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# Risk Retention Reporter

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## Non-Tax Advantages For Forming Risk Retention Groups As Reciprocals

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Many professionals who structure group captives/risk retention groups understand the special tax planning opportunities of a reciprocal inter-insurance exchange (hereinafter referred to as a “reciprocal”), particularly where the insureds are tax exempt entities or have large income tax loss carryforwards. Last month’s *Risk Retention Reporter* article discussed a favorable IRS private letter ruling received by tax-exempt entities. This article, however, will explore key non tax reasons to consider the reciprocal form of organization.

### Basic Entity Types for RRGs

RRGs can be formed as stock, mutual or reciprocal insurance companies. Yet, among the three structures, only the reciprocal, in my experience, offers the flexibility and unique advantages not found in the other two types. This is particularly true where the founders of the RRG may or may not be candidates for future policyholder status, yet are willing to commit their energy and financial resources to see their idea come to fruition.

Before delving into the specifics of a reciprocal, it will be helpful to briefly describe the three basic legal structures available for RRG formation, focusing on how each is used in an RRG setting.

### The Stock Company

The stock company is the most common form of corporate organization. Ownership and control is vested in the stockholders or shareholders. The stock company form usually is employed where the parties providing the capital/surplus differ from the policyholders. This format works well when the entity structure demands the bifurcation of shareholders providing necessary capital and policyholders participating in the distribution of insurance risks through premium payments.

However, the Federal Risk Retention Act does not accommodate the bifurcation of equity contributions and risk pool participation. By statute, all equity holders

must be insureds and all insureds must be equity holders. In my opinion, unless transfer of the equity interest is severely restricted the use of a stock company structure in an RRG program is inconsistent with the legal requirements of its organizational structure. One is essentially forcing an entity type that anticipates different equity holders and insureds into an entity type that requires equity holders and insureds to be one and the same.

### The Mutual Company

In the mutual company structure the insureds concurrently hold an equity and voting interest. Because of the inherent dual role of mutual insureds as equity holders and policyholders, this entity structure comfortably fits the statutory requirements of the RRG law.

Because of the ease of the creation and termination of a mutual policyholder’s equity interest in the company, the mutual structure is particularly appropriate as an organizational structure for an RRG, as it offers little or no complexity in managing equity interests beyond the management of its policy base.

Where both the stock and mutual structures fall short, however, is in providing an incentive framework for founders who wish to provide expertise and assume financial risk in developing and managing an RRG but will not be insured by it. Here, structuring the RRG as a reciprocal can provide a solution, as will be discussed in the following section.

### The Reciprocal Insurance Exchange

The basic elements of a reciprocal were adequately described in the July, 2003 *Risk Retention Reporter* article by Kevin Moriarty. Without repeating the entire article, here are the fundamental characteristics of reciprocals:

- *Reciprocals are an emerging form of structure for property/casualty insurance companies. According to*

one author this organizational form dates back to 1881. Today the best known reciprocals likely are Farmers Insurance Exchange and USAA.

- *Reciprocals represent an amalgamation of two separate parties: the inter-insurance exchange comprised of all of the policyholders (known as subscribers) and an attorney-in-fact (AIF). Without both entities the reciprocal structure cannot function.*
- *The exchange is a legal entity for most purposes (such as suing and being sued), but it is not a corporation, partnership or limited liability company. Rather, the exchange technically is an unincorporated association of subscribers contractually exchanging risks, formed under specific provisions of a state's insurance code which has a legal identity apart from the subscribers and AIF.*
- *The AIF may be an individual, a corporation, partnership, limited liability company or other recognized entity type. The actual entity type for the AIF usually is chosen for business reasons rather than being dictated by the insurance statutes or regulations under the state's insurance code.*
- *Risk sharing (i.e., insurance) in a reciprocal is achieved by the subscribers exchanging with one another their risk exposures as defined in the policies issued by the reciprocal.*
- *This exchange of policies is accomplished through the AIF who is appointed by all of the subscribers as their agent under a Power of Attorney.*
- *Like mutuals, subscribers in a reciprocal occupy dual positions of both policyholders and equity holders in the exchange.*

The AIF manages the exchange under a contract on a day-to-day basis subject only to supervision by the exchange's governing body (often called a "Subscribers' Advisory Committee"). As third party management is the usual operational structure employed by most RRGs, the existence of the AIF fits nicely into the typical RRG's organizational structure.

### **Roles of the Attorney-in-Fact**

A reciprocal insurance exchange and its AIF have a legally symbiotic relationship. Under the various state statutes the exchange does not have operational capacity without the AIF to serve as the agent for the policyholders comprising the exchange. In its modern role the AIF has two important functions in the life cycle of a reciprocal: one at formation and a second during the operational period. I refer to these as the entrepreneurial role and the management role.

### **The Entrepreneurial Role**

At the inception of an RRG, there are usually one or more individuals who come up with an idea and decide to implement a plan for the formation of the RRG. These are the founders of the RRG, and like founders of most

start up ventures they are unique in their commitment and zeal for the insurance program they desire to launch. They devote a good deal of effort in developing their initial idea and are willing to commit their energy and financial resources to see their idea come to fruition. These are the entrepreneurs, indistinguishable from entrepreneurs behind any new business venture.

In the case of the founders of an RRG, they may or may not be candidates for future policyholder status. Quite often they are not. The founders could be from outside of the proposed insured group, yet associated with it and knowledgeable about the insurance risks that the group faces. The founders may be a professional association previously formed by the proposed captive insureds who now desire to create an insurance program specifically tailored for the needs of their members.

Founders come from many different backgrounds, but usually they bring an intense level of commitment to their ideas, a willingness to impart the benefit of these ideas to others, and a desire to receive a financial reward for their intellectual property and their personal investment in time and money. The AIF is often the vehicle through which these founders can make their investment of time, money and intellectual property into the insurance program and through which they can reap a financial reward for that effort.

### **The Management Role**

It is the management contract between the AIF and the RRG that provides the opportunity for the founders to reap the reward of their initiative in forming the RRG. Typically the management contract requires the AIF to perform a number of services such as managing the reciprocal's finances, handling underwriting, claims administration, investments, accounting and financial statements, coordinating RRG governance, as well as selection and management of a distribution network, policy management functions and necessary IT operating systems.

Pricing for the services rendered by the AIF should allow for the recovery of direct and indirect costs associated with providing these contractual services plus a reasonable margin for profit. Cost recovery and profit margin should be considered in the expense component of RRG's actuarial pricing study. The premiums paid to the RRG would typically contemplate anticipated losses and loss adjustment expenses, expenses including the AIF management fee, and a profit and contingency margin for the RRG.

The recovery of the AIF's investment in starting the RRG and the fair rate of return on that invested time and effort are dictated by two factors: (1) the AIF's profit margin built into the management contract, and (2) the recovery period that is principally controlled by the term of the contract.

## The Problem with the GAO Report

In August 2005, the General Accountability Office released its report on Risk Retention Groups. While this report concluded that RRGs had made a positive contribution to the availability and affordability of commercial liability insurance, it contained some reservations about the actual implementation of the law, including relationships between RRGs and outside managers. The report concluded that some RRGs were being subjected to abusive contractual terms by their managers. They referred to such RRGs as “entrepreneurial” and advised Congress and state insurance regulators to be wary of predatory pricing and terms of abnormal length in such management contracts.

An “entrepreneurial” RRG as defined in the GAO report is one founded by a manager for “the primary purpose of making profit for themselves,” thus placing the RRG in a potentially hazardous financial condition. While the GAO places a negative connotation on the word “entrepreneurial”, in the mainstream business world, the word entrepreneurial typically connotes entities on the cutting edge of new technologies, processes or procedures. The entrepreneurs behind these companies are putting the wheels of commerce in motion, not plotting future financial demise.

My conception of the AIF is one headed by persons who have worked long and hard to develop a unique insurance product, process or procedure. In my experience in establishing reciprocal RRGs, entrepreneurs do not work for an instant profit. They have a long term vision for their program and thus strive for the long-term success of the RRG. They are not inclined to place their venture in financial jeopardy. They expect a reasonable return on their innovation, but are willing to wait for an appropriate term to collect that return.

The GAO report warns us to be on the look out for management contracts that include predatory pricing or terms of abnormal length. Of the two concerns, it seems to me that the term of the management contract is the more significant issue for the entrepreneurial AIF, as the term will dictate the ultimate recovery and return on the investment in the insurance program. It is the term of the contract that represents the property right providing most of the value to the AIF and its owners.

In essence, the founders exchange their investment in time, money and property for a management contract of certain duration with the RRG. The shorter the contract period the greater profit margin that needs to be incorporated into the price in order for the founders to recoup their investment plus a reasonable rate of return. A longer contract term allows the AIF more time to recover that same investment. In other words, the shorter term contract has a tendency to create an economic need for a

management fee that might approach the predatory rates feared by the GAO. (Note: The NAIC Risk Retention Working Group Corporate Governance Standards has proposed a five year limitation on management contracts.)

## Conclusion

I have attempted here to explain why I consider the reciprocal inter-insurance exchange as an ideal organizational structure for RRGs. This organizational form easily accommodates the requirement of the Risk Retention Act that all members of RRGs be both equity holders and insureds. In addition, the reciprocal structure provides an efficient vehicle granting AIFs the requisite authority to create and manage RRGs while at the same time enabling them to reap the rewards for their investment in the programs.

I find the concerns of the GAO regarding the pricing and terms of management contracts to be misplaced, at least as regards truly “entrepreneurial” RRGs. I agree that predatory managers and management contracts should be discouraged. However, founders who have made significant investment in time, money and property should have a right to a reasonable return on their investment. I am most concerned about the apparent direction of the NAIC to apply a mandatory maximum length to management contracts without consideration of the symbiotic legal relationship that exists between an exchange and its AIF, the AIF's investment in the insurance program and incorporation of an adequate return on that investment.

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