

# Downs Rachlin Martin PLLC

## Captive Insurance Update | Issue No. 2 | 2016

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## Developments in Vermont

### More Changes at the Top

Governor Peter Shumlin (D-Vt.) is not running for re-election this fall, so Vermont will have a new governor in January 2017. In addition, the Commissioner of the Vermont Department of Financial Regulation (DFR), Susan Donegan, stepped down in June, and Governor Shumlin has appointed a new commissioner. The new commissioner, Michael Pieciak, is an attorney who previously served as Deputy Commissioner of the DFR's Securities Division, and was very active in an investigation by the DFR, in coordination with the federal Securities and Exchange Commission, into the use of large amounts of funds raised under the Immigrant Investor Program (the "EB-5 Program") by Vermont developers. It is not clear whether the new governor will reappoint Commissioner Pieciak (assuming that the Commissioner is interested in staying on) or bring in a new person.

We expect no substantive change to the DFR's Captive Division as a result of these changes "at the top;" Deputy Commissioner David Provost continues to lead the Captive Division along with his deep bench of long-term staffers.

### Vermont Released Aggregate Financial Data for Vermont Captives in 2015

Sandy Bigglestone, Director of Captive Insurance at the DFR, issued Memo #2016/03 on July 15, 2016, providing aggregate financial data for all Vermont captives as of December 31, 2015. Vermont captives' 2015 gross written premium totaled \$27.6 billion, which was a significant increase over the prior year. There were 588 active captives in Vermont as of December 31, 2015. Nine new captives were licensed in Vermont during the first six months of 2016.

### 2016 Captive Legislation

After a busy year in 2015, the legislative package for 2016, signed by the Governor on April 13, 2016, is less ambitious with a focus on improving existing laws rather than introducing new initiatives. Significant provisions of the new law include:

- **Sale or Conversion of Cell Captives.** Three new sections were added to Vermont's Sponsored Captive law. These sections, 8 V.S.A. §§6034(b) - (d), are intended to clarify the process for: (i) converting an existing protected cell into an incorporated protected cell; (ii) selling, transferring or assigning an existing protected cell to a new sponsor; and (iii) converting one or more existing protected cells or incorporated protected cells into a different type of captive (pure, RRG, industrial insured, etc.). These provisions will provide a clear path for Vermont-domiciled cell captives to expand and adapt to the changing needs of their businesses.
- **Dormancy.** 8 V.S.A. §6024 allows pure captives to apply for a certificate of dormancy if they had: (i) ceased transacting the business of insurance; and (ii) no remaining liabilities associated with insurance transactions. If approved, a dormant captive is subject to a statutory minimum capital requirement of \$25,000 (rather than \$250,000), and is not subject to any premium tax. Dormancy, therefore, allows a company to mothball a captive, rather than dissolve it, so that it can cheaply and easily be restarted if and when conditions warrant. The 2016 legislation allows sponsored captives and

industrial insured captives to take advantage of the dormancy provisions and eliminates the prohibition on dormancy for captives that historically insured controlled unaffiliated business.

- **Fiscal Year Filers.** 8 V.S.A. §6007(c) allows pure captives and industrial insured captives to request that annual reports be due after the fiscal year-end, rather than the calendar year-end. This may be useful for captives whose insureds use a fiscal year that does not match the calendar year. The 2016 legislation adds association captives and sponsored captives to the list of entities that can request a fiscal-year-end filing.
- **Governance Standards for Risk Retention Groups.** With a year of experience in implementing the new governance standards for risk retention groups, the 2016 legislation adds several provisions intended to rationalize the governance standards and ease (somewhat) the related implementation burden.
  - 8 V.S.A. §6052(g)(1)(D) was revised to make it clear that a defense counsel will only be deemed to be a material service provider if its annual fees meet the statutory thresholds for three of the past five years. It is very difficult to predict defense counsel's fees in advance so the proposed legislation relaxes the requirement and makes the inquiry retrospective.
  - 8 V.S.A. §6052(g)(2) was revised to eliminate the requirement that the attorney-in-fact of a reciprocal meets the same independence requirements as a company's board. Most reciprocals have a subscribers advisory committee that is subject to the independence requirement and that supervises the attorney-in-fact. Applying the independence requirement to the attorney-in-fact was duplicative.
  - 8 V.S.A. §6052(g)(5) was revised to replace the term "plan of operations" with "business plan" to make it clear that a company's business plan for governance standards, one of the required components of the governance standards, does not need to be filed in each state in which a risk retention group is registered.

In addition, the DFR issued Memo #2016/02 on March 25, 2016 clarifying several provisions of the new Governance Standards, and requiring that all RRGs attest to their compliance with the standards. The DFR is expected to issue additional guidance shortly, which will address a number of other issues that have arisen in connection with the implementation of the new Governance Standards.

## Federal Tax Matters

### 831(b) Legislation

Shortly after so-called 831(b) captives appeared on the IRS's "dirty dozen" list, Congress passed new legislation significantly expanding the scope of the election while tightening the eligibility requirements to address the perceived abuses that led to IRS scrutiny. Section 831(b) of the Internal Revenue Code allows certain small property and casualty insurance companies to be taxed solely on investment income, excluding underwriting income.

For tax years beginning after December 31, 2016, to qualify for the 831(b) election, a captive must satisfy one of the following tests:

- **Diversification.** No more than 20% of a captive’s premiums can be attributable to a single insured (including all companies within the same controlled group).
- **Ownership.** The ownership test is difficult to parse, but it apparently can be satisfied in one of two ways:
  1. None of the captive’s direct or indirect owners is the spouse or lineal descendant of a direct or indirect owner of any of such captive’s insureds; or
  2. If one or more of the captive’s direct or indirect owners is the spouse or lineal descendant of one or more of the direct or indirect owners of the captive’s insured businesses, then the direct or indirect ownership interest of such spouse or lineal descendant must match (plus or minus 2%) his or her ownership interest in the relevant insured business.

For captives that are able to satisfy one of these tests, the new legislation increases the cap on written premiums from \$1.2 million to \$2.2 million and indexes the cap for inflation.

### Protected Cell Litigation

Despite the common use of protected cell captives (a/k/a “sponsored captives” in Vermont) around the world, there is very little jurisprudence on the enforceability of the segregation of assets and liabilities afforded by the structure. On May 13, 2015, the United States District Court for the District of Montana issued an interesting decision in which it found that an unincorporated cell within a protected cell company does not have the capacity to sue or be sued independent of the protected cell company. The case also seems to support the segregation of assets and liabilities in a protected cell company. The full case can be reviewed here: [www.drm.com/uploads/1268/doc/Pac Re v Amtrust NA Order 5-13-16.pdf](http://www.drm.com/uploads/1268/doc/Pac_Re_v_Amtrust_NA_Order_5-13-16.pdf)

In this case, a dispute arose under a reinsurance contract entered into by Pacific Re, Inc. (Pac Re), which is a protected cell captive insurance company, on behalf of Pac Re 5-AT (Cell 5), which is a cell within Pac Re. A demand for arbitration was made against Pac Re by the reinsureds, AmTrust North America, Inc. and Technology Insurance Company, Inc. Pac Re responded that the proper party to be named in the demand for arbitration was only Cell 5, and not also Pac Re. The narrow issue in the case was whether Pac Re was a proper party to the arbitration.

The Court ruled that the unincorporated cell (Cell 5) is not a separate legal entity, although it is clear that the liabilities and assets of the protected cell are segregated from the other cells. Accordingly, the Court found that the cell does not have the capacity to sue or be sued independent of the larger protected cell company. The Montana protected cell legislation specifically states that the “creation of a protected cell does not create, with respect to that protected cell, a legal person separate from the protected cell captive insurance company unless the protected cell is an incorporated cell.” The Court ruled that Pac Re was a proper party to the arbitration.

Two interesting conclusions follow from the Montana case. First, the integrity of the segregation of assets and liabilities between cells in a protected cell company appears to have been respected by at least one court. And second, there is a difference, at least under Montana law, between the rights and obligations of an incorporated cell versus an unincorporated cell.

### **FHFA Issue Rule Preventing Captives from FHLB Membership**

In January 2016, the Federal Housing Finance Agency (FHFA) issued a final rule amending its regulation on Federal Home Loan Bank (FHLB) membership. Prior to the new rule, “insurance companies” were eligible for membership in the FHLB and, therefore, eligible for low-cost government-backed financing. In the last several years, a large number of Real Estate Investment Trusts (REITs) have gained access to this low-cost federal financing indirectly, through ownership of a captive. The new rule, however, defines “insurance company” to exclude captives. As a result, captives are no longer eligible to become members of the FHLB and those that are members have five years to terminate their membership (or one year in the case of a captive that joined after the date the rule was first proposed).

### **Federal Study on the Overall Effectiveness of the Terrorism Risk Insurance Program**

On March 4, 2016, the Treasury Department requested that insurers submit insurance data regarding their participation in the Terrorism Risk Insurance Program Reauthorization Act of 2015 (TRIPRA). The data is being requested on a voluntary basis this year, but reporting of such data may become mandatory in the future. Data being sought includes, among other information, lines of insurance with exposure to terrorism losses, premiums earned on such coverage, geographic location of the exposures, pricing, the take-up rate, and the amount of private reinsurance purchased. The information is intended to assist the Secretary of the Treasury in analyzing the effectiveness of the TRIPRA program, which was mandated by TRIPRA.

David Provost, the Deputy Commissioner of the DFR, has urged all Vermont captives writing terrorism coverage to comply with the request even though it is voluntary. Deputy Commissioner Provost noted that submission of the data will likely become mandatory, and voluntary responses provided now will help identify areas where companies may need to improve their data collection (or where Treasury may need to modify its data request).

### **Risk Retention Group Developments/Federal Preemption**

As we have reported in our Captive Insurance Updates in the past, RRGs have won some significant court victories in the last few years on the issue of federal preemption under the Liability Risk Retention Act (LRRA) of non-domiciliary states’ efforts to regulate RRGs. However, a recent decision in Louisiana has gone the other way. In *Zeigler, et al. v. The Housing Authority of New Orleans* (La. 4<sup>th</sup> Cir., March 23, 2016), the State of Louisiana Fourth Circuit Court of Appeals reversed the lower state court’s ruling that the Louisiana direct-action statute is preempted by the LRRA. The National Risk Retention Association filed an amicus curiae brief in the appeal of the decision, in support of the line of cases that have held that the LRRA preempts all state laws that regulate the operation of risk retention groups outside their state of domicile, including those state laws that grant a right of direct action by injured parties against an insurer (rather than its insured). In June 2016, the underlying case was settled, so the preemption issue will not be pursued further in the case.

## DRM's Captive Insurance Group

Vermont is the leading U.S. domicile for captive insurers and RRGs, and DRM has been at the forefront of the U.S. captive insurance industry since the mid-1980s.

DRM's captive insurance team informs clients about choice of entity, operational issues, developments under legislation such as the Federal Risk Retention Act and the Terrorism Risk Insurance Act, and complex coverage, claims-handling or defense issues that can arise.

Our insurance clients seek advice on all aspects of their operations, including organizational matters for start-up companies, how to adapt or take full advantage of changes in federal and state regulations, and sophisticated risk transfer matters for established entities. Using the right resources drawn from the comprehensive legal services offered by DRM, we help clients solve both simple and complex problems involved in all aspects of the insurance industry:

- Tax, regulatory and legislative matters
- Corporate governance
- Entity selection: stock, mutual and non-profit corporations; LLCs; reciprocal exchanges
- Securities laws
- Domicile selection
- Reinsurance matters
- Coverage and defense matters
- Policy language
- Claims-handling procedures
- Reciprocal formation and the role of the attorney-in-fact
- Sponsored captives with segregated cells
- Other routine issues involving alternate risk transfer mechanisms

To explore how DRM's insurance group can help with your captive insurance matters, contact our Practice Group Chair Kathy Davis or Zaw Win at 802.863.2375, or at [drm.com](http://drm.com).