

GAO

Briefing Report to the Honorable
Edward F. Feighan
House of Representatives

July 1986

INSURANCE

Activity Under the Product Liability Risk Retention Act of 1981



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Human Resources Division

B-223648

July 22, 1986

The Honorable Edward F. Feighan
House of Representatives

Dear Mr. Feighan:

The enclosed briefing report provides information on the extent to which risk retention and purchasing groups have formed under the authority of the Product Liability Risk Retention Act of 1981. The act's major purpose is to enhance the affordability and availability of insurance, principally product liability insurance, by allowing groups of product sellers, manufacturers, and distributors to form risk retention or purchasing groups on an interstate basis. The act was passed after a product liability insurance availability/affordability "crisis," which took place during the mid-1970's. In response to your letter of March 13, 1986, and agreements with your office this report provides information on:

- The number of firms that have taken advantage of the opportunities for collective self-insurance under the act.
- The types of firms, in terms of size, goods or services, location and ownership that have most frequently organized under the act's provisions.
- The obstacles faced by groups that have formed to date under the act's provisions.
- Changes in state insurance laws specifically relating to the act.

We developed this information by contacting the National Association of Insurance Commissioners (NAIC), the insurance departments of each state and the District of Columbia, three insurance industry organizations, and each risk retention and purchasing group we identified. We also contacted consulting firms that specialized in self-insurance alternatives. To determine whether groups were chartered in Bermuda or the Cayman Islands, the two offshore jurisdictions included in the act as chartering jurisdictions, we obtained information through the firms that represent these countries' interests in the United States.

In brief, we identified a total of seven risk retention or purchasing groups that have been formed under the act's provisions. We identified three risk retention groups and four purchasing groups. They vary in terms of ownership, size, member type, and insurer location. (See sec. 2.)

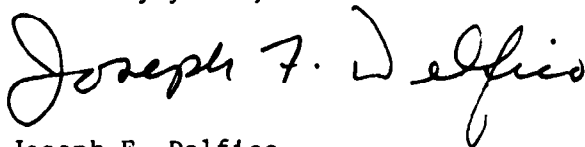
As discussed in section 3, we identified two elements that appear to have affected the formation of risk retention or purchasing groups. First, we were advised that businesses have had little incentive to form risk retention and purchasing groups because product liability insurance has been readily available and more affordable since the act's passage, until approximately a year ago. In addition, considerable effort and, for risk retention groups, financial resources are required to set up and administer the groups. For both these reasons, small businesses may have chosen to obtain product liability insurance through traditional insurance markets, rather than setting up either a risk retention or purchasing group.

Second, state insurance department actions, which have included legal actions, may have led some firms interested in forming these groups to choose other alternatives. In addition, in about one-third of 51 state insurance departments, the staffpersons to whom we were directed as the most informed concerning the Risk Retention Act activity were confused as to either (1) the scope of the act's provisions or (2) its impact on their regulatory activities. This confusion may have hindered firms aware of the act from taking advantage of its provisions.

As discussed in section 4, two states have passed new laws specifically designed to monitor groups formed under the provisions of the Risk Retention Act, according to the National Association of Insurance Commissioners (NAIC).

As agreed with your office, we shall provide copies of this report to others upon request. If you have any questions or if we can be of further assistance on this issue, please contact me at 275-0358.

Sincerely yours,



Joseph F. Delfico
Senior Associate Director

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ABBREVIATIONS

ABC Assurance Buyer's Cooperative, Inc.
D.C. District of Columbia
NAIC National Association of Insurance Commissioners
NAW National Association of Wholesaler/Distributors

INSURANCE:
ACTIVITY UNDER THE
PRODUCT LIABILITY RISK RETENTION ACT OF 1981

SECTION 1: BACKGROUND

Introduction

The Product Liability Risk Retention Act of 1981 (15 U.S.C. 3901) authorizes groups of product sellers, manufacturers, and distributors to form risk retention or purchasing groups principally for insuring product liability risks. The act was passed after a product liability insurance availability/affordability "crisis," which took place during the mid-1970's. The act's major purpose is to enhance the affordability and availability of insurance, principally product liability insurance, by allowing groups of product sellers, manufacturers, and distributors to form risk retention or purchasing groups on an interstate basis.

Both risk retention and purchasing groups are intended to afford businesses, especially small businesses, the opportunity to contain product liability insurance costs, albeit from slightly different perspectives:

- Risk retention groups are insurance "cooperatives" whose members pool funds to spread and assume all or a portion of their product liability risk exposure. The members must be principally engaged in manufacturing, designing, importing, distributing, packaging, labeling, leasing, or selling products, rather than providing services. (A group of homebuilders, for example, has formed a risk retention group, the HOW Insurance Company.) In theory, premiums could be reduced for some businesses because the insured's rates are more closely tied to claims experience, and the group has a greater incentive to practice effective risk management.
- Purchasing groups, on the other hand, consist of persons engaged in business who collectively purchase product liability or completed operations liability insurance¹

¹Completed operations liability is defined in the act as liability arising out of the installation, maintenance or repair of any product at a site not owned or controlled by (a) any person who performs that work or (b) any person who hires an independent contractor to perform that work. For example, if a stove in a person's home exploded as the result of faulty installation, the incident would be classified as one of completed operations, rather than product liability.

from an insurance company, either separately or as part of a comprehensive general liability policy. These groups would be able to obtain coverage at premiums reflective of the group's experience, rather than at manually derived rates.² Because of this correlation between the group's insurance costs and its actual claims experience, insurers might view purchasing groups as having greater incentives to reduce losses, possibly effecting further rate reductions. For example, the National Association of Wholesaler/Distributors (NAW) formed a purchasing group comprised of trade associations. The member associations purchase completed operations and product liability insurance through NAW from CIGNA, a Pennsylvania-based insurance company.

Objectives, Scope, and Methodology

On March 13, 1986, Representative Edward F. Feighan asked us to provide information on activity to date under the Product Liability Risk Retention Act of 1981. Based on agreements with his office, this report provides information on

- the number and types of firms that have taken advantage of the opportunities for collective self-insurance under the act;
- the obstacles faced by groups that have formed to date under the act's provisions; and
- changes in state insurance laws specifically relating to the act.

To identify the number of firms that have organized under the act's provisions to date, we conducted a telephone survey in May 1986 of 50 state insurance departments and the District of Columbia. Using a questionnaire for our telephone survey, we asked the person or persons to whom we were directed as being the most informed concerning the act whether the state had (1) certified any risk retention groups, (2) denied certification (and the reasons for denial), and (3) whether the state was aware of risk retention groups from other jurisdictions operating within the state. We also obtained information on purchasing groups operating in the state.

²Insurance companies tend to "manually rate" the premiums of smaller sized customers they insure. This means that smaller customers are charged rates from an insurance rate book, that includes the claims experience of large companies, which have a larger exposure for risk. This may result in some smaller companies being charged rates higher than warranted by their loss experience, according to proponents of risk retention groups.

To determine whether groups were chartered in Bermuda or the Cayman Islands, the two offshore jurisdictions included in the act as chartering jurisdictions, we obtained information through the firms representing these countries' interests in the United States.

We contacted each organization identified by the state insurance departments. From those groups characterizing themselves as either risk retention or purchasing groups, we obtained specific information. This included the date and place of charter or incorporation, number of group members, type of insurance provided, number of states in which the group operated, and the insuring company (purchasing groups only). We also identified some risk retention and purchasing groups through newspaper articles and from information provided by an identified group. From this information, we identified seven groups that had organized under the provisions of the Risk Retention Act. (See tables 1 and 2.)

To determine whether any obstacles may have prevented groups from taking advantage of the act's provisions, we obtained information from the representatives of six of the seven groups concerning difficulties faced during and after the group's formation. One group's representative declined to comment because of litigation. In addition, we contacted representatives of three consulting firms specializing in risk management (Tillinghast, Nelson, and Warren, Inc.; Kirke-Van Orsdel, Inc.; and Huggins Financial Services) to obtain their perspective on factors affecting the formation of risk retention and purchasing groups.

To identify states that have passed laws specifically relating to the Risk Retention Act, we contacted the National Association of Insurance Commissioners (NAIC). Based on information the NAIC provided, we contacted two state insurance departments (Texas and Maine) to obtain specific information concerning their risk retention legislation.

Other sources of information included one of the act's original authors (Mr. Michael Mullen of Crowell and Moring, a Washington, D.C., law firm), and three insurance industry organizations: the Risk and Insurance Management Society (RIMS), the Insurance Information Institute (III), and the Self-Insurance Institute of America, Inc. (SIIA).

Elimination of State Barriers to Group Insurance

States have traditionally regulated the insurance industry. Some of the basic functions undertaken by state insurance departments are: to license insurance companies and agents; enforce state laws concerning company formation, financial standards,

qualifications of management, and license suspension or revocation; implement statutory standards; enforce unfair trade practices laws; and administer a complaint-handling office. The states undertake these functions with considerable differences in resources, organization, and regulatory activities.³

To facilitate the formation and operation of risk retention and purchasing groups, the act preempts certain state laws that restrict the formation and operation of self-insurance and purchasing groups. State laws preempted include: those which hinder or prohibit (1) the formation of either self-insurance pools, or the establishment of collective insurance groups within the state, and (2) insurance transactions within the state by outside insurers or their representatives.⁴ In relation to the first type, some state laws effectively prohibited businesses from either self-insuring or purchasing insurance on a group basis. For example, some state laws prohibited insurance companies from offering preferential treatment in terms of coverage or rates to groups organized solely for the purpose of purchasing insurance.

In addition, some states had legislation allowing group insurance that was highly restrictive. For example, Colorado's association captive law⁵ made capitalization and other regulatory requirements so burdensome that most businesses did not consider it a useful alternative.

Finally, to preempt state laws that restricted insurance transactions within the state by outside insurers or their representatives, the act allows risk retention groups chartered in one jurisdiction to operate in every state. Many states restricted the ability of insurance companies chartered or licensed outside

³"Issues and Needed Improvements in State Regulation of the Insurance Business"; GAO/PAD-79-72 Washington, D.C., Oct. 9, 1979.

⁴Senate Report No. 97-172; Product Liability Risk Retention Act of 1981 (to accompany S.1096); July 30, 1981.

⁵A captive insurance company is generally defined as one organized by a firm or group of firms to insure the risks of its organizers. A pure captive is a wholly owned subsidiary organized by a company to insure only the risks of its parent and its parent affiliates. A hybrid form of the captive company is the trade association or industry captive, which is a captive formed and operated by a business fraternal organization or trade association. The purpose of the trade association captive is to insure specific risk exposures common to its owners. Unlike risk retention groups, association captives are usually prohibited from operating in more than one state.

the state to operate in the state by requiring them to obtain another charter or license. The act's preemption allows risk retention groups chartered in one jurisdiction to operate in every state.

To allow states time to amend their laws to permit the formation of risk retention groups, the act included Bermuda and the Cayman Islands as chartering jurisdictions until January 1, 1985. To be considered as a risk retention group, these "offshore" groups had to certify to at least one state that they satisfied that state's capitalization requirements. With the state's certification, they are allowed to conduct business in the other 49 states and the District of Columbia, provided they comply with all regulatory requirements (discussed below).

Regulatory Authority

Primary regulatory authority over risk retention groups rests with the chartering jurisdiction. However, nonchartering states may require groups to

- comply with the state's unfair claim settlement practices law;
- pay applicable premium and other taxes;
- participate in any state mechanism established for the apportionment among insurers of product or completed operations liability losses and expenses incurred on the mechanism's policies;
- submit reports and other information required of licensed insurers relating solely to product or completed operations liability insurance losses and expenses; and
- register with and designate the insurance commissioner as an agent for receiving service of legal documents or process and, upon request, furnish the commissioner any financial report submitted to the commissioner of the chartering jurisdiction.

In addition, nonchartering states may examine a group's finances and, if necessary, initiate delinquency proceedings against a risk retention group if the commissioner believes the group to be financially impaired, and the chartering state has taken no action.

The individual owners of risk retention groups are also subject to the provisions of section 17 of the Securities Act of 1933 and section 10 of the Securities Exchange Act of 1934. These laws prohibit, respectively, fraudulent transactions and the use of manipulative and deceptive devices in connection with

purchase or sale of securities, which includes the ownership interests of the group members.

In contrast to risk retention groups, individual members of purchasing groups do not assume any risk of their own; they simply organize as a group to purchase insurance as a group from an existing insurance company. So long as the policy includes product or completed operations liability insurance, purchasing groups may purchase comprehensive liability insurance as well. In addition, any group of persons may form and be members of a purchasing group. The Risk Retention Act specifically prohibits state regulation of membership, either as to number or common ownership or affiliation. A state may require, however, that a person acting as an agent or a broker for a purchasing group obtain a license from the state.

Pending Legislation

Three amendments to the Risk Retention Act of 1981 have been introduced in the 99th Congress (S. 2129, H.R. 4442, and H.R. 4301). Each of the three bills seeks to expand significantly the 1981 act to include all types of commercial general liability coverage.

S. 2129, H.R. 4301 and H.R. 4442 would amend the Risk Retention Act to permit the formation of risk retention and purchasing groups for municipalities, schools, professionals, directors and officers, and nonprofit entities to give them the opportunity to reduce their insurance costs or to obtain coverage that is not available from commercial insurance underwriters.

H.R. 4442 also amends the act to require risk retention groups to comply with state trade practices laws, and identify themselves as such groups in their policies. The amendments would delete the original act's language which states that the commissioner must believe a risk retention group is financially impaired before initiating a financial examination.

As of July 16, 1986, only S. 2129 had been reported out of committee (Senate Committee on Commerce, Science and Transportation). Both H.R. 4442 and H.R. 4301 had been referred from the House Committee on Energy and Commerce to the Subcommittee on Commerce, Transportation and Tourism.

SECTION 2: RISK RETENTION AND PURCHASING GROUPS

Using information provided by (1) state insurance departments, (2) the representatives of the Bermudian and Cayman Island governments, and (3) the risk retention and purchasing groups, we identified a total of seven risk retention and purchasing groups, representing a variety of businesses. Three of the seven are risk retention groups, two of which are chartered in the Cayman

Islands. We did not identify any groups chartered in Bermuda. The four remaining groups are purchasing groups.

Risk Retention Groups

Information on each risk retention group we identified, including the date it was formed, its chartering jurisdiction, member type, number of members, and the number of states in which the group was operating as of June 1986, appears in table 1.

Table 1:
Risk Retention Groups
Operating as of June 1986

<u>Name of group</u>	<u>Date formed</u>	<u>Where chartered</u>	<u>Member type</u>	<u>No. of members</u>	<u>No. of states in which operating</u>
HOW Insurance Company ^a	3/82	Delaware	Home-builders	11,500	All 50 and D.C.
National Warranty Insurance Company	1984	Cayman Islands ^b	Auto dealers	400	36 and D.C. (Those excluded are: AK, HW, WY, CO, UT, AZ, NM, TX, LA, AR, MS, AL, GA, and FL)
C.A.I. ^c	12/84	Cayman Islands ^b	Heavy equipment manufacturers	Approx. 5,000	All 50 states

^aOwned and administered by Home Owner's Warranty Corporation. HOW Insurance Co. provides product liability insurance for homebuilders who own the Home Warranty Corporation, the sole stockholder of the Corporation.

^bBoth National Warranty and C.A.I. certified to the state of Pennsylvania that they met that state's capitalization requirements.

^cAccording to C.A.I.'s representative, the acronym has no meaning.

We identified two risk retention groups which were chartered offshore, both in the Cayman Islands. The public communications firm Gray and Company, which represents the Cayman Islands in the United States, stated that no other risk retention groups have been chartered in that jurisdiction.

To determine whether any risk retention groups were chartered in Bermuda under the act's authority, we obtained information from Ragan and Mason, the law firm which represents Bermudian interests in the United States. According to the firm, as of May 10, 1986, there were 139 insurance companies chartered in Bermuda which insure product liability. Of these, 26 can be eliminated from the number of possible risk retention groups, because:

--20 were owned by interests in countries other than the United States, and thus could not be risk retention groups under the act; and

--6 were chartered after January 1, 1985, the date by which the act required offshore groups to charter.

Of the remaining 113 Bermudian companies:

--97 were chartered prior to September 25, 1981, the date of the act's passage; and

--16 were chartered between September 25, 1981, and January 1, 1985.

Based on the information provided by Ragan and Mason and the results of our survey of state insurance departments, we concluded that there is little likelihood that any of the 113 insurance companies in Bermuda are risk retention groups.

In a June 11, 1986, letter, Ragan and Mason stated:

"Whether a Bermudian company has filed with a local state insurance commissioner in the United States to qualify to write product liability insurance pursuant to the terms of the Risk Retention Act of 1981 is not information which the Government of Bermuda would receive from insurance companies in Bermuda . . . there is a substantial amount of cooperation and interchange of information between the Registrar of Companies in Bermuda, the primary regulator of insurance companies there, and various state insurance commissioners and particularly the National Association of Insurance Commissioners. Although we are of the belief that Bermudian insurance companies may have qualified in the United States under the terms of the Risk Retention Act of 1981, we have not been able, at this time, to identify any such groups."

The information provided by the law firm was consistent with our survey findings; none of the 51 insurance departments we contacted indicated that they had certified a risk retention group chartered in Bermuda. Based upon this information, we did not attempt to contact any of the 113 companies listed by Ragan and Mason.

Purchasing Groups

Table 2 shows the four purchasing groups we identified, along with the date of formation, the number of members, the insurance company used, the type of insurance the group purchases, and the number of states in which the group operates.

Table 2:
Purchasing Groups
Operating as of June 1986

<u>Name of group</u>	<u>Date formed</u>	<u>No. and type of member</u>	<u>Insurer (states)</u>	<u>Type of coverage</u>	<u>No. of states in which operating</u>
National Association of Wholesaler/Distributors	1/83	97 trade associations	CIGNA (Pennsylvania)	Product Liability	50
Assurance Buyer's Cooperative Inc. (ABC) ^b	3/86	No. unknown, ^a hospitality industry	American British Assurance Co., Ltd. (Bermuda)	Liquor Product Liability	26
National Federation of State High School Associations	6/84	75% of nation's high schools	Insurance Co. of North America Inc. (Pennsylvania)	Comprehensive general liability including product liability for sports injuries	47
Dynaspan Corp.	12/83 ^c	684 manufacturers, distributors	New England International Surety Co. (Brussels)	Completed Operations, E and O, ^d Product Liability	26

^aABC could not provide a member count because its provision of insurance to cooperative members is one of many services members elect to purchase.

^bABC is chartered in California as a cooperative. Under California law, businesses can form cooperatives for the sole purpose of buying or selling. ABC is not regulated by the insurance departments; it was issued a charter by California's Secretary of State.

^cDate on which Delaware's Insurance Commissioner recognized the American Builders and Remodelers Association, Inc., (ABRA) as a purchasing group to purchase comprehensive general liability insurance. ABRA was incorporated into Dynaspan in 1985.

^dDynaspan offers errors and omissions insurance (E and O), which insures against losses due to the insured's error or unintentional omission.

SECTION 3: FACTORS AFFECTING THE FORMATION OF RISK RETENTION AND PURCHASING GROUPS

As indicated in section 2, seven groups have organized as a result of the Risk Retention Act of 1981. There seem to be two main reasons for such limited participation under the act's provisions:

- Businesses have had little incentive to form risk retention and purchasing groups. Product liability insurance has been readily available and more affordable since the act's passage, until about a year ago, according to state insurance department staff, an insurance industry organization, consulting groups, and a risk retention group. In addition, formation of a risk retention or a purchasing group requires organizational effort, and for risk retention groups, financial resources, according to several groups and a feasibility study on risk retention groups.
- State insurance department actions, which have included legal actions against risk retention and purchasing groups, may have led some firms interested in forming such groups to choose other alternatives, according to risk management consultants and three of the seven identified groups.

During our survey of 50 state insurance departments and the District of Columbia's insurance department, we noted that some staff were unsure as to either the act's provisions or its impact on their regulatory activities. The state insurance departments' confusion may have hindered potential groups' ability to take advantage of the act's provisions. Some of the state insurance department staff and risk retention and purchasing groups' representatives attributed the departments' confusion, in part, to a lack of a central authority at the federal level who could provide guidance on the proper implementation the act.

Group Formation a Less Attractive Alternative Than Traditional Product Liability Insurance

Product liability insurance, until approximately a year ago, has been readily available and more affordable since the act's passage in 1981, according to staff from state insurance departments, consulting groups, an insurance industry organization, and a risk retention group. Thus, businesses have had little incentive to form risk retention groups during this "soft market" period. Similarly, businesses would be unlikely to band together as a purchasing group if they were able to purchase adequate coverage individually at a reasonable price.

The Risk Retention Act gives businesses, particularly small businesses, the opportunity to obtain greater control over their

insurance costs by either self-insuring as a risk retention group or collectively buying insurance as a purchasing group. However, given the efforts and resources required to form and administer risk retention and purchasing groups, small businesses may have chosen to obtain product liability insurance through traditional insurance markets, rather than setting up a risk retention group.

Because the act defines risk retention groups as insurance companies chartered or licensed in any state, businesses must invest relatively high amounts of effort and capital to form and administer them. According to a 1983 study concerning the feasibility of forming risk retention groups, some of the steps in forming a risk retention group include:⁶

- evaluation of the risk retention and/or purchasing group concept, utilizing actuarial, engineering and other disciplines, which may be costly;
- development and implementation of sound underwriting techniques; and
- procurement and maintenance of a solid reinsurance program.

According to spokespersons from several of the groups we identified, forming and administering a group can be relatively complex. For instance, representatives of one risk retention group believed that most businesses, small and large, would be unlikely to band together as members of a group for competitive reasons. One purchasing group's spokesperson told us that the level of effort and capital required to set up a group might be prohibitive for some small businesses. A purchasing group's sponsoring association chose to form a purchasing group after evaluating both the risk retention and purchasing group alternatives because the latter was the simpler option, the group's representative said. The representative cited several considerations, including the association's ability to capitalize and administer its own insurance company.

The Interagency Task Force on Product Liability, formed in the mid-1970's to study problems in the product liability field, analyzed the feasibility of forming small business trade associations which would then form a captive insurance company for its

⁶J. Robert Hunter, F.C.A.S.; Study of Feasibility of Risk Retention Groups for Hazardous Waste Facilities, Jan. 1983. (Note: While this study deals specifically with hazardous waste facilities, the author presents these steps as applicable to all types of risk retention groups.)

members, as an alternative to traditional insurance. In its final report⁷, the Task Force concluded:

"Although there are several ways in which a captive may meet the needs of its parent more efficiently than a standard insurance company, . . . the initial expenses of incorporation and capitalizing (such a) company would usually be more substantial than the product liability premiums . . . These costs would prevent most small businesses from utilizing captives . . ."⁸

Litigation Between State Insurance Departments and Risk Retention, Purchasing Groups

State insurance department actions, both formal and informal, concerning risk retention and purchasing groups may be underlying factors contributing to the limited participation under the Risk Retention Act's provisions, spokespersons from two purchasing groups, a risk retention group, and risk management consultants told us. Representatives of each of the three risk retention groups we identified told us that litigation had affected their operations. Risk management consultants indicated that the threat of litigation could be a deciding factor in potential groups' formation.

Both kinds of groups have met some formal opposition from state insurance departments. As of June 1986, according to state insurance department staff, nine states had initiated legal actions against one risk retention and two purchasing groups to prevent them from operating. The states have raised arguments, such as:

- the group is offering insurance other than product liability,
- the insurance offered does not constitute product liability insurance, and
- the group members do not qualify under the act.

⁷Product Liability: Final Report of the Insurance Study- Volume 1, Interagency Task Force on Product Liability, Department of Commerce, 1978.

⁸Despite this negative conclusion, the Task Force felt that trade association captives, if set up correctly, represented a viable alternative to traditional insurance for some product liability insureds, including small businesses. Some of the Task Force recommendations later became the basis for legislation that ultimately passed as the Product Liability Risk Retention Act of 1981.

Spokespersons for three risk retention groups told us that the possibility of formal opposition from state insurance departments has affected their operations in some way. For example, one risk retention group was allowed to operate in several states only after those states agreed to wait for the results of litigation in the chartering state. Another risk retention group's representative attributed delaying a significant part of its operations to negotiations with staff from nonchartering state insurance departments. The president of the third group asserted that while the group had not met any formal opposition from state insurance departments, it purposely maintains a low profile (although it operates in all 50 states and the District of Columbia) to avoid such confrontation.

Potential litigation initiated by state insurance departments could be a deciding factor in the choice between risk retention or purchasing groups and other options, such as an association captive, according to representatives from consulting firms who specialize in evaluating and developing self-insurance alternatives for their clients.⁹

Some State Insurance Department
Staff Were Unfamiliar With
Act's Provisions

During our survey of 51 insurance departments, which we conducted primarily to identify risk retention and purchasing groups, we noted that some department staff were unsure of either (1) the scope of the act's provisions or (2) the extent to which they may exercise their regulatory authority. In about one-third of the 51 insurance departments, the person or persons to whom we were directed as the most informed concerning Risk Retention Act activity communicated some misperceptions over these two issues. This confusion may have affected the formation of risk retention and purchasing groups. It may also have hindered the groups' ability to operate as authorized under the act, because the departments' perceptions of risk retention and purchasing groups were unfavorable.

For example, one department staffperson informed us that the state could not allow an offshore risk retention group to operate in that state because the state did not contain an official port-of-entry, which is required of certain lines of insurance offered by foreign insurers. The act contains no port-of-entry requirement for risk retention groups.

⁹For example, according to some of these sources, an offshore association captive is not regulated as heavily as a risk retention group.

In addition, some state insurance department staff were unaware that they could require risk retention groups operating in their state to register with the department. These staff were concerned that they would be aware of groups with solvency or trade practices problems only after the problems had surfaced. Department staff from three states told us that they would not know of any risk retention groups chartered in another jurisdiction operating in their state because the groups are not required to notify the department. The act does not require risk retention groups to notify each state that it is operating within the state, but provides, however, that an insurance commissioner may require risk retention groups to register. Texas and Maine are the only states we identified that had passed legislation requiring registration.

Department staff in four states were confused as to how state insurance laws were affected by the Risk Retention Act. The Director of the Property/Casualty Division of one state's insurance department informed us that the state was unaware of any risk retention groups located in the state because state law does not require self-insurers to apply for certification. Presumably, since risk retention groups are chartered or licensed under the laws of any state, a state would be aware of such a group chartered under its own insurance laws.

Also, several insurance department staff were under the impression that their hands are essentially tied should a group chartered outside the state experience financial problems or engage in fraudulent activities. Staff from four states told us that risk retention and purchasing groups are essentially unregulated. Another department spokesperson believed that his department could take little, if any, action should the propriety of a group's coverage be questioned.

The act does not preempt all state laws, however. According to the applicable congressional reports, a commissioner may exercise the full extent of his authority under the laws of his state dealing with the supervision, rehabilitation, and liquidation of financially impaired insurers. The act specifies that a group must provide copies of any report required by the chartering state to any other insurance commissioner, if requested. In addition, any state may examine and, if necessary, initiate delinquency proceedings against a group, if (1) the insurance commissioner has reason to believe that the group is financially impaired and (2) the commissioner of the chartering jurisdiction has not begun or has refused to initiate such an examination. States may also bring unfair trade actions against groups so long as state laws do not frustrate the act's purposes.

States, Groups Pinpoint Lack of Central Authority

According to several state insurance department representatives as well as those of a risk retention and a purchasing group, a lack of central authority has contributed to confusion over the act's provisions and proper implementation. While none of the representatives advocated forming a federal agency specifically to oversee the act's implementation, they said that little guidance from the federal government has been available since the act's passage.

SECTION 4: STATE VERSIONS OF THE RISK RETENTION ACT

As outlined in sections 1 and 3, a chartering state may apply the full range of its insurance laws with respect to the formation and operation of a risk retention group. Nonchartering states, to a more limited degree, may also supervise and regulate risk retention groups. To assist states in implementing the Risk Retention Act, the National Association of Insurance Commissioners (NAIC) proposed adoption of a model state act.

NAIC's Model Risk Retention Act includes many of the provisions of the federal act. The model act incorporates the federal act's language, which authorizes states to require that (1) all groups not chartered in the state register with the commissioner; (2) any reports filed with the chartering state be supplied to the commissioner of a nonchartering state; and (3) agents and brokers representing risk retention groups be licensed in the state.

In contrast to the federal act, which broadly defines product liability,¹⁰ the NAIC model act defines product liability with reference to each state's tort law. Thus, the model act makes the scope of group insurance coverage dependent upon the nuances in various definitions under state law. The federal act was amended in 1983, to clarify the intent of the Congress that risk retention groups and purchasing groups may insure any coverage which contributes to a "product liability" loss, as defined in the act.

¹⁰The federal act defines product liability as liability for damages because of any personal injury, death, emotional harm, consequential economic damage, or property damage (including damages resulting from the loss of use of property) arising out of the manufacture, design, importation, distribution, packaging, labeling, lease or sale of a product. The act excludes from its definition of product liability the liability of any person for these damages if the product involved was in the possession of such a person when the incident giving rise to the claim occurred.

Two states, Texas and Maine, have passed laws fashioned after the NAIC's Model Risk Retention Act. The Texas law retained the model act's language which defines product liability in terms of that state's laws. Maine, on the other hand, incorporated the federal act's broad definition of product liability into its risk retention law.

GLOSSARY

Association captive: A hybrid form of a captive insurance company; formed and operated by a business fraternal organization or trade association. Also known as an industry captive.

Captive insurance company: An insurance company organized by a firm or group of firms to insure the risk of its organizers.

Chartering state: The state in which a risk retention group is chartered or licensed.

Completed operations liability: As defined in the Product Liability Risk Retention Act of 1981: liability arising out of the installation, maintenance or repair of any product at a site that is not owned or controlled by (1) any person who performs that work or (2) any person who hires an independent contractor to do that work; but shall include product liability for activities which are completed or abandoned before the date of the occurrence giving rise to the liability.

Comprehensive general liability policy: A policy that covers broad business risk exposures, including products and completed operations liability, structural alterations, new construction or demolition operations, ordinary repairs or maintenance, and additional premises and operations not present when the policy was written.

Nonchartering state: Any state, other than the chartering state, in which a risk retention group is doing business.

Product liability: As defined in the Product Liability Risk Retention Act of 1981: liability for damages because of any personal injury, death, emotional harm, consequential economic or property damage, (including damages resulting from the loss of use of property), arising out of the manufacture, design, importation, distribution, packaging, labeling, lease or sale of a product, but does not include the liability of any person for those damages if the product involved was in the possession of such a person when the incident giving rise to the claim occurred.

Purchasing group: A group of persons who collectively purchase product liability or completed operations liability insurance from an insurance company, whether separately or as part of a comprehensive general liability policy.

Risk management: The use of appropriate insurance, avoidance of risk, loss control, risk retention, self-insurance, and other techniques that minimize the risks of a business, individual, or organization.

Risk retention group: An insurance "cooperative" whose members collectively assume all or part of their product or completed operations liability exposure. The members' principal activities consist of the manufacture, design, importation, distribution, packaging, labeling, lease or sale of a product or products.

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