the policy, trigger business interruption coverage**
- **Difference in Conditions (DIC) Coverage**
 - **Because DIC coverage is customized to close the gaps between existing coverage, only those insureds that negotiated for coverage for water damage and flood are likely to be covered.**

Coverage Issues – Commercial Lines

- **Marine/Energy**

- Many of these coverages (e.g., hull and cargo coverage for vessels at sea, or offshore power sources and oil drilling platforms) are written with “all risks” terms

- **Pollution**

- Several environmental statutes provide for an “act of God” defense which serves as a complete bar to liability
- Also, force majeure clauses are limited by an order or decree excusing compliance
- Class action lawsuit was filed against Murphy Oil, which had a storage tank pushed off its base by the storm surge, resulting in one million gallons of petroleum contaminating 2,500 houses

- **Reinsurance**

- Single event or multiple occurrences
- May reinsureds aggregate all property losses caused by wind storm?
- Follow the Fortunes Clauses and Ex Gratia Payments
- Hours Clauses (typically 72 hours) require the reinsurer to indemnify a portion of each and every loss occurrence exceeding the attachment point for the duration of the hours clause
- Collateralization clauses may be triggered by ratings downgrades

Coverage Issues - Generally

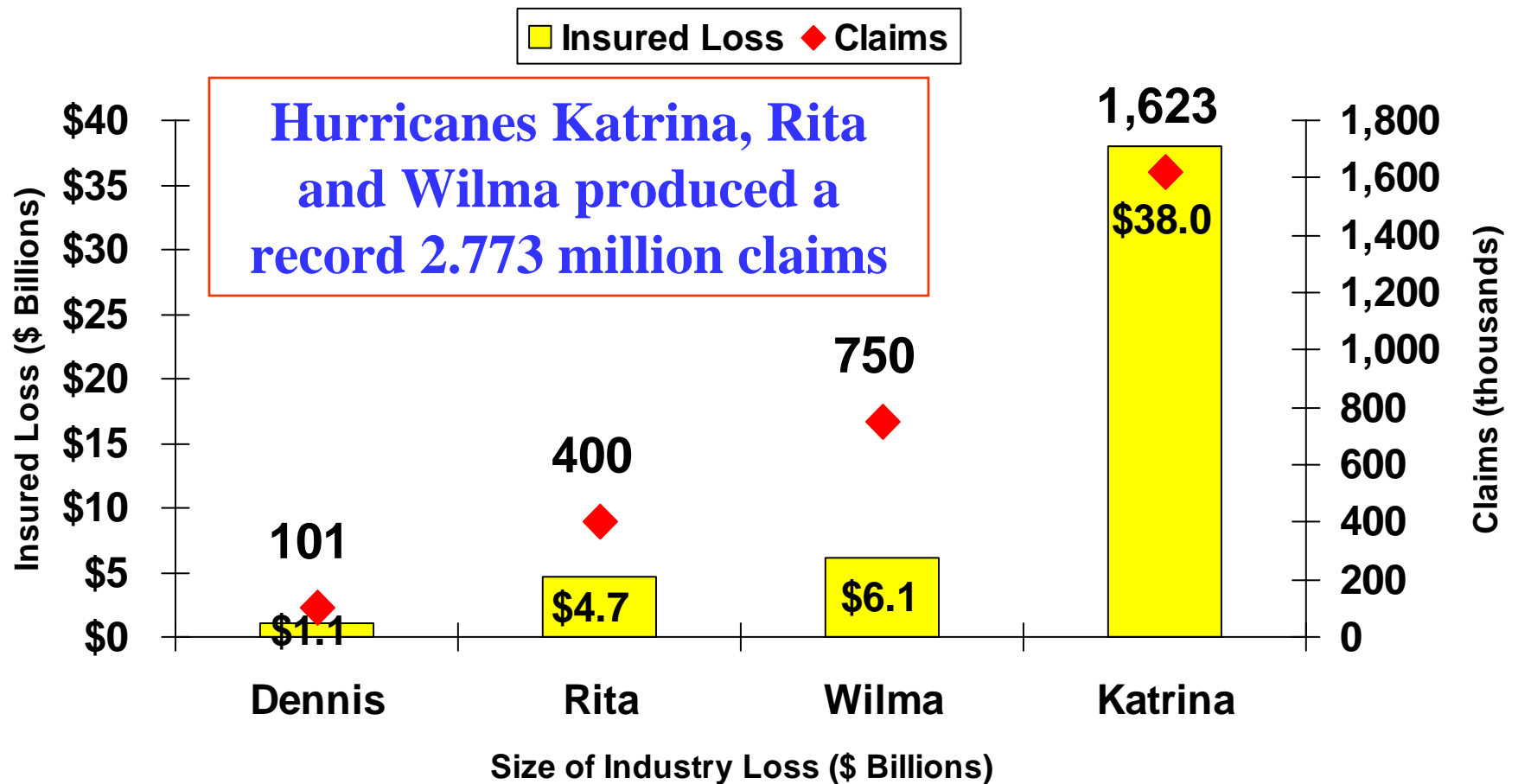
- **In addition to flood, the damage from Katrina also stems from a confluence of some of the following *additional* factors, potentially among numerous others:**
 - **Looting**
 - **Vandalism**
 - **Pollution**
 - **Fire (arson and other causes)**
 - **Power failure**
 - **Governmental action**
 - **Fungus & Mold**
 - **Further deterioration of property on account of inaccessibility for weeks, if not months**
 - **Global warming?**

Additional Issues

● **Claims Processing**

- **Both the volume and complexity of Katrina-related claims will significantly delay resolution of most claims**
 - **As of January 12, 2006, over four months since Hurricane Katrina struck New Orleans, the Insurance Information Institute estimates that the industry has responded to 80%-90% of all homeowners' claims**
 - **Homeowners insurers in MS are expected to pay \$5.5 billion in claims from Hurricanes Katrina and Rita (equal to all homeowners insurance premium paid in the state since 1989)**
- **As of September 14th, State Farm had already received over 300,000 claims from homeowners and 72,000 auto claims**
 - **Reportedly 25,000 adjusters have been deployed to the Gulf Coast region**
- **The NFIP is facing \$23 billion in flood claims, almost twice as much as the \$12.3 billion the program had paid out in its 37 years of existence**
 - **Robert Hartwig at the Insurance Information Institute says that banks should be required to verify that flood coverage remains in effect for required properties and should face severe penalties for failing to comply – flood insurance officials say that over the last 10 years regulators have fined banks only \$800,000 for violations**
- **Liberty Mutual has hired a renowned mediator who oversaw the 9/11 Victim Compensation Fund to resolve complex insurance claims filed by Gulf Coast homeowners through a three-phase program**

Insured Loss & Claim Count for Major Storms of 2005*



*Property and business interruption losses only. Excludes offshore energy & marine losses.

Source: ISO/PCS; Insurance Information Institute.

Additional Issues

- **Form Discrepancies**

- **The NFIP policy form is inconsistent with the private homeowners policy form to which it is attached**
- **Some flood exclusions differ**

- **Higher Insurance Rates**

- **Insurance executives say homeowners across the U.S. should expect to pay higher rates for their insurance, and homeowners along the Gulf could face double-digit increases**
- **Executives also warn that rates for coverage other than homeowners policies could also increase because of the widespread property losses**
- **Hanover Re expects to be able to get up to 100% higher rates for reinsurance cover in 2006**

- **Congressional Action**

- **A subcommittee of the House Financial Services Committee held an informal briefing with insurer and producer representatives to discuss the challenges that adjustors currently face on the ground trying to access loss sites**
- **The subcommittee will hold another meeting in 2-3 weeks and will include regulators from LA, MS, AL and FL, as well as industry representatives**
- **House Financial Services Staff draft post-Katrina insurance bill**

Additional Issues

- **Litigation**
 - **One class action suit has already been filed, seeking a writ of mandamus directing the Louisiana Insurance Commissioner to declare that the flood damage was caused by man-made neglect and wind damage, and thus is a covered under private homeowners insurance policies**
 - **According to a survey by the Insurance Information Institute, over 80% of executives in the property/casualty industry are confident that the industry will win in the wind vs. water lawsuits in MS**
 - **Some law firms in New Orleans have filed dozens of lawsuits targeting the Army Corps of Engineers, local government boards, insurers, an oil company and nursing home**
 - **A major problem for the courts in New Orleans will be finding enough jurors to hear cases – the city’s population has fallen from 462,000 in 2004 to about 170,000**
 - **There is also a strong possibility that errors and omissions claims will be brought against agents for failing to inform their clients of potential flood exposure and the availability of coverage through the NFIP**
- **U.S. Chamber of Commerce 2005 State Liability Systems Ranking Study:**
 - **Louisiana (ranked 47th), Alabama (ranked 48th) & Mississippi (ranked 50th)**
- **Pressure upon FEMA**

Additional Issues

- **Pressure Upon Insurers**
 - **Mississippi Attorney General Jim Hood has filed suit against 5 big insurers seeking to force them to pay flood damage, despite flood exclusions in policies**
 - **Suit seeks to void flood exclusions as unconscionable, unreasonably favorable to insurers and a violation of public policy**
 - **But as New Orleans native and LLGM's Insurance Co-Chair Jane Boisseau stated to *The Wall Street Journal* recently: "You can't provide free flood insurance by rewriting contracts."**
 - **If successful, could result in significant, nationwide increases in homeowners' insurance premiums**

The 2006 Hurricane Season:

Preview to Disaster?

**Meteorologists expect at least another
17 tropical storms in the Atlantic this year**

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Outlook for 2006 Hurricane Season

	Average*	2005**	2006F
Named Storms	9.6	26	17
Named Storm Days	49.1	115.5	85
Hurricanes	5.9	14	9
Hurricane Days	24.5	47.5	45
Intense Hurricanes	2.3	7	5
Intense Hurricane Days	2.3	7	5
Net Tropical Cyclone Activity	100%	263%	195%

*Average over the period 1950-2000.

**As of December 4, 2005.

Source: Dr. William Gray, Colorado State University, December 6, 2005.

Probability of Major Hurricane Landfall (CAT 3, 4, 5) in 2006

	Average*	2006F
Entire US Coast	52%	81%
US East Coast Including Florida Peninsula	31%	64%
Gulf Coast from FL Panhandle to Brownsville, TX	30%	47%
<p><i>ALSO...Above-Average Major Hurricane Landfall Risk in Caribbean for 2006</i></p>		

*Average over past century.

Source: Dr. William Gray, Colorado State University, December 6, 2005.

National Disaster Risk Options

- **National Natural Disaster Pool**
 - **Share of property premiums collected (homeowners and commercial) and pooled to finance mega-catastrophes**
 - **Funds to accumulate tax free**
 - **Federal government to provide backstop to pool by reinsurance line of credit**
- **Regional Natural Disaster Pool(s)**
 - **Same as National Pool program but only property premiums of select states would be involved**
- **Federal Reinsurance Program**
 - **Insurers purchase CAT reinsurance from Federal government**

National Disaster Risk Options

- **Pre-Event Catastrophe Reserving**
 - **Insurers allowed to accumulate reserves tax free for natural disaster risks in advance of the event**
 - **Presently U.S. tax laws do not allow; however most other countries permit pre-event tax free reserving**
- **California EQ Style Authority**
 - **State/Regional Government Authority to cover mega-catastrophes**
 - **Participating insurers buy in with initial capital contribution and are allowed to offer CEA policies**
 - **Reserves are allowed to accumulate tax free because Authority is a governmental entity**
 - **Probably works best when mandatory coverage must be provided**

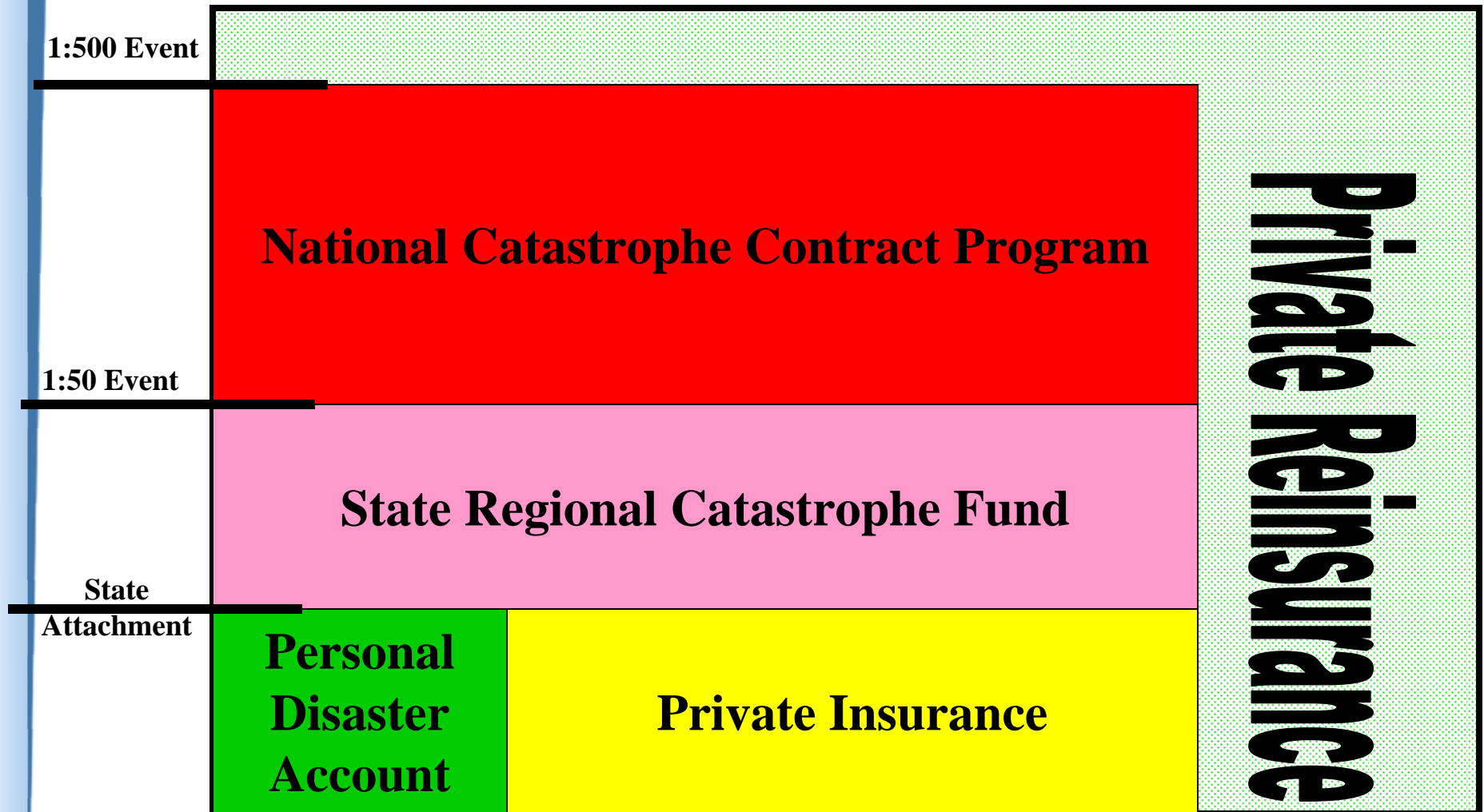
National Catastrophe Insurance Summit

- **November 14-15, 2005**
 - **Insurance Commissioners John Garamendi (CA), Howard Mills (NY), Kevin McCarty (FL) and Michael McRaith (IL) convened the National Catastrophe Insurance Summit in San Francisco**
- **The summit focused on a national approach to catastrophe planning with the hope that a legislative proposal could be developed (most likely the establishment of government-run catastrophe insurance funds) and taken to the U.S. Congress**
- **The Commissioners' objectives:**
 - **To protect consumers by ensuring the affordability and availability of insurance against the financial consequences of catastrophic events**
 - **To spread catastrophic risk broadly among insureds, insurers, reinsurers, the states and the nation, in a public-private partnership**
 - **To reward mitigation of hazards, conserve capital for catastrophes, maximize capacity and provide seamless coverage and service to policyholders**

National Catastrophe Insurance Summit

- **National Catastrophe Insurance Plan**
 - **The Commissioner proposed a multi-layered plan beginning with the individual policyholder and private insurer/reinsurer, through state and regional government mechanisms to a national fund for truly catastrophic losses**
 - **Consumer/Community → strict building codes, demand surge mitigation, hazard area designation, and land use ordinances should be considered**
 - **Individual Private Insurance Policy/Policyholder → participating insurers required to make catastrophic coverage available for all P/C lines that they write; coverage up to full policy limits for any catastrophic event should be available; catastrophe reserves should accumulate on a tax-deferred basis; private insurers continue to service policies in the event of a catastrophe**
 - **State/Regional Catastrophe Risk Management → structure and funding up to the states or regions; coverage begins after first layer of catastrophic losses reached (x dollars), as reinsurance in those participating states**
 - **National Catastrophe Insurance Fund → coverage begins after second layer of catastrophic losses reached (x dollars), but could rise as capacity built in first and second layers, lessening federal exposure; NCIF funds available only to participating states and insurers; not for profit, tax free, earmarked only for catastrophe-related purposes; operates like a private reinsurance facility, not part of the Treasury; managed by a board including insurance regulators or their designees, Treasury personnel, insurance industry and consumer representatives**

Comprehensive National Catastrophe Plan Schematic




Source: NAIC, *Natural Catastrophe Risk: Creating a Comprehensive National Plan*, Dec. 1, 2005; Insurance Information. Inst. LeBoeuf, Lamb, Greene & MacRae LLP

National Catastrophe Insurance Summit

- **Though industry and consumer representatives expressed broad theoretical approval for the National Catastrophe Insurance Plan, the obstacles to implementation of the Plan were evident during the Summit**
 - **No consensus among attendees as to whether the Federal government should play a formal role in providing insurance or reinsurance protection for catastrophic events, or as to whether a National Catastrophe Insurance program should be mandatory or voluntary**
 - **Some industry executives have publicly expressed that a national catastrophe insurance fund is unnecessary, arguing that state regulatory approval of sufficient rate levels is what is really needed**
 - **The National Association of Mutual Insurance Companies (NAMIC) warns that the National Catastrophe Risk Plan has the potential to “damage private insurance markets and exacerbate the very problems it seeks to correct”**
 - **NAMIC takes issue with the Plan’s proposal to require property insurers to sell, on a nationwide basis, an “all-perils” homeowners policy “containing no exclusions except for acts of war” and the Plan’s failure to state whether the price of the policy would be determined by market forces or government fiat**
 - **NAMIC asserts that unless all homeowners are required to purchase an identical all-perils policy, the Plan will lead to adverse selection among high-risk and low-risk buyers**

National Catastrophe Insurance Summit

- **The Summit raised awareness of the need for change in the industry, but the discussions are in their early stages – there is no true consensus around any specific proposal, and implementation of any proposal will require resolution of many technical and potentially difficult (and political) details**
 - **The Commissioners next plan more detailed meetings with insurance legislators and other insurance commissioners, then discussions with congressional leaders about potential legislation**



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California's Proposed Credit for Reinsurance Regulations



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California Reinsurance Regulations

● **Background**

- **Cal. Ins. Code section 922.8(a) empowers the Commissioner to issue a bulletin setting forth reasonable requirements for the allowance of reinsurance as an asset or deduction from liability consistent with Sections 922.4 through 922.6**
- **CDI Bulletin 97-5 is the bulletin currently in force**
 - **The Commissioner failed to promulgate regulations superseding Bulletin 97-5 before December 31, 2001, as is required under section 922.8(d)**
- **“Proposals Concerning Reinsurance Accounting Agreements and Oversight”**
 - **First introduced on September 28, 2004 and a revised draft was circulated to industry representatives on June 3, 2005**
 - **Final version formally proposed and submitted to the California Office of Administrative Law on December 2, 2005**
 - **Proposed Regulations apply on a prospective basis only. Thus, Bulletin 97-5 will continue to govern all existing reinsurance agreements, unless those agreements are “materially amended” after the effective date of the Proposed Regulations**
 - **Public hearing held on January 24, 2006**

Scope

- **Codification of “Underground Regulations”**
 - **The Proposed Regulations are of unprecedented breadth and scope and contain many provisions that are inconsistent with the NAIC’s Credit for Reinsurance Model Regulation and credit for reinsurance requirements applicable in other states**
- **Extraterritoriality**
 - **Apply to all Domestic Insurers**
 - **Many provisions, including many of the most controversial, apply to all Foreign Licensed Insurers & Foreign “Volume” Insurers**
 - **A “volume” insurer is defined as any foreign insurer:**
 - **Whose direct written premium in California represents 20% or more of 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 represent 20% or more of its total direct unpaid losses and unpaid loss adjustment expenses on its most recent annual statement; or**
 - **Whose direct written premium in California exceeds \$20 million as reported on its most recent annual statement; or**
 - **Which assumes more than 50% of its total premium as reported on its most recent annual statement**

<u>Proposed Regulation</u>	<u>Applicable to Domestic Insurers</u>	<u>Applicable to Foreign Licensed Insurers</u>	<u>Applicable to Foreign "Volume" Insurers</u>	<u>Applicable To Non-Licensed Insurers</u>
Affirmation of Compliance	✓	✓	✓	
Disallowance of Credit for Impaired Reinsurer	✓	✓	✓	
LOC Evergreen Clauses	✓			
Reinsurance Intermediaries	✓		✓	
90-Day Execution Rule	✓	✓	✓	
90-Day Overdue Reinsurance Recoverables Rule	✓			
Insolvency Clauses	✓	✓	✓	
Setoff Provisions	✓			
Arbitration Clauses	✓			
ECO Clauses	✓			
Bulk Reinsurance	✓		✓	
Prospective Bulk or Affiliate Reinsurance	✓	✓	✓	
New P/C Transfer of Risk	✓	✓	✓	
Proof of CA Equivalence		✓	✓	✓

Significant Provisions

- **Affirmation of Compliance**
 - **Incorporates the NAIC Reinsurance Attestation Supplement form (adopted by the NAIC in July 2005), but requires California licensed insurers to provide additional details about each separate reinsurance agreement disclosed in the NAIC Attestation Supplement**
- **Disallowance of Credit for Impaired Reinsurer**
 - **Disallows credit for reinsurance ceded to a licensed or accredited reinsurer that is the subject of a “regulatory order” or “regulatory oversight” on the grounds of “financial hazard” by any state in which it is licensed**
- **Letters of Credit**
 - **Requires 60 days notice of non-renewal for the letter of credit under the mandated evergreen clause, as opposed to commonly-required 30 days notice**
 - **Requires the prior written consent of the Commissioner to make any amendment to the LOC other than an amendment modifying the amount of the credit**

Significant Provisions...con't


- **Reinsurance Intermediaries**
 - **If a ceding insurer enters into a reinsurance agreement that provides for the transmission of payments through a reinsurance intermediary, consent for the transaction may be conditioned upon the intermediary having been issued a satisfactory examination report by the CDI**
 - **This applies to “material reinsurance agreements” of domestic insurers and foreign “volume” insurers – “material reinsurance agreement” is defined as one in which the reinsurance premium or a change in the ceding insurer’s liabilities equals or exceeds 5% of the ceding insurer’s policyholder surplus, as of the preceding 12/31**
- **“Ninety-Day” Issues**
 - **90-Day Execution Rule**
 - **90-Day Overdue Reinsurance Recoverables Rule**

Significant Provisions...con't

- **Insolvency and Set-off Issues**
 - **Mandates the contents of insolvency clauses in the reinsurance contracts of domestic ceding insurers and foreign “volume” insurers**
 - **Prohibits use of setoffs in liquidation proceedings entirely**
- **Arbitration Issues**
 - **An arbitration provision in the reinsurance contract of a domestic ceding insurer must require the arbitration to be held in California, though the provision may permit the parties to agree that an arbitration for which a demand has been made may be held elsewhere**
- **ECO Clauses**
 - **Permits the inclusion of an “extra contractual obligation” provision in reinsurance contracts, but such provisions within the reinsurance contracts of a domestic insurer may permit indemnity only to the extent allowed by applicable law**

Significant Provisions...con't

- **Bulk Reinsurance**
 - **Cessions or assumptions of 50% or more of an insurer's total premium or liabilities are not permitted when ceded or assumed under one or more agreements with one party without the prior written consent of the Commissioner**
- **Prospective Bulk or Affiliate Reinsurance**
 - **Consent for cessions of more than 75% of an insurer's total premium on prospective business shall generally be based upon demonstrated business necessity. Consent to cessions of more than 90% shall be based upon further strictly delineated requirements.**
- **P/C Transfer of Risk**
 - **Requires transfer of risk to be determined by application of the NAIC Accounting Guidance, in a manner consistent with certain California-specific principles**
- **Proof of California Equivalence**
 - **Where credit is claimed on the basis that the unauthorized reinsurer is either licensed or accredited in the foreign insurer's state of domicile, the reinsurer must, in substance, meet either the licensing or accreditation standards of California.**



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Significant Legislative Developments in 2005 and the Outlook for 2006



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2005 Legislative Enactments

- **Assembly Bill 729 (Koretz)**
 - **Effective January 1, 2006, this bill amends several provisions of the California Insurance Code impacting upon agents and brokers generally:**
 - **Requires that surplus line brokers organized as limited liability companies (LLCs) provide the Commissioner with a certification of security for claims against them in the form of E&O coverage or acceptable alternative security equal to \$100,000 for each claim multiplied by the number of licensees rendering professional services on behalf of the company (minimum coverage is \$500,000; maximum coverage is not required to exceed \$5 million)**

2005 Legislative Enactments

- **Assembly Bill 1043 (Harman)**
 - **Effective January 1, 2006, this bill requires the broker or agent to return the gross unearned premium to the insured or appropriate party (i) within 25 business days of the termination of a personal lines policy, and (ii) within 80 business days of the termination of a commercial lines policy (instead of 30 days)**

2005 Legislative Enactments

- **Assembly Bill 1424 (Saldana)**
 - **Effective January 1, 2006, this bill provides that, similar to the current tax lien provisions governing insurers, the tax levied upon a surplus line broker under the CA Revenue and Taxation Code is a lien upon all property and franchises of every kind and nature belonging to the surplus line broker, and has the effect of a judgment against the surplus line broker**
 - **AB 1424 clarifies, however, that the lien levied upon surplus line brokers shall not exceed the amount of unpaid tax actually collected by the surplus line broker from the insured (as opposed to the amount of unpaid tax actually due from the insured)**

2006 Legislative Agenda

- **Proposed Amendments of the Surplus Line Law**
 - **Section 1760**
 - **Amend Section 1760 to permit an insured to utilize the services of a licensed California surplus line broker to negotiate and effect insurance directly from a LESLI-listed insurer without the need to obtain three declinations**
 - **Section 1763**
 - **Amend Section 1763(c) to state: “It shall be conclusively presumed that insurance is placed in violation of this section if insurance is ~~actually~~ knowingly placed with a nonadmitted insurer at a lower rate of premium or lower premium . . .**
 - **1765.1**
 - **Amend Section 1765.1 to include large commercial risks to the “gap coverage” exception to the LESLI requirement**

2006 Legislative Agenda

● Citation Program


- **In 2005, AB 729 originally contained language that would have empowered the Commissioner to issue a “citation” as a first warning to producers who violated the insurance laws, instead of forcing the Commissioner to initiate an administrative enforcement action for a minor infraction**
 - **This language was ultimately dropped from AB 729**
- **The CDI has indicated it intends to propose new language to renew the possibility of having a citation program adopted in 2006**
 - **The CDI has not yet released proposed language, and it is unclear whether the CDI will propose citations as “warnings” or whether the CDI will propose to give itself the authority to automatically issue citations and fines without the need to proceed with an enforcement action**

2006 Litigation

- ***Crusader Insurance Company v. Harry W. Gorst Company, Inc.***
 - **Crusader sued Gorst alleging violations of Section 1763 stemming from the submission of fraudulent SL-2 Forms and the placement of surplus line policies despite Crusader's willingness to underwrite the risk**
 - **The trial court awarded Crusader summary judgment, but denied Crusader's motion for attorneys' fees and refused to read Section 1763 as requiring surplus line brokers to present risks to admitted insurers that such brokers know write the particular class of business if three declinations have been obtained**
 - **Crusader has appealed its motion for attorneys' fees to the appellate court, seeking to recover attorneys' fees and attempting to, in effect, re-litigate its interpretation of Section 1763**
 - **The SLA has prepared an amicus curiae "friend of the court" brief to be filed in the appellate court, thus providing the court with an expert analysis and description of the surplus line market in California and the appropriate manner in which the California surplus line laws shape and guide that market**

2006 Litigation

- ***Business to Business Markets, Inc. v. Zurich Specialties London***
 - **In this case, a California Court of Appeal held that a surplus line broker's duty of care extends to third parties who are not clients of the surplus line broker or otherwise in privity of contract with it.**
 - **The Court acknowledged that its extension of a surplus line broker's duty of care to third parties who are not client would likely subject the surplus line broker to increase liability, but noted that the surplus line broker and the insurer could offset this liability by "charg[ing] prices that reflect their costs and risks."**
 - **The SLA is organizing support throughout the industry to (i) seek depublication of the Appellate Court's opinion, and (ii) lend amicus curiae "friend of the court" support in the surplus line broker's petition for review of the Appellate Court decision by the California Supreme Court**



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