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Developments in Vermont

Vermont Leadership Team

Vermont's leadership team for captive insurance was remarkably stable in 2017. Governor Phil Scott and Michael Pieciak, the Commissioner of the Department of Financial Regulation (the "DFR"), completed their first full year in office. David Provost, the Deputy Commissioner of Captive Insurance, completed his 10th year in that position. Since Vermont originally passed its captive insurance legislation in 1981, only 3 individuals have served as Vermont's top captive regulator.

2017 Formation Data

Vermont licensed 24 new captives during 2017, and has licensed 8 new captives year-to-date in 2018. The new captives comprise 11 pure captives, 5 sponsored captives, 3 risk retention groups, 3 special purpose financial insurers, 1 branch captive and 1 industrial insured captive. While the 2017 aggregate financial statistics have not yet been published, as of year-end 2016, Vermont captives' 2016 gross written premium totaled $32.8 billion, which was a significant increase over the prior year. Aggregate data for 2017 will likely be released in June.

2018 Captive Legislation

The initial captive legislation for 2018, which was signed by the Governor on March 8, 2018, is relatively modest. Significant changes include:

- **Annual Report Due Dates.** For pure, association, sponsored, and industrial insured captives whose fiscal year corresponds with the calendar year, annual reports are due on or before March 15th. Annual reports for all other types of captives whose fiscal year corresponds with the calendar year are due on or before March 1st. For captives whose fiscal year does not correspond with the calendar year, annual reports are due 75 days after the captive's fiscal year end.
- **Premium Tax Due Dates.** Premium taxes for all captives are now due on or before March 15th.
- **Taxes on Loss Portfolio Transfers.** No premium tax is due in connection with loss portfolio transfers where a parent, or other affiliated company, transfers self-insured losses to a captive.
- **Branch Captives.** Branch captives are required to designate the Commissioner of the DFR as agent for service of process. Additionally, the requirement that branch captives petition the Commissioner of the DFR for a certificate of general good has been eliminated.
- **RRG Governance Standards.** Previously, risk retention groups were required to maintain an annual determination of director independence and provide same to the DFR upon request. Going forward, such determinations will have to be provided to DFR annually.

Affordable Housing Tax Credits

In 2017, the Vermont Affordable Housing Tax Credit program was expanded to allow captive insurance companies to participate. The tax credits are available to apply against a purchaser's premium tax liability over a 5-year period, and are expected to generate a return of approximately 4%. The purchaser is not required to purchase an ownership interest in a project, and the return is not tied to the financial performance of the affordable housing project.

Avrahami: IRS Victory Provides Guidance for Other Captives

On August 21, 2017, the United States Tax Court (the "Court") issued its long-awaited decision in the case of *Avrahami v. Commissioner*. *Avrahami* has been discussed in depth elsewhere, so we will not go through a full recitation here, but the Court did provide a number of important signals that provide guidance to other captives.

- **Risk Distribution.** The Court continued to move away from simply looking at the number of insureds in determining whether a captive meets the test for risk distribution. While noting that 3 insureds may not be sufficient for purposes of risk distribution, the Court emphasized that analysis should focus on the number of independent risk exposures, not simply on the number of insureds.
- **Pooling Arrangements.** The Court provided a thorough analysis of the factors it considers in determining whether a risk-pooling arrangement qualifies as a bona fide risk distribution mechanism. The Court was extremely skeptical of the circular flow of funds that characterized the Avrahami's pooling arrangement (the premiums paid by the captive to the pool were essentially identical to the reinsurance premiums received by the captive from the pool in exchange for the captive's assumption of a share of the pool's risk). The Court also noted that the premiums charged by the pool were approximately 80 times more expensive than comparable commercial premiums. Finally, the Court noted that the pool was structured in a way that made it unlikely that it would ever pay claims and questions whether it would even have the capacity to do so.
- **Insurance in the Commonly Accepted Sense.** In reviewing whether the Avrahami's captive arrangement constituted insurance in the commonly accepted sense, the Court identified a number of shortcomings. First, it noted that the Avrahami's captive paid claims on a haphazard basis. No claims were paid prior to the commencement of the IRS's investigation and, later, the captive paid claims that it was not legally obligated to pay either because they were submitted late or otherwise not covered under the express terms of the applicable policies. Second, the captive's reserves were invested in commercial real estate—not the liquid investments that would be expected for an insurance company that requires access to its funds to pay claims. Third, the policies issued by the captive contained inconsistent and conflicting terms. Fourth, the Court found that the premiums paid to the captive were grossly unreasonable, in some cases more than 13 times greater than comparable commercial coverage. Finally, the Court found evidence that the calculations used by the Avrahami's actuary lacked any basis in

> sound actuarial practice and, instead, were intended to push total premiums as close as possible to the $1.2 million cap for captive's making the election under section 831(b).

In sum, the captive structure employed by the Avrahamis was far beyond that which is generally utilized by the captive industry and, by way of juxtaposition, reaffirms the sound practices of most captives.

Carlson: Decision Raises Important Issue for Captives with Operations in New York

A recent decision by the New York State Court of Appeals has the potential to greatly expand the reach of Section 3420 of the New York State Insurance Law, which includes, among other things, New York's direct-action statute and disclaimer laws.

Section 3420 applies to insurance policies that are "issued or delivered" in New York. Prior to the Court of Appeals' decision in *Carlson v. American International Group, Inc.*, the general consensus was that in order for an insurance policy to be issued or delivered in New York, it had to have been issued by a New York-based insurer or physically delivered to an insured within the State of New York.

In *Carlson*, the Court of Appeals dramatically expanded the reach of Section 3420 by ruling that an insurance policy may be "issued or delivered" in New York even if the insurer issuing the policy is located outside of New York and the policy is delivered to an insured outside of New York. Instead, New York courts are directed to determine whether (i) the insured has a substantial presence in New York, and (ii) the risk to be insured is located in New York. If the answer to these questions is affirmative, then Section 3420's provisions governing direct action and disclaimer may be applicable regardless of whether the insurance policy is otherwise governed by New York law.

While it is too soon to know how New York's lower courts will apply *Carlson*, it seems prudent for insurers that have issued liability policies to insureds with operations and risks in New York to become familiar with Section 3420, and to be prepared to comply with its strict rules governing disclaimer. For example, Section 3420(d)(2) requires that a disclaimer be delivered to the "insured and the injured person or any other claimant." The failure of an insurer to comply with the strict requirements of Section 3420(d)(2) will render unenforceable an otherwise valid disclaimer of coverage based upon a policy exclusion or breach of a policy condition.

As discussed in our 2014 Captive Update, the United States Court of Appeals for the Second Circuit has already determined that the direct-action provisions of Section 3420 are preempted by the federal Liability Risk Retention Act. Accordingly, the expansion of Section 3420's reach, at least with respect to direct actions, likely does not apply to risk retention groups.

Impact of Changes in the Federal Income Tax Law on Captives

Pursuant to the 2017 Amendments to the Tax Law, the tax rate cut and other major changes will impact many captive insurers. For example, the reduction in the corporate tax rate to 21% impacts the value of the deduction taken for premiums paid to a captive by some owners, as well as the value of deferred tax assets that may be carried by captives. Existing tax sharing agreements will need to be updated if the prior corporate tax rate of 35% is specifically referenced. Also, the rules governing the computation of insurance reserves may generate additional income for a captive (which may be offset by the lower tax rate). There are significant changes to international tax rules, including a new base erosion anti-abuse tax, which imposes a minimum tax on certain US corporations that make deductible payments to related non-US parties. This could cause captives and other insurers transacting business with foreign affiliated reinsurance companies to re-examine those arrangements.

New Cyber Regulations

On October 24, 2017, the National Association of Insurance Commissioners ("NAIC") adopted a model law establishing standards for data security and the response to cybersecurity events.

If adopted by a state, this model law would require insurance companies domiciled within that state to implement a wide-ranging information security program requiring ongoing risk assessments and comprehensive safeguards for the protection of personal data. It also includes detailed requirements for incident response and investigation and notification of regulators and affected parties. Finally, the model law establishes cyber security-related guidelines for corporate governance and board oversight and extends many of its provisions to third-party service providers.

The model law is based on New York's cyber security law, which became effective in 2017. The DFR is reviewing the model law and expects to address cyber security in the captive insurance industry in the next few years. However, the DFR has also indicated that it hopes to make any Vermont laws or regulations related to cyber security scalable, such that they will be more rigorous for larger companies or companies holding significant amounts of personally identifiable information and less burdensome for smaller companies or companies with limited personally identifiable information.

TRIA Data Collection

Beginning in 2018, the United States Department of the Treasury, state insurance regulators, and the NAIC are trying to consolidate their collection of TRIA-related data. Further information on the new data collection procedures can be found online at: https://www.treasury.gov/resource-center/fin-mkts/Pages/TRIP_data.aspx. The submission deadline is May 15, 2018.