*A Special Reprint from*

The
Risk Retention
Reporter

# Are States Abusing the Registration Process In Violation of the Liability Risk Retention Act?

*A Risk Retention Reporter interview with*
*Jon Harkavy, Vice President, General Counsel and*
*Heather Ross, Director, Regulatory Compliance*
*Risk Services, LLC*

***RRR: What requirements must an RRG meet under the LRRA prior to doing business in a non-chartering state?***

**Harkavy/Ross:** An RRG is only required to submit to that non-chartering state a filing containing the information delineated in Section 3902(d) of the LRRA. Specifically, an RRG must submit a copy of its plan of operation or feasibility study submitted to the group's chartering state and any changes to such plan or study if the group ;intends to offer additional lines of liability insurance. Once registered, it is an ongoing requirement under the LRRA that the RRG submit to the non-chartering state a copy of its annual financial statement submitted to its chartering state.

***RRR: What's the problem?***

**Harkavy/Ross:** While the LRRA clearly envisioned registration to be on a file and use basis, a majority of states impose conditions of registration that go beyond the informational filing requirements delineated in the LRRA, and some of these states go even further to require affirmative approval of the registration filing before a non-domiciliary RRG can "officially" do business in that state. Clearly, such conditions frustrate the registration process and undermine the intent of the LRRA by directly contravening the requirements set forth under the federal law for undertaking to do business in non-chartering states.

***RRR: How have these problems been handled?***

The insistence on such conditions and requirements often places the RRGs and non-chartering state regulators at odds with each other. On the one hand, the language of the LRRA is clear on what information is required to be submitted to the non-chartering state. Further, support is provided by existing case law and by the *NAIC Risk Retention and Purchasing Group Handbook*. A federal discussion on point is found in *NRRA v. Brown* in which the Court held that a non-domiciliary state could not impose conditions on registration beyond the provision of the information delineated in the LRRA, stating:

> The burden imposed by the application process for a non-resident risk retention group is broader than is allowed by the LRRA. Section 3902(d) sets out the documents which are to be submitted to the insurance commissioner of a state in which it intends to do business but is not chartered... risk retention groups are preempted from any further requirements under Section 3902(a)(1).

Interestingly, the NAIC's own *Risk Retention and Purchasing Group Handbook* states that:

> Registration is intended to provide states with an orderly mechanism to identify RRGs operating within their borders. Registration is not intended to provide non-chartering states with any regulatory powers over RRGs other than that provided in the LRRA. ... Requests for information outside of the LRRA can be challenged by a RRG.

As a tenacious defender of individual state regulatory autonomy, it seems highly unlikely that the NAIC would issue such pronouncements which delineate a restriction on non-domiciliary regulation unless such restriction was clearly supported by the federal statute and case law.

***RRR: Do you believe that non-chartering states have exceeded LRRA authority?***

**Harkavy/Ross:** In many cases, yes. Put bluntly, many non-chartering are converting what was meant to be a notice filing into a quasi-licensing procedure, thus undermining the LRRA and congressional intent to expedite the multi- state operation of RRGs.

Since passage of the LRRA, almost all states have adopted some form of legislation recognizing RRGs, many based on the NAIC Model. This has been helpful in terms of increasing state recognition and awareness of

RRGs as insurance entities. However, in many cases, it has also served as more of a hindrance than a help to the overall RRG registration process. Such state statutes often require the submission of registration forms and other documents, or may subject the RRG to the payment of fees or other requirements contained in these states' insurance laws which are not delineated in or permissible under the federal law.

***RRR: Why can't an RRG simply wait for a non-chartering state's confirmation of its registration?***

**Harkavy/Ross:** The problem goes beyond a mere waiting game. Many states are conditioning approval of registration on the provision of materials and information by the RRG registrant above and beyond that required by the LRRA.

For instance, in the case of a newly chartered RRG which has yet to write business in any state at the time of a registration filing, some non-domiciliary states are requiring the submission of audited financial statements, actuarial opinions on loss reserves and domiciliary state examination reports before the group can be registered.

Obtaining audited financial statements and actuarial opinions for a RRG that hasn't yet begun to write any insurance policies serves little regulatory purpose and places the RRG in the situation of having to engage in a largely empty exercise at an often significant expense in order to "win" confirmation of registration. As for the submission of domiciliary state examination reports, obviously the time frame in which the chartering state elects to examine a RRG is beyond the control of the RRG.

In other cases, non-chartering states demand as a condition of registration the submission of certified documents, such as Articles and Bylaws, or other items that are clearly outside the scope specified in the federal law. Such requests by non-chartering states clearly impede the registration process in contravention of the LRRA.

***RRR: Any other examples?***

**Harkavy/Ross:** Fees come clearly to mind as another example of non-domiciliary state practice that contravenes the provisions of the LRRA. Many states require the payment of fees for initial registration and for registration "renewal". As set forth in the LRRA, registration of a RRG is clearly a one-time event, and any non-chartering state requirement for renewal of that registration, whether or not a fee is assessed, is clearly preempted.

***RRR: Do you believe that non-chartering states have the authority to charge RRG registration fees?***

**Harkavy/Ross:** No. The imposition of fees on foreign RRGs by non-domiciliary states is simply not supported by the federal law and existing case law. While Section 3902(a)(1)(B) of the LRRA does permit a state to impose "premium and other taxes" on non-domiciliary RRGs, the imposition of a "fee" falls within the scope of state authority that is preempted by the LRRA.

***RRR: What support do you have for this position?***

**Harkavy/Ross:** This is the conclusion that was reached in the federal court decision, *NRRA v. Brown*, in which the Court held that the State of Louisiana was preempted under the LRRA from imposing various requirements on RRGs not chartered in the State of Louisiana, including the charging of fees. In another recent federal court decision, *ALAS v. Fitzgerald (U.S. District Court, Western District of Michigan, 2001)*, the Court similarly held that the State of Michigan's authority to impose a regulatory fee on RRGs not chartered in the State of Michigan was in contravention of and preempted by the LRRA. Indeed, this very issue is discussed at some length in the *NAIC's Risk Retention and Purchasing Group Handbook* which cautions that the language of the LRRA and existing case law do not authorize non-domiciliary states to charge fees against foreign RRGs.

***RRR: Without the ability to impose registration fees on RRGs, aren't non-chartering states, in effect, subjected to an unfunded mandate?***

**Harkavy/Ross:** You fail to take into consideration the premium tax paid by RRGs which in a number of states is at the higher surplus lines rate. However, irrespective of the premium tax, the existence of an unfunded mandate does not create a legitimate statutory basis for a non-domiciliary state to charge such fees. Some states do not impose any fees on foreign RRGs. Others charge fees that range anywhere from $25.00 to nearly $2,500 annually, and many states insist on imposing additional fees imposed on traditional insurers, such as annual statement filing and maintenance fees. For a RRG operating in all 50 states, these fees can accumulate to an often prohibitive cost of doing business, in clear contradiction of the intent of the federal law.

***RRR: Have your registration experiences been uniformly negative?***

**Harkavy/Ross:** Not at all. Some states do recognize the ministerial nature of the RRG registration process under the LRRA, and many more are beginning to recognize that. For our part, we, like other captive managers, have learned through experience to anticipate the requirements and demands various states may have that exceed those of the federal law and to guide our clients in determining whether compliance with or challenge of such requests best serves their interests.

We've also encountered increasing cooperation from many of the state insurance regulators we interact with on a frequent basis on behalf of our RRG clients. Not only is there a greater degree of understanding about RRGs, generally, but more state insurance regulators are beginning to realize the potential RRGs offer for expanding the opportunities for affordable or even available coverage in their state insurance market jurisdictions, which is precisely the intent of the federal Act.

***RRR: Isn't the registration process utilized by non-chartering states to ensure that the RRG is both structured and operating in accordance with the LRRA?***

**Harkavy/Ross:** First, we would suggest that the material required to be provided to the non-domiciliary state under the LRRA should contain all of the information the non-domiciliary regulator needs to make that determination. Secondly, for legal reasons previously stated, the LRRA does not permit a non-domiciliary state to reject a registration containing the requisite information for any reason. However, should a non-domiciliary state wish to challenge whether a registered RRG is lawfully constituted or operational it can make the challenge in federal or state Court after registration. The cases of *HOW RRG v. Delaware* and *ALAS v. Michigan* are two such examples.

***RRR: What do you see as the role of non-chartering states in the registration process?***

**Harkavy/Ross:** What many non-chartering states fail to understand and is clear under the LRRA is that regulation and oversight of the RRG is intended to be largely the purview of the domiciliary state and not of the non-domiciliary state. Under the LRRA, a RRG is licensed in a single state, its state of domicile, and the onus is on the chartering state to ensure that the RRG is soundly structured and operated. Although non-chartering states rely primarily on the regulatory oversight of the "lead", domicile state, they can monitor the RRG's financial soundness through the financial statement filings the RRG is required to make to non-chartering states under the federal law.'

If non-chartering states have serious concerns about a RRG's operation, there are specific means accorded to non-chartering states under the LRRA for addressing such concerns. As delineated in the *NAIC Risk Retention and Purchasing Group Handbook*, registration under the LRRA is not a means to exercise preempted state regulatory authority under the LRRA.

***RRR: How do you navigate your clients through this registration maze?***

**Harkavy/Ross:** Obviously, the strategy chosen varies significantly according to the needs and regulatory compliance temperament of each client. Some clients do not have an immediate need after chartering state licensure to do business in a particular state. For these types of clients, waiting weeks or even months to complete the registration process in non-chartering states poses no real hardship.

More typically, however, the RRG wants to hit the ground running and begin doing business immediately. This is where the regulatory compliance temperament of the client comes in. Some of our RRG clients are comfortable with taking the position that upon making the required LRRA Section 3902(d) registration filing the RRG can proceed to do business in the state. Other RRG clients prefer the more conservative approach of waiting for confirmation of registration by the non-domiciliary state before doing business in the state.

***RRR: Do you see these registration issues being resolved through litigation?***

**Harkavy/Ross:** Frankly no, unless they come up as ancillary issues to much broader litigation. To quote a British phrase, "the game is not worth the candle" to either the RRG or the regulator. From a RRG's standpoint, it's highly unlikely that it will elect to litigate a non-chartering state's registration fee of a couple hundred dollars when legal costs for mounting such a challenge could easily run into the six figures. It's far more likely that the RRG will simply pay the fee, despite its illegitimacy., rather than delay registration. The same is true in the case of a non-chartering state's refusal to accept a registration filing or delays in acknowledging a registration filing. It is much more likely that the RRG will gut out the registration process rather than initiate a legal challenge.

From a state regulator's perspective it is similarly unlikely that a non-chartering state will attempt to litigate against a RRG on the basis that the RRG wrote business in the non-chartering state prior to confirmation of registration, or that it failed to comply with a state-imposed registration requirement. Any reasonably informed counsel for a non-chartering state insurance department will recognize that a non-domiciliary regulator has no authority under the LRRA to regulate through the registration process.

There is also significant exposure on the part of the regulator for the payment of attorneys' fees as a non prevailing litigant under a USCA Section 1983 counterclaim by a RRG for deprivation of federal civil rights under color of state law, as has been awarded in the *Charter* and NWIG cases. In the past these Section 1983 claims predominated against certain state officials who imposed fees and non-fee based restrictions on voter registration. The analogy to RRGs is clear, and courts have indeed assessed such damages.

***RRR: Any solutions to these registration issues other than litigation?***

**Harkavy/Ross:** Education is an important key to the solution. We have seen a considerable improvement in the understanding of RRGs, particularly recently, but many regulators still fail to understand what RRGs are and how to deal with them.

RRGs are neither unauthorized insurers nor admitted insurers in the sense that these entities are typically understood by regulators. They are, essentially, in a category to themselves, and therefore are not subject to the existing state processes that apply to traditionally known insurance entities seeking to do business in a state.

The NAIC has attempted, through development of its Model Risk Retention Act and *Risk Retention and Purchasing Group Handbook*, for example, to foster state recognition and understanding of RRGs, but the idea of a "hands off" approach to foreign RRGs remains anathema to state regulators accustomed to playing a much larger role in the regulation of insurance entities operating in their jurisdictions. Moreover, such NAIC efforts have in themselves often created more difficulties for RRGs by "blessing" state requests for registration forms and other information that exceed the requirements of the LRRA. We have a considerable way to go yet to get to the point intended by Congress with passage of the Act.

***RRR: What do you see for the future?***

**Harkavy/Ross:** Realistically, a clear solution to these registration issues is not likely to be achieved anytime in the near future. It's more likely that certain regulators will continue to attempt to regulate foreign RRGs via the registration process despite being preempted by the LRRA from doing so, and RRGs will continue to muddle along via "mano-a-mano" negotiation with some state insurance departments for the foreseeable future.

The LRRA has been around for some twenty years now, and we have seen some positive developments, particularly recently, in state regulatory views and handling of RRGs. Our hope is that as RRGs continue to develop a track record, more state regulators will come to recognize the real potential RRGs offer for their insurance consumers and will continue to move toward achieving the intent of the federal law in facilitating the creation and operation of RRGs.

*About the authors: Jon Harkavy is Vice President and General Counsel of Risk Services, LLC, which provides alternative insurance market services for policyholders, producers and insurers in the structuring, formation and management of captive and risk retention group programs in both U.S. and offshore domiciles. Jon previously served for nearly a decade as General Counsel and Director of Governmental Affairs of the Risk and Insurance Management Society where he played a key role in the enactment of the federal Liability Risk Retention Act of 1986. Jon is a member of the Board of Directors of the Vermont Captive Insurance Association, has served as past Chairman of the American Bar Association's Self Insurers and Risk Managers Committee of its Torts and Insurance Practice Section, and was formerly on the Board of Directors and Legislative Chairman of the National Risk Retention Association.*

*Heather Ross serves as Director of Regulatory Compliance and Corporate Affairs for Risk Services, LLC, and its affiliates, a group of companies specializing in providing administrative, management and consulting services for the alternative insurance market. Heather's background covers some twenty years of experience in the insurance arena, including nearly a decade with the Risk Services' companies. In her current capacity with the Risk Services' organization, one of Heather's primary responsibilities is managing the regulatory and internal corporate functions of the organization's risk retention group clients, including licensing and registration, premium tax and financial reporting and other matters.*

*Reprinted from the April 2004 Risk Rentention Reporter — Volume 18, Number 4*

**RISK RETENTION REPORTER — Published by INSURANCE COMMUNICATIONS, P.O. Box 50147, Pasadena, California 91115. (626)796-4972. Fax: (626) 796-2363; e-mail: cutts@rrr.com; URL - http://www.rrr.com; Managing Editor: Karen Cutts.**