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Non-territorial Special Jurisdictions in the U.S. Insurance Market

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Abstract
Like most nations, the United States heavily regulates the insurance business. Regulators focus on pre-approval of forms and rates, insurer solvency, and licensing providers. Because insurance regulation is almost exclusively the province of state governments, the U.S. insurance market is highly fragmented. In three areas, however, the federal government has preempted state regulation to a degree, creating opportunities for a law market to develop. This article discusses how the preemptions created by the US Congress for purchasing groups (PGs), risk retention groups (RRGs), and surplus lines insurance have created non-territorial special economic zones (SEZs) for portions of the insurance market. The paper backs this idea by, first, analyzing how surplus lines insurance gives insurance buyers access to insurers not licensed in the buyers' jurisdictions for coverage not available otherwise; second, by examining how risk purchasing groups (PGs) allow buyers to band together to buy insurance despite state laws prohibiting the practice; and third, by discussing how risk retention groups (RRGs) allow groups of insurers to create their own insurer, obtain regulatory approval from a single state, and then provide insurance nationwide. The regulation of these non-territorial SEZs differs in kind from the more traditional state regulation of insurance. It is less "one-size-fits-all" and it is more focused on solving the problems of market gaps. Several states have emerged as leading domiciles, embracing a regulatory approach that sets them apart from those jurisdictions which have not. All three examples provide valuable lessons for constructing non-territorial SEZs in other areas. In this article, I argue that although these federal laws created to expand access to insurance, were not explicitly focused on creation of an SEZ, they do in fact create non-territorial SEZs. Thus there are de facto SEZs for surplus lines, RRGs, and PGs, defined by subject matter rather than geographical boundaries. This, in turn, suggests an alternative pathway to geographical SEZs, one which can expand competition among legal systems. By examining the experience with the federal government's creation of a national "law market" for these types of insurance, the paper shows how non-territorial SEZs can be used to facilitate regulatory competition that expands the choice set for consumers.

Keywords: Risk Retention Groups, Risk Purchasing Groups, Surplus Lines Insurance, Insurance, Federalism, Special Jurisdictions, Special Economic Zones.

Resumen
Como la mayoría de las naciones, Estados Unidos regula fuertemente el negocio de los seguros. Los reguladores se centran en la aprobación previa de formularios y tarifas, la solvencia de las aseguradoras y los proveedores de licencias. Debido a que la regulación de seguros es competencia casi exclusiva de los gobiernos estatales, el mercado de seguros de EE. UU. está muy fragmentado. En tres áreas, sin embargo, el gobierno federal se ha adelantado hasta cierto punto a la regulación estatal, creando oportunidades para que se desarrolle un mercado legal. Este artículo argumenta que las preferencias creadas por el Congreso de los EE. UU. para los grupos de compra (PG), los grupos de retención de riesgo (RRG) y los seguros de líneas excedentes han creado zonas económicas especiales (SEZ) no territoriales para partes del mercado de seguros. El documento respalda esta idea, primero, analizando cómo el

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seguro de líneas excedentes brinda a los compradores de seguros acceso a aseguradores que no tienen licencia en las jurisdicciones de los compradores para una cobertura que de otro modo no estaría disponible; segundo, examinando cómo los grupos de compra de riesgo (PG) permiten a los compradores unirse para comprar seguros a pesar de que las leyes estatales prohíben la práctica; y tercero, discutiendo cómo los grupos de retención de riesgos (RRG) permiten que grupos de aseguradoras creen su propia aseguradora, obtengan la aprobación regulatoria de un solo estado y luego brinden seguros a nivel nacional. La regulación de estas ZEE no territoriales difiere en su tipo de la regulación estatal más tradicional de los seguros. Es menos "una talla única para todos" y está más enfocado en resolver los problemas de las brechas de mercado. Varios estados han surgido como domicilios principales, adoptando un enfoque regulatorio que los distingue de aquellas jurisdicciones que no lo han hecho. Los tres ejemplos brindan lecciones valiosas para construir ZEE no territoriales en otras áreas. En este artículo, argumento que si bien estas leyes federales creadas para ampliar el acceso a los seguros no se centraron explícitamente en la creación de una ZEE, de hecho crean ZEE no territoriales. Por lo tanto, existen ZEE de facto para líneas excedentes, RRG y PG, definidas por tema en lugar de límites geográficos. Esto, a su vez, sugiere un camino alternativo a las ZEE geográficas, que puede expandir la competencia entre los sistemas legales. Al examinar la experiencia con la creación por parte del gobierno federal de un "mercado legal" nacional para estos tipos de seguros, el documento muestra cómo las zonas económicas especiales no territoriales pueden usarse para facilitar la competencia regulatoria que amplía el conjunto de opciones para los consumidores.

Palabras Clave: Grupos de Retención de Riesgo, Grupos de Compra de Riesgo, Seguro de Líneas Excedentes, Seguros, Federalismo, Jurisdicciones Especiales, Zonas Económicas Especiales.

1. INTRODUCTION

While special economic zones (SEZs) traditionally are territorially defined as specific locations which are exempt from tariffs or other taxes or which receive special regulatory treatment (UNCTAD 2019, 128),[1] the United States has created several legal frameworks that produce cross-state competition for insurance regulation. Although at first glance they do not resemble a traditional SEZ, these can be seen as non-territorial SEZs because they share with traditional, territorial SEZs two important characteristics. First, just as with a firm that relocates into a territorial SEZ, these legal frameworks enable firms to opt out of an existing regulatory regime and into an alternative one. Second, firms that participate in these non-territorial SEZs choose to do so because the regulatory package the SEZ offers is preferable to the regulatory regime applicable outside the SEZ. Just as territorial SEZs compete to offer attractive regulatory regimes, so state regulators compete for insurers to select them as their domicile in these insurance

[1]The territoriality of SEZs is largely a means of limiting the benefits of the SEZ regime to those within it, allowing SEZ hosts to effectively engage in regulatory price discrimination in their broader markets. This can be seen in the development of the Cayman Islands' Enterprise City SEZ, which is today based in a physical location but which when formed merely required location in one of four designated, non-contiguous office buildings on Grand Cayman (Cayman Compass, 2012). There was nothing special about these buildings other than their designation by the government as allowable locations. This enabled the SEZ to launch before its permanent site was created.

markets. By making it possible for insurers and insurance buyers who opt into their preferred regulatory regimes in these areas to operate nationally, these laws provide the equivalent of an SEZ. Non-territorial SEZs expand the law market, creating additional opportunities for jurisdictional competition.

Surplus lines insurance, risk purchasing groups (PGs), and risk retention groups (RRGs) all enable buyers of particular types of insurance to purchase insurance from entities not regulated by the insured's home state. As a result, competition occurs between state insurance departments to gain the business of the entities that provide insurance (surplus line insurers and RRGs) or purchasing services (PGs). These measures thus create a "law market" in insurance regulation (O'Hara & Ribstein, 2009) for the parts of the insurance market to which these apply (coverage not available from an insurer admitted in a state for surplus lines and liability insurance for PGs and RRGs).

As detailed below, in those three insurance markets, the U.S. federal government intervened to create or improve the law market through legislation forcing state regulators to accept various degrees of competition. Congress did not use these opportunities to substitute federal regulation for state regulation. Instead, Congress opted to preempt particular state regulatory actions (RRGs, PGs) or reduce transaction costs for the inter-state law market (surplus lines) to enable regulatory competition among state insurance regulators.

In this article, I argue that although the laws created by Congress to expand access to insurance through the requirement that states allow entities licensed by other states to provide specific forms of insurance were not explicitly framed as creating an SEZ, they do in fact create a non-territorial SEZ. Thus there is a de facto SEZ for these insurance markets, defined by subject matter rather than geographical boundaries. This, in turn, suggests an alternative pathway to geographical SEZs, one which can expand competition among legal systems. What I call here "non-territorial SEZs" offer a way to bring greater competition to federalist polities in particular, expanding the zone of competition beyond "voting with one's feet" across jurisdictional boundaries (see Tiebout, 1956). They also offer a pathway for jurisdictions engaged in cooperation in regulating particular economic spaces, since such arrangements can cross national boundaries, as well as ones internal to particular federalist polities.[2]

To put these into context, I begin by describing the use of a 'fronting' insurer to access non-admitted insurers in the overall U.S. state-based regulatory environment for insurance. Fronting serves as a baseline level of regulatory competition. I then explore how insurance can be procured outside any single state's confines through the three SEZ-like measures mentioned above and how they are created. I next discuss how these regulatory regimes have features which create non-territorial special jurisdictions.

Finally, I conclude by discussing how this approach can be used in other areas to expand competition

[2] For the purposes of this article, jurisdiction should be understood as referring to U.S. states as well as both independent and non-independent territories with law-making power over the relevant subject area (e.g, British Overseas Territories such as Bermuda).

within the law market.

2. THE U.S. LAW MARKET IN INSURANCE

The market for insurance in the United States is highly regulated. Indeed, insurance is globally one of the most heavily regulated industries (Krutov, 2010). For historical reasons, in the United States this regulatory activity occurs primarily at the state rather than at the federal level. This makes it, as one expert put it, "a feudal regulatory system with each state acting as its own fiefdom" (Diemel, 2016a, 7). The reliance on state regulation of insurance "is peculiar given the interstate operations of many insurers" (Grace & Klein, 2000:79). Regardless of the historical origins of their near-complete jurisdiction, state insurance regulators tenaciously defend their regulatory turf against federal encroachment. States' resistance to expansion of the federal role is one of the key factors in permitting the law market to emerge through these non-territorial SEZs.

2.1. The Legal & Regulatory Environment for Insurance

Traditional U.S. state insurance regulation is dominated by concerns over the solvency of insurers (who, after all, accept money today in exchange for a promise to pay later, should the insured against event occur) and protection of consumers against exploitation by insurers with respect to both price and coverage. For purposes of this Article, the key features of state insurance regulation are:

> (1) Unless specifically permitted by law, insurers wishing to sell insurance covering a risk must be licensed by the state where the insured is resident (be an "admitted" insurer).
> (2) Regulation of admitted insurers primarily focuses on:
>
> > a. insurer solvency, via required minimum capital and surplus requirements;
> > b. participation in the insurance industry, via evaluating insurers' officers and directors to ensure they are fit and proper people to be engaged in the insurance business;
> > c. the substance of insurance policies, by requiring insurers to file proposed policies and receive approval for their use; and
> > d. rates, by requiring insurers to file proposed rates in advance and receive approval.

These regulations are justified primarily on the basis of information asymmetries: insureds have limited ability to judge whether an insurer will likely be in a position to make good on its commitments when a future claim is made (solvency, keeping fraudsters out of insurance companies), knowing whether they are being charged a fair price (rate regulation), or understanding complex policies filled with technical and legal jargon (policy form regulation) (van den Berghe, 1990; Grace & Klein, 2000; Butler & Ribstein, 2008:09). In addition, regulators often seek to alter market outcomes in pursuit of distributional goals (e.g., via cross-subsidization). Although there has been some deregulation of insurance in most U.S. states over the past few decades, in particular a reduction in reliance on price regulation, state insurance regulators continue to control product offerings, company finances, and market behavior to a considerable degree.

State regulatory dominance in the U.S. market can be traced to the U.S. Supreme Court's 1868 decision in Paul v. Virginia, 75 U.S. 168, that insurance was not "commerce" and so not subject to regulation under the federal government's power to regulate interstate commerce. By the time the U.S. Supreme Court reversed itself on federal authority in a 1944 decision, United States v. South-Eastern Underwriters Association, 322 U.S. 533, state regulators were both firmly entrenched and well organized (They formed their first national association in 1871 and have been organized continuously since.) As a result of this organization, states reacted quickly to South-Eastern Underwriters by pressuring Congress to pass the McCarran-Ferguson Act in 1945, mostly closing the door to federal involvement that South-Eastern Underwriters had opened. States also began to undertake more aggressive regulation of insurers, both in response to specific incentives to do so in McCarran-Ferguson and to help forestall future federal efforts at regulation (Harrington, 2000).

States' desires to preserve their primary role in insurance regulation are powerful motivators for state regulatory activity. Despite periodic efforts to create a "federal option" for insurance regulation such as the choice available to banks between federal and state charters, states have successfully blocked any full-scale federal intrusions into their regulatory turf. (Butler and Ribstein catalog the reasons why a federal option is insufficient to induce genuine regulatory competition. (Butler & RIbstein, 2008-09, 38).) Although Congress has not (yet) supplanted the state role or offer full-fledged competition, it periodically threatens federal regulation as a means of pressuring state regulators to alter particular regulatory practices. For example, after a rash of insurer insolvencies in the 1980s "generated concern about the quality of state solvency regulation," states rushed to increase their regulation of insurers' solvency and the state regulators' trade group, the National Association of Insurance Commissioners (NAIC), quickly developed risk-based capital requirements and a program of accreditation for state regulators. These measures were sufficient to relieve the pressure from Congress and, thus far, end the threat of federal regulation (Harrington, 2000:31, 35).

The state-based regulatory system imposes considerable transaction costs on insurers. An insurer seeking to sell a product nationally needs to obtain licenses and policy language and rate approvals from all fifty states and the District of Columbia. As insurance lawyer and long-time RRG advocate John Harkavy put it, "[m]Iulti-state regulation of insurance has not advanced in many ways beyond when

America was governed by the Articles of Confederation after the [American] revolution" because the states make it hard to buy insurance from out of state by regulating brokers and insurance companies (Harkavy, 2013). In general, alternative insurance products that do not fit into the standard regulatory model are opposed by most state insurance regulators. One attorney specializing in alternative insurance described this as treating "anything they can't get their hands around as 'bad'" so that "[i]f an insurance company wants to operate on a non-admitted or surplus lines basis, reasons the regulator, surely they must be up to something and that something is probably no good" (Kravetz, 1996, 7).

Indeed, one of the certainties of insurance regulation is the intensity with which many state regulators guard their authority by restricting potential insurance customers in their jurisdiction from purchasing insurance from non-admitted (unlicensed in the jurisdiction) carriers. For example, regulators oppose non-admitted carriers from having any contacts with potential insureds. Thus, if an insurer admitted in State A but not in State B contacted a potential client in State B, responded to an inquiry from an individual or business in State B, made a phone call to a prospective insured in State B, or mailed an invoice or policy to an insured in State B, State B's insurance regulator would consider the insurer to be conducting unauthorized insurance business in State B. Of course, the prospective client in State B could physically leave State B and have all its contacts with the State A insurer from locations outside State B, but the transactions costs of doing this would be immense (Pomerantz, n.d.). In addition, most states tax such 'direct procurement' of insurance from non-admitted carriers at much higher levels than they tax premiums paid to admitted insurers, reducing the ability of non-admitted carriers to compete on price. Some states provide an "industrial insured" exemption from many of their insurance regulations, allowing commercial brokers to buy insurance for more sophisticated clients who meet minimum size and premium requirements without requiring as much traveling out of the state to transact business. These exceptions are expensive and limited.

Economist Scott Harrington argues that this costly system of state regulation has persisted despite the considerable transaction costs it imposes for two main reasons. First, insurance markets, in conjunction with state oversight, often perform reasonably, if not remarkably, well. Many states have economically sensible regulatory systems that focus attention on areas where the government can help achieve an orderly market, as opposed to taking actions that substantially undermine efficiency and redistribute wealth. The second cause is related. Although there have been exceptions earlier in this century, especially for life insurers, the insurance industry has traditionally supported state regulation (Harrington 2000: 37).

Harrington's assessment suggests that states primarily benefit from generating income from insurance regulation (as well as jobs for regulators) and enabling state politicians to extract rents from insurers, but do so without being too greedy in rent extraction. Insurers accept the costs of the balkanized market because they benefit from the barriers to entry it creates, blocking potential new entrants. As J.R. Hicks noted in 1935, "[t]he best of all monopoly profits is the quiet life" (Hicks, 1935, 8); raising the cost

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of entry by requiring multiple licenses to reach a market of sufficient size is an effective way to procure quite a bit of quiet.

Moreover, insurance issues rarely reach high degrees of political salience. While we occasionally hear of political disputes over insurance regulations – particularly involving aggressive regulatory efforts in California (Jaffee and Russell, 2002) – for the most part, insurance regulation is not front-page news. The first part of Harrington's conclusion, that state regulation works "reasonably" well, thus seems to be true for many purchasers of insurance (e.g. home owners, car owners, etc.). Where it does not function reasonably well is with respect to new types of coverage (e.g. cyber risks, cannabis businesses) and niche groups (e.g., oral surgeons), particularly during the periodic "hard" markets when various lines of insurance coverage become more expensive and/or less available. As we will see below, these are the areas where the non-territorial SEZs have been created.

One important means by which state regulators have fended off federal regulation is that their national trade association, the NAIC, has successfully worked to harmonize state statutes and regulations in many areas (Patrikis, 2000). The NAIC also works closely with federal regulatory agencies to address their concerns (Chesson, 2000), reducing pressure for federal intervention. This has attenuated the benefits of regulatory competition; as Butler and Ribstein note, "The states have had 60 years since McCarran-Ferguson to evolve toward jurisdictional competition and have instead embraced a state cartel under the NAIC" (Butler & Ribstein, 2008-09, 39). Importantly, there is no existing federal regulator in place seeking to expand its turf, as there is in banking (Wallison, 2000). The Dodd-Frank Wall Street Reform and Consumer Protection Act created the Federal Insurance Office in 2010, but, so far, this office has been limited to a coordinating and information provision role. Of course, a variety of federal regulations touch on various aspects of insurance (e.g., the Employee Retirement Income Security Act has a large impact on the insurance components of employee benefits programs and preempts state law in that area), and so federal law is more relevant in particular areas, but even these intrusions are exceptions to the broad principle of state regulation.

The fundamental problem that state insurance regulation poses for U.S. insurance buyers is that it limits buyers to a restricted set of insurance sellers (only those licensed to do business in the state where the buyer is located), offering a restricted set of insurance products (only those authorized by the relevant state regulator), at a price sometimes subject to regulatory constraints. Further, the insurers with whom buyers can transact and whose products buyers can purchase will be only those which are willing to bear the fixed costs imposed by each state's regulators of selling in the buyers' jurisdiction. This disproportionately limits choices for those seeking innovative, niche, and new products, because insurers are more likely to be willing to incur the fixed costs of regulation for mass products than for ones for which the market is uncertain or limited. More generally, as Henry Butler and Larry Ribstein noted, "the current state-based regulatory system does not capture the benefits of jurisdictional competition that are found in other areas of the law, notably corporate law" (Butler & Ribstein 2008:09, 36)–(Butler and Ribstein do not discuss any of the areas of insurance analyzed here, focusing on a broader view of general licensing.)

Because these are the insureds more likely to be sophisticated buyers than the average buyer of insurance, they are also the group that receives fewer benefits from state regulation of insurers' forms, rates, and solvency, as these buyers are unlikely to need regulators' help in understanding policies, bargaining for coverage, or avoiding being hoodwinked by charlatans. Sophisticated buyers are also more likely to have problems that require tailor-made solutions. And they are more likely to be capable of monitoring insurer solvency without regulators' help. Thus the costs of state regulation for these insureds are higher and the benefits lower than for retail customers.

Two federal statutes have created three non-territorial SEZs for different parts of the insurance market. In 1981, reacting in part to an insurance crisis provoked by the vast expansion of tort liability in the 1960s and 1970s by many American state courts and in part to an exceptionally hard insurance market, the U.S. Congress passed the Product Liability Risk Retention Act (PLRRA). It created "risk purchasing groups" (PGs) and "risk retention groups" (RRGs). The initial proposal came from the Federal Interagency Task Force on Product Liability, which focused on measures to expand competition in the insurance market by facilitating means of self-insurance. One of those involved in developing the proposal stated that a key breakthrough in getting it through Congress was the suggestion from Senator Howard Cannon's office that the law be made self-enforcing, with no role for the federal government. An early version's role for the Department of Commerce was dropped and the statute passed with support from a coalition that included manufacturing and business groups. (Schwartz, 1997: 5). In a sign of the amount of pressure on Congress to increase the supply of products liability insurance, the PLRRA partially opened U.S. liability insurance markets to insurers domiciled in Bermuda and the Cayman Islands.

Congress amended the PLRRA in 1986 despite opposition of most state insurance regulators, expanding it beyond product liability, with the Liability Risk Retention Act (LRRA) (on an astonishing 96-1 vote in the Senate and a unanimous voice vote in the House), primarily expanding its reach but also tweaking it in a few ways to make it more acceptable to state regulators (e.g., dropping the eligibility of Bermudan and Caymanian domiciled insurers). The expansion of the PLRRA by the LRRA can be at least partially attributed to the "elimination of capacity as well as severe price increases" in 1984, a combination which meant that "[t]he traditional insurance marketplace had virtually pushed [traditional insurers'] clients into finding alternative ways to finance their risk." (Sterling, 1992: 8). Under the LRRA, insurance companies can be formed by groups of insureds, obtain a license to operate from any state willing to grant the company one (the "domicile"), and then offer liability insurance to their owners in any of the fifty states (plus the District of Columbia) without being subject to regulation by the non-domiciliary jurisdictions. These risk retention groups (RRGs) thus avoid the considerable transaction costs of complying with multiple states' regulations. In addition, insurance customers may form purchasing groups (PGs) to collectively negotiate for and purchase insurance, including from non-admitted carriers. The LRRA provided more limited preemption of state regulatory measures with respect to PGs than it did for RRGs.

The second major federal intervention that focused on expanding the insurance market was the Non-admitted and Reinsurance Reform Act (NRRA), passed in 2010 as part of Dodd-Frank, after nearly a decade of unsuccessful efforts to pass it as a standalone measure. The NRRA streamlined the surplus lines process (the name for the means by which states allowed non-admitted insurers to write a type of coverage if no admitted carrier does so) and made the criteria for providing such coverage more uniform, thus expanding the number of insurers able to provide insurance in it and easing the transaction costs of doing so.

These two statutes provide models for how federal preemption can create a dynamic typical of what I refer to here as non-territorial SEZs, as they incentivize more entrepreneurial state regulators to compete for business. By establishing a regulatory regime that facilitates RRGs and PGs, states can attract business (earning the registration fees and promoting the growth of law, accounting, insurance, and other service firms in their jurisdiction). As a Vermont regulator noted, Vermont's captive insurance industry (which includes RRGs) brings the state more revenue than the state lottery and, while it is a small business, "it's a very big business for Vermont" (Gjertsen, 2017: 7). By facilitating access to surplus lines coverage, states can promote economic activity that requires innovative or new forms of risk transfer through insurance. The key is that both statutes restrict state-level protectionist measures without adding a new federal layer of regulation or substituting federal regulation for state regulation. This was possible in insurance regulation in part because of the strength of the state insurance regulators enabled them to resist federalization, deterring Congress from grabbing control of insurance regulation from the states.

The U.S. insurance market would thus appear ripe for disruption through regulatory competition if the problem of how to substitute an alternative regulator for an obstructionist state's regulator could be solved. It is a heavily regulated market in which expensive-to-comply-with consumer protection regulation such as form and rate regulation is applied even to insurance bought by sophisticated commercial parties. The market is fragmented among fifty-one regulators, who jealously guard their regulatory turf. Unfortunately, a traditional SEZ cannot enable such disruption because state regulators remain able to prevent entry into their protected markets. To get the benefits of regulatory competition, something other than a territorial SEZ is thus needed.

2.2. Fronting

One simple means of expanding the choice set available to insurance buyers in a state–something traditional SEZs do–is for an insurer not licensed by the relevant state (referred to as either 'foreign' (an insurer licensed by another U.S. jurisdiction) or 'alien' (an insurer not licensed by any U.S. jurisdiction)) to act as a reinsurer for an insurer licensed in the relevant state. Reinsurers are important players in insurance generally, serving to spread risks beyond what any single insurer wishes to bear, and deploying substantial capital to support insurance policies. Reinsurance itself is inherently international as risk-spreading within even a large market like the United States is inferior to doing so on an international scale (Neave 1980). If authorized insurers can simply reinsure risks to an insurance company not licensed in the jurisdiction, there is considerable potential for expanding the choice set for the jurisdiction's insureds by creating or locating reinsurers in other jurisdictions. This is known as "fronting" and is often used to enable captive insurance companies (insurers owned by their insureds) to cover their owners' risks without securing multiple state licenses.

Fronting saves the non-admitted insurer the cost of obtaining a state license in the insured's state but does not necessarily avoid the other transaction costs imposed by state regulation. The fronting insurer must still comply with the rate and form filing requirements of the relevant state(s), be licensed, and bear some residual risk (if the non-admitted reinsurer fails to deliver on its promise to pay). Of course, fronting insurers want to be paid for their services and the risks they assume, adding to the cost of the transaction. However, particularly in the captive context, state regulators "offer some regulatory relief to these companies based on the presumption that owners of captive companies have sophisticated knowledge about managing their risks and would protect their own interests" (GAO 2011: 7). And the state allowing the fronting still has the fronting insurer on the regulatory hook for any problems that might occur, giving the regulator some security that its regulatory objectives will be achieved. Importantly, the fronting insurer will be unlikely to risk its license to permit a dubious captive reinsurer to make use of it, providing market pressure for avoiding inadequately capitalized reinsurers.

Although state regulators acquiesce in some fronting (which they can monitor as the regulated fronting insurer must disclose to the regulator its reinsurance arrangement with the non-admitted carrier), regulators impose limits on the circumstances under which fronting can occur. For example, the NAIC's Fronting Disclosure and Regulation Model Act (1993) provides that when fronting occurs the licensed insurer must make disclosures to the regulator of the identity of the reinsurer and the identity of any third party to whom underwriting or claims settlement procedures have been delegated. These requirements apply where the ceding insurer is delegating underwriting or claims settlement authority to an unlicensed (by the state where the ceding insurer is writing the coverage) reinsurer in a reinsurance transaction that exceeds 5% of the ceding insurer's surplus or where the gross annual premium for business covered exceeds 15% of the ceding insurer's surplus (NAIC, 1999, III-5). Prior approval of the transaction by the ceding insurer's state regulator is required when the transaction exceeds those thresholds and where at least 15% of the risks subject to the reinsurance are in that state (NAIC, 1999, III-5 to III-6). State regulators thus have several tools to control the degree of fronting that occurs in their jurisdiction.

Fronting serves as a partial escape valve for pressure by insureds on state regulators to expand insureds' choice set of potential sellers of insurance and reduces the cost to a subset of insureds of state regulations that limit the opportunity to purchase insurance from non-admitted insurers. However, because the transaction costs of establishing and operating a captive insurance company in another domicile to reinsure the insured's risks via a fronting carrier are substantial, this is primarily an option for large organizations. (In general, captive solutions become cost-effective when annual premiums reach the $1-2 million level, as establishing and maintaining a captive requires substantial fixed costs.) It also is potentially costly to scale across multiple states, because a front and approval for the reinsurance must be obtained in each.

Large organizations are more likely to be able to effectively lobby state legislatures for regulatory relief. As a result, regulators are more likely to permit an exit option where state regulation limits their choices in a costly way. Loosening constraints on politically powerful interests helps state regulators avoid pressure to deregulate more generally. The use of fronting is thus more a form we might refer to as "regulatory price discrimination" than a generalizable solution like an SEZ. Nonetheless, fronting points to an important element shared with territorial SEZs around the world: fronting creates a means by which an insured can bypass at least some of the transaction costs imposed by the insured's state insurance regulator and choose an alternative regulator (the captive's domicile) without forcing the insured to physically move to another state. Further, it does so by substituting another entity (the fronting carrier) for the ultimate insurer for a number of regulatory purposes, relieving the ultimate insurer of regulatory burdens while giving the regulator a proxy motivated to ensure there are no problems that would put its own license at risk. This is why I have referred to this as a non-territorial SEZ solution. That said, given the cost and complexity of establishing a captive and organizing a transaction with a fronting carrier, this escape valve still involves significant fixed costs, particularly if deployed across multiple states, each requiring a front. Demand thus remains for other means of accessing non-admitted insurers.

2.3. Surplus-Lines Insurers

Where a particular type of insurance is unavailable within a state (e.g. coverage for satellites), U.S. state regulators often permit resort to "surplus-lines" insurers. Insurance for high value art, hazardous materials handling, and floods are common types provided via surplus lines insurers. Other examples include unusual coverages such as for food trucks, high-rise window washing, or raising unusually dangerous animals. These are insurers licensed by a state other than the state where the insured or insured activities are but not by that state and that meet some additional criteria (GAO 2014)–Surplus lines insurers can be either foreign or alien insurers. Buying surplus-lines insurance– 'exporting' the risk from the insured's state in insurance terminology– generally involves buying policies which "differ from standard market products in terms and conditions, pricing, claims handling, risk control services, and risk management support provided by intermediaries" (AICPCU 2017, 1.9). Because they do not need regulatory approvals for the terms and prices of the coverage they provide, surplus-lines insurers have more flexibility in designing coverage than do insurers subject to rate and/or form regulation. "This flexibility to tailor the coverage provided and the price at which they provide it enables non-admitted insurers to manage unique or large risks" (GAO, 2014: 8).

To qualify for the surplus lines exception to the general rule that insurance may be purchased only from admitted insurers, buyers must generally:

- purchase the insurance using a broker licensed to handle surplus lines by the state in which the buyer operates or resides;
- conduct a "diligent search" for coverage from an admitted carrier prior to resorting to a surplus-lines carrier;
- deal only with surplus-lines carriers that meet minimum surplus and capital requirements;
- receive a policy containing a notice stating that the surplus-lines carrier is non-admitted and that the policy is not covered by the state's guaranty fund; and
- pay a tax (collected by the broker and generally higher than the tax on premiums paid to admitted insurers) on the premiums.

These conditions ensure that the surplus-lines market does not swallow the admitted market by restricting surplus-lines purchases to policies that fill gaps in the admitted market, give the regulator a regulated entity (the broker) to punish if things go awry, and require a basic level of solvency.

One important benefit of surplus-lines coverage is that it provides insurance products for needs which the admitted carrier market is not meeting. This often involves new lines of coverage, high-capacity policies, and distressed or unique risks. Surplus-lines carriers–just twenty-five provide more than two-thirds of the market (GAO, 2014: 15)–focus their efforts on "loss exposure analysis to ensure that new products meet the needs of targeted customers" (AICPCU, 2017: 4-6).

Surplus-lines carriers can meet these needs in part because they avoid the policy form filing and rate regulation of admitted carriers. For the types of risks handled by surplus-lines carriers, "[t]he time and expense required to make the filing needed to properly handle such risks are seldom, if ever, justified by the resulting premiums. … Freedom from form and rate regulation reduces the time and expense required to bring new insurance products to the market" (AICPCU, 2017: 1.7-1.8). An additional benefit is that as insurers' experience with some of these risk categories grows, coverage often migrates from the surplus lines market to the admitted carrier market.

While all states now permit surplus-lines coverage, this was not always the case. When New York became the first to authorize such coverage 1890, the National Convention of Insurance Commissioners (NCIC), the forerunner of the NAIC, reacted by forming an Unauthorized Insurance Committee to examine the issue. The committee began decades of resistance to surplus-lines markets, seeking a complete ban in 1928 (although it did not persuade the larger group to endorse this position). Over time, more state regulators began to see value in being able to fill gaps in coverage and adopted a strategy of regulating the market rather than attempting to shut it down. In the 1930s, California started a trend toward providing state-sanctioned lists of the insurers eligible to write surplus-lines coverage. Nonetheless, the Unauthorized Insurance Committee continued its campaign against surplus-lines markets until finally giving in and developing a model act to regulate the market in 1948.

State regulation converged to focus on the role of the surplus-lines broker, who was required to be licensed and upon whom the state placed the burden of conducting the diligent search, maintaining records, and, crucially, calculating and collecting the surplus lines excise tax for the relevant states. The regulator's association's evolution to a less hostile position continued when the organization created the Nonadmitted Insurers Information Office (now the International Insurers Department (IID)), partly in response to pressure from a U.S. Senate Antitrust and Monopoly Subcommittee investigation into the effectiveness of state regulation of insurance in the early 1960s (AICPCU, 2017: 2.18). The Office/Department examined alien insurers' financial condition, officers' and directors' biographies, and insurers' audited financial statements and kept a list of those which met its standards. This list became a de facto general eligibility list for alien insurers writing surplus-lines coverage.

Use of surplus-lines insurance expanded considerably after the passage of the Gramm-Leach-Bliley Act in 1999. It pressured states to provide nonresident licensing of surplus lines brokers by authorizing creation of a federal licensing alternative if a majority of states did not enact legislation providing for uniformity or reciprocity in licensing insurance agents and brokers. States quickly passed the legislation necessary to prevent the federal alternative from going into effect. While only a "handful" of states offered nonresident licenses prior to Gramm-Leach-Bliley, afterwards there was widespread adoption of the NAIC's reciprocal licensing model. This expanded the pool of surplus-lines brokers able to operate in many states (AICPCU, 2017: 2.19; CRS 2015).

Nonetheless, the transaction costs of using surplus-lines insurance remained relatively high, because state taxation of surplus-lines premiums varied widely across the states as did regulations of the market, which even the NAIC educational materials conceded were "a hodgepodge of inconsistent and conflicting state rules and regulations" (AICPCU, 2017: 2.21). The NRRA reduced the transaction costs of surplus-lines purchases by:

- allowing only one state to tax the premiums;
- clarifying which state was the "home state" with authority to regulate and tax a surplus lines transaction by establishing a standard definition which was subsequently adopted by most states;
- creating a nationwide eligibility standard, based on NAIC model act language that allowed insurers to write surplus-lines coverage when they were licensed to write such coverage in their domiciliary jurisdiction so long as they met a capitalization requirement of the greater of $15 million or the minimum set by the state regulating the transaction, which effectively allows states to set their own minimum, so long as it exceeds $15 million; and

- effectively making the IID's "Quarterly Listing of Alien Insurers" a universal eligibility list for insurers by barring states from prohibiting placing coverage with an alien insurer which was on the IID list. (It remains an open question whether there are effective alternatives to the IID list.)

Although the NRRA did not accomplish the broader congressional goal of persuading states to create multistate compacts to divide the tax revenue from surplus lines premium taxes (the bigger "home states" generally opted to simply keep all of the revenue rather than agree to share it (GAO, 2014; Crawford 2015), it has lowered the cost of engaging in a surplus-lines transaction. Several alien insurers have entered the U.S. surplus-lines market, with the largest number domiciled in the United Kingdom and Bermuda; Lloyd's is largest source of surplus-lines coverage (GAO, 2014: 9).

After the NRRA's passage, the surplus-lines market became a something that we could say looks like a non-territorial SEZ. The market enables entry by insurers regulated by a variety of jurisdictions, including two non-U.S. jurisdictions with vibrant insurance industries and quite different regulatory strategies than American states, as well as from other U.S. states. The combination of the federal statutory provisions and the state statutes, prompted by both market and federal pressure, cabins state regulators into a narrow focus on solvency and information that restrains some of their more protectionist impulses. As a result, the choice set for insureds is expanded in those areas where the admitted market does not offer coverage. The key characteristics of the market are the transaction-cost reducing features of the NRRA combined with the reduction in state regulatory barriers to sale of surplus-lines coverage induced by Congress' threat of federal regulation. The shift in state regulatory focus to surplus-lines brokers and solvency allows states to pursue limited regulatory concerns without enabling the development of additional protectionist regulation. Thus, being listed on the IID list functions as the equivalent of being located in an SEZ, I argue, even though the limits on surplus-lines markets remain substantial. There must be no admitted carrier willing to write the coverage and the transactions costs of obtaining the required declinations and use of a licensed broker remain (albeit reduced by the NRRA's forced expansion of non-resident licenses for surplus-lines brokers). Nonetheless, post-NRRA, the surplus-lines market constitutes a type of non-territorial SEZ, even if it was not formally designed as such, albeit one with a restricted scope.

2.4. Risk Purchasing Groups

A risk purchasing group (PG) is "in its simplest form, … a group of insurance buyers, banding together for the collective purchase of insurance" (Harkavy, 2019). Members must share a commonality of purpose and risk. PGs do bear risk themselves but rely on third-party insurers for the insurance. To reduce transaction costs, some states allow PGs to develop "master policies" under which individual group members can receive certificates of insurance coverage, preventing fixed costs from being incurred for each policy (e.g., documenting declinations for surplus lines coverage).

Numerous state laws forbid or raise the transaction costs of forming such a group, including so-called "fictious name" statutes–a "barrier that has existed for generations" (Cummings,1995: 10)–that bar the formation of groups solely for the purpose of buying insurance and countersignature requirements and require obtaining a locally licensed broker's signature on any policy the group negotiates. Added to the PLRRA as "no more than an afterthought" (Russell, 1993: 4), federally authorized PGs developed into an important means of accessing the insurance market for many insureds.

PGs are usually, but need not be, a separately incorporated entity. A PG is domiciled in a single state and so subject to that state's regulation with respect to its formation and operations. In addition, non-domiciliary states may regulate PGs in some respects (in more ways than they can regulate RRGs, as discussed below). For example, the set of insurers eligible to sell liability insurance to a PG can be limited to admitted insurers, those surplus-lines insurers acceptable to the state, or RRGs registered in the state where the PG is operating. (State rules on which surplus lines insurers are eligible vary.) They can negotiate only for commercial liability insurance which provides coverage of risks that are common to their members. PGs are comparatively easy to create and operate, as they need not raise capital. Some are created by insurance companies on behalf of their customers; others are created by entrepreneurial brokers; others by trade associations. This development of "entrepreneurial" PGs was not anticipated by the LRRA's drafters (Kravetz, 1990).

One of the first PGs to form was the Pathologists' Liability Insurance Purchasing Group, which came into existence in response to the late 1986 withdrawal from the medical malpractice coverage of a traditional, regulated insurer (CIGNA subsidiary Pacific Employers). This left 1,700 pathologists who had purchased their insurance through a College of American Pathologists program with that insurer without coverage for the coming year. "Because time was of the essence to the physicians in obtaining liability insurance, the decision was made to form a purchasing group and not a risk retention group. Purchasing groups can be formed quickly, requiring nothing more than a resolution of the board of directors of an existing association" (Cutts, 1987d: 6). As the new insurer, Doctor's Company, was admitted only in six states, "it would have been virtually impossible to have written a nationwide program prior to the passage of the 1986 Act" (id.). The PG enabled the pathologists to get coverage that was otherwise unavailable and to do so quickly.

A 1990 survey of PGs by the Risk Retention Reporter found the primary benefits of PGs included the ability to:

- Design a rating structure based on the risks presented by the group members;
- Assemble insureds nationwide, rather than in a single state, to create the critical mass needed to make the group attractive to a carrier;

- Keep data on purchasing group losses, allowing the group to prove its members are a good risk to the existing carrier or to a future one;
- Use a policy form, tailored to the needs of the group (which would not be permitted by most states outside of the purchasing group context);
- Expand a regional program into a national one;
- Use volume buying to make coverage more affordable and available; and
- Ease regulatory restraints, particularly counter-signature requirements, rate approval and policy form (Cutts 1990b: 3-4).

As noted above, PGs were created by the PLRRA and modified by the LRRA, which tightened the definition of a PG from the "very loose" one provided by the PLRRA (MRRA Drafting Note, sec. 2(J). The LRRA specifically bars states from prohibiting the establishment of purchasing groups, prohibiting insurers from dealing with purchasing groups, requiring minimum periods before a PG can purchase insurance, requiring a minimum number of members, requiring that a minimum percentage of the PG buy insurance through the group, or otherwise discriminating against a PG. It also bars requiring the countersignature on a policy by an agent or broker licensed by the operating state. This is a significant cost reduction, since non-resident agents typically pay 5% of their commission to obtain a counter-signature from a resident agent (Cutts, 1999:5). It also represents an expansion on the surplus lines option, because the federal statute preempts state requirements that only resident agents be used for surplus lines coverage; by using a PG, purchasers can use non-resident brokers as well. Although some states–California, Georgia, Nevada–resisted this, most states changed their laws to allow non-residents to become licensed surplus-lines agents.

States can apply any of their non-preempted insurance regulations to PGs. For example, non-chartering states can require the filing of information on directors, officers, or managers of the PG if they also require other entities that purchase insurance on a group basis to do so. (Moving to non-discrimination is itself significant, even if the ability to impose broad controls on who forms entities that purchase insurance remains.) State authority remains over a PG's insurers, agents, and brokers (NAIC, 1999). States can apply cancellation and nonrenewal requirements to policies bought by PG members within those states and the federal Eighth Circuit Court of Appeals held that state laws applicable to surplus-lines insurance can be applied to PGs. Swanco Insurance Company v. Hager, 879 F.2d 353 (8th Cir. 1989). In addition, a Kentucky federal district court upheld a state regulation requiring PGs to buy insurance from an authorized carrier against a PG's argument the regulation was preempted by the LRRA. The court found the financial responsibility provision to be the sort of state regulation that Congress did not intend to preempt. Garage Services and Equipment Dealers Liability Association of America, Inc. v. Holmes, 867 F.Supp. 1301 (E.D. Ky. 1994). Because of the narrow scope of federal preemption, there is considerable variation in how states regulate PGs. For example, states retained the ability to impose financial standards on the non-admitted insurers with which PGs did business, but could not impose constraints on brokers to restrict access to the non-admitted market. A PG accessing the surplus-lines market could get more direct access to it. These measures could reduce premiums by up to 15% (Russell 1993).

From the beginning, PGs faced considerable hostility from some states and from the NAIC. In the first year after the LRRA's passage, PGs filed at least five lawsuits against state regulators over their efforts to control them (Cutts, 1987g: 1). As an example of state regulatory hostility, Florida demanded fingerprints on FBI fingerprint cards together with biographical statements and affidavits from PG officers and directors. State opposition ran deep: Iowa's regulator argued in a 1989 interview that "We have seen formations of purchasing groups which were outright facades designed to do nothing more than make an end run around the law. We can not justify this in the name of competition. The facts are simple: Insurance business is vested in the public interest and requires oversight. That is what the laws are for. If you remove laws, you increase the risk to the public" (Cutts, 1989c, 9). Similarly, the Deputy Superintendent of New York's Insurance Department wrote in 1990 that if only domiciliary states could regulate PGs, "purchasing groups and their insurers would gravitate to the most congenial jurisdictions – with the smallest regulatory resources, the biggest economic development appetite, and the least will to regulate" (Hsia, 1990, 3). State regulators have also argued that insurers were withdrawing liability policies to shift to providing such coverage through PGs to escape state regulation, although the NAIC provided only anecdotal support for this claim (Gates, 1989, 2).

The LRRA's lack of restrictions on PGs while preempting some state regulations was a sore point for state regulators. In a 1989 letter to the U.S. Department of Commerce, the NAIC particularly objected to the lack of a required "identifiable legal structure" or assets for PGs, arguing that this complicated efforts to enforce non-domiciliary state regulations against them (Gates 1989, 3). It also claimed that PGs used insurers who did not meet the financial requirements to write insurance in the traditional market (Gates 1989, 2). Finally, the NAIC was annoyed that entrepreneurial insurers and brokers were helping form PGs, objecting to "aggressive marketing" and alleging this was causing "nonexistent to dangerously liberal" underwriting (Gates, 1989, 5; Cutts, 1990a).

These complaints were unsuccessful in obtaining the imposition of federal limits on PG activities or the restoration of preempted state regulatory authority. As a result, despite the hostility, there was what one insurance executive described as an "explosion" of PGs being formed in the late 1980s and early 1990s (Sterling, 1992, 8). In the first year after the LRRA, at least 134 PGs were formed and, despite considerable market churn in the following year, there were over 400 PGs in existence at the end of the third year (Kravetz 1990, 4). In the first seven years of the LRRA, 939 PGs formed and 508 retired (Cutts, 1994).

PGs mostly appeared in large markets, where there are many potential members, and during soft markets, when competition to provide coverage is increased. The leading domiciles in the early 1990s

(Illinois, California, and Texas had just over half the PGs (Cutts, 1992b, 3)) were not that different from the leading domiciles in 2009 (Illinois, Delaware, Texas, California, and New York; Cutts 2009b). Only one of the 2009 market leaders–Delaware–was primarily a domicile that sought to develop the business. Both Illinois and Delaware attributed their success in growing their PG population "to creating an inviting and responsive regulatory environment that makes it easy for PGs to register in their state" (Cutts, 2014). Discerning welcoming jurisdictions is not hard, and, as one attorney put it, "[t]o deal with a very competent department that is very efficient and very fair is a big advantage" (Cutts, 2014).

Domiciles lacked the same regulatory power that they would have over a traditional insurance company (or an RRG) but nonetheless remained, as the Risk Retention Reporter put it, an "important link in the regulatory chain" as they can deregister a PG when the domiciliary regulator sees a problem arising. (Cutts, 1992c, 3). Indeed, some of regulators' complaints about PGs were more about which regulator had authority than a lack of regulation, as the domicile had the power to seek a nationwide shutdown of a PG by deregistering it, not merely to stop its activities within its own borders.

The market pressures unleashed by PGs did more than constrain regulators; they also improved the performance of the PG's members. For example, when a group of structural engineers formed a purchasing group, they required the members to undergo a "Technical Practice Review" by a structural engineer hired by the PG to ensure that members were complying with professional guidelines and "actively employing effective loss prevention techniques" (Cutts, 1988c: 5). PGs' rapid expansion after the LRRA's passage, with the number of PGs growing much faster than the number of RRGs, partly reflects the relatively soft nature of the insurance market in the late 1980s and early 1990s and partly is the result of the relatively low transaction costs involved in creating a PG.

Of course, there have also been problems with PGs. Bel-Aire Insurance Co., a Missouri-domiciled insurer and an early promoter of PGs, ran into trouble with regulators in multiple states, including Arkansas, California, Illinois, Louisiana, Kansas, New York, Pennsylvania, and Texas and was placed into receivership by Missouri regulators in 1990. Bel-Aire's president was also involved in an insolvent insurance company and had ties to Missouri state representative, the chair of the state House of Representative's insurance committee, who was convicted of multiple felony drug charges while serving on Bel-Aire's board of directors (Cutts, 1990c). The former president was convicted in 1994 in federal court on 27 out of 34 counts charged, including conspiracy, fraud, and money laundering. In general, while a number PGs have closed (sometimes even before purchasing any coverage), there have been relatively few problematic PGs actually operating, based on the comprehensive reporting of the industry journal, the Risk Retention Reporter.

PGs demonstrate the relatively narrow range of preemption of regulators necessary to create a functioning non-territorial form of SEZ. While non-domiciliary states retain broad regulatory powers over PGs (albeit powers which they can exercise only in a nondiscriminatory fashion), by simply preempting the primary protectionist measures used to exclude collective action by insureds (fictitious name laws and countersignature requirements), Congress kicked off a small but robust market that brought new players offering different and less costly coverage into various state insurance markets. Indeed, if the NAIC's complaints about the unintended consequences of the LRRA were all true – that it led to insurers participating in state markets via PGs who would not be able to participate in the admitted market – this could be interpreted as evidence of PGs' success rather than their failure. The most important lesson from the experience with PGs under the LRRA is that they illustrate how simply a non-domiciliary SEZ can be created and how targeted removal of protectionist measures can facilitate the appearance of a robust law market with a meaningful impact.

2.5. Risk Retention Groups

Risk retention groups (RRGs) are risk-bearing entities, chartered and licensed as an insurance company by a single state (the domicile); their primary purpose is to assume and spread commercial liability risks of the group's members. Federal law allows RRGs to operate in states other than their domiciles without being subject to much regulatory control by the non-domiciliary states. RRGs were created by the PLRRA, although it appears that few were formed under that statute. As one state regulator who later became a major figure in RRG regulation recalled, at first "[t]he number of RRGs was small, so few domestic insurance regulators—myself included—really knew the difference between a risk retention group and a doo-wop group" (Crouse, 2011: 9). Despite the lack of initial enthusiasm for them, efforts to broaden PLRRA began "almost from the date of enactment" (Myers & Harkavy, 1999, 1). The NAIC, soon after the PLRRA was passed, tried to restrict the scope of coverages that RRGs and PGs could offer by including a provision in its Model Risk Retention Act that would allow each non-domiciliary state to apply its own definition of "liability" in determining the qualification of an RRG or PG. Congress then amended the PLRRA in 1983 to preclude non-domiciliary states from applying a different definition of "liability," "personal risk" or "insurance" (PL 98-103; Harkavy 1994, 9-10).

The next step was the LRRA, a 1986 major expansion of the types of insurance RRGs could provide. As a former Colorado insurance commissioner put it in a 1989 speech, the statute "rocked the precepts and foundations of today's regulatory system. Regulators were collectively incredulous at the preemption of local control and the grant of basic regulatory power to one jurisdiction" (Kezer, 1989: 3). The LRRA expanded the types of coverage for RRGs beyond the initial products liability coverage authorized by the PLRRA to include all liability insurance, narrowed the permissible jurisdictions (excluding the Cayman Islands and Bermuda), and slightly narrowed the scope of preemption of non-chartering states' laws. In a nod to state regulators' interest in consumer protection, it also added a requirement that policies include a standard notice that the policy was issued by an RRG and so was not subject to the insurance laws and regulations of the non-domiciliary states (Model Act, Drafting Note, sec. 4(G)). Unsurprisingly, as the purpose of the federal statutes was for RRGs to write coverage across state lines, most RRGs write coverage primarily outside their domicile (GAO, 2011: 21).

Not just anyone can form an RRG. It must be owned by its insureds (if owned via a group entity, all members of the group must be insureds). It can offer only commercial liability insurance and reinsurance of other RRGs (or members of other RRGs) that have similar direct risk exposures (liability is defined to include commercial liability, auto liability, and general liability but excluding worker's compensation liability or property liability.) The requirement that the insured group be homogenous is a significant limitation relative to other insurers. For example, doctors could be members of a RRG for their medical malpractice insurance and truck drivers could belong to another for their liability for accidents, but these two groups could not belong to the same RRG insuring both medical malpractice and trucking accidents. By contrast, a traditional insurer could develop product lines for both groups. The required narrowing of RRGs' risk pools is the opposite of the traditional insurance focus on broadening risk pools. Finally, insurance companies were barred from owning RRGs, presumably to block them from using the statute to make a partial end run around state regulators.

An RRG may be organized in a variety of formats; the vast majority are organized as captive insurers and only states that permit organization as a captive have seen a significant number of RRGs choose them as their domiciles. Because the owners of the RRG are also the insureds, some (but not all) of the potential justifications for many regulations are not present. For example, RRGs have no incentive to design clever exclusions which would deny coverage to their insureds, and so form regulation to prevent the hoodwinking of insurance buyers is unnecessary. Eliminating these regulations reduces the cost of operating the RRG as those regulations can impose significant transaction costs. For example, obtaining a conventional insurance license from a state is a costly undertaking; a 1998 study found that the average market value of a state license was $50,000, providing an indication of the cost of obtaining one (Grace & Klein 2000). Nonetheless, the fixed costs of organizing an RRG are non-trivial and were estimated in 1988 to be $70,000 to $100,000. (Members typically make a share subscription of 50% of their first-year premium towards the RRGs' capital and surplus (Cutts, 1988b, 3)).

The crucial innovation introduced by the PLRRA/LRRA was that the regulation of RRGs is left almost entirely to the domiciliary state. Domiciliary states are constrained primarily by market and political pressures (from Congress and other states individually and via the NAIC). Thus the traditional areas of state regulation are the province of the domiciliary state, including form and rate regulation, if any. While solvency regulation has been harmonized to some extent over time by the development of NAIC standards, its implementation remains the responsibility of the domiciliary state.

Even in such relatively harmonized areas, states actively seeking to be RRG domiciles are more flexible than states that are not. South Carolina's chief alternative risk regulator noted this in a 2006 interview, saying that "We carefully monitor financial solvency, but we have reasonable and prudent regulation" (Hyatt, 2011a, 7). An example of the difference in approach taken by RRG-friendly states is the District of Columbia's willingness to allow RRGs to build their capital through partnering with outside investors, a step that D.C.'s regulator said it took because "the market demands it." D.C. recognized that

> "[i]mposing additional regulatory burdens or treating RRGs like traditional insurers will not solve the problem; it will only make the problem worse. The ART market in general and the District's Risk Finance Bureau in particular, exist for the purpose of providing insureds with affordable solutions to their risk finance needs. Too often insurance regulators take the position that if it has never been done before, disapprove it. In the District, we take the opposite view. If it has never been done before and it makes sense, bring it to us and we will take a look at it. If possible, we will work with you to make it work to our mutual satisfaction" (Sheppard, 2005: 10).

Similarly, Vermont's RRG regulator commented that RRGs could not exist without regulators' willingness to allow them to use letters of credit for part of their capital and surplus, something that traditional insurance regulation generally does not allow (Cutts, 2005a). And domiciles compete on service as well. As early as 1987, Vermont, an early and enthusiastic domicile, touted a 30-day turnaround for review of RRG applications, which it achieved by sending the applications out to "top actuarial firms for review and comment" on a short timeline rather than relying solely on an in-house review (Cutts 1987c).

Non-domiciliary states are severely restricted in their ability to regulate RRGs. To operate in a state, a RRG need only file with the operating state regulator an information document (which includes a copy of the plan of operation or feasibility study it submitted to the chartering state) before doing business (soliciting business). Critically, no approval is necessary from the non-domiciliary states. This is a substantial friction point with states that are primarily non-domiciliary states (e.g. California). It is also a significant market-expanding measure: One insurance lawyer estimated that it would take a traditional insurance company at least five years to get licensed in all fifty states, at considerable cost (Myers 2019); by contrast an RRG would take a simple filing, with many states accepting an NAIC common form.

The LRRA's preemption of non-domiciliary state regulation is broad, although some states have aggressively resisted its application. The justification for exempting RRGs from most operating states' regulations is that many consumer protection measures are unnecessary because policyholders do not need protection from an insurer they own. RRGs are exempted from virtually any state law, rule, or regulation of a non-domiciliary state that would restrict the RRG's operations except that an RRG must comply with the unfair claims settlement process and unfair trade practices laws of the states it is operating in, and pay nondiscriminatory premium taxes imposed by the non-domiciliary states. RRGs are also required to register for service of process in each state in which they operate.

One area of contention is the LRRA's ban on a non-domiciliary state charging RRGs fees. See NRRA v. Brown, 927 F.Supp. 195 (M.D. La, 1996). This ban has not prevented non-domiciliary states' efforts to find ways to charge fees, however. They have managed to do so with some success; a Risk Retention Reporter estimate in 2018 was that RRGs collectively pay over $750,000 a year in fees to non-domiciliary states, half of which goes to Indiana ($109,000), Missouri ($120,000), and North Carolina ($133,500) (Diemel, 2018b). Non-domiciliary states can require financial examinations only if the domiciliary state has not conducted one. RRGs must also comply with dissolution procedures in the non-domiciliary state. Further, non-domiciliary states can seek relief against RRGs only in the courts as RRGs are not subject to administrative relief outside the state of domicile.

Non-domiciliary states generally exclude RRGs from state guaranty funds (and RRGs are required to inform their members of this in 10-point type in the policy). However, the LRRA allowed states to require RRGs to participate in joint underwriting funds or similar mechanisms on a nondiscriminatory manner and if the requirement takes into account the LRRA's restrictions on RRGs' activities (i.e. a medical malpractice RRG could not be required to participate in a windstorm pool).

Several states insurance regulators have aggressively resisted out-of-state RRGs' operations, often leading to federal litigation over the extent of LRRA preemption. A 2009 survey of RRGs found that over 60% said that non-domiciliary states overreached in regulation; California, Florida, Kentucky, Louisiana, Massachusetts, North Carolina, and Texas were those most frequently named (Cutts, 2009a). Earlier, over half the attendees at the first meeting of the National Risk Retention Association in October 1987 indicated they were experiencing difficulties with state regulators, prompting Rep. Robert Kasten (R-Wisc.), speaking at the convention, to vow corrective action, stating that "[t]he Act is a national, not a state-by-state program. In drafting it, we intended to simplify and streamline the procedures for establishing self-insurance" (Cutts, 1987f, 7).

Non-domiciliary states do overreach in regulation, often in the areas of registration filing requirements, fees, requiring the use of an in-state agent or broker, reporting, and minimum capital. For example, New York's Insurance Department attempted in 1987 to require RRGs to file rates and forms for approval, a clear violation of the LRRA (Cutts, 1987e, 2). In some cases, the state actions appear to be blatant attempts to thwart the LRRA's goals and courts have found those efforts preempted. For example, in Attorneys' Liability Assurance Society, Inc, a Risk Retention Group vs. Fitzgerald, 174 F. Supp. 2d 619 (W.D. Mich, 2001), the court found a Michigan fee (0.5% of premiums, on top of the 2% tax on out-of-state premiums) to be preempted, noting that the statute "creates a general presumption that non-chartering state regulation of a risk retention group is preempted, unless one of a specific set of exemptions applies." Moreover, the court noted that the fee's stated purpose – to fund Michigan's regulation of non-Michigan-domiciled RRGs – was one "which, with a few minor exceptions, non-chartering states are foreclosed from doing under the LRRA. The fact that other insurers will have to pay the regulatory fee, and non-resident risk retention groups will not, does not save the fee, for those other insurers are not part of the Congressional plan implemented by the LRRA."

RRGs have also won several federal court cases quashing efforts by non-chartering states to impose substantive regulations upon them. One of the most contentious issues involved state "financial responsibility laws," that require carrying insurance that meets statutory criteria to engage in particular activities. One of the most common activities to which these laws are applied is operating a commercial vehicle. Several states excluded RRGs (and some other means of insurance) from the approved list. Louisiana made an especially aggressive, but ultimately unsuccessful, attempt to block RRGs by labeling a law establishing minimum capital and surplus requirements for non-domiciliary RRGs a "financial responsibility" law. NRRA v. Louisiana, 927 F.Supp. 195 (M.D. La. 1996), aff'd 114 F.3d 1183 (5th Cir., 1997). Some courts struck these down as discriminatory against RRGs in violation of the LRRA. For example, a Pennsylvania federal court held that a non-domiciliary state could not limit insureds to purchasing insurance from an insurer enrolled in a state guaranty fund given the LRRA's ban on requiring RRG participation. Charter Risk Retention Group vs. Rolka, 796 F.Supp. 154 (M.D. Pa., 1992). A similar result was reached in National Warranty RRG vs. Greenfield, 24 F.Supp. 2d 1096 (D. Ore. 1998).

However, RRGs have lost other court battles over with the issue, despite the relatively straightforward language in the statute. This was particularly true early in the statute's history. For example, in 1995 a divided panel of the Eleventh Circuit upheld a Florida requirement that an RRG requirement that taxis, limousines and similar vehicles purchase insurance from an insurer that was a member of the Florida Insurance Guaranty Association. Mears Transportation Company v. State, 34 F.3d 1013 (11th Cir., 1994), cert. den. 514 U.S. 1109 (1995). It is nearly impossible to reconcile the Mears majority opinion with the language of the statute. Nonetheless, the case remains on the books and continues to be cited as justification for ignoring preemption.

Even when RRGs lose in court, however, they are sometimes able to persuade states to bring regulation into conformity with the LRRA. For example, despite the Seventh Circuit reaching a similar result to the Eleventh Circuit in a suit involving a Wisconsin requirement that health care licensees demonstrate financial responsibility by purchasing insurance from an admitted insurer, Ophthalmic Mutual Insurance Company v. Musser, 143 F.3d 1062 (7th Cir. 1998), Wisconsin later amended its insurance law to allow RRG policies. Many states have gradually moved to draft financial responsibility laws to permit RRGs to qualify, presumably in response to complaints from the groups of insureds seeking to use RRGs. And, despite outliers like Meers, the federal courts have been generally receptive to efforts by RRGs to seek relief from state overreach. As a result, one of the most significant hurdles to restraining non-domiciliary states has been individual RRGs' unwillingness to invest considerable time and resources to seek judicial review. As Kevin Doherty, chair of the Alternative Risk Transfer committee of the Self-Insurance Institute of America, noted, "Right now, if a state disagrees with something an RRG is doing, all they have to do is deny them the right to do it. Many RRGs are pretty small—usually not more than $10 to $20 million in annual premium and many smaller than that—they can only go to federal court so many times" (Cutts, 2010, 1). Attempts by RRG proponents to amend the LRRA to give the Department of Commerce the authority to administratively overrule state overreaching have thus far failed. RRGs are largely domiciled in just a few states (Vermont, South Carolina, the District of Columbia, Nevada, Arizona, and Hawaii are the most active today), although almost half of U.S. states have at least one RRG domiciled in them. RRGs in some low volume jurisdictions have cited that as a reason to redomicile to jurisdictions with more – Georgia's then lone RRG moved to Vermont in the early 1990s, noting that it was "an odd duck" in Georgia and that Vermont's greater regulatory expertise was helpful to it (Hyatt 2011b, 11). Some of these jurisdictions (especially Vermont) have been active from the beginning; others are comparatively recent entrants into the market. Both South Carolina and D.C. developed their captive laws and RRG regulations after 2000 and had only a few licensed RRGs before that; both had considerable success in quickly attracting RRGs.

Successful domiciles stress that their approach to regulation is different for RRGs. Vermont's captive regulator described its overall approach as based on communication:

> "We have steady communication with the company, from the time they visit us to take about filing an application, through the application and approval process, to their first organizational exam, and continuing through the surveillance process once they are up and running. … During the exam, we are actually in the company offices talking with them, understanding their controls and processes, and getting to know the people involved" (Provost, 2011: 7).

Similarly, if a problem arises:

> "We had constant communications with the companies and said, 'How can we work through this?' We didn't force things down their throat—we didn't make companies change if the path they were on looked reasonable. If they were in trouble, we said, 'How are you going to get yourself out? Come up with some ideas, and if it's sensible we're going to approve it. We're going to let you do things that make sense'" (Id.)

South Carolina's regulator went even further, describing captives generally as a "regulator-driven industry," and saying that

> "you really need to get inside the heads of the regulators because they have a unique position. On one side, they need to make sure the companies are doing the right thing, following their business plans, conducting themselves properly in the marketplace, and doing all the right things financially so their company is solvent. On the other hand, the regulators need to have a relationship with the RRG that will facilitate the RRG owners/insureds apprecia-

> ting the maximum benefit from the captive. It is like a two-edged sword—a regulatory role focused on financial solvency and a pro-business role within the confines of statute and regulation" (Kehler, 2011: 10).

Another Vermont regulator stressed Vermont's culture "where it's known that we expect to hear about issues ahead of time. We prefer to work with a company on a solution if they encounter trouble" (Diemel, 2019c: 7).

The difference in regulatory approach produces some real differences in regulatory requirements for RRGs. Indeed, Vermont's former RRG regulator explained in 1992 that he had a different approach to regulating RRGs (and captives generally):

> "As these entities were formed and capitalized as self help mechanisms for and by the insureds, to apply the same level of consumer protection as I might to a traditional carrier would, in many ways, be as anomalous as protecting a policyholder against him or herself. Thus I would not review risk retention group/captive policy forms, and my only concern about their rates was that they be adequate to sustain the solvency of the facility. As these captives or risk retention groups provided coverages only to their members, I might not require the same level of capitalization that would be required of a traditional insurer, but such capitalization would have to satisfy my all important concern of solvency." On the other hand, he also noted that he required that they operate "strictly within the parameters of the business plan submitted to the state" or receive permission to amend it, something not required of traditional insurers (Meehan, 1992: 4-5).

As a result, RRGs tend to have lower surplus and capital requirements than traditional carriers. At the same time, traditional insurance regulatory practices often are inappropriate for an RRG. For example, the traditional regulatory rule of thumb is that a commercial carrier should have no more than 10% of its surplus exposed to any one insured risk. As Vermont's captive regulator noted,

> "[f]or some RRGs, such as those owned by a single hospital system, the imposition of a strict 10% risk limitation would imply the RRG is required to hold significantly more capital than what's needed for its own risk under a reasonable expected loss projection. That can create a burden on capital levels. While the 10% risk limitation might be appropriate for some RRGs, it's a regulatory standard that is more suitable to a traditional insurance carrier, writing thousands, or hundreds of thousands, of insurance policies" (Diemel, 2019b: 6-7).

RRGs have enabled insurance buyers unable to otherwise acquire insurance to do so and also enabled buyers to, as Colorado's former insurance commissioner put it, "stabilize and control their insurance programs to meet their needs" (Kezer 1989, 4). For example, in late 1985 Chem-Spec Insurance, Ltd., a Bermuda-domiciled captive owned by the Chemical Specialties Manufacturers Association (CSMA), which had been in operation since 1978, lost its fronting carrier through which it insured its clients. The CSMA was unable to find an alternative fronting insurer and decided to create its own insurer. By creating the D.C.-domiciled Consumer Specialties Insurance Company Risk Retention Group (CSI), CSMA found a solution and issued its first policy in October 1987 (Cutts, 1987g: 3).

RRGs' impact on the insurance market includes new forms of coverage. For example, a Nevada RRG formed in 2020 is offering cannabis industry coverage in states that have legalized marijuana products. The impact goes beyond new forms of coverage, however. An early RRG formed in California for non-profit medical clinics, Clinic Mutual Insurance Co. RRG (CMIC), was created to enable the clinics "to gain control over their own destinies" according to the broker who assisted them in creating it. The clinics had been lumped by the market in with individual physicians, which the clinics believed led to higher rates as their five-year loss ratio was just 13% compared to 126% for medical malpractice generally. CMIC retained the first $250,000 on policies with the balance reinsured through Lloyd's of London (Cutts, 1988a). The LRRA also brought about an important change by creating a means "of giving birth to new insurance entities" (Cutts 1989a, 2). Another early example is the Housing Authority Risk Retention Group (HARRG), created by the Council of Large Public Housing Authorities in 1987. HARRG focused on reducing its members' risks and its manager noted that "[t]he need to analyze and reevaluate the status of a given program cannot be stressed enough" was a key to success, citing its development of a slip-and-fall prevention program video educational program. A follow up survey revealed that the videos had been seen by only 60-70% of the intended audience. This prompted a change in distribution methods to get the materials to the proper audience. As a result of such measures, HARRG achieved a loss ratio of just 35%, compared to the industry average of 60% (Weslow, 1990, 6). RRGs thus provide new types of coverage, new insurance entities, and new means of risk reduction.

There have been problems with some RRGs, including some where the RRG's domicile's regulatory efforts proved insufficient. The Lancet Indemnity Risk Retention Group, Inc., a Nevada domiciled RRG, failed in 2008 and Nevada's regulatory efforts were slow at best. Even worse, Spirit Commercial Auto Risk Retention Group, Inc., also domiciled in Nevada, had to revise its 2017 annual statement in August 2018, a revision that turned a $13.4 million surplus into $703,088. Ultimately, considerable funds at Spirit turned out to be missing and the estimated total unpaid losses and loss adjustment expenses were almost $200 million (Diemel, 2019a, 2019b, 2021b). The failure of three RRGs linked to a Virginia-domiciled reinsurer and of the Cayman-domiciled National Warranty Insurance RRG were "major contributors to the findings of the first GAO report on the RRG industry," which pointed to these with alarm (Diemel, 2017, 5). Despite these instances – and RRG defenders are quick to argue that the overall insolvency rate is as good or better for RRGs than it is for conventional insurers – RRG regulation seems to have been at least as successful at avoiding insolvencies as the larger insurance industry.

Regulators seeking the business have refined their solvency and other regulations to attract business, new insurers have entered markets which were previously closed, and competition for liability insurance has increased. The complaints of non-domiciliary states that domiciliary states are engaged in a race to the bottom appear generally unpersuasive as there is no evidence of widespread failure of RRGs. Unlike surplus lines and PGs, non-domiciliary states have almost no regulatory handle with which to control RRG behavior and so they have had to work through the NAIC to establish standards that limit RRG operations. While they have successfully increased domiciliary state regulation – one RRG proponent referred to it as "death by a thousand cuts" (Diemel, 2018a, 3) – the continued demand for RRGs suggests that they have not yet been able to raise costs sufficiently to diminish the appeal of these entities.

3. EXPANDING THE SCOPE OF THE LAW MARKET VIA NON-TERRITORIAL SEZS

In all three areas discussed above, Congress used federal preemption to create non-territorial SEZs for particular kinds of insurance purchases. These range from the relatively limited surplus lines market to the intermediate case of PGs to the more expansive RRG market. Each of these cases provides a fundamental requirement of a functioning "law market": the ability to choose what law will govern a particular transaction, entity, or relationship. In The Law Market, Erin O'Hara and Larry Ribstein noted that Tiebout competition – people voting with their feet to choose the package of public goods and other services provided by governments – is based on a consumer market in governments. As they argued, "[t] here is no reason in principle that this market should not embrace laws which, after all, are an important type of government-provided goods" (O'Hara & Ribstein, 2009:14). Such a market "fundamentally alters the political process to the extent that it makes people 'consumers' or 'buyers' of laws rather than simply voters" (Id.) Each of these initiatives has made those insurance buyers able to take advantage of them buyers of regulatory regimes.

3.1. The Role of Regulator Reputation

O'Hara and Ribstein focused on the ability of choice of law clauses to enable the law market. The examples presented here rely on a different, but related, mechanism: cross-jurisdictional competition facilitated by preemption of protectionist laws. This mechanism is needed because few state regulatory authorities would willingly cede regulatory jurisdiction over ongoing insurance activities in their state merely because the parties to the insurance contract had designated another state as the regulator. Indeed, as noted earlier, state regulatory authorities object even to non-admitted carriers talking to their state residents by telephone and several states have taken aggressive positions on RRGs despite express federal preemption. Unlike corporate law, where the acceptance of the internal affairs doctrine means that states other than the state where a business is incorporated defer to the incorporating state's laws, in regulated markets like insurance, non-territorial SEZs offer one of the few, and perhaps the only, means other than voting with one's feet to develop a law market.

Moreover, non-territorial SEZs allow governments to slice off sections of the market where regulations are particularly costly or deliver relatively low benefits. In the examples described above, the benefits of state regulation appear particularly low as the buyers of the insurance are businesses rather than individual consumers and are often operating as a group (PGs and RRGs) or working with a licensed intermediary (surplus lines). Unlike an individual consumer puzzling over the dense wording of an insurance policy, vulnerable to clever insurance lawyers slipping in exclusionary clauses, the purchasers of policies in these circumstances either have the advantage of economies of scale (PGs) or are active participants in designing the coverage (RRGs, surplus lines). The consumer protection rationale for much insurance regulation is at least considerably weakened in these transactions if not completely absent. Moreover, in each of these examples, the motivation for incurring the fixed costs of participating in the solution (organizing a PG or RRG, incurring the search costs for surplus lines coverage) is that the existing regulated market is not meeting the purchasers' needs. The benefits of allowing additional suppliers in the market thus are likely substantial.

These three non-territorial SEZs are not pockets of anarchy but examples of different methods and amounts of regulation being deployed. In each case, a state regulator remains deeply involved in the transaction, it is just a different state regulator than it would be if regulation continued to be completely territorially based. As noted earlier, many non-domiciliary state insurance regulators are unhappy to lose their monopoly control over insurance transactions occurring within their states. These regulators argue that the domiciliary regulators are merely seeking the economic benefit of registering insurers and lack "skin in the game" and so will thus underregulate.

It is true that the successful domiciles are seeking economic benefits. From the beginning, states such as Vermont have been clear that their goal is to capture those benefits. Indeed, in a retrospective, Vermont's captive regulator described the decision to enter the captive field generally explicitly in those terms:

> "We started with George Chafee and Governor Snelling looking at the captive law and thinking 'what have we got to lose? …. This will bring in some tax revenue, it'll bring in some white-collar jobs, and it'll bring in some tourist dollars. The first captive domiciles were all tourist economies. That was the driver for Bermuda, Vermont, even Hawaii—we want to bring in more tourism revenue—but it turned into so much more" (Diemel, 2021a: 5).

Such arguments ignore the considerable reputational skin in the game the domiciliary regulators have, as well as the strong shared interest that all U.S. state insurance regulators have in avoiding federal substantive regulation of insurance. Even the most active domiciliary regulators (e.g., Vermont) are determined to avoid federal regulation. Moreover, it is Vermont's success in the RRG market, and captive market more generally, that makes it more concerned about the success of Vermont-chartered RRGs and captives, rather than less concerned. Just as a key to Delaware's success in the corporate law market is its heavy fiscal dependence on the revenue from corporate charters, so Vermont's insurance regulator is keenly aware of its state's dependence on these insurance markets. If a Vermont captive or RRG fails due to regulatory negligence, Vermont would lose considerable business as its customers (those from outside Vermont who charter insurers there) seek out more reputable locations. As far back as the first issue of the Risk Retention Reporter in 1987, the industry newsletter was reporting on Vermont regulators' desires "to be the national center for quality risk retention groups" (Cutts, 1987a: 4). The vigorous competition for this business among the states with the most charters would ensure that other potential domiciles would quickly be calling Vermont-chartered RRGs and captives, describing the benefits of the move.

Indeed, the entire race-to-the-bottom argument fails to appreciate the critical importance of jurisdictional reputation to those seeking insurance from these entities. Particularly where the insureds own (directly or via an association) their insurer these businesses know that their reputations require that their insurance come from a reputable jurisdiction. As Tony Freyer and I described in our history of the Cayman Islands' offshore financial center, when Harvard's hospital group decided to create its medical malpractice captive insurer in Cayman, it insisted that Cayman create an insurance regulatory system (Freyer & Morriss 2013). And as former Vermont regulator Edward Meehan commented in 1992, not sufficiently regulating RRGs and captives risked a state developing "a poor reputation among other insurance departments" and the development of a "vicious circle" in which

> "the solid alternative market facilities which a state wants to attract will be reluctant to domicile in a state whose insurance department is regarded as lax or a renegade by other regulators. A self-fulfilling prophecy of adverse selection may start, where the only captive/risk retention group applications that such a state receives are from the so called 'bad actors" (Meehan, 1992, 5).

It is not just Vermont's regulators who have such views; a Barbados-domiciled captive that redomiciled to a Vermont RRG attributed its choice to Vermont's "first rate regulatory climate, its proximity to hospitals, and its stellar reputation" (Cutts, 2005d, 6).

Regulators have also developed reputations as experts in particular subfields of insurance. For example, Jon Harkavy noted that "[a]n important factor [in domicile choice] is the prospective domicile's like or dislike of certain types of coverage. Some states avoid RRGs that provide warranty coverage while others don't like RRGs that cover taxicabs for example" (Diemel: 2016c, 7).

Non-territorial SEZs have advantages over the displacement of one regulator by another, as would be the case if the federal government took over insurance regulation from the states in the United States or simply entered into competition with them as a regulator, as is the case in U.S. banking regulation. Where a "higher level" regulator simply displaces a "lower level" one (as the United States Environmental Protection Agency has largely done with respect to motor vehicle pollution control in the United States, although California continues to play a substantial role (Morriss, 2000)), there is simply substitution of one monopoly provider for another. This has advantages in reducing the transaction costs of coping with multiple regulators in a market that incorporates multiple jurisdictions, precisely the reason that the Big Three U.S. automakers embraced federal regulation of automobile emissions in the 1970 Clean Air Act Amendments: to preclude the development of fifty separate state standards (Morriss, 2000). However, it does not produce competitive pressure on the new regulator to be innovative or more cost effective.

When a new regulator enters into competition with existing regulators, the increased competition can constrain regulators, as state-chartered banks' threats of switching to a federal charter does with state banking regulators.[3] The insurance examples discussed here potentially allow competition among 51 (the states plus the District of Columbia) regulators, although in practice an insurance buyer in most states has only handful of potential regulators for an RRG, PG, or surplus lines transaction. Nonetheless, most of those potential regulators (all but the home jurisdiction of the insured) are highly motivated regulators, seeking to expand their market share. These regulators seek to increase the fees they collect and to bring business to the consultants, attorneys, insurance managers, accountants, etc. which assist their licensed entities, but they will only do so if they can do so consistent with maintaining the long-term viability of their jurisdictions, thus giving them considerable reputational "skin in the game."

3.2. Obstacles to Creating Non-Territorial SEZs

While the above examples are encouraging to those who favor increased regulatory competition, they also illustrate some of the obstacles to increasing such competition. First, many regulators loathe com-

[3] Dodd-Frank, which allowed national banks to open branches in any state (subject to relatively easy to meet conditions). This incentivized states to allow the banks they charter to be able to establish branches in other states, since if they do not, a bank wishing to do so would switch to a federal charter. Unlike the insurance examples here, however, a bank wishing to make use of a charter in State A to operate in State B would need some presence in State A beyond its charter (typically, a home office). Even this restriction is becoming less meaningful as online banking spreads. Thanks to Julie A. Hill for directing my attention to this.

petition. This can be seen in the behavior of the NAIC. In general, it has taken the side of the non-domiciliary state regulators in attempting to expand their ability to regulate RRGs. Indeed, the National Association of Wholesalers-Distributors accused the NAIC of being "institutionally committed to gutting the Risk Retention Act" (Cutts, 1989b: 3). Similarly, RRG advocate Jon Harkavy noted in an interview that the NAIC has vigorously fought RRGs and PGs every chance that it had, arguing that "[t]he NAIC program of accrediting state insurance departments appears to me to be a hijacking of democracy by an unelected trade association through violation of anti-trust principles applicable to trade associations" (Harkavy, 2013: 8).

Since the passage of the LRRA, the NAIC has consistently pushed for greater regulation of RRGs by domicile states and for that regulation to look more like the regulation of traditional insurance companies. For example, as a result of NAIC efforts, RRGs generally now report quarterly to their domiciliary regulator, must meet financial solvency ratios similar to (but often not identical to) those applied to traditional insurers, and meet minimum capital and surplus requirements (albeit at generally lower levels than traditional insurers).

The organization takes an aggressive position on restricting preemption of information filing requirements, arguing that "a non-chartering state is not precluded [by the LRRA] from requesting information that it believes necessary to determine compliance with any law not preempted by the LRRA" (NAIC, 1999, II-3). (This author believes that a better reading of the LRRA is that this is incorrect and that the non-domiciliary state is largely restricted to requesting information except from the domiciliary regulator.)

The NAIC has also worked to pressure domiciliary states to increase regulation of RRGs. For example, its Model Risk Retention Act requires domiciliary states to verify a proposed RRG's members' historical and expected loss experiences and similar exposures nationally; require pro forma financial statements and projections as well as "appropriate opinions" from an independent actuary about minimum premium participation necessary to operate and avoid a hazardous financial condition; and ensure the existence of appropriate procedures for management, underwriting, and claims, as well as investment policies and reinsurance agreements; and material revisions to plans of operation and feasibility studies. (NAIC 1999, II-2). RRG proponents sometimes found NAIC proposals likely to "gut" the LRRA (Cutts 1987b, 2).

The key concern of the NAIC has been that the main domiciliary states are underregulating RRGs. For example, the NAIC told the Commerce Department that it was "gravely concerned" about "the lack of protection of the public from unsound financial practices and commercial abuses permitted by the Risk Retention Act of 1986", in part because it "discarded … the experience of one hundred and fifty years of regulation" (Gates, 1989: 3). Among the NAIC's concerns were that RRGs were undercapitalized and had "inexperienced management." Conceding that states had "widely varying requirements for capitalization," the NAIC argued this was not a problem in traditional insurance "because the company must meet the requirements of each state within which it wishes to do business." RRGs, however, "may form, and frequently have formed, pursuant to state statutes originally enacted to ease the formation of limited risk bearing captive insurance companies" and then are allowed to "go into every state writing highly volatile liability lines" (Gates, 1989: 3). The NAIC also objected to allowing differences in the type and amount of assets an RRG maintains from those required of traditional insurers, noting some states allowed the use of letters of credit as part of the capital assets, while others did not (Gates, 1989:3). The NAIC argued that RRGs may not write much insurance in their state of domicile and "[s]tate insurance departments with limited resources may have minimal incentives to expend those resources closely monitoring and regulating the activity of a company not insuring its citizens" (Gates, 1989, 3). The NAIC also objected to the rapid growth of RRGs and RPGs, arguing that the "seasoning" requirements of traditional insurance regulation, which limited insurers to slow, steady growth was a virtue (Gates, 1989:4).

As a partial solution to what it unsurprisingly perceives as a problem of underregulation, the NAIC developed an accreditation program for state regulators on RRG issues and all fifty states and the District of Columbia are now accredited under it. The accreditation process involves the NAIC assessing "how each state insurance department reviews and monitors the solvency regulation of multistate insurance companies and RRGs to ensure states have (1) adequate solvency laws and regulations to protect consumers, (2) effective financial analysis and examination processes, and (3) appropriate organizational and personnel practices" (GAO, 2011: 7). (The NAIC and Vermont fought a lengthy battle over whether Vermont had to change its captive and RRG regulation approach to be accredited, with Vermont eventually prevailing.)

The NAIC Risk Retention Working Group also launched a corporate governance project for RRGs in response to GAO criticisms of lack of uniformity among domiciliary states regulatory efforts (Myers 2007, 1). Non-domiciliary regulators told the GAO that domiciliary states were lowering regulatory standards to attract business; the NAIC also complained that RRG domicile states lacked "skin in the game" to properly regulate, putting insureds at risk (GAO, 2011: 23). This experience suggests that one obstacle to regulatory competition is the pressure to harmonize regulation.

Four important lessons from these experiences emerge for promoting non-territorial SEZs. First, a successful non-territorial SEZ requires getting a regulator on board with defending its regulated entities against other regulators. With RRGs, there is an example of how a regulator can fail to support a regulated entity, which undermines regulatory competition. California issued an administrative cease-and-desist order against a Montana-domiciled RRG, the Auto Dealers Risk Retention Group. Because it was plainly barred from doing so by the LRRA, California alleged Auto Dealers was not a valid RRG under the LRRA and thus the statute's bar did not apply. The federal district court hearing the case rejected this argument, ruling in an unreported opinion that once an RRG was licensed by another state, a non-domiciliary state could challenge its validity as an RRG only in court, not in administrative proceedings (Cutts 2008a); Auto Dealers Risk Retention Group, Inc. v. Steve Poizner, 2:07CV02660 (E.D. Cal. 03/07/2008). This result is unsurprising as this is consistent with the LRRA; the surprise is the extent to which California was willing to go to attempt to regulate in the face of the LRRA's clear prohibition on its action. Illustrating the problem mentioned above, however, this case settled with the RRG agreeing to convert its coverage to a fronted program reinsured by reinsurers established by the RRG. The RRG attributed its willingness to settle short of victory to the Montana domiciliary regulator not being fully supportive (Cutts, 2008b). The RRG eventually gave up in 2009 and merged into a conventional insurer, citing both economic conditions and the expense of litigation with California regulators (Cutts, 2009c). With the development of the law contingent on the ability and willingness of RRGs to fund costly litigation, even relatively easy cases often do not produce the precedents necessary to clarify the law.

Second, entrepreneurial regulators are an essential ingredient. Only a few states have built successful RRG or PG businesses and only a small number of firms have built large-scale surplus lines businesses. The successful states, typically with strength in captive regulation generally, have invested heavily in their institutional capacity. For example, Vermont's insurance commissioner wrote in 1992 that "[t]he long-term credibility of Vermont is absolutely dependent upon a more systematic approach to the tasks of licensing new captives and regulating old friends" (Cutts, 1992a, 1).

Third, successful regulators compete not on being lax but on providing value added. For example, a captive that operated from Bermuda created an RRG and converted the Bermuda entity to a reinsurer for the new RRG. It did so because its direct operations as a captive required it to find exemptions from state regulatory provisions requiring insurers to be licensed. After the conversion, it "no longer need concern itself with whether direct and personal contacts with Member Firms might technically violate laws in various states on transacting the business of insurance without a license." After initially domiciling in Illinois, it moved to Vermont when Illinois changed its insurance law to prevent a company from being both an industrially insured captive and a RRG (Breakstone 1997). Providing a facilitative environment for new solutions – which Vermont did and Illinois did not – is essential. Illustrating another dimension, D.C. rewrote its captive law four years after its initial passage to add flexibility and innovative structures, such as the first cell company RRG, based on input from regulators and industry volunteers (Perschetz 2005). Similarly, Delaware rewrote its 1984 captive law in 2005 to enhance its appeal as a domicile, focusing on its corporate law as an advantage (Cutts, 2005b, 4; Kinion, 2012).

Fourth, active participation by jurisdictions competing for business in the "top level" regulatory structure process is essential. One example of the NAIC's hostility to RRGs was its initial failure to bring the jurisdictions seeking RRG business onto its task force on RRGs to participate in its development of regulatory policies. As an illustration, in 2005, only Vermont among active RRG domiciles was as voting member of the task force established to evaluate RRG regulation. After complaints from the active domiciles, the NAIC appointed five states that served as RRG domiciles to the task force (Cutts, 2005c). The active domiciles' efforts to make sure their voice was heard in shaping the NAIC policy was thus critical to moderating that organizations' anti-RRG efforts.

3.3. Are the Insurance Non-Territorial SEZs a Success?

Measured by the number of transactions and premiums paid, the available evidence suggests all three have filled important market needs. The U.S. surplus lines market continues to grow, with particularly dramatic double-digit growth over the past few years. Total U.S. surplus lines premium was over $24 billion in the first half of 2020, an almost 22% increase over the prior year. RRG numbers remain in the low 200s and below the 2008 peak number of 262, but RRG premiums have grown substantially over time and reached over $3,383,800,000 in 2020. Three dozen RRGs have been operating for over twenty-five years, suggesting a maturing of the business. More than 800 PGs are operating, although other statistics on that sector are unavailable. Insolvencies and dissolutions of these entities remain at or below market levels. In addition, the leading domiciles continue to innovate and prosper.

More important than the raw numbers is that these SEZs provide access to expanded opportunities for risk transfer. The alternative risk management sector continues to expand, finding new ways to transfer insurance risks to capital markets. Preserving avenues that allow commercial insurance customers to have access to these new products – something no conventional insurer would be able to offer in a mass market product – is likely to become ever more important for the types of insurance customers taking advantage of these SEZs.

4. COMPETING IN THE LAW MARKET THROUGH NON-TERRITORIAL SEZS

Territorial SEZs offer an important tool for expanding the scope of the law market as they add new competitors to the market for law. Non-territorial SEZs expand the scope of activities that can benefit from this expansion as services such as insurance for activities within another jurisdiction are difficult to offer through a territorial SEZ if the other jurisdiction is determined to resist competition, as is the case in insurance. The experience with these three non-territorial SEZs in insurance suggest broader lessons for the expansion of the law market. First, competition in the law market is not for the faint of heart. The jurisdictions that succeeded in building market share in the market for insurance regulation invested in developing their competitive position. Thus one guide to choosing an RRG domicile advised to jurisdictions "which have proven they value RRG business and have a track record for responding to issues as they arise," insisting that only those which "exist in an atmosphere of constant refinement" are worth considering. These jurisdictions will demonstrate this by constant work on their statutory provisions, showing a commitment to "dedication and responsiveness" (Stokes, 2011). Similarly, a former Vermont regulator reflected how "[e]ach year, through administrations of various political stripes, legislators worked with regulators and other captive insurance players to learn how to improve state statutes while building on the state's preeminence in this area" (Crouse 2011, 9).

Second, there will be considerable resistance by vested interests to the creation of non-territorial SEZs. Passage of the LRRA took "intense lobbying" by insurance buyers, armed with arguments that persuaded (the need to expand the market) (McIntyre, 2011: 7). This resistance does not end when a market is opened. As Harkavy summarized in 2016, "the NAIC remains fully resistant to the LRRA's lead state regulation underpinnings. Under the NAIC's view of the world, every state should be a feudal lord with respect to how it regulates insurance, with NAIC as the overlord. There's no way to co-opt their support" (Diemel, 2016b: 6).

Third, opportunities to create non-territorial SEZs need to be seized when they appear. In the examples above, the impetus for the PLRRA and the LRRA was the combination of two trends. The vast expansion of tort liability by state courts in the 1960s and 1970s dramatically increased the need for liability insurance by professionals, manufacturers, and service providers, many of whom were organized enough to press for federal action. This opened the door first for the PLRRA and then for its expansion by the LRRA. As the insurance market further hardened in the early 1980s, it became increasingly difficult for a variety of professionals, firms, local governments, and nonprofits to purchase liability insurance, with some unable to purchase the liability insurance needed at any price. With the goal of quickly expanding the availability of liability insurance, Congress used its power of preemption to restrict non-domiciliary states' protectionist laws. Many state insurance regulators (including the state regulators' trade group, the NAIC) and the insurance industry lobbied against the statutes, but there were also politically attractive promoters of the idea, particularly groups having difficulty obtaining insurance such as nurse midwives. The political compromise that made the PLRRA and LRRA possible was avoiding both federal regulation of insurance (which Republicans and state regulators opposed) and tort reform (which Democrats opposed) while delivering rapid action to meet the needs of powerful constituents of members from both parties. As one of the insurance lobbyists who worked on the LRRA later commented, the lead state regulator model "took the wind out of the NAIC's sails" (Diemel, 2016b: 6).

Moreover, once the process of building the tools for a non-territorial SEZ is underway, participants will use them in unexpected ways. As noted earlier, entrepreneurial PGs were not anticipated by the PLRRA/LRRA drafters but quickly came to be a major part of the market. Similarly, when some states objected to the use of a Cayman captive to insure religiously-affiliated nursing homes without a fronting carrier, an innovative insurer created two RRGs to work with its Cayman captive to provide the necessary coverage (Cutts 2008c), incorporating a foreign jurisdiction into the structure.

Additional areas of insurance could easily be added to the law market described here, by expanding the areas in which PGs and RRGs can write insurance through amendments to the LRRA, by adopting a general lead-state model such as that proposed over ten years ago by Butler and Ribstein (2008-09), or by further expanding federal preemption of state restrictions on surplus lines coverage.

Does the non-territorial SEZ model extend beyond insurance? Yes. The challenge is to find additional areas where it can be deployed. The insurance experience suggests that non-territorial SEZs are more likely to be successful in expanding the scope of regulatory competition where:

- there is a regulated product or service easily offered across jurisdictional lines;
- there is no existing "higher level" regulator to compete for jurisdiction;
- a crisis creates demand for expanding the pool of suppliers; and
- existing regulators are invested heavily in maintaining their regulatory primacy.

A non-territorial SEZ is possible even if these conditions do not all exist; these conditions are merely facilitative rather than necessary.

One example where states have taken steps on their own to create non-territorial SEZs is in banking. For example, New York, New Jersey, and Pennsylvania agreed to allow banks chartered by any of them to operate in the other two states under their home state's regulatory system (New Jersey 2008). Another example is non-bank fintech companies, which need money transmitter licenses in each state (except Montana) where they operate (CRS, 2020: 2), a situation remarkably similar to the insurance markets discussed here.[4] Just as in the insurance case, the Conference of State Banking Supervisors is playing defense on behalf of state licensing requirements much as the NAIC does in insurance regulation. Thus far, the fintech companies have focused on obtaining an alternative national license, something the CSBS has successfully resisted via its own harmonization efforts (CSBS 2020; CRS 2020). The RRG model of allowing companies licensed in any state to operate nationally could offer an alternative path, one which would be likely to foster innovation than the current requirement of a license in each state. Similarly, the structure of RRG regulation resembles the EU's "passporting" scheme for financial institutions (including insurers), in which entities licensed in one EU member can do business in the others, subject to general regulations (such as the EU's "Solvency II" Directive in insurance) and to each member's generally applicable laws for that industry. Indeed, the founding editor of the Risk Retention Reporter, Karen Cutts (1989d, 3), an expert on the industry, argued that the LRRA was "America's 1992," the year of the passage of the Single European Act.

Another U.S. example where the facilitative conditions are met is occupational licensing. In the wake of several natural disasters and the pandemic, some states have accepted occupational licensing by other states for critical personnel. The Uniform Emergency Volunteer Health Practitioner Act (adopted so far by 18 states and the District of Columbia) allows any state to recognize out-of-state licenses for health care practitioners during a state of emergency. Several multistate compacts also permit mutual

[4] I am indebted to Julie Hill for this example.

recognition of specific occupational licenses. Arizona pioneered universal recognition of other states' licenses for some occupations in 2019; at least seven additional states have followed suit (Michael & King,, 2021). In addition, Sen. Mike Lee has proposed legislation to encourage less restrictive means of occupational licensing among states and to reduce licensing barriers for the District of Columbia and federal property. (Id.)

These examples suggest ways in which non-territorial SEZs could be expanded. Where a group of jurisdictions has agreed to a set of comprehensive regulatory standards, such as Solvency II which has been adopted by some non-EU member jurisdictions, or standards developed by an international organization such as the International Association of Insurance Supervisors, those jurisdictions could also agree to allow businesses licensed in any jurisdiction adopting those standards to operate freely across jurisdictional lines. As in the occupational licensing example, recognition of cooperating jurisdictions' licenses could be implemented relatively simply in many cases. Either the surplus lines model (requiring a local regulated entity as an intermediary) or the PG/RRG model (requiring a notice filing for the non-domiciliary jurisdiction) could be used. The former allows local regulators some control over the behavior of those involved; the latter would permit the lowest cost expansion of markets. Jurisdictions operating within an existing economic arrangement, such as CARICOM in the Caribbean or ECOWAS in Africa, could do the same. Non-territorial SEZs offer the opportunity to expand the scope of the law market, introducing regulatory competition into additional substantive areas. While not appropriate for every area of regulation, they could enable greater competition among regulators to move away from one-size-fits-all approaches and enable a closer match between regulations and regulatory goals.

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