

# **Study Guide for the**



# **Arizona Surplus Lines Examination**

## **October 2016**

**The Surplus Line Association of Arizona**  
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**Scottsdale, AZ 85254**

In 2010, the Arizona Surplus Line Association (SLA) and the Independent Insurance Agents and Brokers of Arizona (IIABAZ) combined their resources to develop an online education program for the Arizona Surplus Line licensing exam. This was designed to replace the prior “live” classes that were offered on a periodic basis to help individuals prepare for the exam. Much has changed in the insurance industry since 2010 so in 2016 the SLA and the IIABAZ elected to update the material as well as change the delivery from a video format to webinar.

This Study Guide is designed to be used in conjunction with the webinar and PowerPoint presentation on the SLA website ([www.sla-az.org](http://www.sla-az.org)). The majority of the material in the Guide was obtained from Section 20 of the Arizona Revised Statutes (ARS) that pertain to insurance and we invite you to visit the Department of Insurance website (<https://insurance.az.gov/>). The training class has been divided into four sections to allow students the opportunity to review the entire presentation or just those parts that are relevant to a particular issue or question they have. We hope that you will find it useful and we invite any comments or feedback that you have in regards to the content.

A special note of thanks goes to the IIABAZ team of Lanny Hair, Joni Fairbrother, and Terri Edwards for their assistance in developing this program. In addition, the Surplus Line Association would like to thank Chris Behymer, our designated Surplus Line carrier representative, for his assistance.

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# Section I

## Introduction, Program Objectives, the Insurance Marketplace and Excess and Surplus Lines

## Objectives of this Class

1. Discuss the nature of the Property and Casualty insurance industry
2. Provide an understanding of the Excess and Surplus lines (E&S) insurance industry
3. Explain how E&S works with standard lines companies
4. Discuss workflow and how agents access E&S carriers
5. Administrative procedures associated with surplus lines placements, including regulation, markets, records and taxes
6. Provide an overview of the Arizona Surplus Lines licensing exam in regards to content, structure and continuing education requirements

## Overview of the Insurance Industry

The Property and Casualty industry in the United States is comprised of a number of companies and producers who provide insurance for a wide variety of business and personal exposures to loss. At last count, there are over 4,000 carriers with total annual P&C premium paid by policyholders in excess of \$585 billion as of the end of 2015.

The industry plays a vital role in our economy and in addition to providing millions of jobs, the industry allows people to insure their assets (homes, cars, and businesses) and provides some peace of mind should something happen, like a windstorm, fire or theft.

On a more local basis, the industry in the state of Arizona is vital to our economy as well. According to the Arizona Department of Insurance 2013-2014 Annual Report, there are 1,797 licensed insurance companies (property and casualty and life and health) operating in the Grand Canyon state. These carriers collect in excess of \$25 billion a year in premiums and pay more than \$411.7 million in taxes. From a surplus lines perspective, as of December 31, 2013 there were 116 authorized carriers operating in Arizona and collectively they wrote in excess of \$307 million in premium.

The Arizona Department of Insurance (DOI) is the regulatory body assigned the task of monitoring performance and assuring that rules and guidelines are followed by all insurance entities. Unlike some other jurisdictions, the relationship between the industry (companies, producers, and consumers) and the department is extremely professional and all parties work together to provide a stable, competitive marketplace for Arizona insurance consumers.

Arizona is somewhat unique in that many Excess and Surplus lines companies have elected to set up shop in our state. Throughout the country, and for that matter throughout the world, Arizona is seen as an E&S “hotspot” and, as such, we attract many local, regional, and national meetings which support our valuable convention business.

Before launching into the content of the presentation, it is important to keep a couple of definitions in mind. Standard, or sometimes called admitted insurers, are licensed and issued a certificate of authority by the state to write business in Arizona. Non-admitted or unauthorized insurers, also referred to as surplus lines insurers, are not licensed by the state **BUT** are allowed to operate under specific circumstances. This distinction will become clear as you proceed through this Study Guide. You will also learn that all unauthorized insurers are **NOT** able to sell their policies in the state! This too will be explained in a later section.

Standard insurance companies are licensed entities that, for lack of a better term, write “standard stuff.” In most cases, the products they offer provide insurance on types of exposures to loss that fit a fairly defined set of criteria. These carriers use policy forms and endorsements that have been approved by the Department of Insurance. Standard or admitted companies also participate in the state’s Guaranty Fund which comes into play when an admitted

company can't for whatever reason satisfy its contractual obligations. You will learn more about how this facility functions later on in this program. Collectively this segment of the business writes over 90% of the insurance in the state.

The surplus lines industry is designed to provide an orderly process for insuring those risks that the standard carriers elect not to insure. Accounts that make their way into surplus lines tend to have one or more of the following characteristics:

- Unique. A person who wants to set up remote cameras to look for Bigfoot in a national forest needs a liability insurance policy in the event someone is injured by the camera.
- Distressed. An apartment risk with multiple property and liability losses might not qualify for coverage from a standard insurer.
- High limits. The owner of a billion dollar schedule of commercial property can't find the necessary limits from admitted insurers.
- Tailored coverage forms. A manufacturer of airplane parts needs a type of coverage that is not available in the standard market.

These are a few examples of how the surplus lines market adds value to the insurance process. E&S companies are not required to file their rates or forms with the DOI thus they have the flexibility to develop coverages and rating methods without the need to obtain prior approval. As these companies are not licensed, they do not participate in the State Guaranty Fund.

If a particular risk qualifies for coverage in the admitted market, existing statutes require that it be placed with a licensed carrier. When the risk does not qualify, the agent may seek to place it in the non-admitted (or surplus lines) market. To do so, the agent must contact a licensed intermediary for assistance. The agents who specialize in surplus lines placements go by many names; surplus lines broker, managing general agent, general agent, wholesaler, or managing general underwriter. The key is that you must deal with someone who has either a resident or nonresident surplus lines broker's license in the state of Arizona.

A word of caution is in order. When you receive a quotation for a surplus lines placement, it is very important that you carefully review the quote. Many times surplus lines carriers use manuscript forms which may include special limitations and exclusions that are not used by standard companies. Be sure to notify your customer of these exclusions and limitations at the time of the placement, **NOT** after an uncovered loss!

## Section II

# Licensing, Regulation, Authority, and General Requirements

## Licensing

When an insurance producer sells a policy from a non-admitted insurance company, it is **mandatory** that a surplus lines broker license be in place somewhere along the distribution line of the sale. Generally speaking, the corporation (agency) will hold the license. Individuals may also be licensed. In the case of entity (Corporate, Partnership) licenses, it is necessary that at least one (1) individual license be in force. That individual licensee is known as the "Designated Responsible Licensed Producer" aka "DRLP." The surplus lines broker can be a retail producer selling directly to the insured or can be a wholesale producer, who arranges coverage on behalf of a retail producer and does not deal directly with the general public.

Keep in mind that any producer in an agent's office who assists in the placement of surplus lines insurance must be properly licensed. Some agencies might have 10 producers and one "designated" person to sign off on surplus lines transactions. This is not permitted as anyone who places business in the surplus lines market must have a surplus lines license.

To obtain a surplus lines license, the individual must have a resident property and casualty insurance license and successfully complete the surplus lines broker's examination. A non-resident surplus lines broker, one who is properly licensed in another state, does not have to take the Arizona surplus lines or producers exams in order to qualify for a non-resident license. If the wholesale producer holds a surplus lines license, then it is not necessary for the retail producer to also obtain a surplus lines broker license. The corporation or individual in the transaction that holds the license will ultimately make the necessary state filings and pay the surplus lines tax.

Current law permits the Director to license a corporation or a partnership as a surplus lines broker. The law establishes four (4) requirements that must be satisfied for a surplus lines broker license to be issued.

1. At least one natural person in each of the surplus lines broker's offices must be licensed as a property/casualty producer in this state. That person must take and pass the surplus lines license examination. (It is recommended that a minimum of two people take the examination for each corporation and obtain a surplus lines license).
2. If the surplus lines broker intends to do business under a trade name, that name must have been lawfully registered to the corporation or partnership.
3. The articles of incorporation, partnership agreement or other similar document authorize the entity to act as a surplus lines broker.
4. The surplus lines broker must promptly notify the Director of all changes to its members, directors and officers.

One area that comes up on occasion involves the concept referred to as courtesy filings. Here's how it works. An agent in Texas writes a business located in El Paso and the business owner purchases a location in Arizona. The Texas agent does not have a non-resident producers or surplus lines license in Arizona and calls and asks you to make a courtesy filing to pay the taxes and fees. Don't do it! This practice is prohibited in Arizona and many other states. The potential for errors and omissions (E&O) problems are significant and you can be fined for making this filing. The best advice you can give is to encourage the Texas agent to procure the necessary licenses in order to properly write the Arizona location.

## **License Duration and Maintenance**

The Surplus Lines Broker License works in a similar manner to that of a regular license. The license is valid for a period of four (4) years. At which time it must be renewed or it will be invalid. An application for renewal will be done at the same time as the property casualty producer license. There is, of course, the renewal fee that must also be paid. The applicant must disclose any prior or pending criminal activity and pending civil action on the renewal application.

The renewal application, fees, and proof of evidence of completion of continuing education requirements must be submitted on or before the close of business on the expiration date, which for an individual is the last day of the licensee's birth month. If the license is for a business entity, the renewal documents must be received by the director on the last day of the month four years after the effective date of the license issue date.

If the application is not received by the Arizona Department of Insurance by that time, the application is considered "late" and will be subject to late fees. If the application is renewed within six (6) months of the expiration, a late fee plus the renewal fee can be paid to reinstate the license. After six months, the process of applying for a surplus license, including taking the exam, must be repeated.

As stated, all changes experienced by the licensee must be reported to the Arizona Department of insurance, including a change of address, members, directors, officers or designated producer. This change must be reported within 30 days of the occurrence. Keep in mind that street addresses must be used. Post Office box numbers are not permitted.

The Arizona Department of Insurance also requires a report of any administrative action taken against the producer in another jurisdiction or by another governmental agency in this state. The report must be made within 30 days after the final disposition of the matter. Also a report is required within thirty days after the initial pretrial hearing date of criminal prosecution of the producer taken in any jurisdiction.

## **DISCIPLINARY ACTIONS ON LICENSE**

The Arizona Department of Insurance (ADOI) has the authority to take disciplinary action, including suspension, revocation, refusal to renew or imposition of a civil penalty or a combination of actions where the licensee has committed any one of a number of offenses. The reasons for disciplinary actions include:

1. Providing incorrect, misleading, incomplete or materially untrue information in the license application.
2. Violating any provision of this title or any rule, subpoena or order of the director.
3. Obtaining or attempting to obtain a license through misrepresentation or fraud.
4. Improperly withholding, misappropriating or converting any monies or properties received in the course of doing insurance business.
5. Intentionally misrepresenting the terms of an actual or proposed insurance contract or application for insurance.



6. Having been convicted of a felony.
7. Having admitted or been found to have committed any insurance unfair trade practice or fraud.
8. Using fraudulent, coercive or dishonest practices, or demonstrating incompetence, untrustworthiness or financial irresponsibility in the conduct of business in this state or elsewhere.
9. Having an insurance producer license, or its equivalent, denied, suspended or revoked in any state, province, district or territory.
10. Forging another's name to any document related to an insurance transaction.
11. Aiding or assisting any person in the unauthorized transaction of insurance business.
12. Violating section 41-624, subsection B or C.
13. Violating section 6-1410, 6-1412 or 6-1413.
14. Using the insurance producer's license principally to procure insurance that covers the life, property or insurable interests, other than to insure an interest in property that is being sold under a contract or that is securing a loan, of any of the following:
  - (a) The licensee.
  - (b) The licensee's family or relatives to the second degree.
  - (c) The licensee's employer.
  - (d) The licensee's employees.
  - (e) A firm or corporation, or its employees, in which the licensee owns a substantial interest.

If the Director of the ADOI believes that any person has violated or is about to violate Arizona statute regarding insurance, the director may order a cease and desist. Civil penalties include \$1,000 for each act or violation with an aggregate of \$10,000. If the director finds the violations were intentional, a civil violation of \$5,000 per violation with an aggregate of \$50,000 may be levied.

### **Authority of Surplus Lines Brokers**

Unlike an insurance agent that represents an admitted insurance company, a surplus lines broker, in general, has a different relationship with their partner carriers. By definition an "agent" is someone who represents the company - can speak for the company - has authority with the company such as binding authority, possibly some small claim authority or authority to quote premium on risks. Surplus Lines Brokers, because of the very nature of the business that they are writing, unusual, unique or capacity related risks, generally have no binding authority unless the insurance company specifically gives them the authority. Claim settlement authority is normally not extended unless the company has set up special provisions for this process.

A licensed surplus lines broker may accept or place surplus lines business from any insurance producer licensed in this state for the kind of insurance involved and may compensate the insurance producer. The broker shall have the right to receive from the insurer the customary commission.

The surplus lines broker may also include additional service fees for placing the risk as long as the fees are conspicuously shown on the proposal for insurance and applicable taxes and fees are paid.

## **Licensing of Mexican Insurance Surplus Lines Broker**

People entering Mexico with vehicles are required to purchase Mexican Auto Insurance. Most people buy the coverage before crossing the border. Any licensed insurance producer that maintains an office in this state may be licensed as a Mexican insurance surplus lines broker to transact insurance business if the director determines that the insurance producer is competent and trustworthy and the insurance producer complies with all of the requirements of Arizona insurance laws. The director shall provide application forms for any person that wants this limited insurance license. In addition, Arizona taxes are not paid on accounts written in Mexico. To sell Mexican auto insurance, you must have either the limited Mexican Auto Insurance license or a surplus lines broker license or as a licensed producer, place business through a licensed surplus lines broker.

### **Unfair Practices and Frauds**

(Arizona Title Reference - ARS 20-443, ARS20-443.01, ARS 20-447, ARS 20-444, ARS 20-448, ARS 20-451, ARS 20-452, ARS 20-461)

As with all states, Arizona has laws to require that producers/brokers conduct themselves in a fair manner with consumers and with insurance companies. It is therefore illegal to make, issue or circulate materials or statements which misrepresent the terms of any policy. Statutes state specifically that a producer/ broker cannot:

1. Misrepresenting the terms of any policy issued or to be issued or the benefits or advantages promised or the dividends or share of the surplus to be received.
  2. Making any false or misleading statement as to the dividends or share of surplus previously paid on similar policies.
  3. Making any misleading representation or any misrepresentation as to the financial condition of any insurer or as to the legal reserve system upon which any life insurer operates.
  4. Using any name or title of any policy or class of policies misrepresenting the true nature of the policy.
  5. Making any misrepresentation to any policyholder for the purpose of inducing or tending to induce the policyholder to lapse, forfeit, surrender, retain or convert any insurance policy.
  6. Referring to the coverage or any of the provisions of chapter 3, article 6 or 7 of this title in connection with the sale or attempted sale of any policy of insurance, except in connection with the notice prescribed in section 20 400.10, subsection E, section 20 410, subsection B and section 20 422, subsection C.
- B. An insurance producer, consultant or third party administrator shall not falsely disclose the method or amount of compensation associated with a health benefits plan as defined in section 20 2301.

It is unlawful for a person to knowingly make any misrepresentation as proscribed by section 20- 443 in the sale of insurance. A person who violates this section is guilty of a class 5 felony.

The unfair practice laws also include unfair discrimination which includes victims of domestic violence. Insurance coverage cannot be denied, refused to renew, restricted, cancelled, or charged a different rate to a victim of domestic violence. Claims cannot be denied as intentional acts to a victim of domestic violence. The victim must cooperate in the investigation and cannot have contributed to the creation of the property loss. Further, insurers must adopt procedures to be followed by employees, producers / brokers to ensure the privacy of and to help protect the safety of a victim of domestic violence when taking an application, investigating a claim, pursuing subrogation or taking any other action relating to a policy or claim involving a victim of domestic violence.

## **REBATES**

Rebating is not allowed in the Arizona. Specifically the statute (20-451) says: No insurer or licensee shall ... "offer, pay, allow or give, directly or indirectly, as an inducement to insurance, or after insurance has been effected, any rebate, discount, abatement, credit or reduction of the premium named in a policy of insurance, or any special favor or advantage in the dividends or other benefits to accrue thereon, or any valuable consideration or inducement whatever, not specified in the policy of insurance..." Article 6, 20-452 goes on to define a prohibited inducement as any prize, goods, tangible property of an aggregate value of more than twenty-five dollars (\$25).

## **UNFAIR CLAIM SETTLEMENT PRACTICES**

Claim practices apply generally to insurance companies rather than to producers / brokers. However, if a producer / broker contributes to the violation or keeps information from the insurance company -consequences can be strict as outlined in 20-461.

A. A person shall not commit or perform with such a frequency to indicate as a general business practice any of the following:

1. Misrepresenting pertinent facts or insurance policy provisions relating to coverages at issue.
2. Failing to acknowledge and act reasonably and promptly upon communications with respect to claims arising under an insurance policy.
3. Failing to adopt and implement reasonable standards for the prompt investigation of claims arising under an insurance policy.
4. Refusing to pay claims without conducting a reasonable investigation based upon all available information.
5. Failing to affirm or deny coverage of claims within a reasonable time after proof of loss statements have been completed.
6. Not attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear.
7. As a property or casualty insurer, failing to recognize a valid assignment of a claim. The property or casualty insurer shall have the rights consistent with the provisions of its insurance policy to receive notice of loss or claim and to all defenses it may have to the loss or claim, but not otherwise to restrict an assignment of a loss or claim after a loss has occurred.
8. Compelling insureds to institute litigation to recover amounts due under an insurance policy by offering substantially less than the amounts ultimately recovered in actions brought by the insureds.
9. Attempting to settle a claim for less than the amount to which a reasonable person would have believed he was entitled by reference to written or printed advertising material accompanying or made part of an application.
10. Attempting to settle claims on the basis of an application which was altered without notice to, or knowledge or consent of, the insured.
11. Making claims payments to insureds or beneficiaries not accompanied by a statement setting forth the coverage under which the payments are being made.
12. Making known to insureds or claimants a policy of appealing from arbitration awards in favor of insureds or claimants for the purpose of compelling them to accept settlements or compromises less than the amount awarded in arbitration.

13. Delaying the investigation or payment of claims by requiring an insured, a claimant or the physician of either to submit a preliminary claim report and then requiring the subsequent submission of formal proof of loss forms, both of which submissions contain substantially the same information.

14. Failing to promptly settle claims if liability has become reasonably clear under one portion of the insurance policy coverage in order to influence settlements under other portions of the insurance policy coverage.

15. Failing to promptly provide a reasonable explanation of the basis in the insurance policy relative to the facts or applicable law for denial of a claim or for the offer of a compromise settlement.

16. Attempting to settle claims for the replacement of any non-mechanical sheet metal or plastic part which generally constitutes the exterior of a motor vehicle, including inner and outer panels, with an aftermarket crash part which is not made by or for the manufacturer of an insured's motor vehicle unless the part meets the specifications of section 44-1292 and unless the consumer is advised in a written notice attached to or printed on a repair estimate which:

(a) Clearly identifies each part.

(b) Contains the following information in ten point or larger type:

This estimate has been prepared based on the use of replacement parts supplied by a source other than the manufacturer of your motor vehicle. Warranties applicable to these replacement parts are provided by the manufacturer or distributor of these parts rather than the manufacturer of your vehicle.

17. As an insurer subject to section 20-826, 20-1342, 20-1402 or 20-1404, or as an insurer of the same type as those subject to section 20-826, 20-1342, 20-1402 or 20-1404 that issues policies, contracts, plans, coverages or evidences of coverage for delivery in this state, failing to pay charges for reasonable and necessary services provided by any physician licensed pursuant to title 32, chapter 8, 13 or 17, if the services are within the lawful scope of practice of the physician and the insurance coverage includes diagnosis and treatment of the condition or complaint, regardless of the nomenclature used to describe the condition, complaint or service.

18. Failing to comply with chapter 15 of this title.

19. Denying liability for a claim under a motor vehicle liability policy in effect at the time of an accident without having substantial facts based on reasonable investigation to justify the denial for damages or injuries that are a result of the accident and that were caused by the insured if the denial is based solely on a medical condition that could affect the insured's driving ability.

B. Nothing in subsection A, paragraph 17 of this section shall be construed to prohibit the application of deductibles, coinsurance, preferred provider organization requirements, cost containment measures or quality assurance measures if they are equally applied to all types of physicians referred to in this section, and if any limitation or condition placed upon payment to or upon services, diagnosis or treatment by any physician covered by this section is equally applied to all physicians referred to in subsection A, paragraph 16 of this section, without discrimination to the usual and customary procedures of any type of physician. A determination under this section of discrimination to the usual and customary procedures of any type of physician shall not be based on whether an insurer applies medical necessity review to a particular type of service or treatment.

C. In prescribing rules to implement this section, the director shall follow, to the extent appropriate, the national association of insurance commissioners unfair claims settlement practices model regulation.

D. Nothing contained in this section is intended to provide any private right or cause of action to or on behalf of any insured or uninsured resident or nonresident of this state. It is, however, the specific intent of this section to provide solely an administrative remedy to the director for any violation of this section or rule related to this section.

E. The director shall deposit, pursuant to sections 35-146 and 35-147, all civil penalties collected pursuant to this article in the state general fund.

## **Diligent Search (Diligent Effort)**

As mentioned earlier in this Study Guide, surplus lines coverage is designed to be written on risks that do not meet the requirements of standard or admitted carriers. To that extent, Arizona has a diligent search (effort) statute that requires brokers to make an effort to place the risk with a licensed carrier. To qualify for surplus lines, a minimum of three licensed companies must decline the business before a placing the account with an approved surplus lines insurer.

Keep in mind that the requirement applies to both new and renewal accounts. For example, last year you performed a search for risk and could not find a licensed carrier to accept the risk so you wrote it with a surplus lines company. When it comes up for renewal this year, you must conduct a similar search to assure that a licensed carrier won't offer coverage.

The director of insurance may declare that certain classes and lines of business are generally not procurable from licensed carriers and are recognized as surplus lines. These classes and lines include: reinsurance, ocean marine, insurance on subjects located outside the state of Arizona, railroad related risks, and other lines determined by the director. This list is normally referred to as an "automatic export list" and risks that fall into these categories are not subject to the diligent search requirement.

The director may hold hearings to determine if new classes should be added or existing classes and lines should be deleted. For a current list, go to the Surplus Line Association website at [http://www.sla-az.org/class\\_codes.html](http://www.sla-az.org/class_codes.html).

## **Validity of Contracts**

(Reference to Arizona Title ARS-402)

Surplus lines insurance policies or contracts are as valid as any contract issued by an admitted market insurance company. If the transaction of surplus lines is in violation of the law, it does not invalidate the insurance policy. If an insurer is in violation of the law and fails to pay any claim or loss within the provisions of the insurance contract, any person who acted directly or indirectly as an insurance producer for or otherwise represented or aided the insurer in the solicitation, negotiation, procurement or effectuation of the insurance contract is liable to the insured for the full amount of the claim or loss in the manner proved by the provisions of the insurance contract.

## **Arizona Guaranty Fund**

Like many other states, Arizona maintains a Guaranty Fund to protect consumers in the event their insurance company becomes insolvent and/or is unable to satisfy its financial obligations. This fund, in all states except New Jersey, applies only to policies written by licensed, authorized insurers. As such, policies issued by unauthorized insurers are not covered by the provisions of the fund. However, it is considered an Unfair Trade Practice in Arizona to promote or sell a policy of insurance by referring to the Guaranty Fund.

Any policy and any evidence of coverage that is issued by a nonadmitted insurer and that is issued pursuant to this section for delivery to the insured in this state shall contain a conspicuously stamped or written notice in bold-faced type that states:

**This policy is issued by an insurance company that is not regulated by the Arizona department of insurance. The insurance company may not provide claims service and may not be subject to service of process in Arizona. If the insurance company becomes insolvent, insureds or claimants will not be eligible for protection under Arizona law.**

# Section III

## Insurance Markets

## United States Non-Admitted Market

The non-admitted market provides an orderly process for the placement of insurance on risks that are non-standard, have unique risk characteristics, or the amount of coverage needed is significant. There are a number of sources where this coverage might be available:

- Foreign Insurers: those companies domiciled in another state in this country.
- Alien Insurers: those organizations domiciled outside of the United States.
- Lloyd's of London.
- Other insurance exchanges
- Captives.

Each of these markets is administered in a different fashion. The common thread among each of the categories is that in order to transact business in the state of Arizona they must be on the Director's List of Qualified Unauthorized Insurers, also known as "The White List". In other words, a surplus lines broker may not write an account with a carrier that is not on the list. This information is available on the Arizona Surplus Line Association website at [www.sla-az.org](http://www.sla-az.org).

The director may refuse to add or may remove an insurer currently on the White List if he or she believes:

- The insurer no longer meets the requirements of article 20-413. An example would be an insurer judged to be in hazardous financial condition, is unreliable in insurance transactions, and/or improperly managed.
- Does not have the endorsement of an Arizona surplus lines broker.
- Does not comply with all applicable provisions of this title (Title 20).

Arizona statutes set minimum financial requirements for all unauthorized insurers to issue their coverage in this state on a surplus lines basis. The law sets the financial requirements applicable to unauthorized foreign insurers, alien insurers, and insurance exchanges and their syndicates. The Arizona Department of Insurance (DOI) uses the requirements to determine who qualifies for the White List. The chart below lists the amounts required depending on the legal form of the surplus lines provider:

<b>Type of Surplus Line Insurer</b>	<b>Applicable Financial Requirements</b>	
	<b>Capital and Surplus</b>	<b>Public Custody</b>
Foreign unauthorized insurer	\$ 15,000,000	\$ 2,500,000
Alien unauthorized insurer	\$ 15,000,000	\$ 2,500,000
Unauthorized Lloyd's Association or other similar organizations		\$100,000,000
Unauthorized insurance exchange		
(aggregate)	\$ 50,000,000	\$ 2,500,000
(per syndicate)	\$ 5,000,000	

Public custody as used here refers to cash or securities deposited with the treasurer of Arizona or other state or states. This can be equated to a security deposit of sorts to assure that the entity has the financial resources to meet their obligations.

Arizona is a broker sponsor state and each US non-admitted carrier must be sponsored by a licensed Arizona surplus line broker. The carrier files with the broker all the required documentation necessary to be placed on the "White List". It the sponsoring broker's obligation and responsibility to see this qualification is handled in a timely basis. Once a carrier has been placed on the "White List", they must re-qualify each year to maintain their ability to transact business in AZ.

**Alien Non-Admitted market**  
**"What is Lloyds of London and Other London Markets?"**

No discussion of surplus lines or specialty insurance or the non-admitted market would be complete without a look at Lloyd's of London. Probably the world's most easily recognized insurer and currently the world's leading market for specialist insurance services. It is the world's second largest insurer and the sixth largest reinsurance group. Currently 96 Syndicates are underwriting insurance at Lloyd's. Approximately 5% of the world's reinsurance is placed at Lloyd's, which also accounts for half of the London markets international insurance premiums.

In order to understand the insurance giant; let us take a brief look at the history of Lloyd's of London. Lloyd's began in Edward Lloyd's coffeehouse on Tower Street in the city of London. The exact date of the establishment is unknown, however evidence exists that Lloyd's coffeehouse was well-known in London business circles by the late 1680's. Lloyd himself was not involved in insurance but provided the premises, reliable shipping news and a variety of services to enable his clientele of ships' captains, and merchants to carry on their business of insuring ships and their cargoes. The wealthy individuals in the coffeehouse would take a share of the risk, signing their names one beneath the other on a slip of paper together with the amount they agreed to cover. Thus, they became known as "underwriters".

By the end of the 18<sup>th</sup> century, the underwriters had elected a committee and moved to their own premises in the Royal Exchange. Only members of Lloyd's were allowed to accept insurance business. The Society of Lloyd's was incorporated by Lloyd's Act of 1871, which provided the business with a sound legal basis and laid the foundations for today's market. By the turn of the century the traditional club of marine underwriters had become an international market for insurance risks of almost every type. Lloyd's preeminence as a world center for insurance had been established.

We know that Lloyd's is currently made up of 96 Syndicates. Each syndicate is made up of investors who provide the capital, which permits the syndicate to compete on price, and service for business from 96% of the Fortune 100 companies and 93% of the Dow Jones companies. From its beginning until a few years ago, syndicate membership was limited to individuals, but with changing times and the limited wealth from even the richest of individuals, the syndicates were forced to allow corporate membership.

In summary, it should be pointed out that while Lloyd's is one of the world's largest insurers, it is not an insurance company. Rather, it is an association of syndicate members accepting portions of risk.

While the ultimate responsibility for placement on the "White List" rests solely with the Director of Insurance, the various states have agreed the auditing procedure of Alien Insurers could best be accomplished by the International Insurance Division (IID) of the National Association of Insurance Commissioners (NAIC). Each quarter, the NAIC provides a list of qualified unauthorized alien carriers, with the Director having the option to remove any of these insurers as he feels necessary. It must be noted that while a carrier may be on the NAIC's list, it still must be sponsored by a licensed Arizona surplus line broker in order to transact business in this state. The financial requirements for alien carriers are \$15,000,000 in capital and surplus and \$2,500,000 in public custody. The examination and auditing procedures relative to the Lloyds Exchange are the same as the rest of the alien market and are handled by the III) of the National Association of Insurance Commissioners. Lloyds of London is required to maintain \$100,000,000 in public custody.



## Other Alternative Markets

### Risk Retention Groups and Risk Purchasing Groups

In 1986, Congress enacted the Liability Risk Retention Act (LRRRA) to help businesses, professionals and municipalities obtain liability insurance which had become either unavailable or unaffordable due to the liability capacity crisis which hardened the insurance beyond anything anyone had seen in many, many years. In passing the Liability Risk Retention Act of 1986, Congress provided insurance buyers with an alternative marketplace. It provided a solution to the "liability crisis", enabling buyers to have better control over their liability insurance programs. To achieve this end, Congress created risk retention groups (RRGs) and risk purchasing groups (RPGs).

#### What is a risk retention group?

A risk retention group is a liability insurance company that is owned by its members. Under the Liability Risk Retention Act, RRGs must be domiciled in a state. Once licensed by its state of domicile, an RRG can become registered in any other state and is free to do business across state lines. Because the LRRRA is a federal law, it preempts state regulation making it easier for RRGs to operate nationally. As a RRG is in fact an insurance company, Risk Retention Groups retain risk.

#### What is a purchasing group?

A purchasing group, or risk purchasing group, is comprised of insurance buyers who band together to purchase their liability coverage from an insurance company. The insurance company may operate on an admitted basis, a surplus lines basis or as a risk retention group. As the name implies, the RPG serves as an insurance purchasing vehicle for its members.

#### What is the difference between risk retention groups and risk purchasing groups?

The primary difference between risk retention groups (RRG's) and Risk purchasing groups (PGs) is that RPGs retain risk and the RRGs do not. RPGs purchase insurance from an insurer which issues the policies and serves as the risk bearer. RRGs, as insurers, issue policies to their members and bear risk. Another key difference between the two is that RRG's typically require members to capitalize the company whereas RPG's require no capital. Other differences are the way in which the entities are regulated. Both fall under the LRRRA of 1986, however Purchasing Groups also adhere to State Regulation. Another difference is that Risk Retention Groups engage in the purchase of reinsurance.

#### What are the similarities between risk retention groups and purchasing groups?

Both RRGs and PGs are required by the Liability Risk Retention Act of 1986 to be made up of homogeneous groups, i.e. engaged in similar businesses or activities that expose them to similar liabilities. This is an important similarity as Purchasing Groups can reorganize in RRGs at a future time.

#### What kinds of coverage do risk retention groups and purchasing groups provide?

For both risk retention groups and purchasing groups, the type of insurance permitted is set forth in the Liability Risk Retention Act's definition of "liability" which includes all types of third party liability such as general liability, errors and omissions, directors and officers, medical malpractice and products liability. The LRRRA does not extend to workers compensation, property insurance or to personal lines such as homeowners and personal auto coverage.

## **Other Insurance Exchanges**

As mentioned earlier, Lloyd's is the most well-known insurance exchange but there are other exchanges providing coverage. These unauthorized entities offer admitted or nonadmitted insurance coverages in at least one other state and are required to have a minimum capital and surplus for the total exchange of at least \$50 million. In addition, each syndicate operating within the exchange must have a minimum of \$4 million in capital and surplus.

## **Industrial Insureds**

There is a provision in the statutes that allows certain insureds to deal directly with an unauthorized insurer without using a licensed surplus lines broker. To qualify, they must have a "Risk Manager" as defined in the statute, and must satisfy at least two (2) of the following criteria:

1. Aggregate annual Property & Casualty premiums for all risks totaling at least \$100,000
2. Net revenues or sales over \$25,000,000
3. More than 80 full time equivalent employees (FTE's) or 100 FTE's in a holding company system.

These requirements must be confirmed by a Certified Public Accountant (CPA) and the insured is required to pay premium taxes on or before March 1 in the year following the effective date or renewal date of the policies. Keep in mind that industrial insureds are not the same as a self-insured business and a broker cannot be involved in the industrial insured transaction.

## **Captives**

A captive is an insurance entity formed by an individual company or group of companies engaged in similar operations designed to insure the exposures of the business or group of businesses. Minimum surplus and capital requirements vary from \$250,000 to \$500,000 depending on the nature of the business. A captive may write most lines of business except workers compensation, personal lines, medical services organizations including hospitals, and other classes as specified in the statutes. Captives must file an operational plan with the director of insurance and report any changes in the plan to the director within 30 days.

## **Service of Process** (Arizona Reference, ARS 20-419)

Each policy issued with a surplus lines carrier must contain a service of suit clause appointing the Arizona Director of Insurance the statutory agent for the acceptance of all legal processes issued in this state in any action or proceeding under or arising out of the policy. The Director must transmit this notice by certified mail - return receipt, a copy of the legal service to the surplus lines insurance carrier. An insurer will then have forty (40) days after the date of mailing within which to file an answer or otherwise defend the action.

## Section IV

Records, Taxes, Fees, the Arizona  
Surplus Line Association, Surplus Line  
Examination, and Continuing Education

## Records, Taxes and Fees

### Records

There are certain requirements associated with placing business in the surplus lines market that you need to be aware of. They are not particularly onerous but they are quite specific and to avoid any unnecessary problems it is important that they be followed.

First off, each broker must maintain the following information regarding placement of a surplus line policy for a minimum of three years with one notable exception which is listed below:

- Name and address of the insurer
- Name and address of the insured
- Amount of insurance
- Gross premium charged and return premium if any is paid
- Rate used to calculate the premium
- Effective date and terms of the contract
- Brief description of the risks insured against and property insured
- Results of the diligent search effort. (**NOTE:** Keep this information for **SIX** years!)

Within 60 days after the effective date of the surplus lines policy, the broker shall file with the director or the director's designee (the Surplus Line Association) the following information:

- The name of the insurer and the carriers NAIC identification number
- The policy number of the policy issued
- The name and address of the insured
- The premium, including taxable policy fees
- The identity of the specific surplus line coverage written
- If the coverage is not recognized as a surplus lines (in other words, is not on the automatic export list), an affidavit executed by the broker attesting to compliance with the diligent search requirement. Keep in mind the results of the search, which is required at the time the policy was originally placed and all subsequent renewals, must be kept for six years after the expiration of the policy
- The policy effective dates that are not open to public inspection
- The applicable surplus lines stamping fee is also payable with this report. More on the stamping fee in a minute.

The director may impose a civil penalty of not more than \$25 per day for each day the report is late.

### Taxes

All states impose a premium tax on business written and Arizona is no exception. For licensed insurance companies, the tax is imbedded in the premium and the company remits it directly to the state. For surplus lines, the situation is a bit different. The amount of premium tax is shown separately on the policy declarations page and is paid to the state by the surplus lines broker. Currently, the tax rate is 3% of the premium including all broker, policy, and inspection fees. Taxes are payable no later than **February 15<sup>th</sup>** for policies with effective dates between July 1 and December 31 of the preceding year. For policies effective from January 1 to June 30, taxes are due no later than **August 15<sup>th</sup>**. Amounts due are paid directly to the state department of insurance.

For many years, the surplus lines industry was faced with a host of challenges regarding the payment of taxes and fees for insureds with locations in multiple states. The process of allocating taxes based on premiums was, to say the least, a bookkeeping nightmare. On July 21, 2011, the Federal Nonadmitted and Reinsurance Reform Act (NRRRA) went into effect and this sweeping legislation changed how surplus lines taxes are to be paid and to whom. The Arizona Department of Insurance issued a Bulletin (2011-06) on June 28, 2011 detailing how NRRRA would be applied. A summary of the important points of the Act are included below and a complete copy of the Bulletin is included in this Study Guide.

1. There is no change in procedures for transactions where the entirety of the insured risk is located within Arizona. 100% of the premium is allocated to Arizona.
2. For multi-state transactions (involving insurance that covers risks located in more than one state), it is first important to understand how to determine the "home state."
  - "Home state" means the state where the insured is located as long as some of the insured risk is located in that state. The location of a business is its principal place of business. The location of an individual is the principal place of residence.
  - If none of the insured risk is located in the state where the insured is located, the home state becomes the state where the greatest percentage of the insured's taxable premium is allocated for the insurance contract.
  - If more than one insured within an affiliated group is covered under a single insurance contract, the home state is based on the member of the affiliated group with the largest percentage of premium attributed to it. ARS § 20-401(6).
  - If Arizona is the home state, you must file the transaction with 100% of the premium allocated to Arizona, and pay Arizona the entirety of the tax and stamping fees for that transaction.
  - If Arizona is not the home state, do not file the transaction with Arizona.

Arizona is not currently participating in a compact or agreement for multi-state transactions. Accordingly, you must:

- File with The Surplus Line Association of Arizona all transactions for which Arizona is the home state
- Pay (To the Surplus Line Association of Arizona) the stamping fee invoice you receive for filed transactions before February 15th (for transactions procured the previous July 1 through December 31) or before August 15 (for transactions procured the previous January 1 through June 30)
- Generate statements of surplus line transactions and generate tax reports using our online system
- And file the statement of surplus line transactions with your tax report and payment to the Insurance Tax Section of the Arizona Department of Insurance, either using the OPTins electronic filing system ([www.optins.org](http://www.optins.org)) or by mail (Insurance Tax Section, 2910 North 44th St. #210, Phoenix, AZ 85018-7269).

### **Stamping Fees**

A separate fee of .02% is applied to all surplus lines transactions, including broker, policy, and inspection fees, to assist in funding the Arizona Surplus Line Association. The remittance is different from the tax issue just discussed in the following ways:

1. The fee is paid directly to the Arizona Surplus Line Association.
2. The amount is due at the time of the transaction (within 60 days)

An example will help explain how these processes work. Assume that a broker has written a surplus line policy effective September 1 and the total premium, including the broker and inspection fees, is \$5,000. The transaction must be reported to the SLA no later than November 1 (60 days). The taxes of \$150.00 (3% of \$5,000) are due and payable to the state no later than February 15<sup>th</sup> of the following year and the stamping fee of \$10 (.02% of \$5,000) is payable to the SLA immediately.

### **The Surplus Line Association**

The Surplus Line Association of Arizona was founded in 1970. It was formed by a small group of concerned and yes, even patriotic retail brokers. Their concern was that most of the non-admitted business was being procured by Surplus Lines Brokers operating outside the state of Arizona and the taxes were either not being paid, or being paid to the domiciliary state of the broker. Working in conjunction with the Department of Insurance the Association became a reality and ultimately was awarded a contract by the Department to oversee the filing of surplus lines taxes. Other duties of the Association include:

- Assist in the monitoring, development, and growth of the surplus lines industry in Arizona
- Operates as a "designee" of and has contractual and organizational ties to the Arizona Department of Insurance

- Provides statistics and reports to the DOI regarding surplus lines placements
- Oversees the filing of surplus lines taxes and stamping fees which can be done electronically via their website ([www.sla-az.org](http://www.sla-az.org))
- Assists surplus lines brokers in reporting taxes
- Serves an important advocacy and educational role for the insurance industry throughout the state.

The stamping fee of .02% mentioned above funds and supports these efforts as well as the overall goal of the protection of Arizona surplus lines consumers.

## **The Surplus Lines Examination**

As mentioned earlier, anyone involved in the placement of a risk in the surplus lines market must be properly licensed. Requirements include:

- The person must have a resident property and casualty producer's license
- Take and successfully complete the surplus lines examination.
- File the necessary licensing forms including verification of compliance with state continuing education requirements (if necessary)
- Pay the appropriate fee of \$1,000 for a four-year license which will expire at the same time as the existing P&C license. Note: if the surplus lines license is added mid-term, the cost is \$500 if two years or less remains on the license. For example, Joe received his P&C producer's license on October 1 of 2009 and wants to obtain his surplus lines license on July 1 of 2010, he would pay the full \$1,000 and the license would expire at the end of October in 2013. If, on the other hand, the surplus lines license is added on December 1 of 2011, his cost would be \$500.

The examination consists of multiple choice questions and examinees are allowed one hour to complete the test. The exam will cover insurance regulation, licensing, surplus lines markets, and other relevant topics discussed in this Study Guide.

The content specific to the Surplus Lines Insurance Broker Exam (Series 13-41) is available on the Prometric website via the link below

<https://www.prometric.com/en-us/clients/insurance/Documents/arizona/13-41.pdf>

Licensing forms and instructions are available on the following websites: [www.sla-az.org](http://www.sla-az.org) and [www.id.state.az.us](http://www.id.state.az.us)

## Continuing Education

In the past, Arizona took a unique approach to continuing education and only required those licensees that held a non-resident license to complete approved CE courses. This changed on January 1, 2014 and now most all licensees must complete a total of 48 hours of approved continuing education during their licensing period. A phase-in program was implemented to give producers time to meet the new requirements and it operates as follows. Beginning on the effective date of the first license renewal **after** January 1, 2014, the licensee is required to accumulate 48 hours of approved CE during the four-year licensing period. Included in this total number of hours it is required that licensees complete six hours of approved ethics training. An example will help illustrate how this works.

Assume your current license became effective on July 1, 2013 and renews on July 1, 2017. Since you only held an Arizona resident insurance license, you are not required to begin accumulating hours until your license renews on July 1, 2017. You will be required to complete 48 hours of approved CE (including six hours of ethics) on or before July 1, 2021.

Taking the example above a bit further, if you had a non-resident license in California, you would still be required to meet the 40 hour requirement in order to renew your license until July 1, 2017.

As mentioned above, most producers are subject to the provisions of the CE statute but there are a few exceptions and they are highlighted below:

Subsection A of this section does not apply to a licensee who, as of January 1, 2014, meets and continues to meet the following criteria:

1. Has been continuously licensed as an insurance agent, broker or producer in this state since January 1, 1995.
2. Has not at any time since January 1, 1995, held a nonresident insurance producer license in another state.
3. Has never been the subject of an order issued by the director finding that the licensee has violated any provision of this title in which the director ordered any of the following:
  - (a) The suspension, revocation or denial or renewal of the licensee's agent, broker or producer license.
  - (b) The licensee to cease and desist from the conduct constituting the violation.
  - (c) The licensee to pay restitution or a civil penalty.

## **REFERENCE GUIDE**

The following pages are the statutes used in putting together a big part of this Study Guide. Complete copies of all statutes can be found on the State of Arizona website:

<http://www.azleg.state.az.us/ArizonaRevisedStatutes.asp?Title=20>

Laws, rules and bulletins can be found at the Arizona Department of Insurance website:

<https://insurance.az.gov/home/laws-and-rules>