A Special Reprint from

The
Risk Retention
Reporter

Amendments to District of Columbia Captive Law Chart New Territory For Risk Retention Groups

An RRR interview with Arthur Perschetz
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RRR: Why did the District of Columbia enact an almost entirely new law in 2004 when its first captive law had been enacted only four years earlier?

Perschetz: In the rapidly evolving alternative risk transfer market, developments are occurring at a fast pace. District of Columbia Insurance Commissioner Lawrence Mirel realized that to achieve the full benefits of captives, significant flexibility was needed to deal with the wide variety of entities being formed and the new and innovative structures and financing being utilized in a variety of jurisdictions.

He appointed a committee of staff and industry volunteers to review the District's captive law and encouraged them to be creative and broad thinking. After their review, the drafters realized that while many aspects of the current law could be included in the new version, there were simply so many innovative new aspects to be incorporated that drafting a new law would be more practical than adding extensive amendments to the old.

The new law encourages RRGs of all sizes, allows options in structure and operation, and provides the ability of RRGs domiciled in the District to benefit immediately from new developments around the world. The flexibility and creativity in the new law are responses to the needs of sophisticated insurance buyers who are most able to maximize the law's benefits.

RRR: How are risk retention groups treated under the new law?

Perschetz: RRGs are treated as association captive insurers, not as traditional liability insurers. Thus, under the D.C. captive law, no law relating to the insurance industry applies to captives or RRGs unless specifically provided for in the captive law. RRGs are also governed by the District's Risk Retention Act.

The captive law's more liberal capital requirements and investment and reinsurance provisions apply to RRGs. For example, because an RRG is treated as an association captive, the minimum funds required are $100,000 in capital and $300,000 in surplus. Further, the captive law has no requirement that prohibits associations from being formed to purchase insurance and has no seasoning requirements.

RRR: What is the `best practices' provision of the new law, and what benefits can it provide for RRGs?

Perschetz: The `best practices' provision provides in Section 3(c) of the act that '... the Commissioner may authorize a captive insurer that is otherwise qualified to conduct business in the District to engage in any activity in any form permitted to a captive insurer in any other jurisdiction.'

The drafters of the new law realized that with the rapidly evolving alternative risk arena, it would be difficult to include in a new law all the best practices being utilized and developed in other jurisdictions or to anticipate all new and creative opportunities. The best practices provision was modeled after the `wild card' provision in most state banking laws that allows state banks all present or future powers provided by Congress to federally chartered banks.

At District City Council hearings on the bill, Commissioner Mirel made clear that `any other jurisdiction' meant worldwide. To utilize the best practices provisions, an application must explain where the activity is permitted and why it would be appropriate in the District of Columbia. The Commissioner must then approve the application unless he finds the proposed activity would be harmful to the captive's policyholders.

Since RRGs are formed as association captives under the D.C. law, the benefits of more flexible laws or permitted activities available now or in the future under the laws of other jurisdictions will be available to RRGs under the best practices section in the captive law.

RRR: Could you discuss treatment of reinsurance and investment provisions under the new captive law?

Perschetz: The new law, as did the old law, permits RRGs to take credit for reinsurance ceded to reinsurers in compliance with the District of Columbia Law of Credit for Reinsurance Act of 1993, which follows the NAIC model. Under the new law, with the prior approval of the Commissioner, credit also may be taken for risks or portions of risks ceded to qualifying reinsurers that do not otherwise meet the requirements of the Credit for Reinsurance Act.

Since each situation pertaining to granting credit for reinsurance is unique, the decision whether to allow credit will be determined on its own merits by the Commissioner. One can assume that he will look for capitalization of the reinsurer commensurate with the amount and character of risk being assumed, and that he will consider the reinsurer's reputation and management as well as the laws and suitability of regulation in the reinsurer's domicile.

With regard to investments, the previous law, except for pure captives, required captives and RRGs to comply with the District of Columbia investment law, which followed the NAIC model. Under the more flexible new law, applicants whose investments are in excess of the required capital and surplus, which are required to be in the form of cash or a letter of credit, must file a proposed schedule of investments with the Commissioner, who will approve these investments if they do not threaten the solvency or liquidity of the RRG.

This affords RRGs the opportunity to match investments with loss payout patterns and to use a variety of investments without the various limits that previously existed. Thus, an RRG desiring to invest extensively in small cap companies could spread the risk in its portfolio through the use of mutual funds in a proportion higher than would previously have been permitted. In addition, the Commissioner has the ability under appropriate circumstances to allow nontraditional investments not typically used by RRGs, such as, for example, real property.

RRR: The newly enacted District of Columbia law permits RRGs to create a cell or cells within the existing format. Given the Liability Risk Retention Act definition of an RRG as an insurer `whose primary activity consists of assuming and spreading all, or any portion, of the liability exposure of its group members,' how can you reconcile the two concepts?

Perschetz: The LRRA provides that each owner must be an insured and each insured must be an owner or have an organization, such as an association, as its sole owner, provided all members of the association are provided insurance by the RRG. All members must be engaged in similar activities.

I am sure that many people involved in captives and RRGs could structure arrangements where all or part of the risk of individual cells within segregated-cell RRGs would be shared by all participating cells while still permitting each cell to achieve its insurance needs. Any number of options are available to establish ownership of the RRG in compliance with the requirements of the LRRA.

The segregated-cell provision of the law is a very exciting provision, and I am confident that many uses will be implemented and a variety of risk sharing, ownership, and control structures will be created that take advantage of segregated-cell RRGs while meeting all the requirements of the LRRA.

RRR: Are there any other provisions of the law that would benefit RRGs?

Perschetz: Yes, several. Captives and RRGs are taxed at a lower tax rate than traditional companies. RRGs may be formed under the District's Non-Profit Corporations Law. Another interesting feature is the provisional certificate of authority, which can be issued when the RRG has been approved subject to capitalization, obtaining subscribers, or placing reinsurance, and it allows RRGs to engage in limited activity to facilitate completion of organizational requirements.

The law includes a provision that permits RRGs to redomesticate from another jurisdiction to the District or from the District to another jurisdiction. Several RRGs have already taken advantage of this provision, and more are in the process of filing applications.

About the author: *Arthur Perschetz heads the insurance practice at Muldoon Murphy & Aguggia LLP, a Washington, D.C., financial services law firm, where his practice focuses on regulatory and corporate matters with an emphasis on captives and RRGs. He was active in drafting both of the District's Captive Laws and is currently Chairman of the Captive Insurance Council of the District of Columbia. Prior to joining Muldoon Murphy, he was General Counsel of the Maryland Insurance Group and Senior Legal Officer for Royal Insurance (USA).*

Reprinted from the January 2005 Risk Rentention Reporter — Volume 19, Number 1

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. **The *Risk Retention Reporter* is published 12 times a year. Subscription Rates: One year: $395; Outside U.S.: $425.**