PROGRAM MATERIALS
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May 11, 2020

Shadow Insurance in A COVID-19 Era: A Federal/State Perspective on Negligence and Corporate Formalities

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CELESQ Presents

Shadow Insurance In A COVID-19 Era: A Federal/State Perspective on Negligence and Corporate Formalities

May 11, 2020 – 12:00 PM-2:00PM

Raymond J. Dowd

Samuel A. Blaustein

TIMED OUTLINE

Intro – Ray Dowd – 5 minutes

Insurance Regulation Overview – Blaustein – 5 minutes

Virus and Pandemic Coverage History – Blaustein – 10 minutes

Business Interruption Insurance – Blaustein – 10 minutes

Recent Regulatory Activity Against Unlicensed Insurers/Producers – Dowd – 5 minutes

Shadow Insurance and Corporate/Licensure Formalities – Dowd – 10 minutes

Private Remedies, Insurer Corporate/Licensure Formalities and Pre-Answer Security – Dowd – 10 minutes

Private Remedies, Broker Corporate/Licensure Formalities – Dowd – 5 minutes

Samuel A. Blaustein is a member of Dunnington Bartholow & Miller LLP's litigation, arbitration and mediation and intellectual property and art law practice areas. Prior to joining Dunnington, Mr. Blaustein served as a law clerk in the United States District Court for the Southern District of New York for the Hon. Laura Taylor Swain.

Mr. Blaustein specializes in commercial disputes in New York state and federal courts from inception through appeal. Mr. Blaustein has argued several cases involving novel issues of insurance law ranging from claims against unauthorized insurers, to intervention by title insurers to arbitrability of claims. These cases include:

- *Breakaway Courier Corp. v Berkshire Hathaway Inc.*, 2017 N.Y. Slip Op. 32751(U), 2017 WL 3084991, at *1 (Sup. Ct. N.Y. Co., Comm. Div. July 19, 2017) requiring unauthorized insurers to post pre-answer security of approximately $14,000,000 pursuant to Section 1213(c) of the Insurance Law and, in an order on the record, granting a preliminary injunction against the unauthorized insurers prosecuting claims in the courts or in arbitration in Nebraska
- *The Energy Conservation Group, LLC v Applied Underwriter, Inc.*, No. 710762 2015, 2016 WL 1534170, at *1 (Sup. Ct. Queens Co. Comm. Div. Mar. 22, 2016) imposing pre-answer security requirements and, in an unreported decision, enjoining out-of-state arbitration
- *Reif v. Nagy*, 149 A.D.3d 532, 533, 52 N.Y.S.3d 100, 102 (1st Dept. 2017) affirming denial of motion by title insurer to intervene

Mr. Blaustein attended Brandeis University and Brooklyn Law School. He currently serves as the Co-Chair of the Brandeis Lawyers Network Committee.

Admissions: New York State, the U.S. District Courts and Bankruptcy Courts for the Southern and Eastern Districts of New York and the U.S. Courts of Appeals for the Second and Federal Circuits.

Member: Federal Bar Association and the New York County Lawyers Association.

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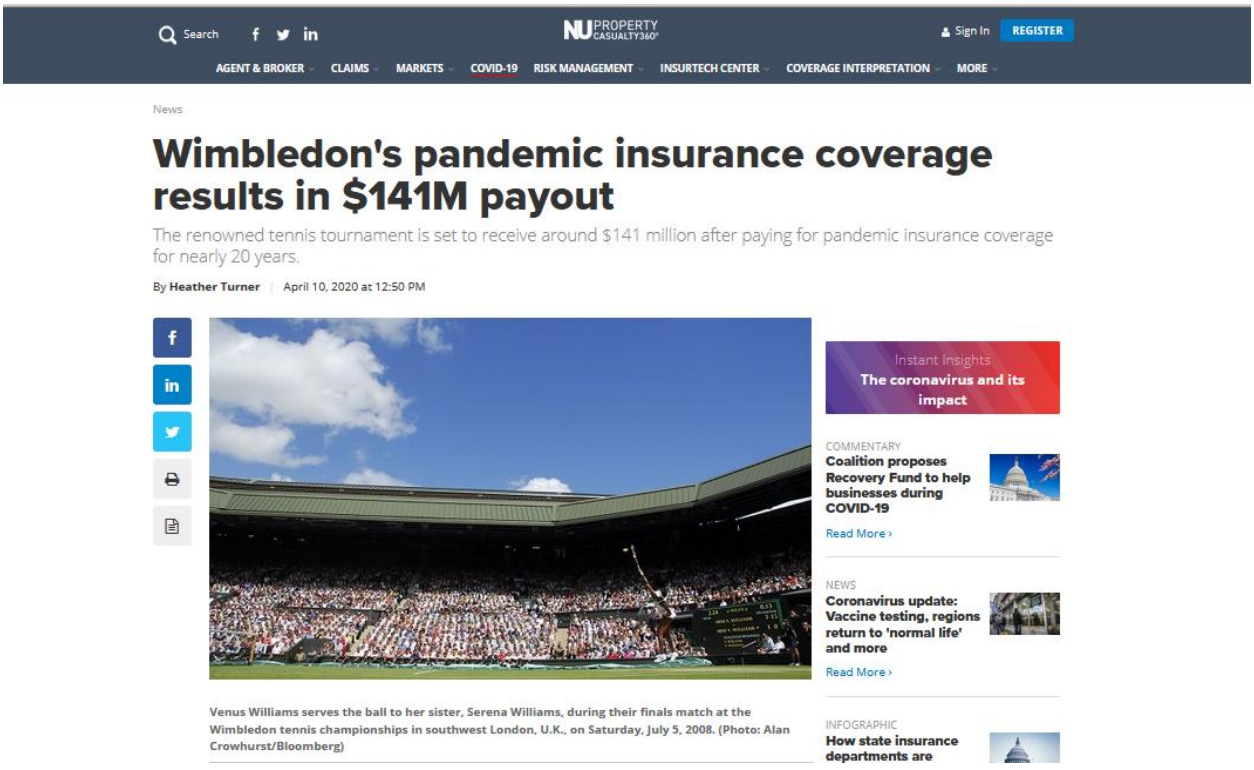
Raymond J. Dowd has served as lead counsel in high-stakes, high-profile litigations and arbitrations in New York for over two decades. His book *Copyright Litigation Handbook* (Thomson Reuters/Westlaw) has received critical acclaim. Acting as a fiduciary by serving on non-profit boards has shaped his practical problem-solving approach and perspective. Business and property disputes form the core of Mr. Dowd's practice. He works with a lean, experienced team, including trusted experts, to contain, avoid, minimize, and settle disputes. Matters often involve foreign law and conflict-of-laws principles, service or discovery in foreign jurisdictions. Mr. Dowd regularly represents television broadcasters in disputes relating to brand protection and content distribution in the United States, particularly anti-piracy work. In the mid-1990's, Mr. Dowd successfully petitioned for the removal of Bernard Lafferty and U.S Trust Company as co-executors of the estate of Doris Duke. He has handled probate and estate-related disputes ever since, gaining international prominence for his work in recovering Nazi-looted art. Mr. Dowd also assists individuals, art owners, dealers and corporations with trademark and transactional work, including international licensing and distribution. He lectures regularly on art law and copyright.

In 2018 Network of Bar Leaders awarded Mr. Dowd the Hon. Harold Baer, Jr. Award for service to the bench and bar. In 2019, Fordham Law School awarded Mr. Dowd the Roger Goebel Award for outstanding international service to the law school.

Mr. Dowd serves on the Board of Directors of the Fordham Law Alumni Association and chaired the law school's International Law Affinity Group (2016-2019). He serves on the Board of the National Arts Club and is a member of the Village of Westhampton Beach Conservation Advisory Council. Past leadership positions include President of Network of Bar Leaders (2013-2014); General Counsel of the Federal Bar Association (2010-2011); FBA Vice President for the Second Circuit (2006-2012); FBA Board of Directors (2011-2016); The Federal Lawyer Magazine Editorial Board; FBA Government Relations Committee; President of Southern District of New York Chapter of the FBA (2006-2008); New York County Lawyers' Association Board of Directors (2003-2006).

Mr. Dowd is admitted to practice law in New York State, the U.S. District Courts for the Southern and Eastern Districts of New York, U.S. Court of Appeals for the First, Second, Fifth, Ninth and Tenth Circuits, U.S. Supreme Court, U.S. Tax Court and U.S. Court of International Trade.
He is fluent in French and Italian.

Why is Wimbledon receiving **$141,000,000.00** While Other Businesses Are Being Told They Lack Coverage For COVID-19 Related Losses?



https://www.propertycasualty360.com/2020/04/10/wimbledons-pandemic-insurance-coverage-results-in-141m-payout/# (last accessed 5/7/20)

The Influx Of Business Interruption Lawsuits Has Begun

Thomas Keller, owner of the Michelin Starred French Laundry, Bouchon and other restaurants has filed claims against insurer The Hartford in California state court.

Major property owner, Thor Equities, is suing Factory Mutual Insurance Company for, among other things "anticipatory breach"

https://www.insurancejournal.com/news/national/2020/03/27/562627.htm (last accessed May 7, 2020)

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Attorneys for Plaintiff Thor Equities, LLC

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

THOR EQUITIES, LLC,

Plaintiff,

v.

FACTORY MUTUAL INSURANCE COMPANY,

Defendant.

Civil Action No.: 20-cv-3380

COMPLAINT

JURY TRIAL DEMANDED

Insurance Is Regulated At The State, Not The Federal, Level

- In 1944, to the shock of observers and commentators, the Supreme Court held that insurance was subject to federal regulation under the interstate commerce clause. *United States v. S.-E. Underwriters Ass'n*, 322 U.S. 533, 552–53, 64 S.Ct. 1162, 88 L.Ed. 1440 (1944).
- In 1945, in response to *South–Eastern Underwriters*, Congress enacted the McCarran–Ferguson Act, 15 U.S.C. §§ 1011–1015.
- The McCarran-Ferguson Act first declares that congressional silence "shall not be construed to impose any barrier" to state regulation or taxation of the business of insurance. 15 U.S.C. § 1011.
- The Act further provides that: "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance." 15 U.S.C § 1012(b).
- In other words, the McCarran Ferguson Act provides for **"reverse preemption"** of generally applicable federal statutes by state laws enacted for the purpose of regulating the business of insurance.
- However, the federal government can specifically regulate insurance where it chooses. For instance, HIPAA and ERISA create substantive insurance law. Likewise, the federal government has created specific legislation for pandemics like the Swine Flu known as H1N1. *See* Public Readiness and Emergency Preparedness Act (PREP Act) (*see* Pub. L. No. 109–148, 119 Stat. 2680 [109th Cong., 1st Sess., Jan. 7, 2005])
- Thus, in the absence of federal law on point, federal courts have certified questions on the issue of business interruption coverage to state courts of last resort e.g. *Cont'l Ins. Co. v. DNE Corp.*, 834 S.W.2d 930, 931 (Tenn. 1992) (answering Certified Questions from U.S. Court of Appeals for the Sixth Circuit)
- Important issues including licensure and reserve amounts are handled at the state level. *Ross v. AXA Equitable Life Ins. Co.*, 115 F. Supp. 3d 424, 427 (S.D.N.Y. 2015), *aff'd*, 680 F. App'x 41 (2d Cir. 2017) (noting that reserves do not account for pandemics and that reinsurance is often purchased to account for large-scale losses).

The States' Have Broad Authority To Regulate Insurance

- An Ohio statute that prioritized policyholders' claims over claims of the United States Government in connection with the liquidation of insurers was held to not be preempted by federal priority statutes to the extent it regulated "the business of insurance" *U.S. Dep't of Treasury v. Fabe*, 508 U.S. 491, 113 S. Ct. 2202, 124 L. Ed. 2d 449 (1993)

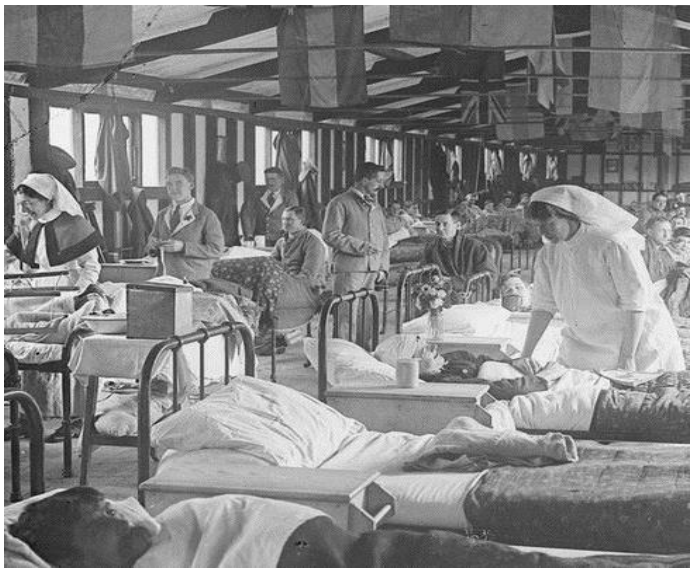
- A Missouri statute that barred arbitration of certain insurance claims preempted the Federal Arbitration Act, an Act that does not explicitly regulate insurance, and required remand to state court of claims, including business interruption claims, resulting from a mine explosion. *Foresight Energy, LLC v. Certain London Mkt. Ins. Companies*, 311 F. Supp. 3d 1085, 1100 (E.D. Mo. 2018)

- Even where important federal laws, like the Fair Housing Act, are in issue, federal courts will certify important questions to state court of appeals. *Ojo v. Farmers Grp., Inc.*, 600 F.3d 1205, 1210 (9th Cir. 2010), *as amended* (Apr. 30, 2010) (concerning Texas Insurance Code's use of credit scores to price insurance)

Viruses And Pandemics Are Not A New Concept In The Law Or The Realm Of Insurance. . .

***Gorder v. Lincoln Nat. Life Ins. Co.*, 46 N.D. 192, 180 N.W. 514, 516–17 (Sup. Ct. North Dakota 1920)**

Deployed soldier in Liverpool, England entitled to full recovery for pneumonia death



The Life Insurance Policy

> This policy is free from restrictions as to residence, travel and occupation after one year from date of issue, except military or naval service in time of war, for which permission must be obtained from the company and an extra premium, at the established rate, shall be paid. In case of death of the insured in consequence of such service and without the company's permit, the liability of the company hereunder shall be for an amount not greater than the legal reserve on this policy.

The Rationale Behind The Clause

> Active military members are more likely to contract "typhoid, measles, and influenza."

The Court's Rationale

> However the policy in question might be construed in reference to diseases that are more peculiarly prevalent in army camps than in civil life, so that a death from such a disease might be regarded as a death in consequence of such service, we are of the opinion that on the record in this case we cannot say that the death of the insured was in consequence of such service. It is our opinion, further, that under the language of the provision in question each individual case is to be determined upon its own facts. For the foregoing reasons, the judgment appealed from is affirmed.

. . .But Different Results Have Been Reached. . .

***Bacon v. United States Mut. Acc. Ass'n*, 123 N.Y. 304, 310, 25 N.E. 399 (1890)**

"'malignant pustule,' or 'charbon,' or '*anthrax*'" also known as "'wool-sorters disease,'" an epidemic, constituted "death by disease" and not "accident" under an insurance policy.

***Duensing v. Traveler's Companies*, 257 Mont. 376, 386, 849 P.2d 203, 210 (1993)**

"contamination and governmental action exclusions" did not preclude coverage where candy manufacturer voluntarily destroyed inventory where employees were exposed to Hepatitis A and received a "Notice of Embargo"

…And Even Cows And Tornadoes Are Covered Perils. . .

***Curtis O. Griess & Sons, Inc. v. Farm Bureau Ins. Co. of Nebraska*, 247 Neb. 526, 531, 528 N.W.2d 329, 333 (Sup. Ct. Neb. 1995)**

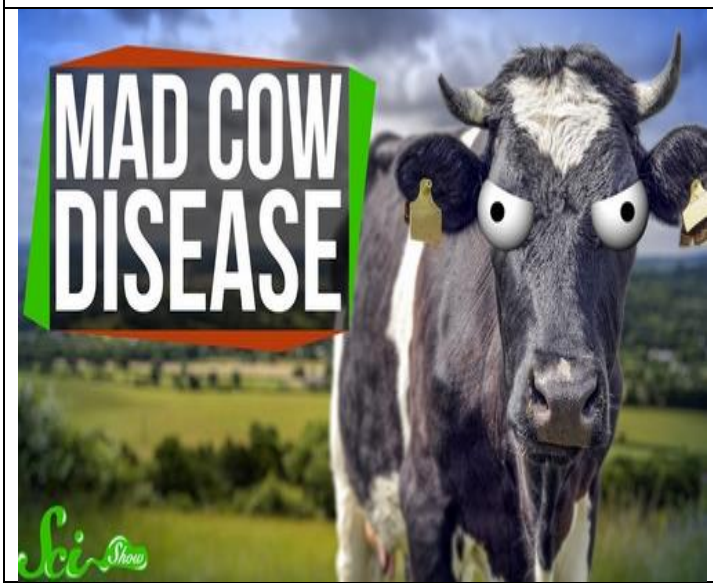
Pseudorabies virus covered where a tornado sent it downwind

> Physical loss by windstorm is a covered peril. **The wind need not pick up and throw the swine to the earth to constitute a direct cause of the loss**. We have never defined windstorm so narrowly. When windborne materials occasion a loss, the loss is considered the direct result of a windstorm, because the windstorm is considered the dominant, efficient cause which set the concurring cause in motion. We can see no reason for treating a windborne virus differently from other windborne objects.
>
> Additionally, where a virus has been transmitted by means of a covered peril, the covered peril has been held to be the proximate cause of the loss.

. . .And Whether There Is Coverage Is An Issue Of Fact

We have previously held that direct physical loss can exist without actual destruction of property or structural damage to property; it is sufficient to show that insured property is injured in some way. *Sentinel Mgmt. Co. v. New Hampshire Ins. Co.*, 563 N.W.2d 296, 300 (Minn.App.1997). In *Sentinel*, we noted that the function of a residential apartment building, to provide safe housing, was seriously impaired or destroyed by the presence of asbestos fibers, although the building itself did not suffer a "tangible injury." *Id.* Likewise, the function of the food products produced by General Mills is not only to be sold, but to be sold with an assurance that they meet certain regulatory standards. When General Mills is unable to lawfully distribute its products because of FDA regulations, that function is seriously impaired.

Gen. Mills, Inc. v. Gold Medal Ins. Co., 622 N.W.2d 147, 152 (Minn. Ct. App. 2001) (Reldan/Dursban)



However, where the US/Canadian border was closed to beef imports due to Mad Cow Disease, no coverage was found to exist because there was no "physical loss" to which coverage could attach

Source Food Tech., Inc. v. U.S. Fid. & Guar. Co., 465 F.3d 834, 835 (8th Cir. 2006) (distinguishing *Gen. Mills*)

Insurers Are Seeking To Create A Narrative That COVID-19 Losses Are Not Covered Losses

"To avoid payments for a civil authority shut down the insurance industry is pushing out deceptive propaganda that the virus does not cause a dangerous condition to property. . .This is a lie, it's untrue factually and legally." (John Houghtaling II, quoted in Insurance Journal).

Business Interruption Coverage

Most property insurance includes business interruption coverage, which often includes civil authority and dependent property coverage. This is generally designed to cover losses that result from direct physical loss or damage to property caused by hurricanes, fires, wind damage or theft and is not designed to apply in the case of a virus.

Every situation, however, will be evaluated on a case-by-case basis and reviewed based on the underlying facts, policy language and applicable law. If you believe you have a business interruption claim, you can **file a claim online**.

Have more questions on business interruption coverage and COVID-19 exposures? The following associations have some helpful content available.

- **National Association of Insurance Commissioners**
- **American Property Casualty Insurance Association**

https://www.thehartford.com/coronavirus/businesses (last accessed May 7, 2020)

The National Association of Insurance Commissioners Statement Provides:

> Business interruption policies were generally not designed or priced to provide coverage against communicable diseases, such as COVID-19 and therefore include exclusions for that risk. Insurance works well and remains affordable when a relatively small number of claims are spread across a broader group, and therefore it is not typically well suited for a global pandemic where virtually every policyholder suffers significant losses at the same time for an extended period. While the U.S. insurance sector remains strong, if insurance companies are required to cover such claims, such an action would create substantial solvency risks for the sector, significantly undermine the ability of insurers to pay other types of claims, and potentially exacerbate the negative financial and economic impacts the country is currently experiencing.

https://content.naic.org/article/statement_naic_statement_congressional_action_relating_covid_19.htm (last accessed May 7, 2020)

States Say Otherwise And Are Seeking Information From Insurers Concerning COVID-19

NEW YORK STATE OF OPPORTUNITY. | Department of Financial Services

ANDREW M. CUOMO
Governor

LINDA A. LACEWELL
Superintendent

March 10, 2020

TO: All authorized Property/Casualty Insurers

RE: CALL FOR SPECIAL REPORT PURSUANT TO SECTION 308, NEW YORK INSURANCE LAW: BUSINESS INTERRUPTION AND RELATED COVERAGE WRITTEN IN NEW YORK

Pursuant to Section 308 of the New York Insurance Law, the Department of Financial Services ("DFS") hereby instructs each authorized property/casualty Insurer (collectively, "Insurers") to provide certain information regarding the commercial property insurance it has written in New York and details on the business interruption coverage provided in the types of policies for which it has ongoing exposure. For the purpose of this letter, DFS considers commercial property insurance to include the following, along with substantially similar insurance: business owner policies, commercial multiple peril policies, and specialized multiple peril policies.

By way of background, in connection with the outbreak of the novel Coronavirus ("COVID-19"), policyholders have urgent questions about the "business interruption" coverages provided by their commercial property insurance policy. Policy terms may vary in treatment of "covered perils" and "physical loss or damage." Coverage implicated by COVID-19 may change depending on how the situation evolves. Given the potential impact of COVID-19 on business losses, particularly concentrated effects in local communities, DFS considers Insurers' obligations to policyholders a heightened priority. In the interest of the timely and equitable fulfillment of insurance contracts, Insurers must explain to policyholders the benefits under their polices and the protections provided in connection with COVID-19. Any Insurer that writes none of the business described herein should notify DFS in a statement signed by an officer or other authorized representative of the Insurer in lieu of complying with the provisions below.

First, each Insurer should provide to DFS the volume of business interruption coverage, civil authority coverage, contingent business interruption coverage and supply chain coverage the Insurer wrote that has not lapsed as of the date of this letter, which should be expressed in amounts of direct premium, policy types and numbers of policies written of each type.

Second, each Insurer should examine the policies it has issued and explain the coverage each policy offers in regard to COVID-19 — both presently and as the situation could develop to change the policyholder's status (i.e., is there any potential for coverage as a result of COVID-19).

States Are Even Trying To Force COVID-19 Coverage But Will Face Constitutional Challenges

- New York introduced New York Assembly Bill 10226 on March 27, 2020.
- Pennsylvania introduced House Bill 2372 on April 3, 2020.
- Louisiana introduced Senate Bill 477 on March 31, 2020.
- Ohio introduced H.B. No. 589 on March 24, 2020.
- Massachusetts introduced Senate Docket 2888 on March 24, 2020.
-

However. . .

"No State shall...pass any...Law impairing the Obligation of Contracts."
U.S. Const. art. I, § 10, cl. 1.

"Although the language of the Contract Clause is facially absolute, its prohibition must be accommodated to the inherent police power of the State to safeguard the vital interests of its people." *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 410, 103 S.Ct. 697, 74 L.Ed.2d 569 (1983) Examination of whether a statute violates the Contract Clause is a two-step inquiry: The threshold inquiry is whether the state law has, in fact, operated as a substantial impairment of a contractual relationship. If a substantial impairment is found, the State, in justification, must have a significant and legitimate public purpose behind the regulation. *Id.* at 401 (citations omitted).

The foregoing is applicable in the "highly regulated" field of insurance.

- *Schniedwind v. Am. Family Mut. Ins. Co.*, 157 F. Supp. 3d 944, 952 (D. Colo. 2016) (Colorado law prohibiting modification of statute of limitations on homeowners insurance policies permitted)
- *Tuttle v. New Hampshire Med. Malpractice Joint Underwriting Ass'n*, 159 N.H. 627, 651, 992 A.2d 624, 643 (2010) (conversely, the fact that an industry is regulated in not sufficient notice that contractual terms may be altered)

Why Are We Here – A 2003 Coronavirus Called SARS

In February 2003, Severe Acute Respiratory Syndrome ("SARS") appeared in Asia and epidemic, as opposed to a pandemic, persisted through 2004. https://www.cdc.gov/sars/index.html (last accessed May 7, 2020)

Avian flu and the H5N1 followed. Insurance actuaries took notice and the result was ISO Form CP0140 (0706):

COMMERCIAL PROPERTY
CP 01 40 07 06

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

EXCLUSION OF LOSS DUE TO VIRUS OR BACTERIA

This endorsement modifies insurance provided under the following:

COMMERCIAL PROPERTY COVERAGE PART
STANDARD PROPERTY POLICY

A. The exclusion set forth in Paragraph **B.** applies to all coverage under all forms and endorsements that comprise this Coverage Part or Policy, including but not limited to forms or endorsements that cover property damage to buildings or personal property and forms or endorsements that cover business income, extra expense or action of civil authority.

B. We will not pay for loss or damage caused by or resulting from any virus, bacterium or other microorganism that induces or is capable of inducing physical distress, illness or disease.

However, this exclusion does not apply to loss or damage caused by or resulting from "fungus", wet rot or dry rot. Such loss or damage is addressed in a separate exclusion in this Coverage Part or Policy.

C. With respect to any loss or damage subject to the exclusion in Paragraph **B.**, such exclusion supersedes any exclusion relating to "pollutants".

D. The following provisions in this Coverage Part or Policy are hereby amended to remove reference to bacteria:

1. Exclusion of "Fungus", Wet Rot, Dry Rot And Bacteria; and
2. Additional Coverage – Limited Coverage for "Fungus", Wet Rot, Dry Rot And Bacteria, including any endorsement increasing the scope or amount of coverage.

E. The terms of the exclusion in Paragraph **B.**, or the inapplicability of this exclusion to a particular loss, do not serve to create coverage for any loss that would otherwise be excluded under this Coverage Part or Policy.

What Is Business Interruption Insurance, Is A Physical Loss A Prerequisite To Recovery And Are There Any Additional Coverages Or Exceptions?

> **The purpose and nature of business interruption or use and occupancy insurance is to indemnify the insured against losses arising from the inability to continue the normal operation and functions of the business, industry, or other commercial establishment insured.**

37 A.L.R.5th 41 (Originally published in 1996)

> **Ordinarily, policies insuring against loss from business interruption do not provide coverage of, or indemnify the insured against, loss or damage to physical property. Business interruption insurance is, as here, generally in the form of a rider or endorsement on a policy insuring against loss or damage to physical assets. Such insurance coverage is, however, intended to protect against losses arising from the inability to use those assets to conduct the business. In order to establish the existence of an insurable interest in a business, as opposed to the real and personal property with which that business is transacted, an insured must be able to show that he is liable to suffer pecuniary loss from the interruption of the business.**

Citizens Sav. & Loan Ass'n of New York v. Proprietors Ins. Co., 78 A.D.2d 377, 380, 435 N.Y.S.2d 303, 306 (2d Dept. 1981)

> **Simply stated, the purpose of business interruption insurance is to "return to the insured that amount of profit that would have been earned during the period of interruption had a casualty not occurred."**

Pennbarr Corp. v. Ins. Co. of N. Am., 976 F.2d 145 (3d Cir.1992)

> **Like any contract case, the plaintiff must prove damages which are generally recoverable during the "period of restoration" and do not compensate for resulting loss of business (i.e. consequential damages), loss of goodwill or other losses unless specifically set forth in the policy.**

Lava Trading Inc. v. Hartford Fire Ins. Co., 365 F. Supp. 2d 434, 440 (S.D.N.Y. 2005)

In its most basic form, a commercial property casualty policy insures against the risk of damage or loss of a business's real and personal property. When a business's property is damaged or lost, it often incurs additional consequential losses such as increased costs or lost profits which are the direct result of their inability, or partial inability, to conduct their business operations. Additional coverage can be negotiated to cover those economic losses.

***Loss of business income*. The general nature of loss of business income, or business interruption, insurance is that it acts in concert with, and as a supplement to, commercial property casualty insurance. The business income or business interruption insurance is designed to do for the business what the business would have done for itself had no loss occurred. . .**

Usually the additional coverage is tied to the underlying property damage coverage because only business interruptions or income losses resulting directly from physical loss or damage to the insured property will be covered.

***Extra expense*. Extra expense coverage is intended for businesses that cannot allow their operations to cease because of damage to their property.... Extra expense insurance meets this need for it reimburses the insured for those expenditures in excess of normal operating costs that are required to keep the business going while repairs to the physical property are made. . .**

Most businesses obtain either business interruption coverage or extra expense coverage. There are situations, however, where a business would want to have both types of insurance protection. . .

***Ordinary payroll endorsement*. The policy provision providing for loss of business income contains an additional endorsement providing direct payment to . . . for the cost of "ordinary payroll expenses."**

Verrill Farms, LLC v. Farm Family Cas. Ins. Co., 86 Mass. App. Ct. 577, 580–82, 18 N.E.3d 1125, 1128–30 (2014)

Physical Loss Is Not Always A Pre-Requisite To Recovery

> **Here, however, Hampton suffered direct, concrete and immediate loss due to extraneous physical damage to the building. <u>Because of the unquestioned danger of reentering the building</u>, Hampton could simply have left its property in the building pending its collapse; in that event, there would have been direct physical damage to the personal property. Hampton merely mitigated the damages—as it should have done—by removing and salvaging as much property as it could before the building's destruction. The loss in value of Hampton's inventory necessitated by the sudden evacuation, and the destruction of its business equipment upon the building's collapse, constitute "loss or damage to the property insured * * * resulting from all risks of direct physical loss."**

Hampton Foods, Inc. v. Aetna Cas. & Sur. Co., 787 F.2d 349, 352 (8th Cir. 1986) (resolving ambiguity in favor of insured)

> **Many insureds in states that have enacted stay-at-home directives have tried to utilize civil authority coverage as a way to bypass the "physical loss" requirement but some courts have held that a claim "requires proof of a causal link between prior damage and civil authority action."**

Dickie Brennan & Co. v. Lexington Ins. Co., 636 F.3d 683, 687 (5th Cir. 2011) (Mandatory evacuation order of New Orleans was not covered in the absence of physical damage).

Whether Coverage Exists Depends On the Policy And The Facts

Ingress/Egress Provisions: Coverage was held to exist under a business interruption policy which provides that "as a direct result of a peril not excludes, ingress to or egress from real and personal property not excluded hereunder, is thereby prevented." *Fountain Powerboat Indus., Inc. v. Reliance Ins. Co.*, 119 F. Supp. 2d 552, 556 (E.D.N.C. 2000)

Pollution Exclusions: Where the odor from cat urine was present, the Supreme Court of New Hampshire found that the "pollution exclusion clause is ambiguous when applied to the facts of this case." *Mellin v. N. Sec. Ins. Co., Inc.*, 167 N.H. 544, 555, 115 A.3d 799, 809 (2015)

Contamination Exclusions: No recovery for E. Coli tainted beef. *Meyer Nat. Foods, LLC v. Liberty Mut. Fire Ins. Co.*, 218 F. Supp. 3d 1034, 1040 (D. Neb. 2016)

Courts Have Reached Different Results On Similar Facts!

Another potential exception to the "physical loss" requirement is coverage for act of civil authority.

The Court of Appeals for the District of Columbia held that a restriction on the sale of alcohol following the assassination of Martin Luther King, Jr. was not sufficient to warrant business interruption coverage. *Bros., Inc. v. Liberty Mut. Fire Ins. Co.*, 268 A.2d 611, 614 (D.C. 1970); *Two Caesars Corp. v Jefferson Ins. Co.*, 280 A2d 305, (D.C. 1971).

Paragraphs 1 and 2 are addressed to business interruption losses 'caused by damage to or destruction of' the insured property. Paragraph 7 speaks to business-interruption losses occasioned by the denial of access to the premises by order of a civil authority. However, no mention is made of the necessity for physical damage to the premises before paragraph 7 can become operative. Such an omission is conspicuous by its absence. Had the insurer sought to embody into paragraph 7 a condition of physical damage to the insured property, it would have been a simple matter to insert such a clause as was done in paragraphs 1 and 2. It is, however, too late an appeal after the insured has sustained a loss to attempt to rewrite the contract of insurance to include this condition. *Sloan v. Phoenix of Hartford Ins. Co.*, 46 Mich. App. 46, 50, 207 N.W.2d 434, 436 (1973); *Southlanes Bowl, Inc. v. Lumbermen's Mut. Ins. Co.*, 46 Mich. App. 758, 760, 208 N.W.2d 569, 570 (1973) *citing id.* "physical damage to the insured premises was not a prerequisite to the insurer's obligation to reimburse the insured for the net losses resulting therefrom.")

TEN TIPS FOR NAVIGATING A BUSINESS INTERRUPTION CLAIM

The following ten tips are designed to help insureds determine (1) if they have a claim and (2) if so, the appropriate steps to take:

1. Contact your insurance broker to discuss (a) whether your policies provide business interruption or extra expense coverage and whether other provisions (i.e., civil authority) or specialized coverages (i.e., perishable goods) apply; (b) deductibles as well as other relevant policy considerations; and (c) the claims process including the time to file a claim;
2. Put your insurance carrier on written notice as required by your policy;
3. Mitigate damages by continuing business operations to the extent possible (Mitigation does not generally harm an insured's position and failure to mitigate may entitle the insurer to a "set off" or other defense. An example of mitigation is a "sit-down" restaurant converting to pick-up and delivery only operations.);
4. Aggregate "books and records" concerning anticipated losses based upon historical projections is an excelled way to put your employees to work during the COVID-19 crisis (insurance policies often require access to, but do not adequately define, "books and records");
5. Institute a litigation hold to preserve any documents pertaining to the claim, including correspondence with the insurer;
6. Prepare a claim with professional input including your attorneys and accountants (the insurer will likely have counsel and, where appropriate, accountants specializing in business losses and the insured should participate in this process and retain their own specialists to ensure proper treatment of their claim);
7. Participate actively in claim management (Insurance policies may be unclear and even omit what documents and information the insurer will consider in evaluating a claim. By inquiring what documents and information are sought, the insured can avoid later claims that adequate documentation was not forthcoming and potentially resolve the claim without litigation.);
8. File any lawsuit timely (breach of contract cases have a six year statute of limitations in New York but the insurance policy documents may impose a shorter time);
9. Continue to update claim documents throughout the process (even if the insured prevails on liability, damages will need to be established separately); and
10. Assess whether consequential losses, special or other damages are available.

Some Current Disputes To Watch

- "Defendants rejected Plaintiff's coverage finding that the Civil Authority Coverage did not apply because Plaintiff did not suffer damage to its property. Defendants also denied coverage under the Contingent Business Interruption because of lack of damage to the property. Finally, Defendants rejected coverage because of its Virus Exclusion Clause." *LITTLE STARS CORPORATION d/b/a The Little Gym of Gilbert, v. HARTFORD UNDERWRITERS INSURANCE COMPANY; The Hartford Financial Services Group, Inc. d/b/a The Hartford; and Sentinel Insurance Company, Ltd.,* (D. Conn. 20-cv-00609)

- Declaratory judgment in California on behalf of a proposed class of "policyholders who purchased standard Farmers commercial property insurance to insure property in the United States and California, respectively, where such policies provide for business income loss and extra expense coverage and do not exclude coverage for pandemics, and who have suffered losses due to measures put into place by a COVID-19 Civil Authority Order. . This action seeks a declaratory judgment that Farmers is contractually obligated to pay business interruption losses incurred due to plaintiff's and other Class members' compliance with COVID-19 Civil Authority Orders." *KINGRAY INC. d/b/a La Quinta Beer Hunter, Individually and on Behalf of All Others Similarly Situated, v. FARMERS GROUP INC., Farmers Insurance Company, Inc. and Truck Insurance Exchange,* (C.D. Cal. 20-cv-00963)

- Famed California Restaurant Musso and Frank is suing its insurer alleging, among other things, breach of the covenant of good faith and fair dealing in connection with an "'All Risk' policy, all risks of physical loss or damage are covered unless specifically and unambiguously excluded." *MUSSO & FRANK GRILL CO., INC., v. MITSUI SUMITOMO INSURANCE USA INC., Et. Al.* (Cal. Super. 20STCV16681)

- SUN CUISINE, LLC d/b/a Zest Restaurant and Market, a Florida limited liability company on behalf of itself and all others similarly situated v. CERTAIN UNDERWRITERS AT LLOYD'S LONDON (S.D.Fla. 1:20-cv-21827) (denial of access coverage)

- *FOOD FOR THOUGHT CATERERS CORP*., on behalf of itself and all others similarly situated, v. *THE HARTFORD FINANCIAL SERVICES GROUP, INC. and Sentinel Insurance Company, Ltd.*, Defendants., (S.D.N.Y. 20-cv-03418) (civil authorities coverage in New York)

Unlicensed Insurers, Shadow Insurance, Private Remedies and Broker Liability: Recent Case Law, Regulatory Developments and Some COVID-Era Predictions

CELESQ – May 11, 2020

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In the COVID-19 era, undercapitalized and unlicensed insurance companies may pose a risk to consumers and will likely be the subject of much litigation and scrutiny. We anticipate that insureds will look closely at an insurance industry that may have chronically underinsured American businesses. Both regulators and litigators will be taking a close look at whether insurers, insurance producers and insurance brokers are properly licensed and whether corporate formalities have been strictly observed. Additionally, businesses that did not receive coverage that they expected may look to brokers for compensation.

I would like to hit three points today that I believe will be hot issues in insurance and reinsurance litigation in the coming year. *First*, I will briefly touch on some recent enforcement activity against unlicensed insurers that we believe will help us predict future decisionmaking. *Second*, I will discuss the problem of shadow insurance. *Third*, I will discuss private remedies for injured insureds and take a deep dive into recent case law authorizing pre-answer security against unlicensed out-of-state insurers operating in New York and the recent seizure of a Berkshire Hathaway subsidiary by the California Department of Insurance. *Fourth*, I will briefly visit some case law on broker liability that we predict will drive future litigation activity.

I. Recent New York Regulatory Activity Against Unlicensed Insurers

On September 19, 2019 the New York Department of Financial Services (NYDFS) issued Insurance Circular Letter No. 10:

> "to remind all life insurers and insurance producers doing business in New York that an unauthorized life insurer's employees or other representatives may not solicit, negotiate, sell or service group annuity contracts, . . . through in-person meetings, telephone calls, mail, emails, access to web portals or in any other manner from an office or any other location in New York. In addition, an insurance producer and any other person, whether licensed by the Department . . . or otherwise, may not aid or call attention to an unauthorized insurer in New York."

On April 13, 2020, the NYDFS issued a consent order imposing a $45MM penalty in the Matter of Athene Annuity, involving pension risk transfer transactions requiring unlicensed life insurance to pay life insurance benefits to employee pension plan participants located in New York.[1]

On July 17, 2019, the NYDFS issued a consent order with a civil penalty of $3,000,000 against Berkshire Hathaway Inc. subsidiaries Continental Indemnity Company, Applied Underwriters Inc. and its affiliates for aiding unlicensed insurance business and enjoining them

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[1] https://www.dfs.ny.gov/system/files/documents/2020/04/ea20200413_consent_order_athene.pdf

from offering a "reinsurance participation agreement" that illegally offered "inducements and rebates" to consumers.[2]

On January 31, 2019, the NYDFS issued a consent order with a civil penalty of $400,000 for acting for and aiding unauthorized insurers. [3]

Regulatory activity against the unlicensed business of insurance is grabbing today's headlines. On February 6, 2020, the NYDFS issued a statement of charges against the National Rifle Association alleging violations of Insurance Law §§ 2102(a)(1)(A), 2102(e)(1), 2117(a), 2122(a)(2) and requesting a hearing on the issue of whether violations should be found with respect to unfair and deceptive marketing materials, together with civil monetary penalties and injunctive relief.[4] The NYDFS alleged that the National Rifle Association marketed "Carry Guard" insurance to gun owners in New York, in conjunction with Chubb, Lloyd's and Lockton, without a license. In a separate action, on February 25, 2020, the NYDFS entered into a consent order with the unlicensed Asurion Insurance Services, Inc. imposing four million dollars in penalties based on violations of laws requiring disclosures to consumers purchasing mobile phone insurance.[5] These enforcement actions show a more robust regulatory environment in cracking down on doing the business of insurance without a license.

II. The Shadow Insurance Problem

In *The Laundromat*, a 2019 film based on the Panama Papers scandal, Meryl Streep's husband is killed when a ferryboat capsizes on Lake George, New York. The ferryboat operator learns that his broker sold him insurance backed by a series of unlicensed shell companies. Perplexed at the insurance company's failure to pay, Meryl Streep flies to the Caribbean to find a post office box and corporate filings backed by no assets. She goes undercover to chase down the bad guy lawyers Mossack & Fonseca (played brilliantly by Gary Oldman and Antonio Banderas). In late 2019, Mossack & Fonseca unsuccessfully sought an injunction against Netflix in Connecticut to block *The Laundromat's* release.[6] Spoiler alert: in *The Laundromat*, the bad guy offshore lawyers get the last laugh on American consumers.

In 2013, the New York Department of Financial Services ("NYDFS") coined the term "shadow insurance" following an investigation finding $48 billion in illegally inflated assets in insurance companies: *Shining a Light on Shadow Insurance: A Little-known Loophole That Puts Insurance Policyholders and Taxpayers at Greater Risk.*[7] The report warned that empty or undercapitalized shell companies within a holding company structure engaging in reinsurance through captives in states with regulations more lax than New York and using concealed parental guarantees or conditional letters of credit were artificially inflating the "risk based capital" ("RBC") of those insurance companies. Unlike some other states, New York does not permit

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[2] https://www.dfs.ny.gov/system/files/documents/2019/07/ea190718_applied_underwriters.pdf
[3] https://www.dfs.ny.gov/system/files/documents/2019/02/ea190131_lockton.pdf
[4] https://www.dfs.ny.gov/system/files/documents/2020/02/nra_statement-charges-and-notice-hearing-1.pdf
[5] https://dfs.ny.gov/system/files/documents/2020/02/ea20200226_asurion.pdf
[6] Patrick Hipes, Judge Ruling In 'The Laundromat' Lawsuit Clears Path For Netflix Release Deadline October 18, 2019 https://deadline.com/2019/10/the-laundromat-streaming-injunction-denied-netflix-lawsuit-1202763535/
[7] https://www.dfs.ny.gov/docs/reportpub/insurance/shadow_insurance_report_2013.pdf

accounting of "hollow assets," "naked parental guarantees" or "conditional letters of credit" in calculating RBC. The NYDFS found incomplete disclosures to regulators, artificially rosy capital buffers, regulatory blind spots, and a regulatory "race to the bottom." The NYDFS compared the magnitude of the shadow insurance crisis to that of junk bonds or mortgage-backed securities.[8]

Second spoiler alert: at the end of *The Laundromat*, Gary Oldman and Antonio Banderas laugh at the regulatory "race to the bottom" because players in the shell game don't have to even go offshore anymore due to lax regulation in states like Delaware, Nevada and Wyoming. But will the shell gamers get the last laugh? Recent case law and regulatory activity by the NYDFS and new decisions permitting claimants to pursue private rights of action against unlicensed insurance and reinsurance companies peddling their products in New York State suggest that New York may be at the cutting edge of protecting insureds and taxpayers from shadow insurance.

III. Private Remedies for Injured Insureds

For decades, New Yorkers in Meryl Streep's position have relied on regulators to chase unlicensed shell company insurers and reinsurers around the globe. New Yorkers now have a remedy under Section 1213 of the New York Insurance Law which requires unlicensed entities to post pre-answer security in the form of cash, a letter of credit or a surety bond from an independent surety in the full amount of a final judgment as a condition of defending any action. Importantly, Section 1213 covers an unlicensed alien reinsurer wishing to pursue an arbitration. Thus, where an unlicensed shell company that has engaged in doing the business of insurance or reinsurance in New York wishes to assert arbitration as a defense, a New York claimant may compel pre-answer security. This powerful weapon has been historically underutilized, and until recently, all but overlooked by private litigants, despite the fact that forty-five of fifty states have similar pre-answer security requirements.

New York Insurance Law Section 1213 was supported by New York's insurance industry because it creates a significant barrier to entry against unlicensed competitors who are not forced to comply with New York's stringent capital requirements and regulatory oversight employed to protect New York consumers. Section 1213 is the expression of New York's public policy in exercising its exclusive regulatory power over persons who do the business of insurance in New York to ensure that assets are available to pay claims. New York, as other states, exercises almost complete regulatory authority over insurance because the McCarran-Ferguson Act of 1945, 15 U.S.C. §§ 1011-1015, exempts the business of insurance from most federal regulation.

Although alien reinsurers are not required to be licensed under Section 1101 of the New York Insurance Law, Section 1101(b)(2) specifically applied Section 1213's pre-answer security and service requirements to alien reinsurers. This means that an unlicensed alien reinsurer, when sued in New York, must post the entire amount of a potential judgment prior to having the opportunity to present or arbitrate its defenses. Section 1213 was challenged by a Bermuda-

[8] See also Ed Leefeldt, "Does 'shadow insurance' lead to dangerous debt deals?" Moneywatch September 13, 2016 https://www.cbsnews.com/news/does-shadow-insurance-encourage-dangerous-debt-deals/

based reinsurer and upheld as satisfying procedural due process under the New York and U.S. Constitutions in *Curiale v. Ardra Ins. Co. Ltd.*, 88 N.Y.2d 268 (1996). In *Curiale,* the New York Superintendent of Insurance Salvatore R. Curiale acted as liquidator to pursue an offshore reinsurer. The reinsurer failed to post the bond and was held liable for the full amount of the reinsurance contract following the default. The Court of Appeals held that Section 1213 is constitutional and a proper exercise of the State's police powers because it is related to the public interest. The *Curiale* court held that reinsurers offering coverage to New Yorkers were on notice that New York law required deposits of the full amount of a potential judgment.

In *The Laundromat,* Meryl Streep's character was not a superintendent of insurance but simply an individual claimant. Can an individual claimant avail herself of the protections of Section 1213 against reinsurers and retrocessionaires when the insurer is unlikely to pay? Over two decades after *Curiale* was decided, the answer has emerged as a clear "yes."

In *Breakaway Courier Corp. v. Berkshire Hathaway,* 2017 WL 3084991, 2017 N.Y. Slip Op. 32751, Justice Marcy Friedman of the Commercial Division of Supreme Court, New York County considered the question of whether the court had the discretion to dispense with the imposition of Section 1213 pre-answer security where unlicensed alien reinsurers had not obtained a certification from the superintendent that they "maintain[] within this state funds or securities in true or otherwise sufficient and available to satisfy any final judgment which may be entered in the proceeding." Id. citing N.Y. Ins. L. 1213(c)(1)(A).[9]

Breakaway involved the sale in New York of a "reinsurance participation agreement" ("RPA") pursuant to which the unlicensed Applied Underwriters Inc., a Nebraska domiciliary, would collect monies and remit the monies to unlicensed alien reinsurers and retrocessionaires domiciled in California, Iowa and Texas. The *Breakaway* plaintiffs alleged that the RPA was a reverse Ponzi scheme because it failed to transfer any risk from the purported insureds. The Applied RPA had been the focus of litigation, with the Third Circuit Court of Appeals characterizing it as as a "derivative investment contract" linked to insurance whose "fundamental nature remains obscure."[10] The RPA "structure" consists of one of five Berkshire Hathaway-affiliated insurance companies issuing a workers compensation policy and pooling the policies in a reinsurance pooling agreement under the leadership of Berkshire-owned California Insurance Company ("CIC"). CIC then engaged in a reinsurance quota share contract with Berkshire-owned Applied Underwriters Captive Risk Assurance Company ("AUCRA"), domiciled in Iowa to exploit limited purpose subsidiary laws. In signing the impossible-to-understand RPA with AUCRA, the New York policyholder re-assumed all risk flowing from worker injuries, plus assuming the obligation of paying substantial fees.

The Breakaway plaintiffs further alleged that defendant Berkshire Hathaway Inc. siphoned off funds through a series of wholly-owned reinsurers and third-party retrocessionaire Commercial General Indemnity Inc, a Hawaiian captive ("CGI") by using a concealed "excess

[9] The author's firm serves as plaintiffs' counsel in this action, which remains pending (Berkshire Hathaway Inc. was dismissed from the action, appeal pending).

[10] South Jersey Sanitation Company, Inc. v. Applied Underwriters Captive Risk Assurance Co., 840 F.3d 138, 146 (3d Cir. 2016).

loss agreement." In a matter of first impression, Justice Friedman determined that the court lacked any discretion to dispense with the pre-answer security requirement based on the plain language of the statute and that requiring pre-answer security was necessary to carry out the purposes of the Legislature.[11] Justice Friedman declined to consider defendants' pre-answer motion to dismiss absent defendants, including CGI, posting security or obtaining a license to do insurance business in New York State and fixed a pre-answer security in the sum of all monies paid to defendants, in excess of $14,000,000 for three plaintiffs. Defendants initially posted a bond in the name of a Berkshire Hathaway affiliate, but following a court order scheduling a hearing requiring justification of the bond, posted a bond from an independent surety.[12]

On June 20, 2016 the Insurance Commissioner of the State of California found the RPA "void as a matter of law" and that "AUCRA's sole purpose in the Berkshire Hathaway family is to serve as CIC's reinsurance arm."[13] On July 17, 2019 the New York Department of Financial Services entered into a consent decree with Applied Underwriters Inc. and its affiliates declaring the RPA illegal and enjoining sales of the RPA in New York.[14] The DFS found that the respondents violated Sections 1102, 2117, 2307 and 2324 of the New York Insurance Law and Section 408 of the Financial Services Law by distributing the RPA. The Consent Order imposed a civil penalty of three million dollars. On November 4, 2019, the California Department of Insurance seized CIC pursuant to a conservation order.[15]

Have regulators caught on to the shell game?

Will the shell gamers get the last laugh on regulators and victims? Meryl Streep's character in *The Laundromat* would be encouraged by how New York law and regulation is putting powerful weapons in the hands of New York victims against unlicensed alien entities, both offshore and in states with lax regulation and opaque limited purpose subsidiary laws.[16] New York is unique in the nation, having enacted in 2010 following the financial crisis a provision that protects counterparties to derivative contracts from stays by liquidators or conservators of insurance companies.[17] Recent NYDFS activity suggests that enforcement against unlicensed insurers will be serious business. Although, prior to *Breakaway*, insurance claimants in New York had not successfully used Section 1213 as a weapon in private litigation, we can expect to see it deployed effectively against shadow insurance shell games.

IV. Private Remedies and Broker Liability

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[11] 2017 WL 3084991, 2017 N.Y. Slip Op. 32751.
[12] Breakaway v. Berkshire Hathaway Inc., 2019 WL 3765350, 2019 N.Y. Slip Op. 32393(U).
[13] In re Shasta Linen Supply, Inc., File AHB-WCA-14-31 at 1, 11. http://www.insurance.ca.gov/0250-insurers/0500-legal-info/0600-decision-ruling/0100-precedential/upload/ShastaLinenSupplyInc.pdf
[14] https://www.dfs.ny.gov/system/files/documents/2019/07/ea190718_applied_underwriters.pdf
[15] http://www.insurance.ca.gov/0400-news/0100-press-releases/2019/upload/Order-appointing-conservator-of-California-Insurance-Company_2019-12-04.pdf
[16] Joseph M. Belth, "Iowa's Frightening Accounting Rules – An Update" July 13, 2015 http://www.josephmbelth.com/2015/07/no-109-iowas-frightening-accounting.html
[17] N.Y. Ins. L. §7437.

Generally, an agent or a broker acting on behalf of an insured "must act with reasonable care, skill, and judgment in selecting an insurance carrier for the client" *Georgas v Kreindler & Kreindler*, 41 F Supp.2d 470, 475 (S.D.N.Y. 1999).

However, where a broker procures a policy for an unlicensed entity, the broker may be liable. *Jamaica Bay Riding Academy v. William F. Slack, Inc.*, 204 A.D.2d 398, 611 N.Y.S.2d 612 (2nd Dept.1994) (holding agent liable for procuring equine liability insurance with insolvent insurer for horseback riding company).

E. Coast Mgt. Ltd. v Genatt Assoc., Inc., 9 Misc 3d 440, 444-45 (Sup Ct 2005):

> In order to demonstrate that the broker exercises good faith when selecting a non-licensed insurance carrier for a client, the State of New York requires that the broker "shall" provide proof that three insurance carriers declined to offer coverage for this risk. This is a requirement. The State also requires the broker to provide a sworn affidavit attesting to the search for more secure coverage.

In this instance, Edward DiGioia, the individual, in whose name the forms were provided to the State, denies having performed such a search, and denies ever signing the form filed with the State (Cross Motion, Exh. G, Exh. P) In addition, Donna Fabrizio, the individual identified as employed by St. Paul Insurance Company, and as having declined to issue coverage, denies that she ever did so. (Motion, Exh. S) These two denials are not disputed by GENATT.

GENATT fails to provide evidence or testimony by another individual that it did comply with the provisions of Insurance Law § 2118 prior to procuring insurance for the plaintiff with Legion.

Based on the proof presented in this instance the Court finds that the broker's failure to comply with the strict provisions of the Insurance Law are evidence that they did not act with reasonable care. Based on the proof presented, the Court also finds that the defendant breached its contract with the plaintiff in failing to procure proper insurance for it.

Thus, that portion of the plaintiff's motion for summary judgment on the First and Third causes of action is Granted. The Court finds that the admitted failure to strictly comply with the provisions of Insurance Law § 2118, constitute a breach of GENATT's fiduciary duty to the plaintiff. Insurance Law § 2120.

E. Coast Mgt. Ltd. v Genatt Assoc., Inc., 9 Misc 3d 440, 445 [Sup Ct 2005]

An insurance broker who breaches his duty to an insured by not obtaining proper insurance becomes liable to the extent that the carrier would have been. *Soho Generation of New York, Inc. v. Tri–City Ins. Brokers*, 256 A.D.2d 229, 683 N.Y.S.2d 31 (1st Dept.1998).

It is well settled that a broker who negligently fails to procure a policy stands in the shoes of the insurer and is liable to the insured *see Andriaccio v. Borg & Borg*, 198 A.D.2d 253, 603 N.Y.S.2d 528, citing *Island Cycle Sales v. Khlopin*, 126 A.D.2d 516, 518, 510 N.Y.S.2d 637), with said liability being limited to that which would have been borne by the insurer had

the policy been in force (*Rodriguez v. Investors Ins. Co. of Am.*, 201 A.D.2d 355, 356, 607 N.Y.S.2d 329, citing *American Motorists Ins. Co. v. Salvatore*, 102 A.D.2d 342, 346, 476 N.Y.S.2d 897; *see also, Kinns v. Schulz*, 131 A.D.2d 957, 959, 516 N.Y.S.2d 817; *MacDonald v. Carpenter & Pelton*, 31 A.D.2d 952, 953–954, 298 N.Y.S.2d 780).

Soho Generation of New York, Inc. v Tri-City Ins. Brokers, Inc., 256 AD2d 229, 231 [1st Dept 1998]

There is a "common-law duty to obtain requested coverage for [its] clients within a reasonable time or inform the client of the inability to do so." *Great Am. Ins. Co. v Zelik*, 19-CV-1805 (JSR), 2020 WL 85102, at *9 (S.D.N.Y. Jan. 6, 2020), *on reconsideration in part*, 19-CV-1805 (JSR), 2020 WL 745969 (S.D.N.Y. Feb. 14, 2020) *citing* Murphy v. Kuhn, 90 N.Y.2d 266, 270 (1997).

It is well established that such a duty to exercise "reasonable diligence" in insurance procurement exists, *Id. citing Baseball Office of Com'r v. Marsh & McLennan, Inc.*, 295 A.D.2d 73, 79 (2002).

In sum, when brokers and insurance producers are not licensed or procure coverage from unauthorized insurers, liability arises and there is a corresponding private remedy. In light of recent regulatory activity, case law developments, and frustrations with lack of COVID-19 business interruption or extra expense coverage, we expect to see a wave of litigation in this area.

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Shining a Light on Shadow Insurance

A Little-known Loophole
That Puts Insurance Policyholders and
Taxpayers at Greater Risk

New York State Department of Financial Services

Benjamin M. Lawsky, Superintendent of Financial Services

June 2013

EXECUTIVE SUMMARY

In July 2012, the New York State Department of Financial Services ("DFS") initiated an investigation into "shadow insurance" — a little-known loophole that puts insurance policyholders and taxpayers at greater risk. This report details the initial findings of DFS's inquiry.

Insurance companies use shadow insurance to shift blocks of insurance policy claims to special entities — often in states outside where the companies are based, or else offshore (e.g., the Cayman Islands) — in order to take advantage of looser reserve and regulatory requirements. Reserves are funds that insurers set aside to pay policyholder claims.

In a typical shadow insurance transaction, an insurance company creates a "captive" insurance subsidiary, which is essentially a shell company owned by the insurer's parent. The company then "reinsures" a block of existing policy claims through the shell company — and diverts the reserves that it had previously set aside to pay policyholders to other purposes, since the reserve and collateral requirements for the captive shell company are typically lower. Sometimes the parent company even effectively pays a commission to itself from the shell company when the transaction is complete.

This financial alchemy, however, does not actually transfer the risk for those insurance policies because, in many instances, the parent company is ultimately still on the hook for paying claims if the shell company's weaker reserves are exhausted ("a parental guarantee"). That means that when the time finally comes for a policyholder to collect promised benefits after years of paying premiums (such as when there is a death in their family), there is a smaller reserve buffer available at the insurance company to ensure that the policyholder receives the benefits to which they are legally entitled.

Shadow insurance also could potentially put the stability of the broader financial system at greater risk. Indeed, in a number of ways, shadow insurance is reminiscent of certain practices used in the run up to the financial crisis, such as issuing securities backed by subprime mortgages through structured investment vehicles ("SIVs") and writing credit default swaps on higher-risk mortgage-backed securities ("MBS"). Those practices were used to water down capital buffers, as well as temporarily boost quarterly profits and stock prices at numerous financial institutions. Ultimately, these risky practices left those very same companies on the hook for hundreds of billions of dollars in losses from risks hidden in the shadows, and led to a multi-trillion dollar taxpayer bailout.

Similarly, shadow insurance could leave insurance companies on the hook for losses at their more weakly capitalized shell companies. The events at AIG's Financial Products unit in

the lead up to the financial crisis demonstrate that regulators must remain vigilant about potential threats lurking in unexpected business lines and at more weakly capitalized subsidiaries within a holding company system.

DFS's Investigation into Shadow Insurance

Over the last eleven months, the New York Department of Financial Services has conducted an extensive investigation into shadow insurance at New York-based insurance companies and their affiliates. DFS's investigation revealed:

- ***$48 Billion in Shadow Insurance at New York-based Insurers and Their Affiliates Alone.*** New York-based insurance companies and their affiliates engaged in at least $48 billion of shadow insurance transactions to lower their reserve and regulatory requirements.

- ***Inconsistent, Spotty, and Incomplete Disclosures.*** New York-based insurance companies failed to disclose the parental guarantees associated with nearly 80 percent ($38 billion) of that $48 billion in shadow insurance in their statutory, annual financial statements. And where those companies did make disclosures, those disclosures were often spotty and incomplete.

- ***Reserves Diverted, Artificially Rosy Capital Buffers.*** Shadow insurance allows companies to divert reserves for other purposes besides paying policyholder claims. Those other purposes may include anything from an acquisition of another company to executive compensation to paying dividends to investors. In most cases, though, DFS's investigation revealed that insurance companies manipulated those reserves in order to artificially boost the risk-based capital ("RBC") buffers that they reported to regulators, investors, and the broader public — all without actually raising any new capital or reducing risk. In other words, shadow insurance makes a company's capital buffers — which serve as shock absorbers against unexpected losses or financial shocks — appear larger and rosier than they actually are.

- ***Weak Transparency, Regulatory Blind Spots.*** Most states have laws that provide for strict confidentiality on financial information related to shadow insurance. These confidentiality requirements thwart regulators from outside that state from having a full window into the risks that those transactions create. Indeed, the current lack of transparency surrounding shadow insurance is what, in great part, drove DFS to undertake this investigation.

- ***Regulatory Race to the Bottom.*** A number of the other states outside New York where shadow insurance is written permit the use of riskier types of "collateral" to back shadow

insurance claims, including "hollow assets," "naked parental guarantees," and "conditional letters of credit" (each of which is described in further detail below). Those weaker collateral requirements mean that policyholders are at greater risk.

As part of its investigation, under Section 308 of the New York Insurance Law, DFS required all life insurers based in New York to provide information on shadow insurance transactions. The findings of this investigation and DFS's authority under Section 308 are limited to New York-based life insurers. As such, the $48 billion in shadow insurance transactions DFS's investigation uncovered are likely to be just the tip of the iceberg nationwide. There are almost certainly tens, if not hundreds, of billions of dollars of additional shadow insurance on the books of insurance companies across the country.

DFS's Recommendations on Shadow Insurance

Given the troubling findings uncovered during its investigation, DFS is taking immediate action and making several recommendations to address the potential risks and lack of transparency surrounding shadow insurance:

- Through its authority under the New York Insurance Law, DFS will require detailed disclosure of shadow insurance transactions by New York-based insurers and their affiliates.

- In the interest of national uniformity, the National Association of Insurance Commissioners ("NAIC") should develop enhanced disclosure requirements for shadow insurance across the country.

- The Federal Insurance Office ("FIO"), Office of Financial Research ("OFR"), the NAIC, and other state insurance commissioners should conduct similar investigations to document a more complete picture of the full extent of shadow insurance written nationwide.

- State insurance commissioners should consider an *immediate national moratorium* on approving additional shadow insurance transactions until those investigations are complete and a fuller picture emerges.

I. DFS'S INVESTIGATION INTO SHADOW INSURANCE

A. Background/Objectives of the Investigation

The use of shadow insurance emerged in great part due to a desire from insurers to do an end-run around higher reserve requirements that states established for certain term and universal life insurance policies. The fact that certain insurers are inappropriately using shell games to hide risk and loosen reserve requirements is greatly troubling to DFS and caused the Department to launch an investigation.

On July 18, 2012, pursuant to Section 308 of the New York Insurance Law, DFS required all 80 life insurers based in New York to provide information concerning reinsurance with affiliated captive or affiliated offshore insurers, including those with parental guarantees ("shadow insurance").

The investigation also focused on the following additional areas of concern surrounding shadow insurance — each of which present serious potential risks to policyholders and taxpayers:

1. ***Conditional Letters of Credit.*** DFS examined whether any of those 80 New York-based insurers and their affiliates engaged in reinsurance transactions using "conditional letters of credit" (i.e., letters of credit that have stipulated conditions that must be met before they can be drawn upon). A conditional letter of credit is at greater risk of not being available to fund policyholder claims during periods of financial stress. New York requires that letters of credit used as collateral have unconditional terms. However, other states allow conditional letters of credit as collateral.

2. ***Two-step Transactions.*** DFS examined whether any of those 80 New York-based insurers and their affiliates transferred insurance to another insurer outside of New York, which then subsequently transferred that risk to a captive subsidiary affiliated with the original insurer (a "two-step transaction"). Two-step transactions are particularly problematic because, in some instances, although a New York-based insurer may not report any direct shadow insurance activity, the New York-based insurer is still ultimately on the hook for losses through a parental guarantee. This complex shell game obscures the risks that insurers are taking on through shadow insurance.

3. ***Hollow Assets.*** DFS examined whether any of those 80 New York-based insurers and their affiliates engaged in reinsurance transactions with affiliated captives or affiliated offshore reinsurers where a letter of credit with a parental guarantee is recorded as an asset on the books of the captive or offshore affiliate ("hollow asset"). In other words, the insurer counts the undrawn letter of credit as an asset — rather than a real asset that

it actually holds, such as cash or a bond. While New York does not allow insurers to count undrawn letters of credit as assets, other states allow such arrangements.

4. ***Naked Parental Guarantees.*** Through a "naked parental guarantee," a captive insurance subsidiary engaging in shadow insurance does not even bother to obtain a letter of credit — conditional or otherwise — as collateral. It simply promises that its parent company would cover potential losses, without identifying any specific, dedicated resources to pay for them. While New York does not allow insurers to back insurance claims with naked parental guarantees, other states allow such arrangements.

B. Summary of the Findings of the Investigation

As part of its investigation, DFS uncovered that 17 New York-based insurers used some form of parental guarantee to support collateral arrangements in reinsurance transactions. Those shadow insurance transactions together totaled more than $48 billion.

Eight of those 17 respondents reported direct reinsurance arrangements through a subsidiary operating in New York. Nine of those 17 respondents reported reinsurance arrangements solely through non-New York affiliates.

- Of the eight insurers that reported direct transactions, their parental guarantees totaled $14.9 billion in the aggregate. In addition, five of those eight New York-based insurers also reported that their non-New York affiliate insurers engaged in transactions that used some form of parental guarantee that, in the aggregate, totaled an additional $18.2 billion.

- Of the nine insurers that reported transactions only through non-New York affiliates in their holding company systems, the total amount of parental guarantees reported amounted to approximately $15.3 billion.

Specific details on the shadow insurance transactions at each of these 17 firms are available in Section I. D of this report.

Conditional Letters of Credit

Five New York-based insurers reported that non-New York-based affiliates within their holding company systems used conditional letters of credit, although only three insurers reported the amounts associated with those conditional letters of credit ("Conditional LOCs"). (*See* Table 1.)

Table 1: Insurers Reporting Conditional LOCs

Case	Total LOCs with Credit Reimbursement Agreements	Amount of Conditional LOCs, If Reported*
Case 3	$658,650,000	$391,000,000
Case 5	$4,322,570,267	0
Case 8	$1,911,071,300	$1,840,571,300
Case 10	0	0
Case 17	$450,000,000	$450,000,000
Totals	**$7,342,291,567**	**$2,681,571,300**

*For entries noted as zero in this column, the firms indicated that they have previously or intend to engage in these practices, but they are not currently active as of the date of the DFS's inquiry.

Hollow Assets

The Department's investigation further revealed that the captive reinsurers of 11 New York-based insurers reported LOCs as admitted assets in the cases where the reinsurers are located in the states of Missouri, Delaware, Iowa, South Carolina, Nebraska, and Vermont. These states — unlike New York — permit LOCs to be reported as admitted assets on the books of the captive reinsurers. All but one insurer that reported a captive with an LOC in the aforementioned six states specifically identified the amount of LOCs reported as admitted assets. The total amount of LOCs reported as assets is approximately $9.6 billion. (*See* Table 2 for a summary.)

Table 2: LOCs Reported as Admitted Assets

Case	Total LOCs with Credit Reimbursement Agreements	LOCs where Reinsurers Are Located in MO, DE, IA, SC, NE or VT	Amount of LOCs Specifically Reported as Assets**
Case 1	$7,109,685,769	$4,446,000,000	$4,446,000,000
Case 2	$216,000,000	$85,000,000	$85,000,000
Case 3	$658,650,000	$658,650,000	$658,650,000
Case 5	$4,322,570,267	$1,879,122,053	0
Case 8	$1,911,071,300	$1,840,571,300	$1,840,571,300
Case 9	$4,745,590,260	$727,000,000	$727,000,000

Case 10	0	0	0
Case 11	$130,040,984	$130,040,984	$130,040,984
Case 14	$1,173,300,000	$1,148,000,000	$1,148,000,000
Case 16*	$100,807,387	$100,807,387	$100,807,387
Case 17	$450,000,000	$450,000,000	$450,000,000
Totals	$20,817,715,967	$11,465,191,724	$9,586,069,671

*This represents a parental guarantee that was reported as an admitted asset.

**For entries noted as zero in this column, the firms indicated that they have previously or intend to engage in these practices, but they are not currently active as of the date of the DFS's inquiry.

Two-step Transactions

The Department's investigation also uncovered several "two-step" transactions where New York-based insurers transferred business to another U.S.-based life insurer outside New York, which then transferred the business to a captive or offshore insurer affiliated with the original New York insurer. Indeed, six New York-based insurers reported engaging in some sort of two-step transactions and, of those, five utilized parental guarantees.

Table 3: Insurers Reporting Two-Step Transactions

Case	LOCs with Parental Guarantees*	Surplus Note Guarantees*	Report LOCs as Assets?	Report Conditional LOCs?
Case 1	$7,109,685,769	$4,647,000,000	Yes	No
Case 7	0	0	No	No
Case 8	$1,911,071,300	0	Yes	Yes
Case 9	$4,745,590,260	$2,212,000,000	Yes	No
Case 10	0	$1,480,000,000	Yes	Yes
Case 14	$1,173,300,000	$127,769,311	Yes	No
Totals	**$14,939,647,329**	**$8,466,769,311**		

*For entries noted as zero in this column, the firms indicated that they have previously or intend to engage in these practices, but they are not currently active as of the date of the DFS's inquiry.

Two-step transactions are particularly problematic because, in some instances, although a New York-based insurer may not report any direct activity involving parental guarantees, the

risks of the New York-based insurer are ultimately being guaranteed by the parent through retrocessions (i.e., reinsurance of reinsurance arrangements) within the holding company system.

Naked Parental Guarantees

The Department's inquiry also uncovered other kinds of arrangements, including "naked parental guarantees." In a naked parental guarantee, a captive insurance subsidiary does not even bother to obtain a letter of credit — conditional or otherwise — as collateral. It simply promises that its parent would cover any losses, without identifying specific, dedicated resources to pay for them.

In one situation, an insurer reported that a non-New York-based company entered into an agreement that used a "naked parental guarantee" for the amount of $1.6 billion. In another instance, a non-New York-based company used a similar affiliate guarantee (a "naked guarantee" from an affiliate, as opposed to the ultimate parent) for the amount of $100.8 million in a reinsurance transaction. (*See* Table 4.)

Table 4: "Naked" Parental Guarantees

Case	"Naked" Parental Guarantee Amounts
Case 5	$1,616,883,275
Case 16	$100,807,387
Totals	**$1,717,690,662**

New York regulations do not permit either a naked parental or affiliate guarantee as collateral in support of a reduction in a reserve liability because, in the event of financial difficulty of the reinsurer, there is no readily available assets to seize to pay claims. That type of arrangement puts policyholders at greater risk.

C. Diverting Reserves, Artificially Boosting Capital Buffers

As previously noted, shadow insurance allows companies to divert reserves for other purposes besides paying policyholder claims. Those other purposes could include anything from an acquisition of another company to executive compensation to paying dividends to investors. In most cases, though, DFS's investigation found that companies use those diverted reserves to artificially boost the risk-based capital (RBC) buffers that they report to regulators, investors, and the broader public — without actually raising any new capital or reducing risk. In other words, shadow insurance makes a company's capital buffers — which serve as shock absorbers against unexpected losses or financial shocks — appear larger and rosier than they actually are.

Regulators created RBC standards in the late 1980s were created to provide a capital adequacy standard tied to risk, raise insurers' safety nets, create uniformity among states, and provide regulatory authority for timely action. RBC represents the amount of capital, based on an assessment of risks, that a company should hold to protect customers against adverse developments. The RBC system was developed after the financial crisis of the late 1980s when state insurance commissioners took a fresh look at the low, fixed minimum capital requirements embedded in the various state insurance laws. Regulators throughout the country determined that a new approach was necessary to better protect policyholders and to raise the minimum capital requirements for insurance companies.

Because the RBC ratio is often interpreted as a measure of the financial strength of an insurer by rating agencies, regulators, company management, customers, creditors, and investors, insurance companies are motivated to engage in shadow insurance transactions — such as reinsurance with affiliated captives and offshore insurers with parental guarantees — to artificially boost their RBC ratio.

Publicly traded companies disclose risk-based capital information in their filed statutory annual statements and 10-K reports filed with the U.S. Securities and Exchange Commission, and discuss risk-based capital at their annual investor days and on their public earnings calls. Additionally, regulators and rating agencies consider RBC as they determine a company's financial strength rating. Parent insurance companies that provide minimum capital guarantees for their subsidiaries or affiliate companies also usually tie the guarantees to a percentage of RBC (e.g., a guarantee to maintain 350 percent RBC-company action level).

Companies can use shadow insurance in a number of ways to artificially boost their RBC levels. In a common scenario, the insurer reinsures a block of policies with an affiliated captive. The original insurer then receives a commission, as well as other capital boosts, equal to the amount that the transaction has effectively lowered its reserve requirements. That commission is then counted as "retained earnings" for accounting purposes — which is a form of capital — even though the firm is essentially paying a commission to itself.

Specific details about the impact of shadow insurance on RBC levels at the 17 firms engaging in that practice are available in Section I. D of this report.

D. Details of Findings

1. Insurers Reporting Direct Reinsurance with Affiliated Captives/Offshore Insurers

As noted in Section I. B of this report, the Department's inquiry revealed eight New York-based insurers that reported direct reinsurance activity with affiliated captives and offshore insurers that involved some form of parental guarantee. The New York-based insurers reported direct transactions that used some form of parental guarantee which, in the aggregate, totaled

nearly $15 billion. In addition, five of those eight New York-based insurers also reported that their non-New York affiliate insurers engaged in transactions that used some form of parental guarantee, which, in the aggregate, totaled an additional $18 billion. The activity of each of the eight insurers and their affiliates is described in greater detail below.

Case 1

A New York-based life insurer reported $1,184,000,000 in LOCs that were used by captives and offshore affiliates that were backed by "contractual parental guarantees" from its ultimate parent. In addition, this insurer entered into a treaty with a captive whereby the captive issued surplus notes in the amount of $1,850,000,000 to fund part of the transaction. The performance of the surplus notes was indemnified by the ultimate parent using a Total Rate of Return Swap. As a result of these transactions, the insurer improved its RBC by 109 percent as of December 31, 2011. The total amount of LOCs and surplus notes guaranteed represents about 22 percent of the New York-based insurer's capital and surplus as of December 31, 2011.

With respect to other non-New York-based U.S. affiliates in the same holding company system, the insurer reported $5.9 billion in LOCs that were issued by affiliated captives and offshore reinsurers that were backed by "contractual parental guarantees" from the ultimate parent. As a result of these transactions, the non-New York-based affiliates have increased their RBC ratios individually in amounts ranging from 211.3 percent to 634.0 percent as of December 31, 2011.

This insurer reported that on a consolidated basis its RBC increased 150.8 percent as a result of reinsurance with affiliated captive and offshore reinsurers.

In addition, the insurer also reported that its captive affiliates reported LOCs as an admitted asset in the amounts of $315 million for New York-based activity and $4.1 billion for non-New York-based affiliate activity.

Case 2

A New York-based life insurer reported $216,000,000 in LOCs that were issued by affiliated captives and offshore reinsurers and were backed by "contractual parental guarantees" from the ultimate parent. As a result of these transactions, the insurer improved its RBC by 294.5 percent as of December 31, 2011. The total amount of LOCs guaranteed exceeds the cedent's capital and surplus as of December 31, 2011. The New York-based insurer reported that $85 million of LOCs were reported as assets by the captive reinsurer.

Case 3

A New York-based life insurer reported $129,350,000 in LOCs that were issued by affiliated captives and were backed by "contractual parental guarantees." As a result, the

insurer's RBC increased 538 percent. The total amount of LOCs guaranteed *exceeds the insurer's entire capital and surplus* as of December 31, 2011.

With respect to other non-New York-based U.S. affiliates, this insurer reported $529.3 million in LOCs that were backed by "contractual parental guarantees" and $391 million in conditional LOCs that they reported had no parental guarantees. The insurer reported a total increase of 137 percent in its RBC from these transactions.

Further, the insurer indicated that its captive affiliates report LOCs as an admitted asset in the states that allow such reporting.

Case 4

A New York-based life insurer reported $1.9 billion in LOCs that were issued by affiliated captives as collateral for two treaties and were backed by "contractual parental guarantees" from an affiliate. The insurer reported an increase of 127 percent in its RBC as a result of these treaties. The LOC amount represents about 41 percent of capital and surplus as of December 31, 2011. In addition, the New York-based insurer reported an $8.1 billion trust used for collateral for reserve credit, which has indemnification from an affiliate of the insurer used to hedge GMIB exposure.

Case 5

A New York-based life insurer reported $958,273,155 in LOCs issued by an offshore affiliate, where the parent is a co-applicant on the LOC. The New York-based insurer reported an increase of 97 percent in its RBC as a result of this treaty. The LOC amount *exceeds the insurer's entire capital and surplus* as of December 31, 2011.

With respect to other non-New York-based U.S. affiliates in its holding company system, an insurer entered into three treaties with an affiliated captive that used a parental "indemnification" with respect to surplus notes issued by the captive in the amount of $1.9 billion to fund a trust, which, taken together, increased its RBC by 26 percent. The insurer also entered into a treaty with an affiliated captive that used a naked parental guarantee in the amount of $1.6 billion for support of reserve credit, which increased its RBC by 17 percent. There are also many other reinsurance transactions within this holding company system where the parent is a co-applicant for $3.3 billion in LOCs used as collateral for reserve credits that increased RBC by a total amount of 261 percent.

In addition, the insurer reported that its non-New York-based affiliates have used conditional LOCs. Further, the insurer indicated that its captive affiliates report LOCs and naked parental guarantees as admitted assets in the states that allow such reporting.

Case 6

A New York-based life insurer reported $408.7 million in LOCs issued by an offshore affiliate backed by a contractual parental guarantee. The LOC amount represents about 22 percent of this insurer's capital and surplus as of December 31, 2011.

With respect to other non-New York-based U.S. affiliates, $243 million in LOCs backed by a contractual parental guarantee were issued.

Case 7

A New York-based life insurer reported LOCs in the total amount of $154 million as of December 31, 2011 for two treaties. There is a contractual parental guarantee in the form of a capital maintenance agreement that requires the parent to adequately maintain the capital and surplus of the affiliate reinsurer (it is noted that capital maintenance agreements can exist separate from any reinsurance arrangement). Total RBC impact of the reinsurance was an increase of about 64 percent and the LOC amount represents about 17 percent of capital and surplus as of December 31, 2011.

With respect to the other non-New York-based insurers in the group, capital maintenance agreements were also used to support other collateral arrangements.

Case 8

A New York-based life insurer reported a LOC in the amount of $70 million as of December 31, 2011 for a treaty with an offshore captive that has a contractual parental guarantee.

With respect to the non-New York-based affiliates in its holding company system, an affiliate had several treaties with captives and offshore affiliates. The transactions included contractual parental guarantees in the amount of $1.8 billion, and $500,000 in LOCs and a $474 million trust with no parental guarantees.

In addition, this insurer reported that its non-New York-based affiliates use conditional LOCs. Further, the insurer indicated that its captive affiliates report LOCs as an admitted asset in the states that allow such reporting.

* * *

In total, eight New York-based insurers reported direct reinsurance with affiliated captives and affiliated offshore reinsurers involving some form of parental guarantee totaling nearly $15 billion.

Table 5 summarizes the artificial boosts in risk-based capital buffers from the transactions by the eight New York-based insurers that reported direct activity utilizing some form of parental guarantee (or credit reimbursement agreement).

Table 5: Direct Activity by Individual New York-Based Insurers

Case*	LOCs with Credit Reimbursement Agreements	Surplus Note Guarantees/ Trust Indemnification	Naked Parental Guarantees	Total Amount of Collateral/ Approximate Reserve Credit	Reported RBC Percent Increase
Case 1	$1,184,000,000	$1,850,000,000	0	$3,034,000,000	132%
Case 2	$216,000,000	0	0	$216,000,000	1,111%
Case 3	$129,350,000	0	0	$129,350,000	538%
Case 4	$1,908,005,543	$8,173,500,000	0	$10,081,505,543	127%
Case 5	$958,273,155	0	0	$958,273,155	97%
Case 6	$408,726,594	0	0	$408,726,594	0.62%
Case 8	$70,000,000	0	0	$70,000,000	1 %
Total	**$4,874,355,292**	**$10,023,500,000**	**0**	**$14,897,855,292**	

*Not included in this table is a case involving a capital maintenance agreement (*see* Case 7 above) that is explicitly tied to the affiliated offshore reinsurer's ability to secure a letter of credit.

The New York-authorized insurers that reported direct reinsurance with affiliated captives and affiliated offshore reinsurers reported direct reinsurance arrangements with guarantees ranging from $70 million to over $10 billion with increases in the RBC ratios up to more than 1,100 percent. The average increase of the RBC ratio was about 287 percent.

Five of the eight New York-based insurers noted above also reported non-New York affiliate reinsurance with affiliated captives and offshore reinsurers involving some form of parental guarantees totaling an additional $18 billion. (*See* Table 6.)

Table 6: Activity by Non-New York Affiliates of New York-Based Insurers

Case	LOCs with Credit Reimbursement Agreements	Surplus Note Guarantees/ Trust Indemnification	Naked Parental Guarantees	Total Amount of Collateral/ Approximate Reserve Credit	Reported RBC Percent Increase*
Case 1 Affiliates	$5,925,685,769	$2,797,000,000	0	$8,722,685,769	758%
Case 3 Affiliates	$529,300,000	0	0	$529,300,000	85%
Case 5 Affiliates	$3,364,297,112	$1,891,474,947	$1,616,883,275	$6,872,655,334	304%
Case 6 Affiliates	$243,706,386	0	0	$243,706,386	0.94%

Case 8 Affiliates	$1,841,071,300	0	0	$1,841,071,300	33%
Total	$11,904,060,567	$4,688,474,947	$1,616,883,275	$18,209,418,789	

*Amounts are cumulative for all non-New York-based affiliates

The New York-authorized life insurers that reported direct activity (as shown in Table 5) that also reported activity by non-New York affiliates reported increases in RBC for their affiliates up to 758 percent in the aggregate. The average increase in RBC was about 236 percent.

2. Insurers Reporting Only Non-New York Affiliate Reinsurance with Affiliated Captives/Offshore Insurers

As noted in Section I. B of this report, the Department's investigation revealed nine New York-based insurers that reported transactions only by non-New York-based affiliates in their holding company system that involved some form of parental guarantee. The total amount of parental guarantees reported by these nine insurers for their non-New York-based affiliates amounts to approximately $14.8 billion. Each of those instances is described below.

Case 9

The insurer reported about $4.7 billion in LOCs with parental guarantees and about $2.2 billion in surplus notes issued that were "indemnity guaranteed" by the parent.

With respect to whether the New York-based insurer engaged in any two-step transactions, the insurer stated:

> There is a treaty . . . whereby a non-domestic insurer assumed business from a domestic insurer which it then retroceded to an affiliated captive involving $95 million in contractual parental guarantees. There is second treaty . . . whereby the non-domestic insurer assumed business from the NY domestic which it then retroceded to an affiliated captive involving $400 million in contractual parental guarantees. There is a third treaty . . . whereby the non-domestic insurer assumed business from the NY domestic insurer which it then retroceded to an affiliated captive involving $232 million in contractual parental guarantees.

The above response makes clear that although the New York-based insurer did not report any direct activity involving parental guarantees by the New York domestic, risks of the New York-based insurer are ultimately being guaranteed by the parent through retrocessions within the holding company.

In addition, the insurer reported that its captive affiliates report LOCs as admitted assets in the states that allow such arrangements.

Case 10

A non-New York-based insurer that has a New York affiliate insurer entered into a treaty with an offshore reinsurer using a trust with collateral of approximately $362 million, $82 million of which would not meet either New York regulations or NAIC guidance for acceptable forms of collateral. However, the non-conforming collateral was accepted by the non-domiciliary state regulator because an affiliate guaranteed the $82 million in non-conforming collateral.

In three other treaties with an affiliated captive, the non-New York-based insurer used LOCs totaling $1.48 billion as collateral. The LOCs that were issued do not meet the requirements for an unconditional LOC, and would therefore be contrary to New York regulation, as well as NAIC guidance. Yet the domiciliary state regulator approved the LOCs as another form of acceptable collateral. Also, the state in which the captive is domiciled granted the captive a permitted practice to record the LOCs as an asset.

Further, the non-New York-based insurer entered into a reinsurance treaty with a captive using a trust for collateral that was funded by the issuance of $1.1 billion in surplus notes. The non-New York-based insurer entered into an agreement with the financial guarantor of the surplus notes to indemnify the captive, the financial guarantor, and other parties to the transaction.

The non-New York-based insurer also entered into another reinsurance treaty with a captive that used a trust as collateral, which was funded from the issuance of $315 million in surplus notes by the captive. The ultimate parent corporation then entered into a Liquidity Commitment Agreement with the captive and the capital market investors that guaranteed the market value of the assets held in the trust. In addition, the ultimate parent entered into a limited guaranty with the captive under which the ultimate parent guaranteed that the captive will receive a prescribed rate of return on certain Modco reinsurance assets. The intent of the limited guaranty is to mitigate credit/interest rate risk within the captive. The Department views these agreements as parental guarantees of the collateral used in the reinsurance transaction.

With respect to the question whether the insurer engaged in any two-step transactions, the insurer stated:

> The NY domestic cedes term business to an affiliate, who retrocedes the business to various captive reinsurers. All of the collateral used in the two-step transactions received either parental guarantee or indemnification . . . .

The above response makes it clear that although the New York-based insurer did not report any direct activity involving parental guarantees by the New York domestic, risks of the New York-based insurer that are reinsured to the affiliated non-New York-based insurer are ultimately being guaranteed by the parent through retrocessions within the holding company.

In addition, the insurer reported that its non-New York-based affiliates use conditional LOCs and that its captive affiliates report LOCs as admitted assets in the states that allow such reporting.

Case 11

A non-New York-based affiliate of a New York insurer entered into a reinsurance transaction with an affiliated captive reinsurer whereby an LOC in the amount of $130,040,984 was issued that had a contractual parental guarantee. The insurer reported an approximately 30 percent increase in RBC for this reinsurance.

Case 12

Two non-New York-based affiliates of a New York insurer entered into two separate reinsurance transactions with an affiliated offshore reinsurer whereby two LOCs totaling $198,000,000 were issued that had contractual parental guarantees. The insurer reported an increase in RBC of approximately 3.01 percent for these two transactions.

Case 13

A non-New York-based affiliate of a New York insurer entered into a treaty with an offshore affiliate using as collateral an LOC in the amount of $370 million and a trust in the amount of $2.08 billion, which was secured by a contractual parental guarantee and parental indemnification of the bonds issued to fund the trust. In another transaction, the same affiliate entered into a treaty with an affiliated captive reinsurer whereby the collateral in the form of a $1.2 billion trust was funded by the issuance of debt that was ultimately guaranteed by the parent corporation. In addition, a transaction between a different non-New York-based affiliate and an offshore affiliate reinsurer used an LOC in the amount of $213 million, which was secured by a contractual parental guarantee. The insurer reported no RBC impact on the first transaction, and a 208 percent and 63 percent increase for the last two treaties, respectively.

Case 14

A non-New York-based affiliate of a New York insurer entered into a treaty with an offshore captive reinsurer whereby an LOC in the amount of $25.3 million was used as collateral for reserve credit purposes that had a "contractual parental guarantee." The insurer reported an increase in its RBC ratio of 434 percent. In another transaction, the same non-New York-based affiliate entered into a treaty with a different offshore captive reinsurer, whereby a trust used as collateral in the amount of $127,769,311 was funded by surplus notes that had parental

indemnification. The insurer reported an increase in its RBC ratio of 360 percent. Also, in another treaty between a non-New York-based affiliate and an affiliated U.S. captive reinsurer, an LOC in the amount of $1.14 billion was used as collateral for reserve credit purposes that had a "contractual parental guarantee."

Case 15

A non-New York-based affiliate of a New York insurer entered into a treaty with an offshore captive reinsurer whereby a trust in the amount of $813 million was used as collateral. The trust was funded from the issuance and guarantee of bonds by the parent of the cedent.

Case 16

Two non-New York-based affiliates of a New York insurer entered into two separate treaties with a U.S. affiliated captive. The reserve credit taken with respect to the two treaties was secured by an Affiliate Guarantee by an entity within the holding company system in the amount of $100.8 million. The amount of the Affiliate Guarantee was recorded as an asset in the financial statements of the reinsurer.

Case 17

A non-New York-based affiliate of a New York insurer entered into a treaty with a U.S.-affiliated captive whereby the reserve credit was secured by an LOC in the amount of $450 million. The LOC is conditional and has a partial contractual parental guarantee for payment of only the LOC fees. The LOC is recorded in the financial statements as an asset of the reinsurer. The insurer reported an RBC increase of 500 percent for this transaction.

* * *

In total, nine New York-based insurers reported that only non-New York-based affiliates in their holding company systems had reinsurance transactions with affiliated captives and offshore reinsurers involving some form of parental guarantee, totaling approximately $15 billion.

Table 7 summarizes the artificial boosts in capital realized from the transactions involving non-New York-based affiliates utilizing parental guarantees, as reported by nine New York-based insurers.

Table 7: Activity limited to Non-New York-Based Affiliates

Case	LOCs with Credit Reimbursement Agreements	Surplus Note Guarantees/ Trust Indemnification	Naked Parental Guarantees	Total Amount of Collateral/ Approximate Reserve Credit	Reported RBC Percent Increase*
Case 9 Affiliates	$4,745,590,260	$2,212,000,000	0	$6,957,590,260	30%
Case 10 Affiliates	0	$1,480,000,000	0	$1,480,000,000	-256%
Case 11 Affiliates	$130,040,984	0	0	$130,040,984	30%
Case 12 Affiliates	$198,000,000	0	0	$198,000,000	3.01%
Case 13 Affiliates	$583,000,000	$3,280,000,000	0	$3,863,000,000	271%
Case 14 Affiliates	$1,173,300,000	$127,769,311	0	$1,301,069,311	794%
Case 15 Affiliates	0	$813,000,000	0	$813,000,000	355%
Case 16 Affiliates	0	0	$100,807,387	$100,807,387	0%
Case 17 Affiliates	$450,000,000	0	0	$450,000,000	500%
Total	**$7,279,931,244**	**$9,167,797,695**	**$100,807,387**	**$15,293,507,942**	

*Amounts are cumulative for all non-New York-based affiliates

New York-based life insurers that only reported activity by non-New York-based affiliates reported increases in RBC for those affiliates ranging from 0 percent to 794 percent in the aggregate (excluding one outlier reporting negative changes). The average increase in RBC was about 248 percent.

II. INVESTIGATION INTO LACK OF TRANSPARENCY SURROUNDING SHADOW INSURANCE

A. Scope of Transparency Investigation

DFS required the 17 New York-based life insurers that reported reinsurance activity utilizing parental guarantees in connection with affiliated captive or affiliated offshore reinsurers to provide additional information. The Department sought to determine the extent that parental guarantees through shadow insurance are disclosed in publicly available documents. To that end, the Department requested the following information:

1. Whether the parental guarantees they reported were specifically disclosed in the ceding insurer's statutory financial statements; in those of any entity within the holding company system; or in any filing that is available to investors, policyholders, or any other segment of the public. If so, what these disclosures were and whether and to what extent reserves have been set aside to support those parental guarantees within the holding company system. If no disclosure was made, the Department requested a detailed explanation as to why not.

2. Whether information regarding the parental guarantees referenced was provided to the ceding insurer's certified public accountants ("CPAs") during their annual review and any such documentation or other information shared with the CPAs. If no information was provided to the CPAs, the Department requested a detailed explanation as to why not. The Department also requested the contact information for the insurer's CPA firm.

B. Findings of Disclosure Inquiry

Of the 17 insurers that responded, the Department carefully reviewed the adequacy and extent of the disclosure. The Department assessed the sufficiency of the disclosures by rating them as either good, fair, or poor. The evaluation criteria are set forth in the following chart.

Disclosure Evaluation Criteria

Type of Disclosure	Information typically included:
"Good"	• Tables (or another clear format) identifying reinsurers in the holding company system that were using LOCs as collateral for reinsurance transactions with affiliates; • Expiration date of the LOCs; • Each reinsurance affiliate's borrowing capacity for LOCs; • Amount of LOCs issued for each reinsurance affiliate; • Amount of draw downs to date on each LOC; • Amount of unused commitments; • Committed borrowing facilities that are used for collateral for affiliated reinsurance liabilities, and lists the fees paid for such facilities; • Identification of the entity that is the ultimate guarantor of the issued LOCs; and • For collateral financing arrangements, description of the reinsurance transaction in detail, the risk-takers and financial institutions involved, financing interest rates, surplus note arrangements, pledges or guarantees, and repayment methods.
"Fair"	• Description, in paragraph form, stating that the ultimate parent maintains LOC facilities with third-party banks to support the reinsurance obligations of onshore captive subsidiaries and/or offshore affiliates. Includes total amounts for all reinsurance captives and how much has been utilized and how much is guaranteed; • Description, in paragraph form, of total amounts of all collateral financing arrangements for all transactions whereby the ultimate parent is the guarantor; and • Moderate detail of certain transactions, but not in an easily understood tabular format.
"Poor"	• Description in paragraph format of the existence by the ultimate parent of credit facilities for general corporate purposes with total amounts committed and utilized; and • Very brief description of reinsurance transactions that are indemnified, or guaranteed by the ultimate parent.

The following table summarizes where the disclosures were made — the statutory annual statement, SEC reporting, and/or consolidated annual report — as well as the amounts of the associated parental guarantees. Only three of the 17 reporting insurers made disclosures in all three places (i.e., statutory statement, SEC filing, and annual report). And only three other insurers made disclosures in even two of the three statements (SEC filing and annual report).

Table 8: Disclosure Request Responses

Guarantee Amounts (Approx.)	Statutory Statement Disclosure	SEC Disclosure	Consolidated Annual Report Disclosure
$12 billion	None	Yes/Good	Yes/Good
$216 million	None	Yes/Good	Yes/Good
$659 million	None	None	None
$10 billion	None	Yes/Fair	None
$2 billion	None	None	None
$8 billion	Yes/Poor	Yes/Poor	Yes/Fair
$652 million	Yes (cedent)/Good	Yes/Good	Yes/Good
$130 million	Yes (parent)/Good	None	None
$1.5 billion	Yes (cedent/reinsurer)/Good	Yes/Poor	Yes/Poor
$450 million	None	Yes/Good	None
$198 million	None	Yes/Good	None
$6.5 billion	None	Yes/Fair	None
$4 billion	None	Yes/Poor	Yes/Poor
$1.3 billion	None	None	Yes/Poor
$813 million	None	None	None
$100 million	Yes (reinsurer)/Fair	None	None
Used Capital Maintenance Agreement	None	None	None

Twelve of the 17 responding insurers stated that they made no disclosure in the statutory financial statements filed with state insurance regulators, *each generally claiming that disclosure of the guarantee obligations of an insurer's ultimate parent company is not required by applicable statutory accounting guidance.*

DFS's investigation revealed that New York-based insurers and their non-New York-based affiliates failed to disclose nearly 80 percent ($38 billion) of the $48 billion in reserve collateral secured by parental guarantees in their statutory annual statements. And even where disclosure may have been made in some form to state insurance regulators, most states have laws that provide for strict confidentiality of the financial information of a captive.

Only five of the 17 responses showed any disclosure in either the cedent's, reinsurer's or ultimate parent's statutory financial statement filed with state insurance regulators. And of those, only three made what DFS considers "good" disclosure.

Ten of the 17 responding insurers asserted that their holding company made relevant disclosures in SEC filings. DFS reviewed those SEC disclosures, however, and found that only five of them were what DFS would consider a "good" disclosure. The other five disclosures were either "fair" or "poor." Seven insurers made no disclosure whatsoever of parental guarantees in any disclosures in their filings with the SEC.

Ten of the 17 responding insurers made no disclosure in their annual reports. While seven stated that they made some disclosure in the annual reports, only three of those were what the Department considers a "good" disclosure.

All 17 of the responding insurers reported that the information concerning their reinsurance collateral arrangements and parental guarantees was provided to their CPAs.

Perhaps most troubling, none of the 17 responses demonstrated that significant reserves or contingent liabilities have been established for the parental guarantees. Sixteen reported no reserves or contingent liabilities whatsoever. One responding insurer, which has about $1.5 billion in total parental guarantees, reported setting up a reserve of only $6 million for one of its guarantees. This lack of reserves for the parental guarantees is exceedingly troublesome because of the potential unfunded liability that would be incurred by the parent company should a drawdown of a letter of credit occur, which could lead to a liquidity issue within the holding company — and thus adversely impact policyholders with ties throughout the holding company system — should a bank demand immediate repayment from the parent company after the drawdown.

III. RECOMMENDATIONS

Given the troubling findings uncovered during its investigation, DFS is taking immediate action and making several recommendations to address the potential risks and lack of transparency surrounding shadow insurance:

- Through its authority under New York Insurance Law, DFS will require detailed disclosure of shadow insurance transactions by New York-based insurers and their affiliates.

- In the interest of national uniformity, the National Association of Insurance Commissioners ("NAIC") should develop enhanced disclosure requirements for shadow insurance across the country.

- The Federal Insurance Office ("FIO"), Office of Financial Research ("OFR"), the NAIC, and other state insurance commissioners should conduct similar investigations to document a more complete picture of the full extent of shadow insurance written nationwide.

- State insurance commissioners should consider an *immediate national moratorium* on approving additional shadow insurance transactions until those investigations are complete and a fuller picture emerges.

NEW YORK STATE DEPARTMENT OF FINANCIAL SERVICES

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In the Matter of:

Continental Indemnity Company,
Applied Underwriters, Inc.,
Applied Risk Services Inc.,
Applied Risk Services of NY, Inc.,
and Applied Underwriters Captive Risk Assurance Company, Inc.

Respondents.

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CONSENT ORDER

WHEREAS the New York State Department of Financial Services (the "Department") commenced an investigation in December 2015 of Continental Indemnity Company ("Continental"), Applied Underwriters, Inc. ("Applied"), Applied Risk Services Inc. ("ARSI"), Applied Risk Services of NY, Inc. ("ARSNY") (collectively, Applied Risk Services, or "ARS") and Applied Underwriters Captive Risk Assurance Company, Inc. ("AUCRA") (collectively, "Respondents") pursuant to the New York Insurance Law and Financial Services Law (the "Investigation");

WHEREAS the Department investigated whether Respondents' design, offering, and marketing and subsequent sale to New York employers of a program consisting of workers' compensation insurance offered with a separate agreement that was not filed with the Department (the "Program") violated the Insurance Law and Financial Services Law;

WHEREAS Respondents voluntarily ceased offering the Program in New York after the Department's Investigation began;

NOW, THEREFORE, the Department and Respondents are willing to resolve all matters involving the Program cited herein in lieu of proceeding by notice and a hearing.

FINDINGS

The findings of the Department are as follows:

Relevant Entities

1. Applied is based in Omaha, Nebraska that, through its subsidiaries, offers workers' compensation insurance to employers in New York. Among its affiliates are Continental and AUCRA. Applied manages most of Continental's insurance business, pursuant to a Management Services Agreement with Continental, including establishing underwriting standards and managing claims.

2. Continental is a subsidiary of North American Casualty Co. ("NAC"), which is, in turn, a subsidiary of Applied, and is incorporated in Iowa. Continental is a property/casualty insurer duly licensed in New York to issue workers' compensation policies.

3. AUCRA is a subsidiary of NAC, and a property casualty company incorporated and licensed in Iowa. AUCRA is not licensed or otherwise authorized to offer insurance in New York.

4. ARS is a subsidiary of Applied, and is incorporated in Nebraska with its principal place of business in Nebraska. ARS acts as a billing agent, collecting and remitting funds on a pass-through basis for the Program.

5. ARSNY d/b/a ARS Insurance Agency, is a subsidiary of Applied and is incorporated in New York with its principal place of business in Omaha, Nebraska. ARSNY is duly licensed by the Department as a property/casualty agent to produce workers' compensation

insurance in New York and is listed as a third-party administrator, with a New York City address and phone number, by the New York Workers' Compensation Board.

Background

6. New York Workers' Compensation Law §§ 2 and 3 require that nearly all New York employers provide workers' compensation coverage for their employees. Workers' compensation insurance is one of the biggest expenses for nearly any business, large or small. Most workers' compensation insurance written in New York is in the form of guaranteed-cost policies, by which insurers charge a set premium based on identified employee classifications and corresponding payroll.

7. Pursuant to Insurance Law § 2313, the New York Compensation Insurance Rating Board ("CIRB") serves as the nongovernment rate service organization ("RSO") for New York State workers' compensation insurers. CIRB is a private unincorporated association of insurance carriers responsible for the collection of workers' compensation data, and the development of workers' compensation rates and rules regarding the proper application of these rates to workers' compensation policies. CIRB also administers various individual risk-rating plans such as the Retrospective Rating Plan, which is publicly available on the CIRB website.

8. Retrospective rating, set out in the Retrospective Rating Plan, is an optional program which is mutually agreed-upon by the employer and the insurer. Retrospective rating premiums are based on projected loss experience and are subject to a contractual adjustment after policy expiration based upon the individual employer's actual loss experience. In contrast, a guaranteed-cost policy sets premiums at a monthly amount that is not subject to change based on an individual employer's loss experience. Retrospective rating programs are approved by the

Superintendent in accordance with Article 23 of the Insurance Law, provided that premiums are calculated using uniformly-applied criteria applicable to all insured employers in a non-discriminatory manner.

9. New York's smallest employers, who generally pay the least in premiums for workers' compensation insurance, are not eligible for retrospective rating and cannot thereby reduce their workers' compensation costs if they manage their claims and have a robust safety program. Pursuant to CIRB's Retrospective Rating Plan Manual, which the Department has approved, retrospective ratings is an option in New York only for policies with at least $25,000 of standard workers' compensation premium.

The Insurance Program

10. Applied offered the Program in New York under multiple names, including "SolutionOne" and "EquityComp." The Program included guaranteed-cost workers' compensation policies issued by Continental on forms and rates approved by the Department along with another contract titled a "Reinsurance Participation Agreement" ("RPA"), that employers entered into with AUCRA. Respondents offered policies under the Program to New York employers ("New York Policies") from as early as January 2010, to late 2016. While some New York employers paid less for coverage under the Program than they would have paid under the workers' compensation policies alone, some New York employers paid more for coverage under the Program than they would have paid under the workers' compensation policies alone, many significantly more.

11. Although the guaranteed-cost policy forms represented that "[t]he only agreements relating to this insurance are stated in this policy," to participate in the Program

employers obtaining guaranteed-cost policies were required to sign the RPAs, which were related to the policies. The RPAs established a loss-sensitive formula, which modified and superseded the agreement established by the guaranteed-cost policies, operating similarly to a retrospective rated workers' compensation insurance policy. The RPAs required the employer to fund a segregated cell with AUCRA from which the insurer's losses would be paid subject to a minimum and maximum estimated at the inception of each Program although Continental remained exclusively responsible for the payment of any and all losses under the policies.

12. Employers remitted monthly payments to ARS, which forwarded the payments to Continental. Continental allocated the monthly payments to AUCRA to fund the employer's segregated cell. When a claim was filed, Continental would pay the claim, but then would cede the liability to AUCRA, which would in turn cede the liability to the employer's segregated cell. As disclosed in Program documents, because the RPAs required the employer to fund the segregated cell, the terms of the RPAs controlled the amount of the employers' monthly payments regardless of the terms of the guaranteed-cost policy.

13. On March 15, 2011, officers of Applied were granted Patent No. 7,908,157 B1 for a "Reinsurance Participation Plan," the formula used in the RPA. The patent explicitly states that its purpose is to introduce a novel premium structure into the marketplace enabling the offering of retrospective-style insurance to small and medium-sized insureds and describes the program as "a reinsurance based approach to providing non-linear retrospective plans to insureds . . . while at the same time complying with state regulation." However, the Program as implemented did not comply with New York law. The patent is filed and publicly available.

14. The RPA was not filed with the Department, and as a result the RPA and the Program as a whole were not reviewed or approved by the Department.

15. Despite the fact that the Program was marketed as a way that employers could "share in the underwriting profit" of their workers' compensation insurance, and because workers' compensation claims have a long tail, the RPAs required the employer to wait three years to receive any "profit distributions," and gave AUCRA the option to withhold funds in some cases for up to four more years.

16. The formula by which the RPAs calculate costs was complex and the way in which it was presented to employers was misleading. When offered the Program, employers were given a visual representation that showed their lowest and highest possible costs, but that did not give an indication of what their total payments might be. The Program's formula was based on a non-linear model, which was novel enough that the Respondents received a patent for it. Under the formula, Program fees can rise rapidly with the first few claims to levels substantially higher than what would have been paid under a typical linear retrospective model.

17. The Department determined that parts of the Program constituted an unlicensed insurance business. Some of the Respondents engaged in the unlicensed business while others actively aided it. Moreover, the RPAs were policy forms that should have been filed with the Department but Respondents issued them for delivery to employers without doing so. The RPAs resulted in fees that were different from the rates in the filed and approved guaranteed-cost policy.

18. Applied has cooperated with the Department's investigation.

19. Respondents have agreed to this Consent Order to avoid the time, expense and distraction of litigation. This Consent Order includes Findings of the Department which have not been the subject of an adjudicatory hearing or judicial process in which Respondents have had an opportunity to present evidence and examine witnesses. The parties agree that this Consent Order

does not create any private rights or remedies against Respondents, create any liability for Respondents, constitute evidence of wrongdoing by Respondents for the purpose of any third-party proceeding, or waive any defenses of Respondents against any person or entity not a party to this Consent Order.

Violations

20. By reason of the foregoing, the Department finds that Respondents violated Sections 1102, 2117, 2307, and 2324 of the Insurance Law and Section 408 of the Financial Services Law:

a. As described under Insurance Law § 1101(b)(1)(E), Applied has engaged in doing an unlicensed insurance business in this state in violation of Insurance Law § 1102;

b. ARS and AUCRA aided unlicensed insurance business in violation of Insurance Law § 2117;

c. AUCRA issued for delivery, and ARS delivered, unfiled policy forms in violation of Insurance Law § 2307;

d. Continental and ARS offered and provided inducements and rebates to consumers in violation of Insurance Law § 2324; and

e. Applied violated Financial Services Law § 408.

AGREEMENT

IT IS HEREBY UNDERSTOOD AND AGREED by Respondents and all subsidiaries, affiliates, successors, assigns, agents, representatives and employees, that:

Injunctive Relief

21. Respondents have voluntarily ceased offering the Program in New York and will not resume offering the Program in New York without the Department's approval. Respondents shall not issue new RPAs, or any documents equivalent to RPAs, or renew existing RPAs relating to any New York Policies.

22. Respondents shall not collect or seek to collect any additional funds from insureds who paid less under the Program than they would have paid pursuant to Continental's filed and approved guaranteed-cost rates. Should Respondents attempt to do so for any reason, including in relation to any private action, Respondents shall return all additional premiums owed to all New York residents who were assessed greater amounts pursuant to the Program than otherwise would have been owed pursuant to Continental's filed and approved guaranteed-cost workers' compensation insurance rates.

23. After the effective date of this Consent Order, Respondents shall not commence arbitration proceedings or enforce arbitration provisions pursuant to contracts entered into in the State of New York or by New York employers.

24. Should any New York employer wish to maintain coverage through Respondents, Respondents shall offer such employer the opportunity to renew the filed policy.

25. Respondents shall comply with New York Insurance Law provisions specified in Paragraph 20, and with New York Financial Services Law § 408, as well as all other applicable laws and regulations.

Civil Penalty

26. No later than ten (10) business days after the Effective Date of this Consent Order, Applied, on behalf of Respondents, shall pay a civil penalty in the amount of three million dollars ($3,000,000) to the Department. The payment shall be made by wire transfer in accordance with the Department's instructions.

27. Neither Respondents, nor any of their parents, subsidiaries, or affiliates shall, collectively or individually, seek or accept, directly or indirectly, reimbursement or indemnification, including but not limited to payment made pursuant to any insurance policy referenced in this Consent Order, or from any of its parents, subsidiaries, or affiliates, with regard to any or all of the amounts payable pursuant to this Consent Order.

28. Respondents agree that they will not claim, assert, or apply for a tax deduction or tax credit with regard to any federal, state, or local tax, directly or indirectly, for any portion of the civil penalty paid pursuant to this Consent Order.

Other Relief

29. Respondents will not contest the authority of the Department to effectuate this Consent Order. Respondents will cease and desist from engaging in any acts in violation of the New York Insurance Law and will comply with those and any other applicable New York laws and regulations.

Breach of the Consent Order

30. If any of Respondents default on any material obligation under this Consent Order, the Department may terminate this Consent Order in its entirety, at its sole discretion, upon five (5) business days' written notice. In the event of such termination, Respondents

expressly agree and acknowledge that this Consent Order shall in no way bar or otherwise preclude the Department from commencing, conducting or prosecuting any investigation, action, or proceeding against Respondents, however denominated, related to the provisions of the Consent Order, or from using in any way statements, documents or other materials produced or provided by Respondents prior to or after the date of this Consent Order, including, without limitation, such statements, documents or other materials, if any, provided for purposes of settlement negotiations.

31. In the event that the Department believes any Respondent to be materially in breach of this Consent Order ("Breach"), the Department will provide written notice to such Respondent of the Breach. Within ten (10) business days from the date of receipt of said notice, or on a later date if so determined in the sole discretion of the Superintendent, such Respondent must appear before the Department and shall have an opportunity to rebut the Department's assertion that a Breach has occurred, and, to the extent pertinent, demonstrate that any such Breach is not material or has been cured.

32. Respondents understand and agree that failure to provide the required submission to the Department within the specified period as set forth in Paragraph 31 of this Consent Order is presumptive evidence of a Breach thereof. Upon a finding of Breach, the Department has all the rights and remedies available to it under the New York Insurance Law, Financial Services Law, or other applicable laws and may use any and all evidence available to the Department for all ensuing hearings, notices, orders and other remedies that may be available under the New York Insurance Law, Financial Services Law, or other applicable laws.

Other Provisions

33. Respondents shall submit to the Department annual affidavits of compliance with the terms of this Consent Order for a period of three (3) years commencing from the Effective Date of this Consent Order.

34. The Department has agreed to the terms of this Consent Order based on, among other things, the representations made to the Department by Respondents. To the extent that representations made by Respondents—either directly or through their counsel—are later found to be materially incomplete or inaccurate, this Consent Order is voidable by the Department in its sole discretion.

35. Upon the request of the Department, Respondents shall provide all documentation and information reasonably necessary for the Department to verify compliance with this Consent Order.

36. Respondents represent and warrant, through the signatures below, that the terms and conditions of this Consent Order are duly approved, and execution of this Consent Order is duly authorized.

37. All notices, reports, requests, certifications, and other communications to any party pursuant to this Consent Order shall be in writing and shall be directed as follows:

For the Department:

Bruce Wells
Associate Counsel, Enforcement
New York State Department of Financial Services
One State Street
New York, New York 10004-1511

For Continental:

10805 Old Mill Road
Omaha, Nebraska 68154
Attention: Jeffrey A. Silver

with a copy to:
DLA Piper LLP
1251 Avenue of the Americas
New York, New York 10020
Attention: Shand Stephens

For Applied:

10805 Old Mill Road
Omaha, Nebraska 68154
Attention: Jeffrey A. Silver

with a copy to:
DLA Piper LLP
1251 Avenue of the Americas
New York, New York 10020
Attention: Shand Stephens

For Applied Risk Services Inc.:

10805 Old Mill Road
Omaha, Nebraska 68154
Attention: Jeffrey A. Silver

with a copy to:
DLA Piper LLP
1251 Avenue of the Americas
New York, New York 10020
Attention: Shand Stephens

For Applied Risk Services of NY, Inc.:

10805 Old Mill Road
Omaha, Nebraska 68154
Attention: Jeffrey A. Silver

with a copy to:
DLA Piper LLP
1251 Avenue of the Americas
New York, New York 10020
Attention: Shand Stephens

For AUCRA:

10805 Old Mill Road
Omaha, Nebraska 68154
Attention: Jeffrey A. Silver

with a copy to:
DLA Piper LLP
1251 Avenue of the Americas
New York, New York 10020
Attention: Shand Stephens

38. This Consent Order and any dispute thereunder shall be governed by the laws of the State of New York without regard to any conflicts of laws principles.

39. Respondents waive all rights to further notice and hearing in this matter as to any allegations of past violations up to and including the Effective Date of this Consent Order and agrees that no provision of the Consent Order is subject to review in any court or tribunal outside the Department.

40. This Consent Order may not be amended except by an instrument in writing signed on behalf of all the parties to this Consent Order.

41. In the event that one or more provisions contained in this Consent Order shall for any reason be held invalid, illegal, or unenforceable in any respect, such invalidity, illegality, or unenforceability shall not affect any other provisions of this Consent Order.

42. This Consent Order may be executed in one or more counterparts, and shall become effective when such counterparts have been signed by each of the parties hereto and the Consent Order is So Ordered by the Superintendent of Financial Services or her designee (the "Effective Date").

43. Upon execution of this Consent Order by the parties, the Department will discontinue the Investigation as to and against Respondents solely with respect to the practices set forth herein through the Effective Date of this Consent Order. No further action will be taken by the Department against Respondents for the conduct set forth in this Consent Order provided Respondents comply fully with the terms of the Consent Order.

WHEREFORE, the signatures evidencing assent to this Consent Order have been affixed hereto on the dates set forth below.

DEPARTMENT OF FINANCIAL SERVICES

By: _____
R. BRUCE WELLS
Associate Counsel, Enforcement
Consumer Protection and Financial
Enforcement Division

July 17, 2019

By: _____
CHRISTOPHER B. MULVIHILL
Deputy Superintendent, Enforcement
Consumer Protection and Financial
Enforcement Division

July 17, 2019

By: Katherine A. Lemire /s/ SF
KATHERINE A. LEMIRE
Executive Deputy Superintendent
Consumer Protection and Financial
Enforcement Division

July 17, 2019

APPLIED UNDERWRITERS, INC.,

By: _____
JEFFREY A. SILVER, Secretary
July 17, 2019

CONTINENTAL INDEMNITY COMPANY,

By: _____
JEFFREY A. SILVER, Secretary
July 17, 2019

APPLIED RISK SERVICES INC.,

By: _____
JEFFREY A. SILVER, Secretary
July 17, 2019

APPLIED RISK SERVICES OF NY, INC.

By: _____
JEFFREY A. SILVER, Secretary
July 17, 2019

APPLIED UNDERWRITERS CAPTIVE RISK ASSURANCE COMPANY, INC.

By: _____
JEFFREY A. SILVER, Secretary
July 17, 2019

THE FOREGOING IS HEREBY APPROVED.
IT IS SO ORDERED.

Linda A Lacewell
LINDA A. LACEWELL
Superintendent of Financial Services

July 17, 2019