

# JUST WHAT IS THE FEDERAL LIABILITY RISK RETENTION ACT?

Rosita Steele, CIC, CLU, ChFC, CPIW.

## FEDERAL LIABILITY RISK RETENTION ACT LEGISLATIVE BACKGROUND, DEFINITIONS AND PROVISIONS

The Committee on Commerce, Science, and Transportation, during the 99th Congress, conducted numerous hearings for the purpose of examining the availability and cost of liability insurance. As a result of these hearings and involvement by the Committee, the United States Congress revised the Products Liability Risk Retention Act of 1981 through the Risk Retention Amendments of 1986. The final Act, which was signed into law by President Reagan on October 27, 1986, is known as the Liability Risk Retention Act of 1986.

Since its enactment, this federal law has been the subject of numerous interpretations by various legal bodies, groups, and individuals. To understand all of the implications under the Liability Risk Retention Act of 1986, it is necessary to review the Congressional purpose for enacting the legislation, as well as of the National Association of Insurance Commissioners'(NAIC) Model Risk Retention Act. To facilitate your understanding of the Risk Retention Act (RRA), the following outlines the components with deviations as they occur under the NAIC Model Risk Retention Act.

The Committee, supported by the administration's Tort Policy Working Groups' report, was convinced that an expansion of the Products Liability Risk Retention Act of 1981 was needed to facilitate group insurance programs. It was presumed that this expansion would reduce costs, provide alternative mechanisms for coverage, and promote greater premium competition among general liability insurers. It was believed that this expansion would encourage insurers to set premiums that would compete with the new formations created under the revised law.

To accomplish these goals, the Congressional history is very clear on the absolute need of preemption from certain state laws which would hinder or oppose the formation and interstate operation of association captive insurance companies or Risk Retention Groups (RRG). The record also reflects the need for preemption of prohibitive or restrictive state laws that would preclude insurers from giving preferential rates, terms, and conditions to groups seeking liability insurance coverage. Legislation provides the following definitions to aid in gaining an understanding of RRGs.

### GENERAL DEFINITIONS

**Insurance** means primary, excess, reinsurance, surplus lines, or any other means for transferring risk under state or federal law.

**Liability** is defined as the legal liability for damages (including legal fees and other claims expenses) resulting in bodily injury, property damage, personal injury, or other types of loss or damage arising out of any business or governmental activity. The term **does not** include personal risk liability of railroads for injuries to their employees under the Federal Employer' Liability Act (FELA).

**Personal risk liability** is defined as liability for personal injury or property damage resulting from personal, familiar or household responsibilities, rather than from business-type activities.

A **hazardous financial condition** exists when a risk retention group appears to be unable (1) to meet its policyholders obligations regarding known claims and reasonably anticipated claims, or (2) to pay other obligations of business operations.

## **RISK RETENTION GROUPS**

A Risk Retention Group is a corporation or other limited liability association, functioning as a captive insurance company and organized for the primary purpose of assuming and spreading the liability risk exposure(s) of its group members (member-owners). It must be chartered and licensed as a liability insurance company in one of the fifty states or the District of Columbia. It can also charter as an industrial or association captive under special state captive laws such as Vermont, Delaware, Colorado, Illinois, etc.

RRGs chartered or licensed under the laws of Bermuda or the Cayman Islands that have met the capitalization requirements of one state prior to January 1, 1985, can continue to operate as RRGs. These are the only off-shore formations permitted.

Structuring of the RRG will conform to the laws of the chartering state and can include formation as a stock or mutual company, or as a reciprocal exchange.

Members of an RRG must be engaged in businesses or activities which are similar or related in regards to the liability exposures created by virtue of common business or trade practices, products, services, premises or operations. In addition, an individual or firm that meets this criteria cannot be excluded from the group if the intent of the exclusion is to provide the group with a competitive advantage.

Owners of RRGs must be both members of and insured by the group. Indirect or secondary ownership through a wholly-owned, single organization is permitted as long as the organization's owners are members of and insured by the RRG. Insurance companies cannot have an ownership interest in an RRG unless all members of the group are insurance companies.

The ownership interests of an RRG are exempt from filing registration statements under Federal Securities Law and State Blue Sky Laws. However, in line with the anti-fraud provisions of applicable State and Federal laws, any solicitation for funds must disclose all material facts regarding the RRG and its insurance operations.

Except for the chartering state, an RRG is exempt from any state law, rule or regulation that regulates or makes an RRG unlawful except, any state can require an RRG to:

- a. Comply with unfair claim settlement practices;
- b. Pay applicable premium or surplus lines taxes;
- c. Participate in residual market mechanisms (Joint Underwriting Authorship's/Assigned Risk Pools);
- d. Designate the insurance commissioner as agent for service of process;
- e. Submit to financial examination by other state insurance commissioners if the chartering state has not initiated such an examination;
- f. Comply with state deceptive, false, or fraudulent trade practice laws;
- g. Comply with lawful orders for delinquency or dissolution proceedings;
- h. Comply with an injunction for hazardous financial condition;
- i. Include a notice in insurance policies, in 10-point type, stating the RRG is not subject to all state laws and regulations, and that the insolvency guaranty fund is not available for the RRG.

The non-chartering state has no approval authority over rates, coverages, forms, insurance-related services, management, operation, investment activities, or loss control and claims administration. In addition, the Act prohibits states from otherwise discriminating against RRGs.

Each RRG must submit a feasibility study or plan of operation for approval to the chartering state before offering insurance. Under the Federal Act, the plan or study must include coverages, deductibles, coverage limits, rates, and rating classification systems. The NAIC Model Act defines the feasibility study as an "analysis which presents the expected activities and results of a risk retention group." The NAIC requires more information including historical and expected loss experience of the members, pro forma financial statements and projections, an actuarial opinion defining the minimum premium necessary to begin operations and to avoid financial difficulties, information on underwriting and claims procedures, reinsurance agreements, investment policies, and management and marketing methods. In addition, the NAIC also requires that the RRG provide information identifying the initial members, the organizers, the administrator and anyone else who will otherwise influence or control the RRG.

In each state in which the RRG is or plans to do business, the RRG is required to submit a copy of the feasibility study (including revisions) and a copy of the annual financial statement. The statement must be certified by an independent accountant and include an opinion of loss and loss adjustment expense reserves by an actuary or a qualified loss reserve specialist.

An RRG cannot write coverage which is prohibited by state statute or by the highest court in the state (ex: punitive damage, intentional or criminal conduct). This is not the same as coverage which is prohibited by the state insurance department. However, the states do have broad discretionary powers in deciding whether coverage from an RRG is acceptable where proof of financial responsibility is needed to obtain a license to engage in certain activities (i.e.: hazardous waste hauling, motor vehicle operations).

If an RRG is found to be "in hazardous financial condition," any state or U.S. District Court may issue an order enjoining a RRG from soliciting, selling insurance, or continuing operations.

### **PURCHASING GROUPS**

A Purchasing Group (PG) is an organization which purchases liability insurance on a group basis from an insurance company or a Risk Retention Group (RRG) for its members. Unlike an RRG, a PG is not an insurance company and its members do not underwrite their own coverage. However, like RRGs, PGs are subject to the same, similar, or related tests pertaining to membership, exposures, and types of coverage(s) offered.

A PG is exempt from any state law, rule, regulation or order that would:

1. Prohibit the establishment of a PG
2. Make it unlawful for an insurer to provide or offer insurance to, or to discriminate in favor of the PG (based on loss experience)

Prohibit a PG or its members from purchasing insurance on a group basis, regardless of a minimum time in operation, the number of members or member participation level, or otherwise discriminate against a PG or its members.

Apart from these specified exemptions, a PG must comply with all other state laws and regulations regarding its operation and procurement of insurance.

A PG intending to do business in any state must give notice of intent to the appropriate state's insurance commissioner. The notice must identify the state of domicile and principal place of business for the PG, categorize the lines and classifications of liability insurance to be purchased

and provide the name and domicile of the insurance company from which insurance is to be purchased. In addition, the PG must designate the commissioner of each state as its agent of process. It should be noted that the NAIC Model Act authorizes a monetary filing fee in conjunction with this last provision which applies to both PGs and RRGs.

The Federal Act allows for advantages in rates, forms and coverages as long as they are based on the PG's loss and expense experience. In addition, it makes no reference to individual state authority regarding approval of rates, forms, or coverages. On the other hand, the NAIC Model Act gives individual states the right of prior approval on rates, forms, and coverages which are specifically designed for PG members.

The Federal Act does not contain any provisions regarding deductibles or aggregate limits for PGs. The NAIC Model Act provides for separate and individual deductibles. Group deductibles are excluded. The NAIC Act maintains that the purchase of aggregate limits is subject to the same standards as all other group insurance purchases within a state. For example, the Illinois Captive Law does not allow for a group aggregate coverage level, only individual aggregate coverage limits.

A PG may not purchase insurance from an insurer that is not admitted in the state where the PG is located, or from a RRG that is not chartered in a state unless the purchase is through a licensed broker acting pursuant to applicable surplus lines laws

### **APPLICATION OF STATE AGENT AND BROKER LICENSING REQUIREMENTS**

For both RRGs and PGs, chartering and non-chartering states may require agents who are acting on behalf of these entities to be licensed. However, states cannot impose residency requirements for licensing, nor can they require that the policy be countersigned by a resident agent or broker.

### **OVERSIGHT OF IMPLEMENTATION**

Under the Risk Retention Act, the Secretary of Commerce is responsible for reporting to Congress a summary of comments and conclusions regarding the implementation of the Act.

For further information contact:  
**NATIONAL RISK RETENTION ASSOCIATION**  
4248 Park Glen Road  
Minneapolis, MN 55416-4758