Alternative Insurance in the United States and Bermuda and the Threat to Traditional Regulatory Schemes

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In 1985, the U.S. excess liability insurance market collapsed. Excess liability insurance is the business of insuring companies for liabilities in excess of a given amount that result from accidents such as factory explosions or toxic spills.\(^1\) Since the financial consequences of one catastrophe could bring down even the largest businesses, companies have always been loathe to bet on the chances of a disaster, no matter how remote, and consider excess liability insurance a necessity.

Different theories have been offered to explain the liability insurance crisis.\(^2\) While it is important to know the reasons why insurers and insureds got into trouble, it is more interesting to consider the ways in which the insurance industry and insurance regulation have responded in order to help participants get out of trouble and maximize the chances of avoiding a new crisis. The traditional regulation of insurance, conducted largely at the state (rather than the federal) level, has drawn two frequent complaints:

\(^1\) Generally, companies may buy their liability insurance in layers of coverage under different policies. For example, a policy from Insurer A could cover liability claims of up to $50 million, while an excess liability policy from Insurer B may cover claims from $50 million to $150 million. Ideally, the policy from Insurer B will not be triggered unless the policyholder incurs losses greater than $50 million and exhausts the limits of its policy with Insurer A. However, problems can and do occur when policies from different insurance companies do not clarify their relationship to one another, delaying the payment of claims, prompting litigation, and possibly imposing costs and duties not anticipated by the insurers or the insured. See, e.g., BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 11.03 (1994) (discussing conflicts in clauses making reference to “other insurance”).

Excess liability differs from reinsurance. In a reinsurance scheme, the policyholder contracts for all of its coverage with a primary insurer, which subsequently sells (“cedes”) part of the risk to a reinsurer in exchange for giving up a portion of the premium. When a sufficiently large claim is made, the policyholder looks only to the primary insurer, and it is up to the primary insurer to collect from the reinsurer. With excess liability, there is no contractual privity between the primary insurer and the excess liability insurer. It is up to the policyholder to collect from the excess liability insurer when it has exhausted its primary insurance.

One is that the regulation of insurance is inflexible and prevents buyers and sellers of insurance from adjusting to changing market conditions in a timely fashion. The other is that the separate state procedures for licensing, policy approvals, and other regulatory obligations impose heavy burdens on companies that wish to operate in multiple jurisdictions.

The public and private sectors reacted to the 1985 crisis in various ways. Congress enacted legislation that expanded the ability of companies prone to similar risks to band together and either form their own insurance pool or purchase insurance collectively. Some states, such as Vermont and Hawaii, have broken with tradition by enacting laws that encourage the development of alternative methods to manage risk, such as captive insurance. These states have aggressively promoted their regulatory schemes, particularly in light of changes in the federal tax code that have made domestic facilities at least as appealing as offshore mechanisms. Many players in the business have taken advantage of these various opportunities, while others have pursued new strategies offshore.

The most notable of the offshore initiatives was the inception of ACE Limited (ACE). Soon after the crisis broke, the insurance broker Marsh & McLennan persuaded some of its corporate clients to pool their capital and form their own excess liability insurance company. Since these clients needed their coverage immediately, and acquiring a license and policy approval in even one state would have taken at least several months, the company, ACE, incorporated in the Cayman Islands and operated out of Bermuda. Under Bermuda's lean regulatory structure ACE quickly began to write coverage for liability in excess of $100 million. The next year, in 1986, Marsh & McLennan assisted in the creation of a similar facility, X.L. Insurance Company Ltd. (X.L.), 3 which writes lower layers of excess coverage than ACE. ACE and X.L. provided

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3 X.L. was originally incorporated in Barbados. It is now incorporated in Bermuda, where it has always operated. X.L. is a wholly-owned subsidiary of Exel Limited, a Cayman Islands corporation.
desperately needed capacity, and both became financial successes that eventually went public: X.L.'s parent company, EXEL Limited, made an initial public offering in 1991, and ACE went public in 1993.

ACE and X.L. changed conventional insurance business by using policy contracts that were more favorable to the insurer than traditional policies. They also deliberately chose to operate in a domicile that lacked the perceived problems of American regulation; Bermuda has no income taxes, it was fairly easy to start up an insurance business there, and there is little continuing oversight. Surprisingly, probably because of the large amounts of capital required, virtually no one tried to copy the offshore success of ACE and X.L. until recently, although one domestic syndicate was formed in 1986 to provide more excess capacity. At the time of ACE's formation, Bermuda was already home to over 1000 captive insurance companies, but the island did not really become a hot insurance market until the early 1990s, after a series of natural disasters beginning in the late 1980s wore out the U.S. catastrophe reinsurance market. Smelling an opportunity, insurers and reinsurers rushed nearly $4 billion of capital to Bermuda in 1993 alone, setting up eight catastrophe reinsurance companies. Although there were some indications that these new reinsurers were overly optimistic about their prospects, the current conventional wisdom is that Bermuda is an international insurance market that's here to stay, particularly in light of the troubles of Lloyd's of London in recent years. More importantly, there is growing understanding that the Bermuda facilities, along with

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4 Recent changes in the regulation of insurance in Bermuda have made it more difficult now to establish an insurance company there. See infra text accompanying notes 207-16.

5 See BERMUDA: THE WORLD'S PREMIER DOMICILE (promotional pamphlet obtained from the Bermuda Registrar of Companies) (on file with author) [hereinafter BERMUDA]. A captive insurance company is a corporation owned by one or more corporations that insures the risks of its parent or parents. See infra part II.A.


other so-called "alternative insurance mechanisms" developed in the United States, are now established techniques that will most likely continue in industry practice permanently.

Recently, the National Association of Insurance Commissioners (NAIC) and Congress have taken a harder look at these alternative insurance mechanisms, and they have drafted proposals to address perceived dangers to the public, prompting a spirited response and debate. In the last session of Congress, for example, Representative John Dingell (D-Mich.) introduced an ultimately unsuccessful bill to bring insurance regulation under federal control. At the same time, some regulators and industry professionals have loudly called for greater recognition of the soundness of alternative insurance and more flexible regulation to permit its operation.

This paper endeavors to outline the key developments in commercial high-risk insurance since the 1985 crisis that have led to the establishment of a significant alternative insurance market, including recent events in the area of catastrophe reinsurance, and it seeks to assess the impact of these developments on the traditional regulation of insurance in the United States. Part I begins by tracing the historical developments that led to the liability insurance crisis of 1985, beginning with a brief overview of U.S. regulation by the states. Part II will describe the regulatory and industry responses to the crisis, including the creation of the Bermuda excess liability insurance companies and the efforts of certain states to develop other means to provide capacity. Part III then presents the emerging trends in commercial insurance and examines the current debate over the role of insurance regulation in light of U.S. policy concerns.

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I. The Liability Insurance Crisis of the 1980s

A. The Regulatory Background in the United States

For reasons of historical accident, followed by inertia, insurance business in the United States has been primarily regulated by the individual states, and not by Congress as interstate commerce.9 One might suppose that this would present large insurers and insureds with fifty regulatory regimes from which to choose the most favorable. State regulation, however, is typically strict, reflecting great concern for the individual policyholder and suspicion of the financial soundness of the insurer.

When an insurance company wishes to do business in a state, it generally must comply with that state's licensing requirements in order to receive authorization.10 However, a state is limited in the reach of its jurisdiction by the Due Process Clause of the Fourteenth Amendment.11 Under a minimum contacts analysis, factors such as an insurance company's location before and after making a contract, the interest of a state in regulating the object insured, and the location of the insured property are "of great weight."12 Even the mere collection of premiums within a state could suffice to bring an insurer within that state's jurisdiction.13 On the other hand, there has been a "distinct split of authority" on what a state can call "doing the business of insurance."14 In general, if a

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9 In 1869, the Supreme Court decided that the business of insurance was not commerce subject to federal regulation. Paul v. Virginia, 75 U.S. (8 Wall.) 168, 183 (1869). Accordingly, each state developed its own body of insurance regulation. This placid state of affairs was disrupted in 1944, when the Court decided that insurance business conducted across state lines may constitute interstate commerce. United States v. South-Eastern Underwriters Assn., 322 U.S. 533, 64 S. Ct. 1162 (1944). In response to the fear that states could lose the power to tax and regulate insurance, Congress passed the McCarran-Ferguson Act, ch. 20, 59 Stat. 33 (1945), which provides that "[t]he business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business." 15 U.S.C. § 1012(a) (1988).


11 Id. § 10341, at 113.

12 Id.

13 Id. at 117.

14 Id. § 10342, at 124.
citizen of a state makes an insurance contract with a foreign corporation outside the state, then the contract is not controlled by the state, even if it concerns property within the state. 15

These constraints are implicit in the key provisions of a state's insurance code where the term "doing the business of insurance" is defined. If a person does insurance business in a state, within the meaning of the relevant statute, then it is subject to the state's regulatory regime. In New York, for example, any solicitation of insurance business to residents, including by mail, falls within the definition of "doing an insurance business" and is illegal unless the soliciting company is an authorized insurer in New York. 16 On the other hand, if a New York resident negotiates an insurance contract outside of New York with an unauthorized insurer legally doing business in another jurisdiction, then the insurer is not deemed to be "doing an insurance business" that would subject it to New York regulation. 17 Notwithstanding this acknowledgment of lack of jurisdiction, the New York Insurance Code provides for a procedure for service of process on unauthorized insurance companies making insurance contracts with New York residents, if they transact any kind of business within the state. 18

Even after an insurance company gets its license to do business in a state, it generally must submit for approval each policy that it proposes to underwrite 19 and is

15 Id. at 124-25.


17 Id. § 1101(b)(2)(E).

18 Id. § 1213.

19 A state may exercise its police power to prescribe the form, terms, and conditions of any insurance policy. APPLEMAN & APPLEMAN, supra note 10, § 10452, at 344. A state may delegate broad regulatory authority to an insurance commissioner or department for the approval or disapproval of policy forms. See id. § 10454.
subject to the state's continuing supervision, such as through reporting requirements\textsuperscript{20} and rate regulation.\textsuperscript{21}

One of the most important constraints on an insurance company's business is the amount of reserves it is required to maintain. Generally, reserves must be sufficient to cover expected claims on its policies\textsuperscript{22}; otherwise, the insurer is technically insolvent.\textsuperscript{23} As a practical matter, an insurance company's capital limits the amount of business it may undertake. One way that insurance companies expand their capacity is by ceding reinsurance. This means that the original or "primary" insurer transfers part of the risk on one or more policies to a reinsurance company while giving the reinsurer part of the premium(s) it had received on the risk. Accounting rules permit the primary insurer to treat the reinsurance as an asset, lowering the amount it must hold in reserves and freeing it to underwrite more coverage.\textsuperscript{24}

The numerous hurdles of state regulation give insurance providers significant incentives to operate in jurisdictions that impose the least regulation, and they also provide jurisdictions so inclined with opportunities to attract insurance companies with friendly regulation. However, even when an insurance company is authorized to conduct business in a state with a desirable level of regulation, the company's authorized activities are usually limited to that jurisdiction; if it wishes to operate in other states, it must repeat the process of obtaining authorization. On the other hand, since the individual states are limited in the reach of their jurisdiction, an offshore insurance company can carefully

\textsuperscript{20} \textit{See id.} § 10431.

\textsuperscript{21} \textit{See id.} § 10491.

\textsuperscript{22} \textit{See, e.g.,} N.Y. Ins. Law § 1303 ("Every insurer shall . . . maintain reserves in an amount estimated . . . to provide for the payment of all losses or claims incurred on or prior to the date of statement . . . which are unpaid as of such date and for which such insurer may be liable . . . ").

\textsuperscript{23} \textit{See id.} § 1309(a) ("Whenever the superintendent finds . . . that an authorized insurer is unable to pay its outstanding lawful obligations . . . , as shown by an excess of required reserves and other liabilities over admitted assets . . . such insurer shall be deemed insolvent . . . ").

\textsuperscript{24} \textit{See id.} § 1308; OSTRAGER & NEWMAN, supra note 1, § 15.01[b].
arrange its behavior so as to avoid the regulation of all fifty states, even when it insures risks located in the United States for American parties.

B. The Decline of the Traditional Comprehensive General Liability Policy

In 1941, the U.S. insurance industry began to offer liability coverage to businesses through a standardized form called the Comprehensive General Liability (CGL) policy. From 1973 until 1986, the CGL policy covered the consequences of an "occurrence" during the policy period, which was defined as "an accident, including continuous or repeated exposure to conditions, which results in bodily injury or property damage neither expected nor intended from the standpoint of the insured." However, the CGL excluded from its coverage injury or damage caused by pollution that was not "sudden and accidental." Although this language could be interpreted to exclude instances of gradual pollution, the courts of many jurisdictions have interpreted this "pollution exclusion" to exclude only intended or expected pollution. By its terms, the CGL policy was triggered if there was an occurrence during the effective period of the policy, and there is no deadline by which a claim had to filed. The judicial interpretation that gradual pollution constituted an occurrence meant so-called "long-tail" claims could be filed for injuries or damages, such as disease, that did not appear until long after the


26 See id. at 264. From 1941 to 1966, CGL policies covered losses caused by an "accident," which was interpreted to include injuries and damages incurred over a period of time. In 1966, the term "occurrence" was substituted for "accident," and in 1973 the definition of "occurrence" was revised to incorporate "continuous or repeated exposure to conditions." id. at 263-64.

27 The exclusion applies to "bodily injury or property damage arising out of the discharge, dispersal, release or escape of smoke, vapors, soot, fumes, acids, alkalis, toxic chemicals, liquids or gases, waste materials or other irritants, contaminants or pollutants into or upon land, the atmosphere or any water course or body of water; but this exclusion does not apply if such discharge, dispersal, release or escape is sudden and accidental." The exclusion was added to the CGL in 1970. See id. at 263.

28 See Abraham, supra note 2, at 962-64. The propriety of this interpretation has been the subject of debate. See id. at 964.

expiration of the policy.30 This began to have an unexpectedly drastic effect in the mid-1970s, particularly from asbestos exposure, product liability, and environmental damage.31 Finally, in 1984, the insurance industry began to withdraw the CGL policy from the market, eventually replacing it with the 1986 Commercial General Liability policy, available in a modified occurrence form and a new claims-made version.32 The claims-made policy was the industry's attempt to limit long-tail exposure; under the policy, the insured is required to file a claim within a specified time period in order to receive coverage.33

When massive claims for environmental damage, asbestos exposure, and similar problems accumulated, affected companies and their insurers exhausted initial layers of coverage and turned to reinsurance and excess liability insurance.

C. The Disappearance of Capacity

Before 1985, commercial liability insurance business in the United States was characterized by easy coverage and low premiums.34 The excess liability insurance was an "exotic corner of the marketplace" that never had a well-capitalized market leader.35 The casualness of excess liability insurance was reflected in conflicting, non-concurrent policy forms and a fragmented, thinly capitalized market heavily dependent on

30 See Abraham, supra note 2, at 964-65.

31 See Anderson et al., supra note 25, at 264.

32 See id. at 265. Certain insurance and reinsurance companies pressured the industry to further restrict the terms of coverage in the standard policies; state insurance authorities and other interested parties responded with a fiercely contested antitrust suit. See Hartford Fire Insurance Co. v. California, 113 S. Ct. 2891 (1993).

33 See Anderson et al., supra note 25, at 265. For an analysis of the issues raised by the 1986 claims-made policy, see Thomas M. Hamilton & Karen J. Kowal, The 1986 Commercial Liability Policy Claims Made Form, in CURRENT PROBLEMS AND ISSUES IN LIABILITY INSURANCE 9 (PLI Commercial Law and Practice Course Handbook Series No. 421, 1987)

34 Carol J. Loomis, Naked Came the Insurance Buyer, FORTUNE MAG., June 10, 1985, at 67.

reinsurance. The virtual absence of major disasters and consequent claims in the early 1980s lulled both primary insurance companies and reinsurers into lax underwriting and haphazard distribution of coverage.

During the 1980s, the weaknesses of this system became apparent. When courts began to interpret CGLs to hold insurance companies liable for long-tail exposures, insurance companies were caught off-guard, suddenly liable under policies that had long expired. Massive claims reached reinsurers and caused them as well as primary insurers to incur large losses. Throughout 1984, reinsurers put pressure on primary insurance companies, raising prices and withdrawing from certain lines of insurance. On December 3, the Union Carbide disaster broke in Bhopal, India, just as buyers and sellers of insurance were negotiating renewals for policies expiring on January 1. Premiums soared, and insureds were forced to get less for their money, by taking higher retentions and lower coverage limits. Some coverage could not be had at any price. The problem was particularly acute in environmental pollution insurance, but the

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36 Id. at 3. See also OSTRAGER & NEWMAN, supra note 1.

37 See G.H.C. Wakefield, Today's Reinsurance and Its Relationship to Reality, VIEWPOINT (Marsh & McLennan Companies, New York, NY), Winter 1994, at 1, 3; Loomis, supra note 34.

38 See Loomis, supra note 34 (regarding sudden and accidental pollution); Redmond, supra note 35, at 4.

39 Loomis, supra note 34.

40 See id.; Redmond, supra note 35, at 4.

41 Loomis, supra note 34.

42 Id. (reporting premiums increasing as much as 1000%).

43 Id. A retention is the amount of liability "retained" by the policyholder before coverage attaches; it is analogous to a deductible in insurance for individuals.

44 In the early 1980s, a risk manager could easily assemble $700 million of excess liability coverage at favorable rates; after the crisis began, finding even $25 million of coverage became difficult. Redmond, supra note 35, at 1.

45 Loomis, supra note 34.
capacity crunch affected many lines of liability insurance. Even the fabled British insurance market Lloyd's of London could not escape the crisis. As of June 1993, one syndicate, managed by R.H.M. Outhwaite Ltd., has suffered losses of £266.8 million for its still-open 1982 account on reinsurance for policies issued decades ago for asbestos and pollution.

Although not directly affected by the problems stemming from broad interpretation of the CGL, similar problems occurred in the area of professional malpractice insurance. The insurance industry loudly blamed the civil justice system for permitting large jury awards and encouraging malpractice litigation; a 1986 federal report agreed. As with CGL coverage, however, malpractice insurance rates had been unusually low for several years prior to the crisis, as insurers chased premium dollars for investment. Some studies pointed to these industry actions as the major cause of the capacity shortage in the mid-1980s, not excessive tort litigation. The General

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46 Id. See also Gerald M. Lachowicz, Excess and Surplus Lines Developments, in CURRENT PROBLEMS AND ISSUES IN LIABILITY INSURANCE 269, 285-87 (PLI Commercial Law and Practice Course Handbook Series No. 421, 1987).

47 Lloyd's is a market located at One Lime Street in London. It is composed of hundreds of syndicates, each of which issues a particular type of insurance and is managed by an underwriter. Until recently, for over 300 years capital was provided by individual investors called Names who assumed personal and unlimited liability.


Accounting Office of the federal government all but accused insurance companies of
gouging policyholders by charging higher rates than necessary to maintain profitability.53
Nevertheless, there was agitation for tort reform.54

The 1985 insurance shortage was painfully felt in many sectors of the economy.55
Faced with outrageous rates or no rates at all, many companies simply chose to "go bare"
(do without insurance) just at the time they wanted to buy more liability insurance than
ever before.56 The vacuum in liability insurance capacity elicited different responses.

II. Responses to the Liability Crisis

A. An Introduction to Captive Insurance

During another crisis in insurance availability that occured in the 1970s, some
corporations formed wholly-owned captive insurance companies to provide insurance
that was otherwise unavailable.57 Although the insurance benefits of such self-insurance
may seem illusory, properly funded captives are actuarially sound.58 Captives are also
attractive because they tend to incur lower overhead costs than independent insurance
companies, and they lack the incentives to drive premiums up or down according to
market demand and outside investment opportunities, providing more stable rates and

53 See Reid, supra note 52. The insurance industry vigorously denied such charges. Id.

in WESTLAW, 1986 WL 2029551 (letter from President of the American Tort Reform Association).

55 Insurance Crisis, supra note 49 (detailing problems in financial institutions, transportation, chemical,
professional services, and other industries).

56 Loomis, supra note 34.

57 See Leon I. Jacobson, Self-Insurance Using Captives and Risk Retention Groups and Purchasing
Groups, in CURRENT PROBLEMS AND ISSUES IN LIABILITY INSURANCE 207, 221-22, 223-24 (PLI
Commercial Law & Practice Course Handbook Series No. 421, 1987).

58 See E. James Stergiou, Risk Retention — Domestic and Offshore Captives: An Actuary's Perspective, in
INTRODUCTION TO COMMERCIAL INSURANCE 59, 66 (PLI Commercial Law & Practice Course
coverage.59 Besides the basic "pure captive," which insures the risks of one corporate parent and its subsidiaries and affiliates, variations include the "association captive" or "group captive," a company formed by numerous corporations in the same business and hence prone to similar risks.60

In the 1970s and early 1980s, several states, such as Tennessee and Illinois, passed laws permitting the formation of captives, but most states never had more than a handful. In fact, most captives of U.S. corporations chose to operate in Bermuda, boosted by a favorable tax and regulatory climate. Other foreign jurisdictions that encouraged the formation of captives include the Bahamas and the Cayman Islands. However, state insurance officials have traditionally viewed offshore captives with suspicion, because these insurers are usually outside the reach of state solvency regulation.61 The fact that most Caribbean offshore centers have confidentiality laws protecting insurance company information has not helped this perception.62 Even some insurance consultants and brokers have distrusted the notion of captives.63

These suspicions are shared by accountants and the Internal Revenue Service (IRS).64 The IRS has traditionally prohibited deductions for premiums paid to captive insurance companies on the logic that no risk is actually transferred out of the

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59 See id. at 61-64, 66.

60 See Jacobson, supra note 57, at 210.


62 Id.


64 Laura Jereski, The Naked Truth, FORBES, May 18, 1987, at 86. Shortly after passage of the LRRA, a director of accounting standards with the American Institute of Certified Public Accountants declared, "There's really no such thing as self-insurance. There's either insurance or noninsurance." Id.
parent/policyholder. Recently, however, taxpayer corporations have been more successful in obtaining recognition for captive insurance in the courts.65

B. Congressional Actions

1. The Liability Risk Retention Act of 1986

In response to the liability insurance crisis, Congress amended the Product Liability Risk Retention Act of 1981 (PLRRA)66 by enacting the Risk Retention Amendments of 1986.67 Together, these statutes are now called the Liability Risk Retention Act of 1986 (LRRA).68 Congress had passed the PLRRA to give companies two new ways to overcome the contemporary difficulties of purchasing product liability insurance. Firstly, the PLRRA preempted contrary state law to permit manufacturers to band together and form association captives called "risk retention groups" (RRGs) that would provide product liability insurance.69 Secondly, the PLRRA allowed companies to form "purchasing groups" (PGs) that could bargain collectively for the purchase of insurance; this option was attractive to businesses reluctant to incur the overhead costs of forming an RRG.70 States retained the ability to regulate the formation and licensing of RRGs,71 but a key consequence of the PLRRA was that once an RRG was licensed to operate in one state, it could operate in every other state without having to apply for any further authorization.72 Obviously, this eliminated the traditional insurance problem of


70 Id. § 4(a)(1).

71 Id. § 3(a)(1).

72 See id. (prohibiting states from making unlawful the operation of an RRG).
obtaining multiple licenses. Despite the avenues opened up by the PLRRA, however, few companies took advantage of its provisions, partly because the statute applied only to product liability insurance, which eventually became more available, but also because state insurance authorities construed narrowly the permissible activities of RRGs and PGs. In the LRRA, Congress expanded the types of insurance that could be provided by RRGs and obtained by PGs to include most kinds of liability insurance, and it resolved some of the regulatory issues that had arisen under the PLRRA.

The odd relationship between federal preemption and state regulation inherent in the LRRA reflected Congress' uncertainty at the time as to the causes of the liability insurance crisis and the proper role of federal authority. Despite the widespread belief that the civil justice system helped precipitate the crisis, Congress did not enact tort reform. Although Congress did broaden federal preemption in the LRRA to facilitate the acquisition of liability insurance coverage, it left the regulation of RRGs and PGs to the states. Many members of Congress believed lax state oversight had permitted the crisis to occur, yet Congress was reluctant to establish a new federal scheme to take over the regulation of insurance, and it chose not to trim state authority under the McCarran Ferguson Act.

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74 15 U.S.C. § 3901. RRGs formed after January 1, 1985, under the law of a foreign country cannot take advantage of the LRRA. Id. § 3901(a)(4)(C).

75 See generally Soldate & Johnson, supra note 73, at 180-89.


77 Id.


79 Harkavy, supra note 76.
The LRRA generated significant interest from businesses exasperated by the insurance crisis, and dozens of RRGs have been formed since its passage. Some insurance officials warned of potential abuse by aggressive, undercapitalized RRGs that could meet one state’s minimal solvency requirements and later endanger policyholders in other states.

2. The Tax Reform Act of 1986

Although the Tax Reform Act of 1986 (TRA) was not enacted as a response to the liability insurance crisis, it did help significantly to level the regulatory playing field between domestic and foreign captive domiciles by changing the tax consequences for American shareholders of offshore captive insurance companies. Ordinarily, U.S. shareholders of foreign companies are not taxed on their investments unless and until they receive dividends. Under certain conditions, however, a U.S. shareholder will instead be taxed currently on its attributed share of the foreign corporation’s "Subpart F income." The TRA imposed a new special rule for offshore captive insurance companies that applies if a U.S. person holds stock in a foreign insurance company from which it receives insurance coverage. If at least 25% of the combined voting power or value of the insurer’s stock is owned by U.S. persons, then all U.S. shareholders of the insurer are taxed currently on the company’s "related person insurance income" (RPII) subject to certain exceptions. A U.S. shareholder’s RPII is income of the foreign insurer attributable to insurance coverage issued to the shareholder or persons related to


84 Id. § 953(c) (1988).
the shareholder for risks located outside the foreign insurer’s country of incorporation.\(^{85}\) However, this rule does not apply if less than 20% of the voting power and less than 20% of the total value of the insurer’s stock is owned by policyholders or persons related to policyholders of the foreign insurer.\(^{86}\) Moreover, there is a de minimis exception if less than 20% of the insurer’s income from insurance is RPII.\(^{87}\)

For many U.S. parent corporations of pure and association captives the TRA eliminated a major incentive to operate offshore; some captives have since been patriated in the United States in popular captive states such as Vermont.\(^{88}\) Yet the migration from offshore jurisdictions has not been as heavy as some observers had anticipated.\(^{89}\)

C. State Initiatives in Captive Insurance: The Example of Vermont

In 1981, Vermont took the initiative to promote in-state captive formation when it passed the Special Insurer Act.\(^{90}\) This made Vermont the first state to be truly competitive with offshore domiciles such as Bermuda.\(^{91}\) It was not until after the enactment of the LRRA and the TRA, however, that Vermont became the hot U.S. domicile for captive insurance companies. In 1985, the state had around twenty-five captives; by 1987, there were fifty; and less than six months later, there were eighty.\(^{92}\)

\(^{85}\) Id. § 953(c)(2).

\(^{86}\) Id. § 953(c)(3)(A).

\(^{87}\) Id. § 953(c)(3)(B).

\(^{88}\) See J. Brady Young, Captivating Captives, BEST’S REV. - PROP.-CASUALTY INS. EDITION, July 1, 1992, at 45.


\(^{91}\) Greg Myers, How to Domesticate Non-U.S.-Based Captives, NAT’L UNDERWRITER PROP. & CASUALTY - RISK & BENEFITS MGMT., Mar. 9, 1992, at 13.

\(^{92}\) Clarke, supra note 90.
Vermont is now the most popular American jurisdiction for captive insurance companies. Captive insurance in turn has been good to the Green Mountain State; in fall 1994, on the occasion of the licensing of Vermont's 300th captive insurer, officials said the industry had brought $44 million in revenues to Vermont since 1981.\textsuperscript{93} Captives pay $10 million in annual taxes and fees to Vermont, comprising one-third of the state's corporate tax revenues.\textsuperscript{94} Small wonder that insurance authorities in Vermont aggressively support and promote the state's captive industry.

Promotional materials tout the advantages of Vermont's regime: the state does not require proof of insurance unavailability, minimum premiums, approval of rates or forms, or participation in guaranty associations.\textsuperscript{95} Vermont claims low capitalization requirements, low premium taxes, and simplified annual reporting.\textsuperscript{96} The rosy picture of gentle regulation painted by Vermont's self-promotion, however, obscures the fact that over ninety percent of proposals for captive insurers are rejected by the Green Mountain State.\textsuperscript{97} The rigorous application process may explain the state's clean record in terms of solvent captives. Vermont is committed to licensing only non-entrepreneurial captives; with narrow exceptions, a Vermont captive may only underwrite risks for the parent, association, or group that owns it.\textsuperscript{98} One official has insisted the state strictly scrutinizes


\textsuperscript{94} Frank Sopper, Lucrative Captives Industry Threatened, VT. BUS. MAG., Mar. 1, 1995, at 21.


\textsuperscript{96} Id.

\textsuperscript{97} See H. Lincoln Miller, Jr., The Case for Vermont's Captive Insurance Regulation, NAT'L UNDERWRITER PROP. & CASUALTY - RISK & BENEFITS MGMT., Mar. 21, 1994, at 13.

\textsuperscript{98} VT. STAT. ANN. tit. 8, § 6002(a) (1993).
the business plans of proposed captives for feasibility and requires close adherence to these plans. 99

After registration, captives must provide annual reports, 100 submit to an annual audit by an independent accountant, 101 obtain certification of loss reserves by an actuary, 102 and pay premium taxes. 103 A captive insurance company must also hold at least one meeting of the board of directors within Vermont, 104 and submit to an examination at least once every three years. 105

A few other states have followed Vermont's lead in encouraging in-state formation of captive insurers with friendly regulation and vigorous promotion. Hawaii passed its original captive insurance law in 1987 106; in 1993, it edged out Colorado, another captive-friendly state, to be the second most popular captive jurisdiction after Vermont -- with only twenty-eight captives. 107 Colorado, which had passed its original captive insurance law in 1972, is the oldest U.S. captive domicile; the state revamped its statute in 1994. 108

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99 "The regulator insists on knowing the details of the proposed business plan, the merits of the actuarial feasibility study, the prior loss experience of the policyholders, the capital being raised and who's supplying it and the coverage the captive is offering." Miller, supra 97.

100 VT. STAT. ANN. tit. 8, § 6007.

101 Reg. 81-2, § 3, reprinted in DEPT OF BANKING, INS. & SEC., supra note 95.

102 Id. § 3(E).

103 VT. STAT. ANN. tit. 8, § 6014.

104 Id. § 6002(b)(2).

105 Id. § 6008.


D. The Bermuda Companies

1. An Overview of Bermuda Insurance Regulation

Bermuda insurance companies are subject to the Insurance Act 1978.109 An insurer cannot operate in Bermuda unless it is registered.110 Typically, a prospective insurer files an application for registration with the Bermuda Monetary Authority (BMA), which handles all Bermuda incorporation matters, along with an insurance programme specifying details such as sources of capital and descriptions of types of insurance to be written.111 The BMA examines the financial soundness of the proposed beneficial owners, while the insurance programme is reviewed by the Registrar of Companies and the Insurers Admissions Committee.112 Bermuda officials insist that the application process is no small formality,113 and the government is "adamant" that any company with "the slightest suggestion of links with narcotics or money laundering" will be prohibited from doing business in Bermuda.114

After an application has been processed, the BMA presents it with its recommendations to the Ministry of Finance, which issues the consent for registration.115 The registration process normally takes about two weeks "but in exceptional

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110 Insurance Act 1978, supra note 109, § 3(1).

111 BERMUDA, supra note 5. See also Insurance Applications Regulations 1980, B.R. 17/80 (Berm.), reprinted in PHOTOCOPY, supra note 109, at 39.

112 BERMUDA, supra note 5. See Insurance Act 1978, supra note 109, § 5 (factors to be considered as to registration); id. § 12 (discretion to refuse registration if registration is "not in the public interest").

113 "You can't just come here and set up a company off the shelf. Our vetting process is very comprehensive." David Fairlamb, The New Bermuda Angle, INSTITUTIONAL INVESTOR, Aug. 1993, at 27 (quoting Bermuda Financial Secretary Idwal Wyn Hughes).


115 BERMUDA, supra note 5. See Insurance Act 1978, supra note 109, § 13(1).
circumstances can be reduced to a matter of days." Companies planning to write liability insurance must have a minimum paid-up capital of $120,000 prior to registration.

Following registration, regulatory compliance consists mainly of making and filing annual financial reports, maintaining mandatory solvency margins, and maintaining a prescribed level of liquid assets. No approval is required for the use of particular policy forms or rates of insurance. Bermuda does not collect income taxes, capital gains taxes, or premium taxes. Thus, unlike insurers in the United States, Bermuda companies can build up their reserves tax-free. To encourage foreign investment in insurance, Bermuda has guaranteed tax exemption for insurance companies until 2016.

Many observers equate thin regulation with lax regulation; Bermuda, however, has managed to sustain a burnished image in spite of its reputation as a tax and regulatory haven. Apparently, this stems from the fact that Bermuda has long viewed its insurance industry as an important part of its economy and takes the maintenance of its smooth operation seriously. The government subscribes to the philosophy that insurance

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116 BERMUDA, supra note 5.

117 Insurance Act 1978, supra note 109, § 7. In fall 1994, however, the Bermuda authorities announced new proposed regulations that would impose higher capital requirements for certain insurance companies. See infra text accompanying notes 207-16.


120 See id. § 11, reprinted as amended in PHOTOCOPY, supra note 109, at 119.

121 BERMUDA, supra note 5.

122 Id.

123 See Fairlamb, supra note 113.
regulation should be a cooperative effort between the public and private sectors. The Insurance Act 1978 created the Insurance Advisory Committee (IAC) to advise the Minister of Finance on regulatory matters concerning the Bermuda insurance industry. Members of the IAC represent groups such as underwriters, brokers, managers, accountants, actuaries, the Insurance Admissions Committee, and consultants; ex officio members include the Registrar of Companies and the BMA. Besides the careful registration process, Bermuda regulation relies a great deal on shared accountability among officials and local professionals. For example, Bermuda law requires each insurance company to appoint a principal representative who has a legal duty to notify authorities of any likelihood of insolvency or illegal conduct within thirty days of learning such information. Bermuda's long experience with captive insurance companies led to the development of a strong professional and telecommunications infrastructure by the time of the 1985 U.S. liability insurance crisis.

2. The Excess Insurance Companies

In 1985, as corporations clamored for liability insurance that was nonexistent, especially in the highest layers of coverage for the biggest disasters, the insurance broker Marsh & McLellan hit upon the idea of helping some of its clients create themselves the

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124 BERMUDA, supra note 5.

125 Insurance Act 1978, supra note 109, § 2(1).

126 Id.


128 Insurance Act 1978, supra note 109, §§ 8(1B), 8A.

129 In 1994, Bermuda proposed new and more stringent regulations that would establish four classes of insurance companies. See infra text accompanying notes 207-16.
capacity that they needed. The strategy was to create a group captive with thick capital that could stand to write excess liability coverage for infrequent but devastating events: the coverage would provide $100 million of coverage excess of $100 million of losses. Eventually, thirty-four companies, including such household names as IBM, Eastman Kodak, and General Electric, each contributed up to $10 million in exchange for shares in ACE Limited, incorporated in the Cayman Islands and operating in Bermuda with a capital of $285 million. Besides excess liability insurance, ACE also offered another type of coverage that had become difficult to obtain, directors and officers liability insurance.

A key component of the venture was the use of a claims-made liability policy to eliminate the problems of unexpected long-tail exposure inherent to occurrence policy forms. Marsh & McLennan had originally planned to set up ACE in the United States, but none of the ten largest insurance companies were interested in selling the proposed policy; Lloyd’s was also uninterested. In the end, Clements took advantage of the fact that if the new insurance company operated out of Bermuda, reserves could accumulate tax-free, an impossible circumstance in the United States. In addition, the company would not have to go through the tedious process of obtaining multiple state

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130 See e.g., Eleanor Johnson Tracy, Insure Thyself: IBM, GE, and 32 Other Corporate Giants Have Started Their Own Insurance Company, FORTUNE MAG., Feb. 3, 1986, at 99.

131 Id.

132 Redmond, supra note 35, at 1, 2. For a complete list of the 34 companies, see id. at 8. Apparently, ACE chose to incorporate in the Cayman Islands to cover the possibility of political instability in Bermuda stemming from agitation for independence from Great Britain. These fears have failed to materialize so far.

133 Tracy, supra note 130.

134 Steinmetz, supra note 6.

135 Fairlamb, supra note 113.

136 Steinmetz, supra note 6.

137 The passage of the TRA in 1986 changed this somewhat, but it apparently did not create much concern. See infra part II.D.3.
licensing and the approval of the new liability policy forms, which could take years.\textsuperscript{138} Finally, ACE's policies provide that any disputes shall be arbitrated in London, avoiding costly litigation in the United States.\textsuperscript{139}

Although ACE was formed to provide coverage for American companies regarding risks located in the United States, it carefully tailored its activities so as to avoid falling under the regulatory authority of any state. ACE accomplished this by conducting its business entirely in Bermuda; ACE has no U.S. offices and does not engage in soliciting, advertising, claim settlement or similar insurance activity in the United States.\textsuperscript{140} ACE obtains its business through non-U.S. insurance brokers or non-U.S. affiliates of U.S. insurance brokers.\textsuperscript{141} The issuance and delivery of policies and the collection of premiums are all accomplished in Bermuda.\textsuperscript{142} According to its 1994 annual report, ACE has occasionally been the subject of inquiries by state insurance regulators, but only one state, Nevada, has formally challenged ACE's position.\textsuperscript{143} That challenge was finally resolved by legislation.\textsuperscript{144}

Soon after ACE's formation, Marsh & McLennan helped create another offshore excess liability insurance company, X.L.\textsuperscript{145} Sixty-eight companies contributed capital to this insurer, which writes a lower layer of excess liability coverage than ACE.\textsuperscript{146} Its

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\item \textsuperscript{138} Steinmetz, \textit{supra} note 6.
\item \textsuperscript{139} Tracy, \textit{supra} note 130. Some ACE policies now provide for arbitration in Bermuda. ACE LIMITED, ANNUAL REPORT 1994, at 4.
\item \textsuperscript{140} ACE LIMITED, \textit{supra} note 139, at 18.
\item \textsuperscript{141} \textit{Id.}
\item \textsuperscript{142} \textit{Id.}
\item \textsuperscript{143} \textit{Id.} at 19.
\item \textsuperscript{144} \textit{Id.}
\item \textsuperscript{145} Redmond, \textit{supra} note 35, at 2. X.L. originally incorporated in Barbados but later reincorporated in Bermuda. Exel is a Cayman Islands corporation.
\item \textsuperscript{146} \textit{Id.} For a list of the 68 original shareholders, see \textit{id.} at 9. X.L. began by offering general liability insurance of $25 million in excess of $25 million. \textit{Firms Agree to Invest over $250 Million in Liability Insurance for New Offshore Insurer X.L.}
parent company, EXEL, went public in 1991, before ACE. Until 1994, ACE and X.L. were the only excess liability insurers at their levels of coverage operating in Bermuda, and they were almost certainly the leading underwriters of such policies in the world.

Clearly, the establishment of ACE and X.L., with its mostly American shareholders and policyholders, must be of concern to state regulators, and both companies have been relying on certain premises. They rely on the validity of their claims-made basis policies to avoid the potential for long-tail exposure, and they rely on the inapplicability of state regulation and jurisdiction. A corollary to this assumption is the proposition that a corporate policyholder will not challenge provisions requiring disputes to be arbitrated outside of the United States (usually in London or Bermuda). ACE and X.L. also assume that the policies will be construed in arbitration in the manner they intended. So far, policyholders apparently have had no objection to the arbitration requirement. As long as that is the case, the other assumptions may never be tested.

Chagrined by the success of the Bermuda companies, the American insurers who had turned down Marsh & McLennan's idea for ACE put together in 1986 an excess liability facility of their own, the American Excess Insurance Association (AEIA, often called the American Slip). In contrast to ACE and X.L., which can insure risks located anywhere in the United States, American Slip has had difficulty in obtaining licenses to operate in the various states. Recently, some new companies have offered competition in Bermuda. For example, in 1994, Starr Excess Liability Insurance Co. Ltd. and Chubb

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147 EXEL LIMITED, supra note 146, at 11.

148 The American Slip is a syndicate of insurance companies, each of which assumes responsibility for a percentage of the underwritten risks. Marsh & McLellan also helped to form this facility, with insurance broker Johnson and Higgins. Redmond, supra note 35, at 2.

149 See Fairlamb, supra note 113.
Atlantic Indemnity Ltd. were established in Bermuda.\textsuperscript{150} Both companies offer coverage that tends to compete with X.L.

Bermuda also saw the formation of companies responding to the shortage of professional liability insurance in the mid-1980s. This was not a new idea; Attorneys Liability Assurance Society (ALAS), a facility that insures law firms, had been operating in Bermuda since 1980.\textsuperscript{151} In 1986, the insurance broker Johnson & Higgins and Chase Manhattan Corp. sponsored the creation of Corporate Officers and Directors Assurance Holding Ltd. (CODA) to provide directors and officers insurance for corporate officials.\textsuperscript{152} Another example, Accountants Liability Insurance Co. (ALAC), was established in Bermuda in 1987 to insure accounting firms.\textsuperscript{153}

3. Some Issues of Federal Taxation

The TRA, passed the year after ACE's formation, did change the picture for the excess liability companies by requiring certain U.S. shareholders to include related person insurance income (RPII).\textsuperscript{154} In fact, this was sufficient to halt Marsh & McLennan's efforts to set up yet another facility, this time for professional liability insurance.\textsuperscript{155} The TRA provided a significant motive for offshore captives to go public, if they could, since this would help lower the ownership stake of policyholders down to


\textsuperscript{151} \textit{Id.}

\textsuperscript{152} In 1993, ACE acquired CODA after managing it for six years. ACE LIMITED, supra note 139, at 8.


\textsuperscript{154} \textit{See supra} part II.B.2.

the twenty-percent RPII de minimis threshold for exemption. EXEL, in fact, made two public offerings for precisely this reason.

ACE did not make its initial public offering until 1993; until then, its dividends included a special dividend to cover RPII tax liability. Although the TRA attempted to remove the tax advantages provided by Bermuda and other countries, it only taxed certain premium income of offshore insurance companies, leaving accumulation from investment income on assets untouched. ACE's thick capitalization may have compensated for the tax problem; even if shareholders had to pay taxes, at least they knew their insurance carrier was steadily building up reserves. In 1994, the year following its initial public offering, ACE took the position that it believed its RPII fell below the de minimis threshold, and that it would endeavor to maintain this status for subsequent tax years. EXEL also anticipates that its RPII will be de minimis in the future.

ACE and EXEL have never paid U.S. corporate income taxes; both claim they are not engaged in a trade or business in the United States. As a precaution, however, ACE has filed U.S. income tax returns reporting no taxable income, to preserve the ability to deduct business expenses if its position is successfully challenged by the IRS. In 1990, the IRS made one inquiry to EXEL as to why it had not filed any U.S.

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156 Id. See I.R.C. § 953(c)(3)(B).

157 "The [first] offering was designed to reduce X.L.'s RPII as a proportion of X.L.'s gross insurance income because many of the selling shareholders were X.L. policyholders and all selling shareholders were disposing of all of their Ordinary Shares... [The second] offering was again designed to reduce X.L.'s RPII." EXEL LIMITED, supra note 146, at 11-12.

158 In 1993, ACE declared dividends of $0.43 per Ordinary Share which included a special dividend of $0.23 per Ordinary Share to cover any RPII tax liability. ACE LIMITED, supra note 139, at 37.

159 "Insurance income" must be "attributable to the issuing (or reinsuring) of any insurance or annuity contract." I.R.C. § 953(a)(1). The words "attributable to the issuing" appear to limit taxable income to premiums paid for policies and exclude investment income.

160 ACE LIMITED, supra note 139, at 20.

161 EXEL LIMITED, supra note 146, at 12.

162 ACE LIMITED, supra note 139, at 20; EXEL LIMITED, supra note 146, at 11.

163 Id.
tax returns and on another occasion requested access to financial records\textsuperscript{164}; so far, it appears no further action has been taken. Clearly, the nexus between U.S. persons and the Bermuda companies has raised the concern of federal tax authorities, and this is acknowledged by both ACE and EXEL.\textsuperscript{165}

Under section 4371(1) of the Internal Revenue Code, policyholders must pay an excise tax of four percent on policies issued by foreign companies for the insurance of risks located in the United States.\textsuperscript{166} Insurance companies in Barbados and Bermuda were exempt from this excise tax by treaty until the beginning of 1990. Since then, the excise tax liability has eliminated the advantage of avoiding premium taxes in most states,\textsuperscript{167} further leveling the playing field for domestic companies but apparently still not enough of a drag for companies like ACE and EXEL.

III. The Maturation of Alternative Insurance

A. The Domestic Picture: Vermont's Fight for NAIC Accreditation

The National Association of Insurance Commissioners (NAIC) is comprised of the insurance commissioners of the fifty states, the District of Columbia, and the four territories of the United States. Over the years, the NAIC has drafted model insurance statutes for adoption by the different states and served as a means for state insurance regulators to exchange information. In 1990, the NAIC adopted an accreditation program in an attempt to standardize insurance regulation across the fifty states.\textsuperscript{168} Under the

\textsuperscript{164} EXEL LIMITED, supra note 146, at 12.

\textsuperscript{165} Both companies have conceded the possibility of U.S. income tax liability and have stated that such a finding could have a material and adverse affect on earnings. ACE LIMITED, supra note 139, at 20; EXEL LIMITED, supra note 146, at 11.

\textsuperscript{166} I.R.C. § 4371(1).

\textsuperscript{167} Grayson, supra note 89.

\textsuperscript{168} 2 1990 PROCEEDINGS OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 10 [hereinafter 1990 PROCEEDINGS].
program, states must enact particular NAIC model statutes and submit their insurance departments for independent review of their operations in order to receive accreditation. After January 1, 1994, the program required accredited states to refuse to accept the results of insurance company examinations by non-accredited states. This would make business more difficult for insurers domiciled in non-accredited states and make those states less attractive. As of March 1995, forty-four states had received NAIC accreditation. Vermont is one of the remaining six unaccredited states.

Despite its strong regulatory record, the NAIC has refused to grant accreditation to Vermont because of the way it regulates RRGs. After Congress passed the LRRA, the NAIC adopted a Model Risk Retention Act (Model Act) and made its enactment a requirement in its accreditation program. Under the Model Act, an RRG must be "chartered and licensed as a liability insurance company" under the law of a state; in other words, an RRG must be authorized and regulated just like traditional insurance companies. Under Vermont law, however, RRGs are considered to be captive insurance companies and are regulated accordingly. One consequence is that Vermont closely monitors an RRGs conformance with the particular business plan it filed as part of its

169 Id. at 20-29.
170 The Sanctioned 16, BEST'S REV. - PROP.-CASUALTY INS. EDITION, June 1, 1994, at 33. An insurer from an unaccredited state can avoid sanctions by having a senior examiner from an accredited state "materially" participate in the examination. Id.
171 See Sopper, supra note 94.
173 The Model Act is item A.16(b) of the NAIC Policy Statement on Financial Regulation Standards. See 2 1989 PROCEEDINGS OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 35. These standards were incorporated in the accreditation program. 1990 PROCEEDINGS, supra note 168, at 21.
175 An RRG formed under Vermont law is an "industrial insured group," and the facility that insures the risks of the group is called an "industrial insured captive insurance company." VT. STAT. ANN. tit. 8, § 6001(8)-(9).
application; NAIC regulation would not do this but instead would impose other regulations Vermont does not find necessary.\textsuperscript{176} As of March 1995, Vermont was home to thirty RRGs out of about seventy-five nationwide.\textsuperscript{177}

Interestingly, Colorado and Hawaii also regulate RRGs as captive insurance companies.\textsuperscript{178} While the NAIC has not yet accredited Hawaii, that state's regulation of RRGs apparently has not caused any concern.\textsuperscript{179} Colorado has already received accreditation and continues to maintain it.\textsuperscript{180} It is not clear what distinguishes these states from Vermont.\textsuperscript{181}

Vermont's fight to receive accreditation has prompted questions about the wisdom of the NAIC's program. Some commentators claim the NAIC is overreaching and using the accreditation program to bully state legislatures.\textsuperscript{182} The National Risk Retention Association and other groups have even considered suing the NAIC for violating the preemption provisions of the LRRA.\textsuperscript{183} In February 1995, Vermont legislators heard

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\textsuperscript{177} Rodd Zolkos, \textit{Vermont Hearing Probes NAIC Accountability}, \textsc{Bus. Ins.}, Mar. 6, 1995, at 27.

\textsuperscript{178} \textsc{Colo. Rev. Stat.} \textsection 10-6-103(5); \textsc{Haw. Rev. Stat.} \textsection 431:19-101.

\textsuperscript{179} \textit{See The Sanctioned 16}, \textsc{Best's Rev. - Prop.-Casualty Ins. Edition}, June 1, 1994, at 33.


\textsuperscript{181} "[The NAIC] has already accredited Colorado and Georgia, two states with captive laws similar to those of Vermont, which has not been accredited. . . . Why is Vermont singled out?" Donn P. McVeigh, \textit{NAIC Giving Short Shift to Risk Retention Groups}, \textsc{Bus. Ins.}, Jan. 24, 1994, (letter to the editor), available in \textsc{Westlaw}, 1994 WL 3834151.

\textsuperscript{182} \textit{See, e.g.}, Zolkos, supra note 176.


However, the LRRA does not expressly grant a private right of action for violation of the preemption provisions, and it is unclear whether such a right would be implied by the courts. \textit{See} Cort v. Ash, 422 U.S. 66 (1975) (articulating four-part test for implying private rights of action); Cannon v. University of Chicago, 441 U.S. 677 (1979) (focusing on legislative intent). A suit against the NAIC could be particularly problematic, since the association might not even be considered a public entity, and presumably the preemption provisions are binding only on the states.
testimony from insurance officials from Vermont and other states in connection with a
bill to impose greater oversight of the NAIC's activities.\footnote{Zolkos, supra note 176.} The bill would require the
commissioner to approve any fees paid by Vermont insurance companies to the NAIC, 
require the NAIC to file an annual fiscal report, and require the NAIC to document the
merits of accreditation standards.\footnote{Id.} At bottom, however, the controversy over Vermont's
accreditation is a clash between traditional notions about the regulation of insurance,
represented by the NAIC, and more innovative approaches to the management of risk,
represented by Vermont.\footnote{See, e.g., Karen Cutts, \textit{Certified Regulatory Specialists Needed for Alternative Markets}, NAT'L UNDERWRITER PROP. & CASUALTY - RISK & BENEFITS MGMT., Mar. 24, 1994, at 23 (calling for
NAIC recognition of expertise in alternative risk regulation to facilitate exchange of information).}

B. Property Catastrophe Reinsurance in Bermuda

The five-year period from 1988 through 1992 saw a string of natural and other
disasters that shook the international property catastrophe insurance market. These
included Hurricane Hugo and the San Francisco earthquake in 1989, a 1991 typhoon in
Japan, Hurricanes Andrew and Iniki in 1992, bombings in London in 1992 and 1993, and
the World Trade Center bombing in 1993.\footnote{Kevin Stevenson, \textit{The Property Catastrophe Reinsurance Boom: Big Fish in a Big Pond}, THE BERMUDIAN, Jan. 1994, at B11, B14 (Supp.).} As happened with the liability market in
1985, the crisis in catastrophe insurance threatened to dry up capacity for the highest
limits of insurance as companies withdrew from the market.

In particular, Lloyd's of London, traditionally a major market for these risks,
suffered losses of $908.3 million in 1988 (its first loss in twenty-one years).\footnote{Nicholas Bray, \textit{Lloyd's to Cap Members' Loss Liability in Effort to Stem Retreat by Investors}, W ALL ST. J., Jan. 16, 1992, at A10.} $4 billion
in 1989, $4.3 billion in 1990, and $3.2 billion in 1991 through a combination of disasters and long-tail claims. Although the disasters themselves affected the entire catastrophe insurance industry, they also exposed sloppiness at Lloyd's. During the period from 1982 through 1988, Lloyd's had opened its membership to "everyone from professional athletes to unsophisticated grandmothers" looking for profits and prestige, increasing the number of personally liable Names from 20,000 to 32,000. The influx of cash lulled the market into lax underwriting. Compounding this was the infamous LMX Spiral, a scheme where syndicates reinsured other syndicates without keeping careful track, until some of the risk wound up back where it came from. When calamities produced a flood of claims, the Spiral collapsed, and many Names who never anticipated any risk lost everything. Horrified by this turn of events, investors left Lloyd's in a mass exodus that brought the number of Names down to 18,500 in 1994, and sixty percent of syndicates closed during the same period, severely contracting capacity.

In this state of affairs, Marsh & McLellan did it again; in November 1992, with J.P. Morgan and EXEL, it created Mid Ocean Reinsurance (Mid Ocean Re) in Bermuda.


192 Steinmetz, supra note 6.


194 Id.

195 Robinson, supra note 188.


to underwrite property catastrophe reinsurance on a global basis. 198 This time, however, other insurers, reinsurers, brokers, and banks fell over each other to join the party: eight other property catastrophe reinsurers incorporated in Bermuda, representing a total surge of $4 billion of capital to the tiny island from November 1992 to January 1994. 199 These reinsurance companies were started up with rosy forecasts to investors of quick returns topping twenty percent. 200 Two, Mid Ocean Re and Partner Re, rode a wave of market optimism and quickly went public. 201 However, by the time a third reinsurer, Renaissance Re, attempted to put together an IPO, much of the excitement had died down, and no offering was launched. 202

The initial idea for these companies had been to write a geographically diversified book of insurance and follow the pricing lead of the London market. 203 In the January 1994 season, however, the Bermuda reinsurers were struggling to get the risk portfolio they wanted. The London market set prices so high insurance buyers did not take all the capacity that was offered, and while there was ample business from the United States, the anticipated capacity crunch for risks in Europe and Japan did not materialize. 204 Then, in

198 Stevenson, supra note 186.

199 Seven of the other catastrophe reinsurance companies (and their sponsors) were Centre Cat (Centre Re, Morgan Stanley, and Zurich Re), International PIC Re (American International), Renaissance Re (USF&G, Warburg Pincus, GE Investment), Global Capital Re (Johnson & Higgins, Underwriters Re, Goldman Sachs), Partner Re (Swiss Re, John Head Partners), Tempest Re (General Re, Donald Kramer), and LaSalle Re (CNA, Aon). Schut, supra note 7. The eighth, Sphere Drake Insurance, was registered in 1990 but not activated until 1993. Stevenson, supra note 186, at B18.

200 Schut, supra note 7.

201 Id.

202 Id.

203 Id.

204 Id. In hindsight, the inability to attract large amounts of Japanese business proved to be a blessing in disguise for the Bermuda companies, since it resulted in the bulk of the estimated $4 billion of claims from the Kobe earthquake in early 1995 falling on the London market and European reinsurers. John Jennings, Cat Re Market Seen Tightening after Kobe Quake, NAT' L UNDERWRITER PROP. & CASUALTY - RISK & BENEFITS MGMT., Feb. 20, 1995, at 19.
January 1994, California suffered the Northridge earthquake, forcing some of the new reinsurers to pay out claims just after collecting premiums.\textsuperscript{205} Some industry watchers wondered what would happen to all the capital in Bermuda lying fallow as catastrophe reinsurance capacity.\textsuperscript{206} There was speculation that the companies would move into other, riskier areas of reinsurance or insurance.\textsuperscript{207} By the end of 1994, it appeared these worries were unfounded. The "big cats" in Bermuda are committed to staying for the long term.

Meanwhile, Bermuda took steps in the fall of 1994 to make sure that those who play in the new insurance market are big enough to do so. Based on recommendations from the IAC and with the support of the local insurance industry, Bermuda announced new and tougher regulations.\textsuperscript{208} Previously, Bermuda had made no attempt to distinguish between types of insurers. Under the proposals, regulation of an insurance company will be keyed to its status in one of four classes of insurance.\textsuperscript{209} Most of Bermuda's insurance companies will be Class 1 companies (single-parent captives) or Class 2 companies (group captives and captives earning no more than 20% of net written premiums from third parties).\textsuperscript{210} While capital standards will not change for Class 1 insurers, Class 2 companies must show capital and surplus of $250,000.\textsuperscript{211}

Bermuda's big excess liability and catastrophe reinsurance companies will comprise the new Class 4 category.\textsuperscript{212} These insurers must maintain a minimum capital


\textsuperscript{206} \textit{Id.} at B20.

\textsuperscript{207} \textit{Id.}

\textsuperscript{208} Bermuda Department of Information Services, Press Release (Sept. 1, 1994).

\textsuperscript{209} \textit{Id.}

\textsuperscript{210} \textit{Id.}

\textsuperscript{211} \textit{Id.}

\textsuperscript{212} \textit{Id.}
and surplus of $100 million. The Bermuda government intended the Class 4 provisions to be "more onerous than in the major industrial countries of the world" and "assure the world marketplace of [Class 4 companies'] continued long-term stability and sound financial condition." Class 3 companies will be insurers that do not fall within the other classes.

In addition to the stratification of the insurance industry, the proposed regulations impose new solvency requirements for Class 3 and 4 companies, stricter loss reserves requirements, and tougher controls on excessive distributions and reductions in surplus and capital. The regulations are expected to become effective by the end of 1995, and a twelve-month transitional period will allow companies to come into compliance.

C. Stability at Last?

The high-risk insurance market in the United States has been experiencing a transition over the past decade. ACE and X.L. were created to provide "permanent solutions" to the problem of excess liability insurance capacity. So far, these companies, with the addition of some competing latecomers, appear to be succeeding in this goal. The establishment of the Bermuda catastrophe reinsurance companies, moreover, has solidified for the industry the concept pioneered by ACE and X.L. Though not yet truly tested by stresses similar to those that led to their creation, these highly

213 Id.
214 Id.
215 Id.
216 Id.
217 Id.
218 Redmond, supra note 35, at 4.
capitalized facilities for the upper limits of disaster insurance aspire to be the pillars that will stabilize the catastrophe and liability insurance markets for the long haul.

It is probably too early to tell, however, whether the perceived stability is real or a reflection of a market that is still hard enough at the highest layers to support healthy premiums. Lloyd's has disciplined its operations and is implementing a plan to restructure the way it gets and uses capital. The current conventional wisdom is that a recovered London market and Bermuda should be complementary rather than cutthroat, and more insurance buyers are looking to spread their insurance coverage among the major markets just as insurers are trying to spread their exposure. A positive sign is that insurers appear much more serious about sound underwriting and want to concentrate on stability, not competition. Nonetheless, if supply were ever to outpace demand, there is always the danger that insurers will submit to temptation and lower rates to capture premiums, leaving the market vulnerable to a new commercial insurance crisis.

Besides the consolidation of capital and the changes in attitudes that have occurred on the side of commercial insurance providers, there has been an equally significant change in the views of insurance purchasers and some regulators over the last ten years. Companies and professionals have become more sophisticated in the use of self-insurance or "alternative insurance," particularly through group or association

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221 Lisa S. Howard, Ceding Firms Fear Reliance on One Market, NAT'L UNDERWRITER PROP. & CASUALTY - RISK & BENEFITS MGMT., Jan. 30, 1995, at 3.

222 Id.

223 The term "alternative insurance" is a catchall phrase for insurance and other risk management techniques beyond coverage by traditional carriers. Captive insurance, RRGs, and PGs are generally understood to be the principal types of alternative insurance. For an interesting overview of the growth of different types of alternative insurance, see J. Brady Young, High Stakes in the Alternative Market, BEST'S REV. - PROP.-CASUALTY INS. EDITION, Jan. 1, 1992, at 47.
captives, RRGs under the LRRA, and other pooling arrangements. Captives are no longer merely temporary band-aids created in hard markets. They are tools now viewed as permanent devices that can ensure stable coverage of more predictable risks. Supporters say well-run captives better understand the risks they manage than conventional insurance companies, who have proven unable to control market volatility.

Insurance authorities in jurisdictions willing to accommodate these changes in the industry, such as Vermont in the regulation of captives and RRGs and Bermuda in the regulation of captives and highly capitalized disaster insurers, share many of the same attributes that distinguish them from traditional state regulation in the United States. With both Vermont and Bermuda, the hardest part is getting in; both jurisdictions require detailed business proposals that are scrutinized for soundness, and both inquire into the sources of capital. After authorization, however, both jurisdictions rely heavily on the cooperation of professionals, such as auditors of annual reports and actuaries who certify reserves, for the continued safe operation of insurers. Vermont stresses conformance with the filed business plan. There is otherwise little continuous inquiry into the business activities of an insurance company. Vermont and Bermuda have both developed strong track records with these lean regulatory schemes, yet many U.S. insurance officials are still skeptical of the alternative insurance they encourage.

There has been growing impatience in the United States among domestic alternative insurance providers with the more rigid, traditional regulation of insurance. In 1993, five organizations, the Vermont Captive Insurance Association, the Captive Insurance Companies Association, the National Risk Retention Association, the Colorado


226 Id.
Association of Captive Entities, and the Risk and Insurance Management Society, formed the Coalition of Alternative Risk Funding Mechanisms (CARFM). CARFM’s main goal is to lobby state regulators, the NAIC, members of Congress, and other lawmakers against restrictions of risk management activities in the alternative market. The controversy surrounding the denial of NAIC accreditation to Vermont has focused the attention of regulators in several states on the importance of alternative insurance and could undermine the NAIC’s efforts to develop a uniform and traditional regulatory regime. At least one commentator has warned that the refusal of most state insurance authorities to acknowledge the establishment and importance of alternative insurance hampers the productive exchange of expertise from experienced jurisdictions such as Vermont.228

In the previous session of Congress, Representative John Dingell (D-Mich.) introduced a bill to impose federal regulation of insurance.229 Although the bill was ultimately unsuccessful and unlikely to be reconsidered in the near future, the idea of federal regulation had garnered support from some alternative insurance professionals who had become annoyed by the NAIC’s attitude towards self-insurance.230 Even if it is unwilling to establish a new area of federal administrative law, Congress might someday expand the preemptive scope of the LRRA or enact other measures that undermine state authority, if organizations like CARFM convince it that the NAIC and the states are strangling innovative risk transfer techniques.

IV. Conclusion: Policy Concerns for the United States


228 See Cutts, supra note 185.


230 Wojcik, supra note 182.
Before the 1985 liability insurance crisis, commercial buyers of insurance were willing to accept the cyclical nature of supply and demand. The prolonged duration of the crisis left professionals and corporations with the unacceptable situation of operating without sufficient insurance. Captive insurance companies, risk pooling, and other forms of alternative insurance were not new in 1985, but these techniques were exploited to provide desperately needed capacity. Although ACE and X.L. are now public companies, they essentially began as large group captives. While their status as part of the alternative insurance market may be debatable now, they and the other highly capitalized companies that have sprouted up in Bermuda share with the U.S. alternative insurance market the need for a flexible regulatory attitude. Interestingly, experience seems to show that once business goes to alternative insurance, it does not return to the primary insurance market.231 The alternative insurance market has grown too big to ignore232; it has been identified and accepted as a fact of life by even the traditional insurance industry. Regulatory recognition is weaker but seems to be growing, with the awareness raised by the activity in Vermont and Bermuda.

State insurance regulation has historically been parochial and paternalistic. The state's authority to regulate comes from its police powers, traditionally exercised to protect the health, safety, and morals of the citizens. The working assumption of state insurance regulation is that the consumer of insurance is the vulnerable individual policyholder with little information who depends on the state's protection from insolvency and fraud. This assumption is reflected in the detailed regulation of licenses, policy forms, solvency requirements, investment restrictions, and guaranty funds. The consequence of this paternalistic view is that state vigilence may mean burdensome compliance and second-guessing that can hamper management.

231 See Briggs, supra note 179.

232 Insurance industry estimates for the 1993 premium volume of the alternative insurance market range from $73 billion to $88 billion. Michael Murphy, Alternatives Devour a Primary Marketplace, BEST'S REV. — PROP. & CASUALTY INS. EDITION, Mar. 1995, at 44.
Insurers of high-level commercial risks operating in jurisdictions like Bermuda, however, view their activities not as a means to avoid state regulation in bad faith, but as a rational selection of a more accommodating regulatory regime that allows necessary flexibility to changing conditions. The huge Bermuda companies sell their policies to sophisticated corporations with professional risk managers and/or insurance brokers who can seek out the best coverage within the United States or abroad. If ACE were to attempt to sell automobile insurance to New York residents, it would inevitably have to engage in activities, such as selling through agents or advertising, that would give rise to contacts within the state and the justifiable concern of its regulators. So long as ACE and similar companies remain in their specialized niches in commercial insurance, there is less reason to require close regulatory supervision. The same is true for captives and RRGs in states like Vermont, where such companies may insure only the risks of their owners. The owners/policyholders are businesses with the interest and resources to keep adequate tabs on their captives, and the captives lack the incentive either to slash rates below a sound level or raise rates unreasonably. While providers of alternative insurance are currently able to operate satisfactorily, this is in tension with traditional state regulation. The recent actions of the NAIC, Congress, and states favoring strong regulation reflect regulatory suspicion of these companies.

The growing acceptance of the principle that some consumers (large corporations) need less regulatory protection than others (individuals) is reflected in the growth of alternative risk mechanisms and the frustration of their supporters with the current, unreliable market, and rigid regulation. Congress took a step in favor of alternative insurance when it passed the LRRA, by giving enterprises the opportunity to break free of the traditional market and find new ways to manage risk. The emerging segmentation of the insurance market based on the sophistication and needs of the purchaser is a familiar pattern in financial services. In the field of securities, the Securities and Exchange Commissioner (SEC) also traditionally assumed that every securities transaction could
involve naive individual purchasers who needed the government's protection from more knowledgeable issuers and underwriters. Over the last decade, the SEC has gradually promulgated simplified registration and reporting requirements for many transactions between equally sophisticated parties in recognition of the fact some investors need less protection. These measures have significantly reduced the burden of complying with regulations in cases where expected regulatory benefits were likely to be small.

Similarly, the success of Vermont's experiment with captive insurance regulation and similar efforts by other states like Hawaii are not mere races to the regulatory bottom, but attempts to seize opportunities to optimize regulation with flexibility for parties who need less paternalistic assistance from the state. The struggle between the NAIC and Vermont over the question of accreditation is really a fight over acceptance of alternative insurance and the response of commercial insurance regulation. Only when and if this question is resolved in favor of Vermont and its supporters will there be a general acceptance of the validity of slimmer regulation for sophisticated parties. It is then that there can be a serious discussion of ways to regulate all commercial insurance intelligently to serve the twin goals of supervision and efficiency.

Getting past the issue of alternative insurance as legitimate insurance is not merely academic. For example, the Bermuda property catastrophe reinsurers believe their long-term survival depends on a risk portfolio that is diversified geographically and in terms of types of risk insured. The LRRA permitted corporations susceptible to similar risks but located around the country to pool their risks, permitting geographical diversification. An understanding of alternative insurance can help state regulators and the insurance industry to break out of the localized focus of state regulation and give serious attention to the potential benefits of such risk diversification.

Similarly, evidence that state insurance officials are willing to work with providers of alternative insurance can encourage more of such insurers to do business domestically, where states can extend regulatory and judicial jurisdiction. This could be
important, for example, in cases where it is necessary to reach an insurer for the benefit of
an injured third party to whom the insured is liable. Although there’s no sign that ACE or
any other large Bermuda insurer is out to defraud policyholders, if they did, enforcing
insurance contracts through legal process is problematic for the states. Finally, a dialog
between the public and private sectors about alternative insurance could lead to
reconsideration of insurance tax policy. The Bermuda property catastrophe reinsurers
claim that the need to build up thick reserves quickly is frustrated by U.S. insurance
taxes, which penalize insurers in good years and leave them vulnerable when disaster
finally strikes. An insurance tax structure more sensitive to insurers’ concerns could
mean more domestic alternative insurance business, a situation that Bermuda, Vermont,
and other jurisdictions have found highly rewarding for their economies.

Commercial insurance in the United States is a complex market. At present, there
is a rough conceptual and philosophical divide between traditional insurance and
alternative insurance. Within alternative insurance, there are further segments of the
large Bermuda insurers, domestic and offshore captives, RRGs, and other pools that
sprung out of necessity during the liability insurance crisis in the 1980s and the threat to
catastrophe reinsurance a few years later. In Bermuda, the government has recognized
something fundamental has changed in the makeup of its insurance industry and the
markets that use it. The new regulations announced last fall separate insurance
companies there into four classes, each with different levels of supervision, but still part
of an overall, coherent scheme. Sooner or later, U.S. regulation must also devise a single
strategy to reconcile the different pieces of the insurance industry and supervise them
according to their various functions and the needs of their policyholders. This can be
done at the state level, perhaps through NAIC leadership, but a failure to make progress
now could lead to the need for eventual intervention by Congress to get the job done.

233 Donald Kramer, chairman of Tempest Re, has said, "Bermuda nicks you... [But in the U.S.]\nIn good
years you get taxed to death, and when you have losses the only benefit is to carry them forward. You have
to wait too many years to recover your investment." Robert Lenzner Phillipe Mao, It's Not Just the Climate
... (Bermuda), FORBES, Nov. 7, 1994, at 42.