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LEGISLATIVE HISTORY

With the enactment of the Risk Retention Act Amendments of 1986 (15 U.S.C. s3901 et seq., hereinafter referred to as the “Act”), more options are available for businesses, professionals, institutions and public entities to obtain difficult to secure liability insurance coverage. In brief, the Act facilitates the ability of qualified individuals or organizations to form special association insurance captives (“risk retention groups”) or to join together to purchase insurance on a group basis. The Act is an expansion of the Product Liability Risk Retention Act of 1981 which permitted these groups to offer primarily only completed operations/product liability insurance coverage. The 1981 Act enjoyed only limited use because of two factors:

a. The restricted coverage which could be offered was generally of interest to only product manufacturers and,

b. Product liability coverage became more readily available in the traditional insurance marketplace after the bill was enacted into law.

To understand and deal with the ambiguities that exist in the Act it is important to recognize the problems confronted by Congress in enacting this legislation. There can be little doubt that the insurance crisis was the Act’s reason for being. The causes largely blamed for the crisis were:

a. The U.S. Civil Justice System;

b. Questionable underwriting practices by the insurance/
reinsurance industries exacerbated by less than vigilant state regulation;

c. Lack of competition in the insurance industry, with some allegations of collusion.

The 99th Congress did not enact significant federal tort reform or carve out a larger federal role in the regulation of the insurance industry by modifying or repealing the McCarran Ferguson Act. While Congress did overwhelmingly approve the Risk Retention Act Amendments of 1986, the legislative lack of certainty as to what caused the insurance crisis is reflected in the Act’s ambiguities as to where limited federal preemption ends and legitimate state regulation over risk retention and purchasing groups begins. On the one hand, Congress wished to spur competition in the insurance industry and lessen the consumer’s vulnerability to insurance market cycles by facilitating the formation of purchasing and risk retention groups. The Act facilitates the formation of these groups by a limited federal preemption of state insurance regulation in jurisdictions where these groups operate but are not licensed or formed. On the other hand, however, many in Congress were concerned that the lack of adequate state regulation is what precipitated the insurance affordability/availability crisis. It is important to note that but for limited reporting oversight by the U.S. Department of Commerce, integral regulation of risk retention and purchasing groups created under the Act is left to the state where these groups were licensed or formed. Many state insurance commissioners and federal elected officials were loathe to unilaterally entrust the regulation of these groups to what might be the weakest links in the state regulatory chain. Yet there was little desire by the 99th Congress or state insurance commissioners for the federal government to fill any regulatory void that might exist. The result of these conflicting concerns were changes in the Act from the 1981 Act initially passed by Congress which may create a gray area of federal preemption and state regulatory authority. Given this gray area, purchasing and risk retention groups are well advised to develop cooperative regulatory relationships in the jurisdictions in which they operate, rather than relying soley on the limited federal preemption granted to groups under the Act.

RISK RETENTION GROUPS

A risk retention group is an association captive which provides liability insurance for its members. By way of historical background the first captives were probably the mutual insurance companies developed by groups of manufacturers and other business persons in the late nineteenth and early twentieth centuries to take care of particular specialized risks to which these policyholders were subject. Many of these facilities were formed because the policyholders were dissatisfied with their treatment by the traditional insurance marketplace. Perhaps analogous to Orwell's Animal Farm, many of these non traditional insurers have long since become conventional insurance carriers.

Prior to passage of the Act it was most difficult for smaller associations and groups to form the type of mutuals that were formed in the late nineteenth and twentieth centuries. For a group to operate nationwide it would have to engage in the expensive and time consuming steps of getting licensed as an admitted or eligible surplus lines insurer In every state where its potential member/policyholder may be located. Varying and often conflicting regulation by the individual states in such areas as capital and surplus requirements; policy form and rate review; countersignature laws (requiring that a policy be signed by a resident insurance agent in the state); "seasoning" requirements (that a facility be in existence a certain number of years before it can become an eligible surplus lines insurer); guaranty fund assessments, and a myriad of other requirements made it nearly Impossible for smaller insurance facilities to offer uniform coverage for its members on a multi—state basis. The Act has made the formation of these smaller association facilities far more feasible from the viewpoint of regulatory compliance and in many instances, capitalization.

STATE LAW PREEMPTION IN THE REGULATION OF RISK RETENTION GROUPS

Under the Act a risk retention group is exempt from the state law of the non licensing jurisdiction to the extent that:

1. It would make unlawful or regulate the activities of a risk retention group;

2. It would require a risk retention group to participate in a guaranty fund for licensed insurers;

3. Require policies issued by a risk retention group to be countersigned by a resident insurance agent or broker in that state;

4. It would discriminate against a risk retention group or any of its members.

Despite these broad based preemptions, numerous other provisions were also included in Section 3 of the Act which may potentially significantly broaden the non licensing state's jurisdiction over a risk retention group. The state may require the group to:

1. Comply with the state unfair claims settlement practices requirements;

Thus a risk retention group will likely have to meet the same standards imposed on a state's licensed insurer as to the settlement of claims.

2. Pay premium and other taxes;

This requirement subjects risk retention groups to multi—state insurance tax premium allocation problems that have long plagued surplus lines brokers. Both the state of insurer/group domicile and the state(s) where the policyholder or its risks are located can legitimately make some claim to a portion of the state premium tax owed. Unfortunately, any two state's tax rates or allocation formulas are rarely the same. The result may be a great difficulty for a risk retention group with multi-state policyholders to devise a premium allocation formula to satisfy both its domiciliary states and the states of its policyholders.

3. Participate in a Residual Market Mechanism established by the state;

The residual market is composed of those risks that the traditional market does not want to insure. The state may devise mechanisms such as Joint Underwriting Associations (JUA's) and assigned risk programs to compel insurers underwriting that class of business in the state to insure such risks. Generally the extent to which each insurer must participate in such residual market mechanisms is determined by the premium volume written by that insurer in the state. To be required to participate in such a mechanism, an insurer would have to offer the line of coverage for which the program was formed. For instance, a medical malpractice insurer would likely not have to participate in a state residual market mechanism formed for day care center liability. Given the specialized coverage that risk retention groups are likely to offer, there may only be limited circumstances where such groups will be required to participate in these state mandated programs. Moreover, as participation in these residual market programs are usually based on premium volume share, a risk retention group's assessment or degree of involvement in these programs will likely be minimal due to their comparatively small share of the premium volume in a state.

One must also consider the type of residual market mechanism which the state may request a risk retention group to participate in. Unlike a JUA, an insurer in an assigned risk plan may be asked to underwrite a policyholder directly. The Act imposes ownership restrictions on risk retention groups, and requirements that the group's members be engaged in similar or related activities. (This will be considered more fully later in this paper). Such conditions may preclude the group from accepting an insured from the state's assigned risk plan.

4. Designate the local insurance commissioner as its agent for service of process in any state where it is doing business;

5. Submit to an examination by the State Insurance Commissioner in any state where the group is doing business to determine the group's financial condition If the licensing state has not begun or refused to initiate such an examination. Any such examination shall be coordinated to avoid unjustified duplication and repetition;

The intent of this provision is to preclude a risk retention group from having to submit to needless financial examinations in every state that if may operate in. However the language is ambiguous in that it establishes no period of time in which a financial examination of a risk retention group by the licensing state would preclude a request by a non licensing state for another examination. Thus taken to the extreme, if Vermont completed a financial examination of a risk retention group licensed in its state on December 1, 1987, could New York insist on conducting another financial examination of the group on December 2nd? In short, what length of time should elapse before a non-licensing state can insist on another financial examination - one day; one month; one year?

Making this ambiguity even more crucial is that a risk retention group must comply with a lawful order issued in a delinquency proceeding commenced by a state insurance commissioner if there has been a finding of financial impairment after such a financial examination has been conducted. “Financial impairment” is not defined in the Act. Again, using a hypothetical, Vermont conducts a financial examination of a risk retention group licensed in the state and finds it to be in sound financial condition as of December 1, 1987. One month later New York insists on conducting its own financial examination of the group and decides that it is financially impaired and thus cannot operate in the state. The real question is the extent to which a non licensing state can substitute its judgment of financial condition for that of the licensing state. An overly aggressive regulatory posture by non licensing states in this regard would seriously undermine the Act. In such an instance the risk retention group could assert the broad based preemption in the bill prohibiting a state from “otherwise discriminating against a risk retention group”. Thus the group could compare the practices of an Insurance Department in accepting the financial examination conducted for approved surplus lines carriers operating but not licensed in the state. For instance, it may be proof of discrimination if New York would accept the financial examination conducted on a traditional insurance carrier licensed in Vermont and operating in New York as an approved surplus lines carrier, but not accept the financial examination conducted by Vermont on a risk retention group licensed in Vermont and operating in New York.

The resolution of this ambiguity will not lie in the extreme. On one hand the state cannot insist on a de novo financial examination of a risk retention group operating in its jurisdictions without regard to when such an examination was conducted on the group by the licensing state. In a very real sense this would undermine the Act. On the other hand the state is not precluded from conducting a financial examination of a risk retention group because of a prior examination of a licensing state, if the Commissioner has legitimate reason to believe the potential of financial impairment exists.

6. Comply with an injunction issued by a court of competent jurisdiction sought by a state insurance department alleging that the group is an a financially impaired or hazardous condition;

“Hazardous financial condition” as defined in the Act “means that based on its present or reasonably anticipated financial condition, a risk retention group is unlikely to be able — (A) To meet obligations to policyholders with respect to known claims and reasonably anticipated claims, or (B) to pay other obligations in the normal course of business”. If the court order is issued by a state court it is binding in only that state. If the order is issued by a federal court, then it is binding in any state or territory of the U.S.

The fact that a finding of financial impairment or hazardous financial condition must be made judicially rather than by the unilateral determination of a commissioner will hopefully deter administrative abuse. From a practical viewpoint however a risk retention group does not want to spend its limited resources defending its solvency in delinquency proceedings or court actions initiated by state insurance commissioners in the numerous jurisdictions where the group may operate. The key to success is cooperating with the state insurance departments where the group intends to operate, so that the regulators’ solvency concerns can be addressed.

7. Provide boiler plate language that the policy is provided by a risk retention group which may not be subject to all the state's insurance laws and which will not have guaranty fund protection;

8. Comply with state law regarding deceptive false, or fraudulent act or practices. To enforce this provision however, an injunction must be obtained from a court of competent jurisdiction.

POLICY FORMS AND COVERAGES WRITTEN BY A RISK RETENTION GROUP; STATE AUTHORITY TO REGULATE

Although a risk retention group has a great deal of freedom with regard to the policy form that it can offer to its members, it can not offer a form or coverage prohibited generally by state statute or declared unlawful by the highest court of the state. Coverages such as punitive damages, strike insurance, and "hole in one" insurance, may not be offered by a risk retention group in states where they are prohibited by statute or declared unlawful by the state's highest court. The same principle would apply to policy forms such as claims made. Note however that for coverage or policy forms to be precluded, the prohibition must be by statute rather than by insurance department regulation. Thus for example, a New York Insurance Department regulation restricting the use of claims made policies, would probably not preclude a risk retention group operating in that state from offering claims made coverage. A state or federal court can similarly enjoin the solicitation or sale of insurance by a risk retention group to any person who is not eligible for membership in the group. The Act's membership requirements will be discussed later in this paper. A state or federal court could also enjoin the sale or solicitation of insurance by a group that is financially impaired or in a financially hazardous condition.

LINES OF COVERAGE THAT CAN BE OFFERED BY A RISK RETENTION GROUP

A risk retention group can offer almost all forms of liability insurance except personal lines, workers' compensation, private passenger auto insurance and employee benefits. It may appear that a risk retention group could not offer property coverage. However, the Act does include in its definition of liability "legal liability for damages because of injuries to <u>other</u> persons, <u>damages to their property</u>...." (emphasis my own). It seems clear that a risk retention group could not offer a policyholder under most circumstances, indemnification for property damage because of fire. However, it may be possible for such coverage to be offered if the group was formed as a reciprocal. "Reciprocal exchanges resemble advance premium mutuals, but in their purest form they differ from these mutuals in many ways. First, they are not corporations but unincorporated associations. Second, the association is not technically the insurer. Instead, the association makes it possible for the policyholder to insure one another individually and not jointly. Each member of the reciprocal insures and is insured by every other member of the reciprocal. This reciprocal exchange of contracts is the essence of the arrangement. In order to simplify the administration of the agreement, each subscriber receives only one contract, which states that he or she is in effect exchanging contracts with other members of the association. (1)

If the risk retention group was formed in the manner of a reciprocal exchange, each member would be legally liable for the property damage to others. Thus It is possible that property coverage could under such circumstances be offered by a risk retention group under the Act.

Another means to possibly offer property coverage under the Act is if a policyholder had a contractual liability to indemnify a franchisee, subsidiary, or other third party for a property loss. The risk retention group would thus be indemnifying a policyholder for property damage which the insured was legally obligated to pay a third party for a property loss.

1. **<u>Risk Management and Insurance,</u>** Fifth Edition, P. 524, C. Arthur Williams, Jr. and Richard M. Heinz, 1985 McGraw Hill, Inc.

REINSURANCE

A risk retention group can act as a reinsurer to other risk retention groups or members of a risk retention group, but only for liability insurance and only for groups or members whose liability risks are similar or related to those of the risk retention group which is acting as a reinsurer. The "similar or related" requirement will be discussed more fully later in this paper.

With regard to whom and how much a risk retention group can reinsure, this is left to the regulation of the licensing state. Thus the licensing state could permit the group to reinsure with a domestic, foreign, or alien reinsurer or an offshore or domestic captive.

RISK RETENTION GROUP MEMBERSHIP

Membership in a risk retention group is limited to persons engaged in businesses or activities that are similar or related with respect to the liability to which the members are exposed by virtue of any related, similar, or common business, trade, product, service, premises or operation. Perhaps no other section of the Act is so prone to varying interpretation as this "similar or related" provision. The following series of hypothetical's will indicate potential problems:

HYPOTHETICAL #1
Anesthesiologists form a risk retention group for medical malpractice liability insurance. There would be no problem in this situation as the members share the same profession and risk exposure.

HYPOTHETICAL #2
All physicians regardless of subspecialty wish to form a risk retention group to provide medical malpractice coverage. Although the common profession is more generalized, there would likely be no problem in qualifying as a risk retention group as the members share a profession and common risk exposure.

HYPOTHETICAL #3

What if chiropractors and nurses were included in the group mentioned above? Chiropractors and nurses would have a profession or activity similar to medical physicians if one viewed them all as health care professionals. Whether their liability exposures are similar or related would probably be factually determined, most likely through expert testimony, possibly from an insurance underwriter.

HYPOTHETICAL #4

A group of Fortune 500 Companies, all publicly held but engaged in markedly different endeavors, wish to form a risk retention group for the purposes of securing Directors' and Officers' Liability coverage. Although the risk retention group members are engaged in different endeavors they share a common Directors' and Officers liability exposure as a result of their operations as publicly held companies. A strong case can be made that this is a qualified risk retention group. However a legitimate contra position could be made that while the exposures may be "similar or related" the risk retention group members who generate these exposures do not share "related, similar, or common business, trade, product services, premises, or operations", as required by the Act. A more narrowly construed interpretation of the Act's language could preclude the formation of the risk retention group stated in this hypothetical.

HYPOTHETICAL #5

The same group of Fortune 500 Companies wish to join together to form a risk retention group offering catastrophic liability insurance coverage. For the purposes of this example the proposed policy would indemnify the policyholder to the extent that a liability loss exceeds 200 million dollars.

Although the businesses engaged by the members of this potential risk retention group may be dissimilar, from an insurance underwriting perspective the catastrophic loss exposure (that in excess of $200 million) of General Motors may be the same as that of the Marriott Corporation. To determine whether the members of this potential risk retention group are eligible to form such a group two factors should be considered:

1. Do the members of the group have a “similar or related” liability exposure? Can this be established by traditional insurance underwriting practices or methodology? If so, this risk retention group could possibly satisfy this criterion; and

2. Are these exposures by virtue of any related, similar, or common business, trade, product, services, premises or operations” of the risk retention groups’ members? If all the members of the group fell within some standard industry classification (such as retailing, manufacturing, service etc), the criterion would likely be met. However, this may not be the case with the Fortune 500 Companies offered in this hypothetical. Thus again a narrower reading of the Act’s language may preclude risk retention group formation.

OWNERSHIP OF RISK RETENTION GROUPS

All owners of a risk retention group must be members of the group and provided insurance by the group. If the risk retention group has as its sole owner an organization, all members of the risk retention group must be members of the organization and the organization must be owned by persons who are members of the risk retention group and who are provided insurance by the group. The purpose of this provision is to assure that policyholders maintain ownership and control of the risk retention group.

LICENSURE REQUIREMENTS TO OPERATE AS A RISK RETENTION GROUP

A risk retention group must be established as a corporation or other association and be chartered and licensed as a liability or property casualty insurance company under the laws of at least one state. A group may choose to be chartered as an industrial or association captive under the special enabling statutes enacted in such states as Vermont, Delaware, Colorado, Tennessee, and Hawaii. The Act requires a risk retention group to submit to the insurance commissioner of the state in which it is chartered a plan of operation or a feasibility study which includes the coverages, deductibles, coverage limits, rates, and rating classifications systems for each line of insurance the group intends to offer. The Act does not require a state to license any risk retention group even if all the above stated information is supplied. The licensing state is free to impose any additional requirements it chooses as a condition of licensure. If a licensing state requests less information than required by the Act, the group seeking licensure would still be well advised to submit the information required in the group’s feasibility study under the Act. If all the information required under the Act is not supplied, a non licensing state where the risk retention group is operating might challenge the group’s status as a risk retention group.

Before the risk retention group begins operating, a copy of this plan or study must be submitted to the insurance commissioner of each state in which the group intends to do business. While under the Act there is no requirement that the group provide additional information to that supplied in the copy of the feasibility study, the group would again be well advised to cooperate with the non licensing state insurance department to the fullest extent possible. Given the ambiguity as to the extent of the non-licensing state's authority to conduct a financial examination of the risk retention group, and the state's potential right to hold a delinquency hearing or request an injunction in court on grounds of financial impairment or hazardous financial condition, any effort on the part of the group to assuage a commissioner's solvency concerns may be well worth it in the long run.

The National Association of Insurance Commissioners (NAIC) recently adopted a mode law for states to enact with respect to the implementation of The Risk Retention Act. The model law is advisory only, but It may be enacted in whole or in part by state legislatures. An amendment to Section 3 of the Model Act requires the group, upon being licensed, to send a summary of the group's licensure application containing certain specifically delineated information to the NAIC. Most of the information requested in the Model Law will undoubtedly be contained in the group's application or feasibility study.

It should be emphasized that even if states adopt such language in their own enabling legislation, there are no provisions in the Act to require a group to provide such information to the NAIC. However, in the spirit of cooperation rather than any mandate contained in the Act, the risk retention group should favorably consider sending a copy of its plan of operation or feasibility study (and any subsequent modifications thereto) to the NAIC.

As an ongoing affirmative requirement the Act requires a risk retention group to furnish to the insurance commissioner of each state in which the group is doing business a copy of the group's annual financial statement that was submitted to the state in which the group is chartered as an insurance company. This statement must be certified by an independent public accountant and contain a statement of opinion on loss and loss adjustment expense reserves made by a member of the American Academy of Actuaries or a qualified loss reserve specialist. A point not fully resolved by the Act is what is meant by "doing business". Is it the state where the policyholder is located, where the insurance is purchased, or where the risk is located? If it is the latter then a policyholder such as a manufacturer could have a potential product liability exposure in virtually every state. The risk retention group would presumed to be doing business in every state of the Union. A more likely interpretation of the "doing business provision is the state where the sale of insurance was effectuated as provided in Section 3(I) (d) (1) (A) of the Act regarding the feasibility study.

If a group later decides to offer any additional, liability insurance coverage not contained in the initial feasibility study which it submitted to the licensing state, it must submit a revision of its study to the state in which it is chartered and to the insurance commissioner of each state in which it is doing business.

MINIMUM NUMBER OF MEMBERS NEEDED FOR A RISK RETENTION GROUP

According to the definition section of the Act the primary activity of a risk retention group "consists of assuming and spreading all, or any portion of the liability exposure of its group members". From this language it may be construed that a risk retention group must have at least two members/policyholders. However, with some planning a single parent captive licensed in the U.S. (a single parent captive is an entity with only one member) could possibly qualify as a risk retention group under the Act. Similarly, an offshore single parent captive that is willing to become licensed in one state and comply with the other provisions of the Act may also qualify as a risk retention group. One technique would be for the parent (captive owner) to form a subsidiary and have the captive insure as policyholders both the subsidiary and parent. This may satisfy the Act's definitional requirements that a group has at least two members. However, the question remains as to whether there can be "a spread of liability exposure" between a corporation and its subsidiaries. This question has come up frequently in the courts regarding the deductibility by the parent of a premium paid to its captive. The issue was raised in these cases in the context of whether such a transaction was insurance and thus deductible under the Tax Code. However the Act does not preclude the possibility that there can be shifting or spreading of risk without such activity being considered "insurance".

Thus a court may more readily accept the premise that there can be a spreading of liability risk between a corporation and its subsidiary, and qualify such an entity as a risk retention group.

A more conservative approach for a single parent captive to take if it wishes to qualify as a risk retention group would be to take on some token outside risk of a policyholder engaged in similar or related activities as the parent. Thus to use an example, the Acme Supermarket single parent captive could underwrite the exposure of a small corner grocery and qualify as a risk retention group under the Act.

ENTITIES WHICH MIGHT BE PRECLUDED AS MEMBERS OF A RISK RETENTION GROUP

The definitional Section of the Act makes virtually all entities and individuals eligible to become members of risk retention group. However, it is possible that public entities and insurance companies could be ineligible under certain circumstances.

With respect to public entities, their eligibility is specifically stated in Section 2(a) (2)(ii) of the Act. However, such public entities are often political subdivisions or functional subunits of larger entities that enable their creation. Thus if the state of Iowa passes a law precluding any of its municipalities from becoming a member of a risk retention group, a strong argument can be made that under our federal system Iowa's law will be controlling.

With respect to insurance companies, Section 3(I) (h) permits a state to preclude an insurance company from being a member of a risk retention group which is not composed of all insurance company members. Section 2(a)(G) of the Act may similarly preclude insurance company membership under such circumstances. Thus an insurance company could become a member of a risk retention group formed by other insurance companies to provide Director's and Officer's coverage. It could probably not do so if the D&O group had non insurance carrier members.

SECURITY AND EXCHANGE COMMISSION REGISTRATION REQUIREMENTS; EXEMPTION FOR RISK RETENTION GROUPS

One key means by which the Act facilitates the formation of risk retention groups is by providing an exemption from certain SEC registration requirements and other regulations in the solicitation of funds for capital and surplus by a risk retention group. The Act provides that the ownership interests of members in a risk retention group are exempt from the registration requirements of the federal securities laws and are exempt from any state Blue Sky law. However, any prospectus or solicitation for capital and surplus for a risk retention group is considered a security for the purposes of the anti—fraud provisions of federal securities laws. Therefore, although formal registration is not required, any solicitation to potential members of the group must provide disclosure of all material facts regarding the nature of the group and its insurance operations.

USE OF AGENTS OR BROKERS BY A RISK RETENTION GROUP

Section 3(a)(I)(C)(c) of the Act permits a state to require that a person acting as an agent or broker for a risk retention group obtain a license from the state. The state however cannot impose any qualification or requirement which discriminates against a non resident agent or broker. In most states only surplus lines brokers or agents are permitted to procure insurance on behalf of their clients from insurers that are not licensed in the state. Thus it would be only the surplus lines agent or broker who could procure insurance on behalf of their clients from a risk retention group. The problem is that almost all states require a surplus lines agent or broker to be a resident of the state. Such a requirement would be invalid if it precluded a non resident from serving as an agent or broker for a risk retention group. Thus presumably anyone could serve as an agent or broker for a risk retention group, in the absence of **valid** state regulation. If the state wishes to step into this regulatory void it has several options. It could of course eliminate the residency requirement as a condition of surplus lines agent licensure. However, for valid regulatory reasons the state may wish to retain residency requirements for surplus lines producers not acting on behalf of risk retention groups. To resolve this problem a state could provide a special license to risk retention group agents or brokers, limiting the licensee to serving only risk retention groups. Such a special license could not contain a residency requirement.

From a risk retention group's perspective, however, the use of an agent or broker may increase its compliance problems in jurisdictions where the group is not licensed. Through the broker or agent, a state could regulate a risk retention group indirectly in areas where its authority has been preempted under the Act.

For instance, many states have regulations which require agents to obtain numerous declinations from insurers licensed in the state before coverage can be obtained from the non admitted insurance market. Under many state regulations, even if the premium quoted by the admitted carrier is significantly higher than that offered on the admitted market, the agent would be precluded from obtaining coverage from the non-admitted carrier. An agent or broker acting on behalf of a risk retention group may very well be subject to such a regulation.

Similarly, the New York Insurance Department has a regulation restricting the use of claims made policies written in the state. Through Regulation 41 the Department maintains that surplus lines producers are prohibited from placing certain coverages on a claims-made form. A New York surplus lines agent could possibly be precluded by the Department from placing business on a claims made form underwritten by a risk retention group. On the other hand, if such a risk retention group solicits policyholders directly without the use of an agent or broker, New York would clearly be preempted from enforcing its claims made regulation under the Act.

A possible ambiguity is whether a state can require a risk retention group to use the services of an agent/broker if no residency requirement is imposed on such a licensee. Sections 3(a)(I)(3) and 3(a)(I) and (C)(c) would prevent the state from requiring that the policy be countersigned by a resident broker/agent. However the broad pre-emption section of the Act (Section 3(a)(I), exempts the group from any law, order, rule, or regulation which would make unlawful or regulate, directly or indirectly the operation of a risk retention group". Requiring a risk retention group to use an agent/broker through a countersignature requirement (even involving a non resident agent/broker), would be a clear state effort to regulate the operations of a risk retention group directly, and indirectly through the agent/broker.

Moreover, Section I (3) was a clear exemption prohibiting a state from requiring a risk retention group policy to be countersigned by a resident agent/broker. Particularly, because of Section 3a(i), it cannot be interpreted that these provisions, by omission, permit the states to require a policy to be countersigned by a non resident agent.

Similarly, Section 3(a)(I)(C)(c) of the Act permits a state to require "that a person acting or offering to act as an agent or broker for a risk retention group obtain a license in the state", if no residency requirement is imposed as a condition of the license. If the group sells Insurance to a policyholder directly, no agent or broker is involved, and thus this provision does not become operative.

In short, any attempt by the state to require countersignatures of non resident agents/brokers on policies issued by risk retention groups, and in particular to regulate such groups through the agent/broker, is clear state regulatory overreaching under the Act. Any other interpretation would require a risk retention group wishing to market its coverage to eligible members directly to use the services of an agent or broker. Such authority is clearly preempted under Section 3(a)(I) of the Act.

FINANCIAL RESPONSIBILITY REQUIREMENTS

The Risk Retention Act does not preempt the authority of a state to specify acceptable means of demonstrating financial responsibility if a state requires a demonstration of financial responsibility as a condition for obtaining a license or permit to undertake specified activities. This state authority is limited however by the provisions of Section 3(a) (4) in the Act which prohibit a state from discriminating against a risk retention group. Therefore, a state may not use this financial responsibility authority for the purpose of prohibiting the operation of a risk retention group in that state. On the whole, however, Section 6(d) of the Act gives the states broad leeway in precluding coverage obtained from a risk retention group as satisfying financial responsibility requirements.

Some activities which often entail meeting financial responsibility requirements include asbestos removal and hazardous waste site operations.

PURCHASING GROUPS

The purchasing group provisions in the Act (Section 4(a)) facilitate the ability of insurance consumers to purchase insurance on a group basis. State "fictitious group" insurance laws effectively precluded most multi—state policyholders from purchasing insurance collectively prior to passage of the Act.

As the purpose of the purchasing group (P.G) is to purchase coverage for its members rather than underwrite the risks itself, a P.G. is not required under the Act to be licensed as an insurance company in any state. No specific requirements are imposed regarding the legal structure of a P.G. Prospective members could simply form a new organization that have as one of its purposes the purchase of insurance on a group basis. In the case of a trade organization or society, a simple resolution by the Board of Directors authorizing the organization's officers to make arrangements to purchase liability insurance on a group basis, would be sufficient to establish a P.G. Coverage which could not be underwritten by a risk retention group under the Act could not be purchased by a P.G. The "similar or related" membership provisions of a risk retention group apply to members of a P.G. Unlike a risk retention group a P.G. cannot underwrite the risks of its members. A P.G. can utilize an agent and broker in much the same way that the Act permits its use by a risk retention group. The state similarly has the authority to require such producers to obtain a license, subject to the same "anti-discrimination" clause. No agent or broker's license is needed by the P.G. itself to purchase insurance for its members.

Like a risk retention group a P.G. cannot offer coverage to a member in whose state such coverage is prohibited by state statute or declared unlawful by the state's highest court. State law can similarly preclude insurance purchased from a P.G. as satisfying financial responsibility requirements imposed on the policyholder. Unlike a risk retention group a purchasing group is not subject to financial examination by the state insurance department. However if the carrier of the P.G. is a licensed or an approved non admitted carrier in a jurisdiction where the P.G. is doing business, then that state most likely has ample authority outside of the Act, to exercise its regulatory prerogatives on the carrier directly. If such a carrier is neither licensed nor an approved surplus lines carrier in the jurisdictions this carrier may rest exclusively on the shoulders of the insurance department where the P.G. is domiciled. Any injunction or legal action which a state can bring against a purchasing group is not clearly delineated in the ACT, but may be granted to the commissioner under the broad authority granted to the state in Section 4 (a) (h).

INSURERS FROM WHICH A PURCHASING GROUP CAN OBTAIN COVERAGE FOR ITS MEMBERS

Section 4 (f) of the Act states that "A purchasing group may not purchase from a risk retention group that is not chartered in a State or from an insurer not admitted to the State in which the purchasing group is located, unless the purchase is effected through a licensed agent or broker acting pursuant to the surplus lines laws and regulations of such State". If the work "located" (which is not defined in the Act) is given its ordinary interpretation as where the P.G. is domiciled or has its office, then a P.G. could operate in every state even though its insurer is admitted in only one of them. Regulators may attempt to construe "located" as every state where the P.G. does business or where the risks are situated. However, such an argument would undoubtedly not be upheld by the courts. The language "state in which the risk is located" is phrased in the singular and specific; not the plural and generic. A "doing business" or "risk sites" interpretation would require Section 4 (f) to be worded in the plural and generic if Congress had so intended. Moreover, "doing business" was used in the Act in numerous sections. Congress would have substituted that phrase for "located" if it so intended.

It should also be noted that under Section (f) an insurer or captive not admitted in any state, could serve as an insurer of a P.G. if the purchase was effectuated through a licensed agent or broker acting pursuant to the surplus lines law of the state where the P.G. is located. Thus an offshore captive (which is licensed as an insurance company and is not a risk retention group) or an alien (non-US.) carrier could potentially serve as an insurer of a P.G.

If this was the objective of the P.G., the proper strategy would be to locate in a state whose surplus lines law offered the freest access to the non-admitted market. The most attractive statute would require a minimum or no declinations from admitted insurers and would impose the fewest and least onerous requirements on the surplus lines agent or broker as a condition to permitting placement of insurance on the non-admitted market.

However under the Act, notice must be given to the insurance commissioner where the P.G. is located, informing that official of the identity and domicile of the carrier insuring the group. If the commissioner has reservations about the carrier, he most likely has the regulatory authority to preclude surplus lines agents licensed in the state from placing business with that carrier.

Additionally, even the more favorable surplus lines statutes may not permit surplus lines placement when the coverage is readily available on the admitted market. Thus as insurance market conditions hopefully improve, it may be more difficult for the P.G. and its agent or broker to continue obtaining coverage through the surplus lines market.

Nevertheless the short term strategy of using an alien insurer may be a viable option. Present market conditions may be such that coverage cannot be obtained by the P.G. from a carrier admitted in the U.S.

Under other circumstances, members of an offshore captive may wish to "test the waters" of the Act by establishing themselves as a P.G. in the U.S. and obtaining coverage from the offshore captive. At some later point these members could form a risk retention group onshore under the Act, either closing down their offshore facility or using it to reinsure their risk retention group.
It should also be noted that Section 4 (f) would also mandate the use of a surplus lines agent when the PG's insurer, although a domestic carrier, is not admitted in the state where the PG is located. Thus a Texas licensed insurer that was not admitted in New York could not insure a P.G. located in New York without a surplus lines broker licensed in New York.

STATE LAWS WHICH P.G. 'S ARE EXEMPT FROM

Section 4 (a) exempts P.G.'s from state laws that would prohibit the establishment of a P.G. or make it unlawful for an insurer to provide coverage on a group basis, or that would prohibit the insurer from offering to the group any special terms regarding rates, policy forms, coverages or other matters.

Thus a purchasing group is exempt from state laws requiring approval of rates, policy forms, or coverage terms and may provide to its members national uniform rates and policy forms. These rates may be below the standard rates filed for that class of business so long as that rate is based on the loss and expense experience of the P.G. and its members.

OTHER REQUIREMENTS A PURCHASING GROUP MUST MEET

A purchasing group is required to give notice of its intention to operate as a purchasing group to the insurance commissioner of each state in which the members of the group (or persons solicited for membership) reside. This notice must identify the state in which the purchasing group is domiciled and its principal place of business, the lines and classifications of liability insurance coverage which the group intends to purchase, and the name and domicile of the insurance company that will provide liability coverage to the group. The P.G. must notify the commissioner in any state in which it is doing business of any subsequent changes in any of the items provided in the notice. In addition, any new purchasing group must register with and designate the state insurance commissioner of each state in which it does business as its agent for the purpose of receiving service of process for any claims against the group.

In reviewing these requirements an important difference between PG.'s and risk retention groups should be noted. The Act requires no state to license a risk retention group, even if all of the requirements in the Act are met. On the other hand, if a purchasing group meets the requirements imposed by the Act, the Commissioner in the state where the P.G. is located has little or no authority to prevent them from forming. This by no means minimizes the need for cooperation by the P.G. as the commissioner is likely to have substantial authority over the P.G. 's insurer. Moreover, it would not be productive for the P.G. to spend its limited resources to discover through potentially costly litigation what authority is not preempted by the Act under Section 4(a) (g).

RISK RETENTION OR PURCHASING GROUPS?

For consumers without the capital or desire to form their own insurance facility, a P.G. may be the most desired option. Start up time should be relatively short and formation fees minimal. Insurers might underwrite a risk collectively through a P.G. which it might not write on an individual basis. An insurer's marketing and expense cost may be lower on a group basis. A larger number of policyholders may make a carrier more willing to underwrite low frequency, higher severity risks. It may be easier to impose sound underwriting standards and loss control requirements on a group basis. The fact that an insurer could offer uniform coverage not subject to 50 state form and rate review may also be an important inducement for an insurer to underwrite a P.G. For all its advantages, the status of a purchasing group is linked to its insurer. A purchasing group is a little value to I\its members if it cannot find an insurer which will provide coverage in an acceptable form and at acceptable rates to its members. Similarly, a purchasing group will still remain vulnerable to the inevitable cycles of availability and affordability in the insurance marketplace.

On the other hand, while the formation of a risk retention group is more expensive, lengthy, and complex it may be a viable solution to members who cannot find acceptable coverage on the traditional market or who do not wish to be as vulnerable to insurance market cycles in conducting their businesses, professions or activities.

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