

ROBERT G. HUTCHINS - LEGAL ESSAYS

Raising Capital for Risk Retention Groups - Problems and Solutions

Preliminary Note

A “Risk Retention Group” is a US insurance company specially authorized by Congress to sell liability policies and “ownership interests” to “members.” The “members” must be engaged in “similar” or “related” commercial activities that subject them to common risks, but there are no other qualifications that limit their number. The “ownership interests” are “securities” for federal anti-fraud purposes, but exempt from registration. Accordingly, a Risk Retention Group may raise capital lawfully by selling equity securities to as many “members” as it can reach, using any media, without filing a registration statement. In addition, the organization, capital structure and corporate operations of a Risk Retention Group are to be governed exclusively by its “chartering” state, which frees the Group from redundant regulation by the other states in which it sells policies. These advantages have contributed to a steady increase in the number of Risk Retention Groups nationwide.¹

The advantages, however, carry a cost. A Risk Retention Group *must* provide ownership interests to *all* members to whom it sells insurance. That converts each sale of a Group policy into an integral component of a continuous offering of Group securities. Notwithstanding the exemption from registration, in the absence of full disclosure every policyholder will emerge from that offering as the potential lead plaintiff in a securities fraud class action. This Essay first examines the disclosure obligation. It then offers suggestions for discharging that obligation efficiently and exploiting the exemption from registration profitably.

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¹ From 1988 through March, 2005 the number of Risk Retention Groups operating in the US increased from 54 to 190. See, Risk Retention Reporter, Education Center; Marketplace Statistics, www.rrr.com.

Rationale and statutory authorization for Risk Retention Groups

When an insurance carrier experiences an erosion of its investment portfolio, or an increase in its required reserves, its capital surplus is proportionately diminished. That reduces its underwriting capacity which, in turn, reduces the availability, and increases the cost, of its policies. When these conditions are widespread, they produce a so-called “hard” market. From 2000 to 2003, for example, hard market conditions were acute. The stock market collapse that began in early 2000 was followed by massive liability claims that arose from a series of corporate financial scandals. In addition, several major carriers insured commercial real estate that was damaged or destroyed by the September 11 terrorist attacks. The ensuing contraction in the supply of property/casualty/liability insurance caused substantially increased premiums for those products.

There are persons in high risk occupations, such as health care, who are unusually vulnerable to “hard” markets for liability insurance, but vital to their communities. When these persons cannot obtain coverage at a tolerable cost, they may be forced to relocate or shut down, depriving their communities of essential services. Beginning in 1981, Congress tried to provide relief by encouraging the formation, and simplifying the regulation, of self-insuring, member organizations called “Risk Retention Groups.” Congress wanted to free these Groups from regulation by multiple states, and reduce their cost of capital, while minimizing federal oversight. The current manifestation of that effort is found in the Liability Risk Retention Act of 1986 (the “LRRRA”).²

Congressional objectives - reducing the cost of regulatory compliance and capital formation

The LRRRA streamlines the regulation of a Risk Retention Group by providing that only the “chartering” or original licensing state may govern the Group’s “formation and operation.” The supervisory authority of other states in which the Group sells insurance is limited to such things as auditing the Group’s financial records if the chartering state fails to do so, enjoining the operations of a Group in “hazardous financial condition,” collecting non-discriminatory premium taxes and prohibiting unfair claims settlement practices or the fraudulent sale of policies.³

The LRRRA reduces the transactional cost of raising Group capital by exempting the Group’s equity securities from registration requirements. Section 3904 provides that, while the “ownership interests” of a Group are subject to the anti-fraud provisions of federal securities laws, they are exempt from registration under those laws and are not securities at all for state law purposes. As a result, Risk Retention Groups can sell equity securities by means of a general or “public” solicitation of their members without registering the transaction with the SEC or state securities authorities. That alone produces an enormous savings in transaction costs.⁴

² 15 USC 3901 et. seq. The LRRRA also provides relief to member “Purchasing Groups” that pool their resources to buy insurance on the open market at discounted rates, a subject beyond the scope of this Essay.

³ 15 USC 3901(a)(4)(i) and 3902. Under the “Supremacy Clause,” Article VI Clause 2 of the United States Constitution, the LRRRA, as a federal statute, is part of the “supreme law of the land.” When Congress intends this result, a federal statute can “preempt” (override) conflicting state laws. The constitutional limits of the preemption doctrine are uncertain, but the LRRRA has been construed to prevent a state from imposing minimum capital requirements on a foreign Risk Retention Group exceeding those imposed by the chartering state. National Risk Retention Association v. Brown, 927 F. Supp. 195 (M.D.La. 1996).

⁴ 15 USC 3904. Although the LRRRA is not explicit on the point, it seems clear that the exemption from

Offering and selling securities - the basic duty of disclosure

The fact that its ownership interests are exempt from registration does not protect a Risk Retention Group from misrepresentation claims by purchasers. Regardless of what they are called, the LRRRA makes the interests “securities” for the purposes of the anti-fraud provisions of Section 17 of the Securities Act and the anti-fraud and civil liability provisions of Section 10 of the Securities Exchange Act. There is no exemption from those provisions for any offer or any sale of any “security” that occurs within the United States. Accordingly, a Risk Retention Group has a duty it cannot avoid to disclose fully to purchasers of its ownership interests all “material” facts and investment risks associated with those interests. Breach of the duty will subject the Group, its directors, participating officers and selling agents to civil and, if willful, criminal liability. To comply with the duty, Risk Retention Groups should furnish the line-item financial and narrative disclosure imposed upon comparable issuers and transactions by SEC Regulations.⁵

The problem for Risk Retention Groups - continuous offers and sales

If the matter ended with a straightforward exemption from registration, the Congressional objective of reducing Group capital costs while still protecting investors would be achieved. The states, however, interpret the LRRRA to require that Risk Retention Groups provide “ownership interests” (and hence full current disclosure) to *all* policyholders, not merely to those targeted for investment. Furthermore, the policyholders must *retain* their interests to remain eligible for coverage. The source of this interpretation is Section 3901. It defines a Risk Retention Group as, among other things, a limited liability entity which either (a) has as its “owners” “only” persons who “comprise” the membership of the Group and are “provided insurance by such Group” or (b) is a wholly owned subsidiary of an organization that has (i) as its “members” “only” persons who “comprise” the membership of the Group *and* (ii) as its “owners” “only” persons who “comprise” that membership and are “provided insurance by the Group.” In either case, the “members” must be engaged in “businesses or activities” that expose them to “similar” or “related” liability risks.⁶

It ought to be apparent that, as used in Section 3901, the phrase “provided insurance by such Group” refers to “owners,” not “members,” and the words “only” and “comprise” refer to “owners,” not policyholders. In other words, the logical reading of the Section, which serves the objective of reducing capital costs, requires merely that the “owners” of a Risk Retention Group be “comprised” “only” of members of the Group who are also Group policyholders, not that all policyholders must also be “owners.” If that reading were applied by the states, a Risk Retention

registration available to “ownership interests” would not apply to debt securities. A Risk Retention Group that wanted to sell, say, subordinated notes to policyholders would be required to register unless it could claim a transactional exemption under Section 4 of the federal Securities Act and the securities statutes in the states in which the notes were to be offered.

⁵ In a curious omission, the LRRRA does not subject ownership interests to Section 12(a)(2) of the Securities Act, which provides a private right of action to purchasers damaged by fraudulent sales of securities. Moreover, the courts are divided over the question whether there is an implied private right of action under Section 17, which simply criminalizes securities fraud. Nevertheless, Section 10(b) of the Exchange Act confers such a right expressly and should close any inadvertent gap in the LRRRA.

⁶ 15 USC 3901(a)(4). It is not clear what quantum of “ownership interest” must accompany a policy, but presumably the interest must be meaningful or the LRRRA would be a dead letter.

Group could pick the times when, and the members from whom, it would solicit equity capital. It could raise that capital by selling its “ownership interests” to selected members who also agreed to purchase its liability insurance and it would provide full disclosure to those members, albeit without registration. Having done that, it could then sell insurance to other members in the normal course of its business without including a security as a mandatory part of the sale. The effect would be to minimize premiums for members interested only in purchasing coverage while providing investment opportunities, through cost-effective, discrete transactions, for insured members interested in becoming owners.

The states, though, insist that all Risk Retention Group policyholders must have “ownership interests.” Their implicit assumption is that a Group so owned is more likely to hold down rates and otherwise act in the interests of policyholders than one owned by independent investors. (Policyholders, after all, do not need protection from themselves.) With all respect to state regulators and mutual insurance companies, there are some difficulties with this:

First, Group members are much too dispersed to exercise effective oversight, even though they may elect directors or managers annually. Second, members who are both policyholders and owners face an inherent tension between their interest in low rates and their interest in a return on investment and that diffuses any residual cohesion. Third, the first objective of an insurance manager in a capitalist society, owner or not, is to maximize earnings. That is not invariably achieved by combining low rates with generous coverage. As a result, protecting policyholders by vesting them with ownership interests is arguably hapless; the equivalent of protecting Chevrolet owners by vesting them with General Motors stock. In any case, the reading of the LRRRA suggested here would still confine Group ownership to members who pay premiums, salvaging whatever may be gained by that result.

Nevertheless, the state position is firmly entrenched. Unless Congress intervenes to clarify matters, all policyholders of a Risk Retention Group are (a) as a matter of *state law*, *required* to purchase securities as well as insurance and (b) as a matter of *federal law* *entitled* to full and accurate disclosure of all material facts associated with the resulting investment.

The facts that must be disclosed include some daunting structural anomalies. The equity securities and insurance policies issued by a Risk Retention Group are mutually dependent in the sense that a member cannot own either without owning the other. Thus, a member who purchases securities cannot resell them except to another member who also purchases insurance. A member whose own insurance lapses must resell the related securities immediately or surrender them to the Group for redemption. Correspondingly, a member who first resells the securities must surrender the policy. Finally, the National Association of Insurance Commissioners (the “NAIC”) apparently believes that unless a Group adopts a holding company structure all of its *members* must be both owners and policyholders.⁷

⁷ In Section 5 of the NAIC’s model Risk Retention Group registration form a stand-alone Group must certify to its chartering state that “(its) owners ... are the only persons who comprise (its) membership ...and are provided insurance by the Group.” A subsidiary Group need only certify that a named organization is its “sole owner” and the organization “has as its members only persons who comprise the (Group) membership and as its owners only persons who comprise (such) membership ... and are provided insurance...etc.” Like the LRRRA, either NAIC formulation leaves open the option of having policyholders who are *not* owners, but in practice the contrary interpretation prevails.

Insurance policies and “ownership interests” - selling the package

The net effect of the LRRRA’s regulatory scheme is that even though a Risk Retention Group is free from much of the regulation that applies to conventional insurance carriers, it faces formidable competitive obstacles. Its “ownership interests,” though exempt from registration, are highly illiquid and subject to both mandatory redemption and securities law disclosure requirements. The Group must sell these interests along with its policies, simultaneously and continuously. The Group must convince policyholders that the added cost of the interests is justified even though the only immediate impact may be to raise the aggregate cost of coverage above competitive levels. The interests will not readily be perceived as investments and will be weighed against marketable securities, money market instruments and other alternatives on the basis of their comparative return. The interests must be sold by insurance agents who, though proficient in their field, may find it difficult to tout investments alongside their traditional products. As a practical matter, the Group must also help reselling owners find buyers and it must do so lawfully without having to register separately with the SEC as a securities broker-dealer or stock exchange. Perhaps most importantly, the Group must plan financially to provide a return to investors and for the ultimate redemption of every ownership interest it sells.

By contrast, insurance policies sold by conventional, regulated carriers are exempt both from registration and from the anti-fraud provisions. Conventional policies need not be accompanied by a prospectus or sold with “ownership interests.” Oversight of the disclosure to be furnished purchasers has been left by Congress to the states which, through the NIAC, have developed a substantial body of approved documents. The resulting disclosure is generally adequate though far less comprehensive than the disclosure required by securities laws.⁸

Uncertain about how to respond to this dilemma, many Groups launch their capital raising effort with a single class of common equity securities. These are promoted as a necessary element of coverage and sold in the normal course of business to members interested primarily in managing risk. The members are urged to support “their” insurance company by purchasing the securities as well as the policies. The sales pitch is that, as policyholders, members gain protection against hard markets and pay relatively low premiums based upon the loss experience of “their” Group, rather than the less favorable, industry-wide experience utilized by conventional carriers. As a supplementary bonus, members may even receive a dividend from time to time if all goes well.

That pitch can be effective if the sum of the price for the Group’s common securities plus the premium for the policy is competitive. In the real world, however, meeting the competition often requires that the securities be priced too low to raise the desired capital. To make up the difference, the affected Group must devise a second tier of higher priced, preferred securities that can be sold as a pure investment to affluent members willing to look beyond the coverage issue.

⁸ See, however, “Distinguishing between ownership interests and insurance policies” below, at page 11. Section 3(a)(8) of the Securities Act exempts “Any insurance ...policy...issued by a corporation subject to the supervision ... of any state...” There is no corresponding exemption in the Exchange Act, but the McCarran Ferguson Act provides that no federal statute “...shall impair or supersede any (state) law for ... regulating the business of insurance.” 15 USC 1012. That should prevent a conflict between the Exchange Act and state insurance laws in areas not preempted by the LRRRA. See, American Mut. Reinsurance Co. v. Calvert Fire Ins. Co. Ill.App. 1 Dist. 1977, 367 N.E.2d 104, cert. denied 98 S.Ct. 2238, 436 U.S. 906.

Here the promotional obstacle takes a different turn, but can be just as imposing. A fledgling Risk Retention Group that cannot spread risk over a large number of members will have difficulty meeting capital surplus requirements. Its initial mandatory claims reserve will be high relative to its initial assets, dragging down surplus. Yet, its surplus must increase rapidly to match the initial growth in its business volume. Unless the Group simply stagnates, its early growth rate will exceed the rate at which its premiums are considered “earned” for accounting purposes and thus available to enhance surplus and keep pace. The necessary stabilization process can continue for several years and the interim shortfall in surplus must be made up by investor’s contributions. The chartering state will freeze the contributions until the surplus requirements are satisfied. Any investment return on “ownership interests” during the stabilization period will be problematical.

The case for a holding company organizational structure

There may be a better alternative. The LRRRA limits the “primary” business of a Risk Retention Group to the sale of liability policies, but the limitation does not apply to the Group’s parent “organization.” Many Risk Retention Groups are sponsored by professional and business associations that have a large base of existing members. If those associations were organized (or could be reorganized) as for-profit entities, they might do well to adopt a holding company structure under the LRRRA. In this structure, the association would form a Risk Retention Group as its wholly owned subsidiary. As the parent organization, the association would offer a broad range of financial and consulting services to all members, creating an income stream that could provide an immediate return to investors. The members (who would not be *required* to do so) could purchase policies from the subsidiary and equity securities (plus the other services) from the parent. The parent would capitalize the subsidiary with proceeds from the sale of the securities. As its insurance business matured, the subsidiary could transfer excess cash flow to the parent for distribution to investors, enhancing their return. The marketing potential and operating efficiencies inherent in such a structure would be attractive in any number of instances.

Disclosure implications - “material” facts and liability to purchasers

The precise disclosure duty imposed on a Risk Retention Group is to reveal to purchasers, a reasonable time prior to their purchase, all “material” facts associated with an investment in the Group’s “ownership interests.” “Material” facts, for this purpose, are facts to which a reasonable person would attach importance in determining whether to buy the interests. The duty can be breached by misstating, or failing to state, *any* material fact. If a breach occurs, the Group, its directors, officers, other participating managers and outside selling agents can be held liable to purchasers who were misled. If they have retained the securities, the purchasers can recover the full offering price, payable against surrender of the securities, even if they have not suffered a total loss. Purchasers who have sold out can recover their actual loss.

To guard against misrepresentation claims, the organizers of a Risk Retention Group should act *affirmatively* to investigate and verify the accuracy of the Group’s disclosure, a process known as “due diligence.” Due diligence should be conducted with the realization that the standard of disclosure for securities offerings is much higher than the standard that applies to commercial transactions or, for that matter, to the sale of insurance. Furthermore, the question whether disclosure is adequate is *always* raised in a context in which something has gone seriously wrong and investors have been damaged. If unresolved, the question will be determined by a court or jury using *hindsight* at a time when the cause of the damage is known. Experience has shown that the single most difficult intellectual task facing the directors and officers of a first-time issuer of securities is to grasp fully the implications of the duty to disclose material facts.

Above all, due diligence should not be viewed as an onerous and empty burden. If conducted grudgingly, a due diligence investigation is likely to be inadequate, with predictably bad consequences, but apart from that there is a definite plus side to being thorough. Business success is influenced by complex factors and all business is associated with financial risk. Experienced investors are leery of a management team that does not seem to recognize those elementary facts of life. Proper disclosure helps show that senior executives understand and can manage effectively the risks that threaten their company.

Disclosure format

The SEC has not left the *subject matter* of the disclosure to the discretion of corporate officers. The subjects that should be addressed are extensive and they appear by line item and suggested order of presentation in SEC regulations. The disclosure document is called a “prospectus” in registered offerings, an “offering circular” in small, “mini-public” offerings under SEC Regulation A and an investment, disclosure or offering “memorandum” in exempt offerings. The last term would be stylistically appropriate for a Risk Retention Group. While generalizations are always risky, the disclosure for most Groups would probably be adequate if it complied with SEC “safe-harbor” requirements for exempt private placements.⁹

Despite the commonly held assumption that no one actually reads them, securities disclosure documents should be prepared with extreme care. The text should be written in clear, simple sentences using the active voice. Jargon and technical language should be kept to a minimum. If technical terms must be used, a glossary should be included. The SEC’s “Plain English Handbook” provides helpful guidance to lawyers and companies alike. Risk Retention Groups would be well advised to consult it even though it is formally required only for the cover sheet, summary and risk factors sections of a prospectus used in a registered offering.¹⁰

The Group’s memorandum should begin with a cover sheet disclosing the identity of the Group, the securities offered, the size of the offering, the offering price, a legend disclaiming any implication that the offering has been approved by securities authorities and an effective date. The cover sheet should be followed by a short summary of the information contained in the memorandum as a whole. The summary should include a profile of the Group, contact information and investment instructions. The profile should highlight the Group’s insurance products and geographic markets, capital structure, corporate structure and operating history with cross references to the later sections that will discuss those subjects comprehensively.

“Risk Factors” should be set forth in a special section immediately following the summary. They include all material investment risks attributable to the Group, its business and the securities being offered. The risks must be labeled conspicuously and described succinctly in descending order of importance. Risk disclosure is discussed below beginning on page 12.

⁹ See, Rule 502(b) of SEC Regulation D, “Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933.”

¹⁰ There are at least two people who can be relied upon to read every word of a disclosure document. The plaintiff’s lawyer is one and the judge is the other. The Handbook can be obtained from the Office of Investor Education and Assistance, U.S. Securities and Exchange Commission, 450 5th Street, N.W., Washington DC 20549.

A “Use of Proceeds” section describes and prioritizes the specific uses to be made of investors’ money. The net proceeds of most Risk Retention Group offerings will be devoted to the capital surplus required by the Group’s chartering state. The amount of that surplus, and hence the size of the offering, will be driven by the Group’s current balance sheet and its estimated gross written premium for the ensuing year. As a rule of thumb, the beginning surplus required for a startup will be about one third of its estimated first year premium revenue.

Additional short sections summarize the Group’s capitalization before and after giving effect to the offering and discuss the manner in which the offering price for the securities was determined (usually with an admonition that the determination should be regarded as arbitrary). There should also be a summary of the method proposed for selling the securities, called a “Plan of Distribution.” Most Groups sell their securities through their executives without employing brokers or finders or paying selling compensation. If intermediaries are used that fact, and any compensation, should always be disclosed. An assessment of the Group’s ability to sell its offering is important to investors.

The names, ages, current and previous executive positions, compensation, and ownership interests of the Group’s directors, senior executives and other managers with decision making authority should be presented together with the identity of the Group’s outside counsel and independent auditors. The memorandum should also disclose the identity of the Group’s insurance consultants and the amount of their ongoing compensation if it is paid as a percentage of gross revenue or is otherwise material. The routine compensation of the Group’s counsel and auditors will be disclosed in the financial section as general and administrative expense, usually as a separate line-item. Transaction based compensation will be disclosed in the use of proceeds section as a cost of the offering.¹¹

Attention should be paid to disclosure of actual or potential conflicts of interest that confront the Group’s key executives and advisers. These persons often occupy dual roles, providing services for compensation on the one hand and making self-benefiting decisions as managers on the other. Conflicts of interest are commonplace in business and it is the rare Group that will not encounter them. There is nothing inherently wrong with a Group taking action in disregard of a conflict that has been disclosed in advance if the action is approved by a majority of disinterested directors, managers or partners. Nevertheless, disclosure to investors of known conflicts, and of any actions taken in disregard of them, is critical to avoid the appearance of impropriety.

Discussion of business and properties

Substantially longer sections of the memorandum will be devoted to a detailed discussion of the Group’s actual or proposed insurance business and to its facilities, infrastructure, properties and personnel. The specific subjects, and their relative importance, will obviously vary from Group to Group. It is not practical to review them comprehensively here, but representative topics would include the following:

¹¹ The consultants engaged by a Group will include a variety of business and risk managers, actuaries, underwriters, brokers and adjusters. Virtually all Groups will depend on consultants, at least initially, for the conduct of their operations. As a Group grows in size and sophistication, it may gradually bring key business functions in-house, but the use of outside professionals by a startup Group is essential. See, “Managing offerings and controlling costs,” below at page 15.

- √ The history, membership, objectives and strategy of the Group and any parent entity;
- √ The liability insurance products offered by the Group plus any products or services offered by the parent;
- √ The states in which the Group and any parent conduct, or plan to conduct, operations;
- √ Underwriting, pricing and claims administration;
- √ Net retention and reinsurance amounts, carriers and ratings;
- √ Current and anticipated capital and reserve requirements;
- √ The accounting methods used by the Group with attention to the differences between the “statutory” and “generally accepted” accounting principles summarized below;
- √ The tangible assets, intellectual property and personnel to be utilized by the Group;
- √ The Group’s fiscal and investment policies;
- √ The Group’s competitive environment, special competencies and major challenges and
- √ Government regulation including the impact of the LRRRA.

Financial disclosure

The heart of the disclosure in any securities offering is comprised of financial information. The financial narrative should include management’s discussion and analysis of the Group’s financial condition and results of operations with attention to the Group’s liquidity and capital resources, its “off balance sheet” arrangements, if any, the “key indicators” that management uses to assess trends and the “critical” accounting policies the Group has adopted. The major indicators for most Groups will include changes in membership levels and investment portfolios, in claims reserves and in the reported claims that trigger changes in reserve requirements.

The chartering state will determine the Group’s financial condition and surplus requirements in accordance with “statutory” principles of accounting. Among other things, statutory accounting principles impose valuation criteria for investments and claims, and timing requirements for the recognition of income and expense, that are significantly more conservative than those imposed by generally accepted accounting principles or “GAAP.” While statutory principles are for the most part applied uniformly, there can be significant differences from state to state that may be important to Group organizers when selecting an appropriate domicile. The Group’s financial presentation should include both methods in a side-by-side comparison to avoid confusion.¹²

The financial statements for the Group are appended to the memorandum as an Exhibit. They must include, as a minimum, an audited balance sheet dated within 120 days of the start of the offering and a statement of income, cash flows and changes in stockholder’s equity covering the previous two fiscal years or, if shorter, all fiscal periods from inception to a date within 60 days

¹² Many accounting firms are not familiar with statutory accounting principles. Others are expert in them and specialize in auditing insurance companies, including Risk Retention Groups. The NAIC’s two volume “Accounting Practices and Procedures Manual,” its “Financial Examiner’s Handbook” and its pamphlet on “States’ Prescribed Differences from NAIC Statutory Accounting Principles” are helpful and should routinely be consulted. They can be obtained from NAIC’s Insurance Products & Services Division at (816) 783-8300, Fax (816) 460-7593, www.naic.org, prodserv@naic.org.

of the offering. All financial statements should be presented on an alternative basis in accordance with both GAAP and “statutory” accounting methods.

For offerings up to \$2 million, the income statement should be "reviewed" by independent accountants, though it need not be audited. For offerings up to \$7.5 million, the Group should furnish the audited balance sheet plus audited income statements for its prior two fiscal years or from inception. For offerings above \$7.5 million, the Group should furnish the audited financial statements required for a registered offering of comparable size. In any offering, the Group should provide an unaudited interim balance sheet dated as of the end of its most recent quarter, plus unaudited interim statements of income and cash flows for the stub period from the prior year end to the balance sheet date.

To provide a financial context for the memorandum as a whole, a Group that has been in business for more than one year should include in the body of the document a tabular summary of financial highlights with comparative results for the prior year. Finally, even if not required legally, a new Group should begin furnishing investors with full, audited annual financial statements as soon as possible. The attractiveness of any securities offering is substantially enhanced when financial statements are accompanied by an auditor’s opinion of fair presentation.

Rights and limitations of the securities

The LRRRA makes no attempt to define “ownership interests.” Accordingly, the attributes of those interests will be found in the Group’s charter documents and in the statute under which the Group is organized. The memorandum will contain a special section devoted to the rights and limitations of the securities being offered. The section will, of course, contain a full explanation of the consequences arising from the requirement that “ownership interests” be owned solely by Group members who also are “provided insurance” by the Group. The specific subjects will include:

- √ Voting rights;
- √ Dividend and liquidation preferences, if any;
- √ The procedure and pricing mechanism applicable to mandatory redemptions on expiration or lapse of the insurance;
- √ The comparative rights and limitations of other classes of authorized or outstanding securities, if any, and
- √ The restrictions on voluntary resales or other transfers imposed on the securities.

Tax factors

Risk Retention Group investments, as such, are neither “tax advantaged” nor associated with unusual tax risk, but a summary of relevant factors should be included in the Group’s memorandum with an admonition that investors should consult with their own advisers respecting the tax effect of their purchase and disposition of ownership interests. The tax status of the Group as an entity, and that of any parent, should be discussed first. In brief, a Risk Retention Group is taxed as an insurance company in accordance with Subchapter L of the Internal Revenue Code. The Group may also be subject to income taxes imposed in some of the states in which it sells insurance and it will pay a premium tax in virtually all of them. The premium tax rate varies, but on average approximates 2% of the Group’s gross premium revenue.

Ordinary corporations serving as parent organizations are taxed separately in the usual manner under Subchapter C of the Code. By contrast, the net income of general partnerships, limited partnerships and limited liability companies is passed through and allocated to partners or members in proportion to their ownership. Because of the large number of members typically involved, it is not feasible for a Group or its parent to be organized as an S corporation.

The discussion should address the tax concerns of investors by explaining the tax treatment of dividends and distributions from the Group and of gain or loss earned or sustained on resales or redemptions of the investors' securities. The disclosure should include the fact that partners or members of a Risk Retention Group organized as a pass-through entity will pay tax on their allocable share of Group income in the year in which the Group realizes it regardless of when, or whether, the income is actually distributed. That may result in tax liability for a given year that exceeds distributions.

Distinguishing between ownership interests and insurance policies

Ownership interests confer the right to participate in a Group's assets, earnings and management and carry investment risk. Insurance policies confer the right to shift claims exposure to the Group and its reinsurers and carry the risk of inadequate or failed coverage. Throughout its memorandum, the Group should distinguish clearly between the rights and risks purchasers will have or accept as owners and those they will have, accept or try to manage as policyholders. The failure to recognize the LRRRA's separation of policies from ownership can produce a badly garbled memorandum. It can also lead to the practice of selling a bare policy at a premium plus an undifferentiated "surplus contribution" that appears merely to be an additional payment for coverage. That extends the confusion to purchasers, cementing in their minds the false impression that the attributes of the Group's policies and those of its "ownership interests" are the same. As a result, if the Group has not provided securities level disclosure about its coverage, it may find itself in the absurd position of defending fraud claims brought by policyholders whose only real grievance is a lower than expected claim settlement.

A Risk Retention Group is well advised to furnish a certificate evidencing its ownership interests that is separate from its policy form. In any case, the Group should base its ownership disclosures on the federal securities laws and its policy disclosures on relatively lenient state insurance laws. State insurance departments approve policy forms, rates and any amendments prior to use. The NAIC has developed model forms that have become the standard for the industry. The International Organization for Standardization ("ISO") offers data collection and risk management services useful for setting rates and publishes an innovative "System for Electronic Rate and Form Filing." The NAIC forms and ISO based rates and filings are routinely accepted by state regulators. The LRRRA and the McCarran Ferguson Act clearly reflect Congress' intent to delegate the regulation of policy disclosures to the states.¹³

On the other hand, the insurance *market* for Risk Retention Groups is limited to commercial liability policies sold to Group members. In addition, risk Retention Groups may not be fully regulated by state laws and state insurance insolvency guaranty funds are not available to protect

¹³ The added policy disclosures required by securities laws might include a carrier's litigation experience, its average payouts expressed as a percentage both of premiums and original demands, risk coverage and payout comparisons with competing carriers and adverse coverage developments or trends perceived by its management.

their policyholders. The LRRRA requires that all policies bear a legend disclosing those limitations. The resulting competitive disadvantages affect ownership interests adversely and that fact should be made clear in the Risk Factors section of the memorandum.

Risk disclosure

The most difficult disclosure task for most Groups will be to identify, analyze and describe the investment risks that should be highlighted. One way to begin is by challenging the Group's financial forecast. What are the critical assumptions that drive that forecast? What are the factors that could change the assumptions or make them inaccurate? What are the internal and external conditions that must be created, or remain in effect, for the Group to achieve its objectives?

The risk factors discussion as a whole should be divided between risks attributed to the Group as a legal and business entity and those attributed to its parent organization or other affiliates, to its insurance business and to the securities that represent its "ownership interests." An exhaustive recitation of every conceivable business risk is unnecessary and will be misleading if it obscures the risks that actually apply. The risks that do apply should be described prominently and succinctly. Here are some examples of major risks facing startup and emerging Groups:

Risks related to the Risk Retention Group and its affiliates

Small, non-public company

Because of the limitations attaching to its ownership interests, a Risk Retention Group will not have access to public investors. Its securities will not be useful as a form of currency to attract executives, make acquisitions or collateralize loans. Even if it is successful, the Group will lack the financial resources possessed by most public companies, including its major competitors. Its ability to attract investment from members will be impaired because the overall risks associated with it will be inherently greater than those associated with publicly traded issuers.¹⁴

Significant competition

The insurance business is highly competitive. A Risk Retention Group will face competition in all geographic markets from much larger companies. To compete effectively, the Group must offer commercial automobile and general liability coverage at competitive overall rates using relatively limited capital, technical and personnel resources compared to some of its competitors.

Dependence on future offerings

Unless the Group has an exceptionally large base of enthusiastic and claim-free members eager to buy policies, it will incur startup losses. The proceeds from an initial offering are rarely adequate to finance the operations of a Group until it is self-sustaining. The Group's failure to achieve

¹⁴ As an aside, nothing would be gained by a *voluntary* registration of Group securities. Registration, periodic reporting and ongoing compliance costs are very high for public companies and the only sound reasons for incurring them are to provide liquidity to investors and gain access to the public capital markets. Group securities may be issued and resold only into a microscopically small market comprised of insured members. A Group that engaged in a registered offering would have all of the burdens, and none of the benefits, of being public.

forecasted policy sales within anticipated time periods, at predicted premiums and for anticipated costs may leave it chronically short of capital for the first years of its existence. Investors will assume the risk that the Group will be unable to replenish its capital through additional offerings.

Restrictive capital surplus requirements

Capital surplus exists to protect claimants, policyholders and other creditors, not owners. Statutory accounting principles require higher surplus than GAAP. The cash flow that can be devoted to general activities by a Risk Retention Group is therefore limited compared to other entities. Moreover, the contingent liabilities that reduce Group surplus include actuarially estimated reserves for the cost of claims. The number of Group policyholders may initially be too small to provide a stand-alone database for the estimate. The actuaries may base the estimate upon the less favorable claims experience of the Group's entire industry segment. As a result, the Group's mandatory reserves may be substantially higher relative to its total assets and business volume than the reserves required for established carriers.

Dependence upon reinsurance

The Group will be liable to policyholders for the full amount of each covered loss subject to the liability limits and other terms and conditions of its policies. To limit its risk, the Group will rely upon reinsurance contracts through which other carriers assume liability for claims in excess of a pre-set maximum in exchange for a negotiated premium. Even with reinsurance in place, however, the Group will remain liable for all claims and must pay them if its reinsurance carriers are insolvent. The reinsurance market is volatile and unpredictable. The Group may not be able to obtain adequate reinsurance each year at budgeted cost levels.

Limited operating history and industry data

The operating history of a new Group may be too limited to provide a reliable indication of its future performance. While it will have been assured by its consultants that its business plan is feasible, the Group may lack sufficient data to support estimates respecting its growth rate, future loss experience or financial results. The Group's actual results could fall short of its expectations for a number of reasons, including lower than anticipated revenue or reinsurance collections, or higher than anticipated claims expense, capital surplus requirements, unearned or retroactively adjusted premiums or reinsurance premiums.

Lack of relevant business experience

While the directors and officers of a Risk Retention Group usually have substantial experience in the industry segment that defines Group membership, their experience in the insurance business may be limited. To be successful, the Group must maintain premiums and capital surplus at high enough levels to cover its potential claims and business expenses and produce a reasonable profit. At the same time, the Group must keep premiums at low enough levels to remain competitive in the marketplace. That is a specialized and complex process for which the Group will depend initially upon independent consultants. The Group's directors and officers may lack sufficient knowledge or experience to evaluate the qualifications and supervise the activities of the consultants adequately.

Lack of experience in selling securities

The officers, directors and agents of a Risk Retention Group often have little, if any, direct

experience in selling securities. Purchasers thus assume the risk that all of the capital sought by the Group in a given offering may not be raised and that the Group may be cash short as a result. One hedge, discussed below, involves a so-called "contingency" offering. Investors' funds are held in escrow and will be refunded unless the minimum capital necessary for the Group to achieve basic objectives is raised.

Limited insurance market

Under the LRRRA, a Group may sell only "commercial liability" insurance. Such insurance may cover commercial automobile and general liabilities arising from a business, trade, profession, product or premises, but not liabilities arising from personal, family, or household activities or the duties of employers to employees. Moreover, the Group may sell its policies only to members.

Lack of financial strength rating

Financial strength ratings by recognized agencies are commonly used to evaluate carriers. Established carriers are rated in accordance with objective "quantitative standards," but these do not apply to startups. The A.M. Best Company, for example, uses "qualitative standards" for startups that are "stringent," and "transcend" all others because startups "have yet to demonstrate a track record in operating performance." Most Risk Retention Groups will be unable to obtain a rating until they have a "track record" of at least three year's duration. Members purchasing Group insurance in the interim must rely for financial assurance upon the surplus requirements imposed by the chartering state plus any favorable ratings of the Group's reinsurance carriers. As owners, members will assume the risk that the Group may be at a competitive disadvantage until it receives a favorable Best's or equivalent rating in its own right.

No state insolvency fund protection

The LRRRA requires that Risk Retention Group policies contain a notice to the effect that the Group is not subject to all insurance laws and that state insurance insolvency guaranty funds are not available for it. The notice may curtail sales. The absence of insolvency protection can harm the Group's ability to sell policies in competition with conventional carriers that are protected.

Risks related to the "ownership interests"

No effective resale market

While not a violation of law, the fact that the Group's ownership interests are not registered deprives them of a public resale market. In addition, members may not resell their interests except to another member who is or immediately becomes a Group policyholder. Members will not be able, at their option, to "put" their interests to the Group for redemption except by surrendering their own policies. The Group will sell additional interests continuously in competition with members' resale efforts. As a result, ownership interests are highly illiquid. Members may be required to bear the financial risk of their investment in them indefinitely.

Mandatory redemption

A Risk Retention Group must redeem its ownership interests automatically if the holder's policy expires or is terminated. The mandatory redemption price may be based upon the book value of the securities or some other formula, but is likely to be conservative. In any case, there will be a deduction or offset for unpaid premiums or other charges that the holder owes the Group. The

Group typically will retain the right to pay the price in installments, perhaps over several years, until claims on the policy are time-barred. All redemption payments will be subject to all requirements imposed by law for the preservation of capital surplus and the protection of creditors. The redemption price and terms of payment may be less favorable to the holder than the price and terms the holder could negotiate with another member.

Arbitrary offering and redemption prices

Because there is no public market for the securities, the determination of the offering and mandatory redemption prices by the Group will not be based upon any verifiable market valuation, standard or data. There will be no reliable correlation between those prices and the Group's present or future profits, cash flow or enterprise value.

No assurance of dividends or distributions

The charter documents of a well advised Group will provide that, although dividends may be paid on ownership interests from time to time, payment will be neither mandatory nor cumulative. That means the Group will not be obligated to pay dividends in any year, or to "cumulate" unpaid dividends and carry them forward for payment in future years, even if profitable. There will be no assurance of profitability and no sinking fund for the payment of dividends or other distributions to owners. In addition, "common" interests may be inferior with respect to dividends, liquidating distributions and voting rights than senior securities.

Disclosure updates

A disclosure document speaks only as of its effective date. Because a Risk Retention Group is engaged in a continuous offering of securities, it must update its disclosure when necessary to provide investors with current material information. As a minimum, the disclosure should be reviewed and updated quarterly. Fluctuations in the Group's financial condition and results will be reported in quarterly financial statements. These need not be audited, but should be appended to the memoranda as soon as they are complete and posted on the Group's website in a password protected information center devoted to registered owners. Other intervening events are inherently material and will require immediate updates. These include resignations or terminations of directors, disagreements with accountants, the entry, termination or breach of material contracts, ratings downgrades affecting the Group or its reinsurers, material increases in required surplus and investment losses or large reported claims that could trigger such increases.

Managing offerings and controlling costs

Before it may offer insurance, a Risk Retention Group must obtain approval from its chartering state of a detailed "plan of operation." The Group must submit copies to all other states in which it proposes to conduct business. The plan must include the "coverages, deductibles, limits, rates and rating classification systems for each line of insurance the group intends to offer..."¹⁵

The task of preparing the plan, shepherding it through the regulatory process and getting it approved is a major undertaking that will not be completed without close guidance from the

¹⁵ 15 USC 3902(d).

Group's insurance consultants and a substantial expenditure of time and effort by its executives. A Group engaged in this process may overlook the fact that a securities offering requires just as much planning. Furthermore, the cost of a given offering will resist scale economies because the information that must be compiled, analyzed and disclosed to investors is fundamentally the same regardless of the size of the transaction. The time frame for completion will be limited and the transaction fees of the advisers engaged for the offering will be time-based. If the work is to be completed on schedule and within budget, there will be no tolerance for mistaken assumptions about what is to be done, or by whom, or for redundant research, unnecessary amendments or endless rewrites. Under the circumstances, the emphasis from beginning to end should be upon a firm allocation of project responsibilities and rigid adherence to a formal schedule. While that admonition seems obvious, it is easy to ignore when a hard market for liability insurance has reached crisis proportions. Here are some time-honored suggestions:

Engage advisers for the offering early

Engage securities counsel and outside auditors early in the planning process to align the Group's organizational and capital structure with the financial objectives of the offering and help focus the due diligence process. The financial objectives will be determined initially by the capital surplus required by the chartering state, but the Group should also take account of its longer term prospects, including any supplementary products or services that could be offered members through a parent organization. Advisers engaged for the offering will of necessity work closely with the Group's insurance consultants. The Group should schedule an organizational meeting of all participants at the beginning of the project. The ensuing collaboration should be well underway before the first draft of the plan of operation is completed.

Coordinate the project actively through Group executives

Establish a command and control hierarchy headed by a senior Group executive with overall project responsibility. Ideally, there will also be a single person functioning as editor to fine-tune the offering documents and avoid a makeshift appearance. In most cases, regularly scheduled, "all-hands" meetings, conducted in person or by conference telephone, will be the most effective means of identifying problems and keeping the project on schedule.

Conduct a feasibility study for the offering

Obtain non-binding letters of investment intent from a representative sampling of prospective Group members. The letters will be based on the members' review of an offering summary and term sheet derived from the draft plan of operation. The summary will be cursory compared to a full blown memorandum, but will contain sufficient information to make the letters meaningful. The summary will not be wasted if the offering goes forward. If the responses are negative, the offering can be abandoned before additional resources are devoted to it.

Obtain expert opinions before pricing the offering

Determining a realistic offering price for its securities is difficult for any non-public company and a Risk Retention Group is no exception. The emphasis for discrete offerings designed to raise a lump sum will be upon establishing a plausible enterprise value for the Group that is at least equal to its pre-offering members' equity plus the anticipated offering proceeds. The emphasis for continuous, mandatory offerings to policyholders will be upon the relationship between the offering price, the current book value of the securities and the accompanying premium. There will be no external guidelines for the determination in either case since the financial results of

other Groups will not be available and those reported by public insurers will not be comparable.

The Group must also take account of some intractable constraints. First, the source of the investment return on ownership interests will be limited to internally generated cash. The Group will never go public and the restricted nature of its securities and insurance market will frustrate alternative liquidity strategies based on acquisitions, partial liquidations or refinancings. Second, unless the Group can rely upon distributions from a parent organization, it will be slow to develop cash flow in excess of required surplus. As a result, its securities will be viewed as long-term investments. Third, the Group itself will provide the ultimate market for its securities through mandatory redemptions and the redemption price will be the benchmark for intervening resales by members. Fourth, there will probably be more than one round of financing. The pricing mechanism for each round should be understood from the outset so that initial investors can be told how their securities have been priced in terms that compare the valuation method with the method that will be used for subsequent offerings. Fifth, there is a universal bias among sophisticated investors against "cheap stock." Equity securities offered by a Group for less than \$10 are associated with "penny stock" frauds and viewed with suspicion. Sixth, the Group's dividend policy will depend upon its business cycle; the time required for the receipt and recognition of premium or investment income and reinsurance proceeds versus the recognition, quantification and payout of claims and normal course operating expenses.

Taking all this into account, the Group should solicit opinions from qualified experts confirming the reasonableness of the Group's pricing strategy and financial forecast. Assessments of proposed coverages and rates by insurance brokers and risk management firms will obviously be essential and will already have been obtained. The Group's accountants will have a comprehensive grasp of the technical side of the financial valuation process. Their measurements of balance sheet risks and future cash flows will discipline the effort to make the Group's financial forecast realistic. Reliable pricing advice may also be provided by an investment banking firm familiar with the insurance industry and with the Group's specific business segment, assuming one can be found. Investment bankers make their living in the trenches. Time and again they subject their own capital, and the capital of their investors, to the risk that their judgments are wrong. They survive by avoiding catastrophic or repeated error and they flourish only when they are consistently accurate. Successful investment bankers possess an invaluable blend of technical competence and marketplace realism.

Conduct a corporate review or "cleanup"

The Group should direct its litigation, insurance and general corporate counsel to conduct a formal review or "clean-up" in their respective areas to identify disclosure issues promptly or, in the alternative, confirm that the Group's pending litigation is not material and that its employment and brokerage agreements, insurance policies, leases and other major facilities contracts are enforceable as written, do not need updates and can be explained clearly to investors.

Prepare an alternative financial forecast and projections

The Group's insurance sale forecast and related financial projections should be prepared in an "ABC" format, with the A alternative representing the base case, B the optimum case and C the worst probable case. There are two reasons for this: First, SEC Rule 175 creates a "safe harbor" in registered offerings for financial forecasts that are provided in good faith, have a reasonable basis in fact and are accompanied by warnings that "caution" investors not to accept them at face value. The safe harbor concept builds upon court rulings and has spilled over into the exempt offering arena. Second, the overwhelming probabilities are against the Group achieving the

optimum results predicted for it. Promoters of a new enterprise simply do not recognize all the variations of "Murphy's Law" that can impede their progress. Investors will be more receptive to a Risk Retention Group if its forecast recognizes that fact.

Structure the offering on a contingency basis

An offering can be so structured that investors' funds will be held in escrow and refunded unless sufficient capital is raised, and other conditions are satisfied, for the realization of the Group's minimum objectives. A contingent offering provides some assurance that investors' funds will not be squandered needlessly while permitting the Group to seek additional funds to satisfy more aggressive objectives if the contingency is satisfied. The Group should be careful to disclose the fact, if this is the case, that executives, advisers or others with an existing financial stake in the Group may purchase securities. Under those circumstances, investors could not assume, merely because the offering had closed, that all securities had been purchased by disinterested persons exercising independent investment discretion.

Include provisions for extending the offering

In an unregistered, self-sold offering, delays in obtaining investor's funds are the rule rather than the exception. The scheduled selling period for a typical exempt offering is about three months, or one business quarter. A Risk Retention Group should retain the right to extend its offering for an additional 30 to 90 days if all funds are not raised by the initially scheduled expiration date, always with the recognition that the Group's disclosure must be amended in response to intervening changes in material facts. Most amendments are limited to normal course changes in financial results disclosed by attaching updated quarterly statements to the memorandum. Narrative changes usually can be disclosed through "sticker amendments."

Assess the Group's management team critically

The managers of early stage Risk Retention Groups may lack the business sophistication associated with mature firms. Most new Groups will benefit from a frank discussion with their outside advisers respecting the composition of their proposed management team. When a management team must be expanded to round out its capabilities, the first and most important outside hire is usually the Chief Financial Officer. Few things discourage investors more than missed targets, budget overruns or continuously revised financial projections. To minimize such disasters, the Chief Financial Officer must have, in addition to basic financial literacy, a thorough understanding of the interplay between the Group's capital requirements, revenue sources and operating expenses. As gatekeeper to the Group, this officer must also communicate effectively with regulators, members and policyholders.

Dealing with resales and redemptions

While investing in ownership interests is a long-term proposition, a mature Risk Retention Group will experience a steady stream of resales and redemptions triggered by members who are retiring, selling their businesses or switching to a conventional insurance carrier. A Group that does not have a system in place for facilitating resale and redemption transactions will be at a decided disadvantage when selling its securities in the first instance. To be effective, the system should involve more than a general undertaking to provide ad hoc or case-by case assistance. The system should be self-executing with respect to resales so as not to involve Group executives. At the same time, the system should permit members to access the current redemption price that would be paid by the Group.

Establish a resale bulletin board

Most successful systems will be based on a paper or electronic bulletin board through which prospective sellers and buyers can contact each other and access current information about the Group and its financial condition. The legal issues presented here derive from the fact that Group will neither be registered nor exempt from registration as a securities exchange and neither the Group nor its owners will be registered or exempt from registration as a securities brokers or dealers. It will therefore be critical that the bulletin board not be seen as a medium for “affecting” securities transactions within the meaning of registration requirements. Moreover, reselling owners are bound by the anti-fraud provisions of the federal securities laws as fully as the Group itself and must provide full, current disclosure to their buyers of material facts.

Restrict access to qualified owners and disclaim responsibility for unauthorized information

The bulletin board will contain sensitive and confidential information. Access should be restricted, by paper or electronic password, to qualified owners. The bulletin board should also contain a prominent notice disclaiming any implication that unauthorized information can be attributed to the Group. As a matter of policy, the Group should not participate in, approve or ratify the publication or distribution in any other media of any information about the Group or its ownership interests that is not contained or referenced with approval in the Group’s disclosure memoranda. Online links to other websites should be accompanied by a notice that they are furnished as a courtesy only and not as an endorsement.

Publish rules for use

The Group should publish formal rules for use of the bulletin board substantially as follows:

- √ The bulletin board is provided solely to owners qualified as such at the time of use;
- √ Owners may not list simultaneously both the price at which they would buy and the price at which they would resell their interests; and
- √ Sellers and buyers must close resales, directly or through a bank, for their own account. They may not post listings or bids, or negotiate resales, for others. The Group itself will not facilitate negotiations, provide advice, handle closings or hold or transfer funds relating to any resale. After a resale has been reported, the Group will, if the buyer is qualified as an owner, cancel the seller’s ownership certificate (against surrender of the original endorsed for transfer) and issue a replacement to the buyer.

Advise owners of the inherent limitations of a bulletin board

Include a warning that, in accordance with the Liability Risk Retention Act, the ownership interests are not registered with the SEC or listed on any exchange. There is no public market for the interests and the bulletin board does not create a reliable alternative market. Posted bid and asked prices are not firm, may not be current and in any case are not supported by market data. Book values disclosed in Group financial statements should not be viewed as indicative of the market value of the Group’s ownership interests.

Structure the redemption mechanism and price formula in advance

The charter documents for the Group should define the events that would trigger a mandatory

redemption of ownership interests. They should also provide that, upon the occurrence of any such event, the holder must surrender certificates for the interests to the Group, duly endorsed for redemption and cancellation, against payment of the redemption price. The payments will be subject to all legal requirements for the preservation of the Group's capital and the protection of its creditors. The charter should authorize the Group to adopt reasonable procedures respecting its confirmation of a redemption event, for cancellation of the affected interests and for deposit of the redemption Price, without interest, in a segregated bank account for the benefit of any person entitled to the same who has not surrendered the certificates and, after reasonable investigation, cannot be found. Thereafter, the Group should be relieved of any further obligation.

Conclusion

The regulatory environment for Risk Retention Groups contains a mixed bag of benefits and limitations, but the benefits are significant and the limitations can be managed with careful planning. Interest in Risk Retention Groups continues unabated fueled by the success of established Groups and by continuing increases in the cost of alternative coverage. It should not be forgotten that the insurance business can indeed be lucrative and the advantages of raising capital without registration from a captive membership of unlimited size can be stunning.

One commonly overlooked but promising strategy involves the adroit use of a holding company. Risk Retention Groups are usually sponsored by persons and organizations that already possess an in-depth knowledge of the needs and attributes of their target membership. Over the long term, the most intriguing by-product of the LRRRA may be the emergence of national enterprises that began by providing insurance through a subsidiary and eventually developed the capacity to provide comprehensive financial and administrative services to entire industries.

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