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On the Horizon: Application of the Insurance Holding Company System Regulatory Act to Captive RRGs

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Risk retention groups formed as captive insurance companies are not subject to the same regulation as traditional insurers. To date, state regulation of captive RRGs has largely varied based on the company's choice of domicile. However, changes are on the horizon. Last year, the NAIC voted to require that states apply Part A of the NAIC's accreditation standards to captive RRGs. As a result, effective January 1, 2011, the Part A standards will require application of the NAIC's Model Insurance Holding Company System Regulatory Act (Act) to captive RRGs. (This will entail a state-by-state implementation process as it will likely require each state amending its version of the Act to make it applicable to captive RRGs.)

Overview of the Holding Company Act

The Act is a comprehensive law that governs the relationships and activities within insurance holding company systems and regulates certain activities of 'persons' or entities that are affiliated with insurance companies and not otherwise subject to such regulation. It was originally enacted in 1969. According to the Act, the definition of a "person" includes an individual, a corporation, a limited liability company, a partnership, an association, a joint stock company, a trust, or an unincorporated organization.

The Act defines a "holding company system" as two or more affiliated persons, one or more of which is an insurer. "Affiliates" includes persons that directly or indirectly control, or are controlled by, or are under common control with, the person specified. "Control" refers to possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or management services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control is presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing 10% or more of the voting securities of any other person.

Significant Elements of the Holding Company Act

The Act includes the following requirements:

- *No person may acquire control of an insurer unless prior to the acquisition such person files a Form A Statement and receives approval of the acquisition from the insurer's domestic regulator.*
- *An annual Form B Registration Statement must be filed by the insurer with its domestic regulator and must be kept current to the extent there are any material changes. The Form B must include financial statements of the ultimate controlling person, contain an organizational chart, and describe all relationships between the insurer and its affiliates.*
- *Material transactions (including management and service agreements, purchases and sales of assets, loans and guarantees, reinsurance agreements, and cost-sharing agreements) involving an insurer and any affiliate must be filed at least 30 days in advance and be "non-disapproved" by the regulator. These transactions are generally scrutinized by the regulator to determine whether the terms are fair and reasonable.*
- *Extraordinary dividends (exceed the greater of 10% of the company's surplus or prior year's net gain from operations) declared by an insurer must be reviewed and approved by the regulator prior to distribution.*

Implications of Applying the Holding Company Act to Captive RRGs

Applicability to Captive RRGs

The Act will apply to a captive RRG if the RRG is considered part of a "holding company system." This depends on whether or not the RRG is controlled by, or is under common control with, some other person or entity. If such "control" exists, then the RRG will be subject to the Act.

Because the Liability Risk Retention Act (LRRA) speaks in terms of "ownership" and not "control," applicability of the Act to captive RRGs will vary depending on the ownership and control structure of the RRG. Traditional captive RRGs that are owned and controlled directly by their members will likely not be subject to the

Act so long as no member owns more than 10% of the voting "securities" of the RRG or is otherwise deemed to control the RRG. But, a traditional captive RRG that has a single owner organization/association, that (i) has as its members only persons who comprise the membership of the RRG and (ii) is owned only by persons who comprise the membership of the RRG and are provided insurance by the RRG, may be subject to the Act because the captive RRG and its sole owner could be considered "affiliates." Other types of captive RRGs, such as reciprocal RRGs, may find themselves under the purview of the Act, not from the controlling-owner perspective, but rather from the nature of the contractual relationship with the RRG's attorney-in-fact. However, determining whether such "control" exists with many entrepreneurial RRGs will be a very fact-specific analysis.

As stated, "control" may exist if a person possesses, directly or indirectly, the power to direct or cause the direction of the management and policies of the RRG. This control may be found through ownership, contract or "otherwise." As the 2005 GAO Report on RRGs pointed out, the LRRA does not have a requirement that RRG insureds retain control over the management and operation of their RRG. As a result, many RRGs have been structured in a manner that provides certain service providers the power to control and direct the management and policies of the RRG. Where such service providers are found to have this level of "control," such RRGs will likely be considered part of holding company systems and thus subject to the Act.

Additional Layers of Regulations and Costs of Compliance

Application of the Act will impose new reporting obligations and additional costs on captive RRGs. On one hand, the filing of certain agreements (such as reinsurance agreements and service provider agreements whether between affiliates or not) with a RRG's domestic regulator is generally already required. Application of the Act to captive RRGs provides specific standards for the review of such agreements. Moreover, service providers found to be the ultimate controlling person of a RRG could find themselves subject to additional biographical and financial information reporting requirements. Additionally, with respect to dividends, the Act gives clear guidance on the amount of dividends that a "controlled" RRG may declare without receiving prior approval from the regulator.

It is worthwhile to note that under the Act, if control does not in fact exist despite certain ownership thresholds, a party may attempt to rebut the presumption of control and disclaim affiliation by a filing, setting forth all material relationships with the insurer/captive RRG and the basis for disclaiming such affiliation. This essentially allows the regulator some flexibility in the application of the Act. While this could provide some opportunities for relief, the regulatory burdens for captive RRGs will certainly increase as a result of the NAIC's action.

Conclusion

The NAIC is requiring the states to impose requirements on captive RRGs that are similar in nature to those imposed on traditional insurance companies. The application of the Holding Company Act may be just the start—the NAIC also voted in October 2010 to incorporate the application of the Annual Financial Reporting Model Regulation (aka Model Audit Rule) to captive RRGs within the Part A standards, effective January 1, 2012. Since RRGs are like snowflakes (no two are alike), an analysis of their ownership and control structure must be made on a case-by-case basis to determine whether or not the Holding Company Act will apply. Since many captive RRGs do not have the experience and mechanisms in place to comply with the Holding Company Act, they will likely incur additional compliance costs associated with the new filing and prior approval requirements. Although greater accountability will soon be required of captive RRGs as efforts for imposing additional regulations on captive RRGs continue, the possibility of inconsistent regulation between different types of RRGs and different regulators remains and may lead to continued confusion down the road.

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