

E&O Newsletter

A Primer on Purchasing Groups

Beth Kravetz, Of Counsel
Greenbaum, Doll & McDonald, PLLC

What is a purchasing group?

A purchasing group is a creature of federal law. It is a vehicle which allows insurance consumers the opportunity to purchase, on a group basis, liability insurance coverage from a licensed or surplus lines insurer free from some of the usual restrictions imposed by the states.

Many associations, agents, brokers and administrators, and others interested in forming a purchasing group, have questions as to the actual **process** involved in forming these groups. The process is not all that complicated, but so many of the states have imposed their own minor (or, in some cases, not so minor) additional requirements, that there is a lot of paperwork involved. A summary of the issues and actions involved in establishing and operating a purchasing group follows.

The Group

While this may seem so basic as to be unnecessary to state, there first must be a group. The Risk Retention Act requires that the group be comprised of members whose business or activities are similar and have related risk exposure. One of the stated purposes of the group must be to purchase insurance on a group basis and the purchasing group can only provide this to its members. There is no size limitation (minimum) on a group; theoretically a group could form with as few as two members.

What does this mean in practice? The proponents of the Act originally had in mind that an existing trade or professional association would, for all intents and

A Little History

In the mid-1970s, many businesses began experiencing difficulty in obtaining product liability insurance. Either coverage was unavailable due to insurers leaving the market (sometimes voluntarily and sometimes involuntarily because of insolvency) or premium costs escalated so high as to be unaffordable. Instances of premium increases of 200-300 percent were not uncommon. Although other lines of commercial liability insurance were similarly effected, the main problem seemed to be in the area of product liability insurance.

A task force comprised of representatives of many government agencies was assembled by then-President Carter, and chaired by the Secretary of Commerce. Its directive was to study the problem of scarce product liability insurance and recommend solutions. Among the many findings of the Task Force was the inherent complexity of complying with the present 51-state regulatory scheme. One major recommendation in this area was to allow the establishment of "self-insurance captives" as an alternative to the traditional insurance market and essentially allow these captives to be free from duplicative and burdensome state regulation.

The recommendations of the Interagency Task Force were the basis for the original Product Liability Risk Retention Act of 1981 ("the Original Act").

Very generally, the Original Act was restricted to product manufacturers and others in the product distribution chain and allowed them to form cooperative insurance entities solely for the purpose of providing product liability and completed operations insurance. A "risk retention group" formed pursuant to this legislation would be licensed by one state and then be allowed to operate in any other state free from the other state's regulation. The Original Act also allowed "purchasing groups" of product manufacturers and sellers to purchase product liability and

completed operations insurance on a group basis (much as group life and health insurance is often purchased), a practice usually prohibited by state insurance laws. Although the federal law pre-empted many state insurance laws, no direct federal involvement in the operation or regulation of either risk retention or purchasing groups was established.

By September 25, 1981, when President Reagan signed the Original Act into law, the product liability insurance crisis had disappeared. Interest rates were high; premiums were low. Insurance industry capacity was large and getting larger. Every conceivable risk was being accepted by insurers at very competitive, even low, prices. There did not appear to be a need for risk retention or purchasing groups.

The Original Act was a solution without a problem. During the next five years only one risk retention group and a handful of purchasing groups were formed. In 1986, a new crisis in liability insurance emerged, far more encompassing than the one of ten years before. This time, all types of liability insurance were in jeopardy, not just product liability. Doctors and nurse-midwives, schools and churches, transit systems and police departments, camps and playgrounds, all faced the loss of liability coverage.

This time Congress had an existing vehicle ready to respond. The Original Act formed the basis for the expanded Liability Risk Retention Act of 1986 ("the Amendments" or "the Act"). Essentially, the Original Act was expanded to allow more lines of insurance to be covered through risk retention and purchasing groups -- all liability coverages, not just product liability. The Amendments also allowed more types of insureds to become members of a group -- any business or profession with a third party liability exposure, not just product manufacturers or sellers. At the same time more regulatory controls were instituted to give the state insurance regulators of all states more oversight regarding the operation of risk retention and purchasing groups.



purposes, already be that group and thus would be in position to have that larger purchasing power to find a commercial insurer willing to provide the liability coverage to that group's members on a competitive or preferred basis.

The other scenario --- and the one which has turned out to be the most active --- would be where an agent or broker would have one or two insureds in the same business and have difficulty placing insurance for these two. "Perhaps," the agent would reason, "there are other widget repairmen in this same situation. If many widget repairmen could get together, perhaps ACME Insurance Company would be willing to look at the risks as one."

In this instance, an agent (or broker or insurance consultant/administrator) would be the prime mover in putting a group of similarly situated individuals together for the purpose of negotiating group insurance coverage, which otherwise, under existing state law, would not be possible.

As it has turned out, this is the most prevalent kind of purchasing group...and the type that the state regulators were, in the beginning, most concerned about (especially in the cases where the group has been "generated" by an insurance company or agent).

Does the group have to be incorporated? The Risk Retention Act is silent on this point and the general law of associations does not require that an association be incorporated. Many states have specific laws on the rights and responsibilities of

unincorporated associations. The nature of the group, the other purposes and goals, the number of members, etc. will determine whether it should be incorporated. There are different state recordkeeping and reporting requirements (not related to insurance, but under the general corporation laws of the state) depending on the state of incorporation.

Coverage

The benefits of using the purchasing group format accrue only to "liability" insurance. Congress envisioned this to be a very broad definition and wider in scope than many state laws. The most common forms of purchasing group coverage are CGL and professional liability, although any liability coverage can be placed in a purchasing group, e.g., commercial auto, garage-keepers, contractual, employment practices (but not workers compensation).

State of Domicile

The 1986 amendments required that a purchasing group must be domiciled in a state. Thus, a group must choose a state of domicile. If an association is chartered or incorporated in State A, but has an office which houses all the professional staff in State B, the state of domicile would be State A, and the state of operation would be State B.

The only federal court to rule directly on the issue of "domicile" versus "location" found that a purchasing group is only located in one place...the state of domicile, which is the state of charter (or organization, if not incorporated). Notwithstanding this finding, the Court went on to assert that even though a group is located in only one place, a state could require the insurer of a purchasing group to either be licensed or an eligible surplus lines company in that state if a member of the group resides in that state.

Thus, unless and until Congress changes the law to give the state of domicile more (and sole) regulatory authority over the purchasing group and its insurer, it really is of little insurance regulatory consequence where the group is domiciled.

There are, however, certain states that place more onerous requirements or restrictions on purchasing groups domiciled in their states, and it is usually unadvisable to domicile in those states.

Notice to Regulators

The Act requires that the purchasing group itself notify the insurance commissioner in each state where it intends to operate (i.e., market, solicit, insure members). The law is specific in the four items that must be included in the notice:

1. the state of domicile of the purchasing group;
2. the lines and classifications of liability insurance the group intends to purchase;
3. the insurance company from which it will be purchasing the insurance and that company's state of domicile; and
4. the principal place of business of the purchasing group.

In addition, the purchasing group must designate the commissioner as its agent for receipt of service of process or other legal documents.

The National Association of Insurance Commissioners ("NAIC") adopted a standard purchasing group registration form. As with other NAIC models, this is only advisory, and states are not required in any way to conform their own documents to this model. Presently, 30 states use the NAIC form, either alone or in some combination with their own forms; the rest of the states have forms which are similar to the NAIC form, but not exactly the same, and therefore are only acceptable to those individual states.

Any changes to a purchasing group's operation must also be reported in a timely fashion to the state insurance commissioner. About half of the states require annual renewal filings for the purchasing group (which are also not required by the Act.)

The Insurer

It is fairly well-settled now that the insurer for the purchasing group must be either licensed (admitted) or eligible (approved) for surplus lines in each state where the purchasing group has a member.

The Agent/Broker/Administrator

Most groups will have an agent or broker, or administrator handling the day-to-day insurance operations, e.g., marketing, soliciting, taking applications, collecting premiums and issuing policies, although the Act itself does not require that a group have an agent. It does, however, ►



allow a state to require that if an agent is used, that agent must be licensed.

Most insurance departments have interpreted that provision to mean that a group must have an agent, although some have allowed direct marketing by the group itself and exempted a group's officers, directors and full-time employees from state agent licensing requirements.

Reports and Taxes

Purchasing groups, as the rest of us, have at least one area of certainty --- taxes! Either the group itself, its agent / administrator or the insurer will pay to the states premium taxes based upon the gross written premium on insureds group members in each state. Payment is usually due by the 1st of March each year. Who pays depends upon whether the insurer is admitted in the state or is operating as a surplus lines insurer.

Licensed and admitted companies will pay at their regular admitted rate at the time of filing their annual statements; purchasing groups using surplus lines companies are required to pay at the surplus lines rate (usually higher) and the taxes will be paid either directly by the group or by the group's surplus lines broker.

Advantages and Disadvantages of Purchasing Groups

Advantages for Admitted Companies

The main advantage for an admitted company is relief from rate and form filings. When using a master policy with certificates, the number of states where filings are required is dramatically reduced, thus saving the insurer both significant time and expense. This translates into a more

uniform program for insureds and a speedier time to market.

Advantages for Surplus Lines

The most obvious advantage of using a non-admitted company is that under most state laws, surplus lines companies are exempt from the usual rate and form filing rules. In general, a surplus lines company is free to offer coverage different from the admitted market. This makes it ideal for the specialized or individualized insurance coverages that a purchasing group may need.

The main reason why the Risk Retention Act makes use of a surplus lines company feasible (if not desirable) is that the usual mechanics of surplus lines placement are replaced.

Under the Risk Retention Act, a purchasing group (either on its own or through its agent) can negotiate directly with the surplus lines company. There is no need for the intermediary, the surplus lines broker. An agreement is made that the surplus lines company will insure the group, and each member of the group is thus able to be insured by the surplus lines company, obviating the usual procedures involving the surplus lines broker (and, in practice, the declinations of coverage from the admitted market).

Generally, insurance producers of any sort (e.g., agents, brokers and surplus lines brokers) are prohibited from soliciting clients on behalf of surplus lines companies or marketing surplus lines business directly to potential insureds. However, under the Risk Retention Act, these prohibitions may be preempted. This can be quite beneficial when the surplus lines company is a well-known, A+ company.

Advantages for a Trade/ Professional Association

Using a purchasing group allows an association to separate out its insurance program from its other association functions. This can be especially important when dealing with income and tax issues (commonly referred to as "unrelated business income tax" or "UBIT"). It allows the purchasing group entity to receive and distribute income.

Another advantage is that it allows the insurance company to use the master policy approach (discussed above). For example, in some states group policies can only be written on a purchasing group basis.

Disadvantages

The only disadvantage in forming and operating a purchasing group is the associated cost and administrative paperwork. The fees that states charge to register purchasing groups runs approximately \$6,000. There may be additional charges for maintaining purchasing groups, by state, that run approximately \$3,000.

Beth Kravetz has practiced in the risk retention and purchasing group arena since the original act was passed in 1981. She was involved in the passage of the original act and the development of the NAIC Model Act. Ms. Kravetz advises and assists in the formation, operation and regulatory filings for numerous purchasing groups throughout the United States.



**Brown & Brown of California, Inc.
dba Cita Insurance Services**

**P.O. Box 7048
Orange, CA 92863-7048**

(800) 280-7150

**Email:
programsinfo@citainsurance.com
www.citainsurance.com**