Downs Rachlin Martin PLLC
Captive Insurance Update | Fall Edition | 2021

Brattleboro, VT | Burlington, VT | Lebanon, NH | Montpelier, VT | St. Johnsbury, VT

In this edition:

Developments in Vermont

Continued Impact of COVID-19

The measures taken by the Vermont Department of Financial Regulation (the "DFR") in 2020 in response to the COVID-19 pandemic have been extended through 2021. These include a recognition that in-person board meetings in Vermont may not be feasible until travel restrictions have been relaxed. Captives are invited to request a waiver of the physical presence requirement for their 2021 annual meetings.

2021 Captive Legislation

Despite its focus on the State's COVID-19 response, the Vermont legislature passed its annual captive "housekeeping" bill, which was jointly proposed by the DFR and the Vermont Captive Insurance Association. The new legislation includes the following notable provisions:

- Mergers and Redomestications. New procedures are adopted for the most common types of captive mergers and redomestications. These procedures are expected to be significantly clearer and more efficient than the existing rules.

- Cell Conversions. The laws governing protected and incorporated protected cell conversions were consolidated and language was added to clarify the status of protected cells under Vermont law.

- Formation / Organizational Documents. The requirement that a newly formed captive submit copies of its organizational documents that have been certified by the Secretary of State was eliminated. Executed copies will be sufficient.

- Minimum Capital and Surplus. The minimum capital and surplus requirement is now a precondition to a newly formed captive's issuance of any insurance contracts, rather than its licensure. Newly formed captives will have 30 days from the date on which they commence business to file a certificate regarding their capital and surplus.

- Agent for Service of Process for Risk Retention Groups. The agent for service of process for risk retention groups is now the DFR, rather than the Secretary of State.

2020 Vermont Formations

In 2020, 38 new Vermont captives were licensed, bringing the total to 1,197 captives licensed, of which 564 were active as of December 31, 2020. The types of active captives break down as follows:

Pure	357
Risk Retention Group	87
Special Purpose Financial	38
Sponsored	43
Industrial Insured	21
Association	12
Branch	3
Affiliated Reinsurance Company	2
Agency	1

Notably, Vermont's 43 sponsored captives have experienced significant growth, with well over 300 cells.

2020 Aggregate Data

The aggregate amount of gross premium written by all Vermont captives for the year 2020 was $30 Billion; total net written premium was $23.3 Billion. Aggregate total capital and surplus as of December 31, 2020 was $60 Billion and total assets were $198 Billion. Total Vermont premium tax paid on 2019 gross written premiums was approximately $26 Million.

Federal Issues

IRS v. Delaware

In June of 2020, the Internal Revenue Service (the "IRS") petitioned the U.S. District Court for the District of Delaware for an order to enforce document requests served on the Delaware Department of Insurance ("DDOI"). The IRS is seeking records relating to filings by Artex Risk

Solutions, Inc. (“Artex”) and Tribeca Strategic Advisors, LLC (“Tribeca”) relative to the role of Artex in transactions involving micro-captive insurance companies formed under Section 831(b) of the Internal Revenue Code.

These micro-captive programs were designated as “Transactions of Interest” by the IRS in 2016, meaning the IRS believes they have the potential for tax evasion. The IRS is also investigating whether Artex or Tribeca promoted micro-captive programs and whether their actions may result in penalties applicable to promoters of abusive tax shelters.

In its suit against the DDOI, the IRS alleges that the DDOI has failed to provide records responsive to its summons for records. The DDOI has moved to “quash” the IRS Petition on the grounds that, among other things, enforcement of the summons would require the DDOI to violate a Delaware statute that prohibits disclosure by the DDOI of captive insurance licensing information unless the insurer consents to disclosure or such information is disclosed to another state insurance department or to a state or federal law enforcement agency and the department or agency agrees to hold the information as confidential. The DDOI also argues that, under the McCarran-Ferguson Act, the regulation of insurance is within the exclusive authority of the states.

A hearing was held on March 12, 2021. The final decision could impact a domiciliary state’s ability to protect the confidentiality of captive insurance company records.

CIC Services, LLC v. IRS

The U.S. Supreme Court recently decided a case involving a challenge to the IRS’ reporting requirements relative to micro-captive insurance companies formed under Section 831(b) of the Internal Revenue Code.

In 2016, the IRS published Notice 2016-66, which classified certain micro-captive transactions as “reportable transactions,” which are transactions the IRS believes have the potential for tax avoidance or evasion.

In 2017, CIC Services LLC (“CIC”), an advisor to micro-captives engaging in reportable transactions, sued the IRS claiming that Notice 2016-66 violated the Administrative Procedure Act because the IRS failed to follow formal rule-making procedures. The IRS responded that the lawsuit was barred by the Anti-Injunction Act, which provides that the federal courts lack subject matter jurisdiction over suits filed to restrain the assessment or collection of any tax before the tax or penalty is paid by the taxpayer. The District Court granted the IRS’ motion to dismiss, and the Sixth Circuit Court of Appeals affirmed.

The Court reversed the lower court decisions finding that CIC’s action is directed at a reporting requirement, not a tax, and, accordingly, it is not barred by the Anti-Injunction Act. Moreover, the Court found that it is not reasonable to require a person to violate a law imposing criminal penalties before he or she is able to challenge that law.

However, the Court’s decision does not address the substance of the dispute between CIC and the IRS over the validity of Notice 2016-66. It merely removes the IRS’s Anti-Injunction Act defense.

We will have to wait for a further decision from the District Court as to whether the IRS violated the Administrative Procedures Act in connection with Notice 2016-66.

Allied Professionals Inc. Co. RRG v. Anglesey

In March of 2021, the Ninth Circuit issued another decision supporting Liability Risk Retention Act of 1986 ("LRRA") preemption of state law prohibitions on arbitration clauses in insurance contracts.

Allied Professionals Insurance Company ("Allied") is an Arizona-licensed risk retention group providing malpractice coverage to physicians and the claim at issue arises out of certain professional services rendered by Dr. Anglesey, a chiropractor practicing in Washington state.

Dr. Anglesey had professional liability coverage with Allied, and each of his Allied policies had a mandatory arbitration clause requiring all disputes to be arbitrated in Orange County, California. In April 2013, Dr. Anglesey notified Allied of the claim and Allied denied coverage for failure to timely report the claim and rescinded his policies.

In 2014, Dr. Anglesey's attorney notified Allied that Dr. Anglesey was signing a consent judgment, pursuant to which the claimants agreed to seek satisfaction of the judgment in their case only from Allied. The parties proceeded to execute a settlement agreement stipulating to entry of judgment against Dr. Anglesey in the amount of $3 million dollars, to be executed only against Allied. Allied filed suit with the Ninth Circuit against the plaintiffs and Dr. Anglesey seeking an order compelling arbitration.

In holding that the LRRA preempts Washington state's prohibition on mandatory arbitration clauses in insurance contracts, the Ninth Circuit cited to its decision in *Attorneys Liab. Prot. Soc'y Inc. v. Ingaldson Fitzgerald, P.C., 838* F.3d 976, 980-81 (9th Cir. 2016). In *Attorneys Liab. Prot. Soc'y*, the Ninth Circuit held that the LRRA preempts an Alaskan law attempting to regulate substantive terms of an insurance policy of an out-of-state RRG, stating that "The LRRA leaves regulation of an RRG to the state where the RRG is chartered, and broadly preempts 'any [non-chartering] State law, rule, regulation, or order to the extent that such law, rule, regulation, or order would … make unlawful, or regulate, directly or indirectly, the operation of a risk retention group." *Id.*

This Ninth Circuit ruling is another win for risk retention groups, lending further support to the preemption of state law restricting arbitration clauses by the LRRA.

Caylor Land & Development, Inc. v. IRS

Continuing a string of recent victories for the IRS, the Tax Court recently found that another 831(b) captive's insurance program failed to constitute "insurance" for federal tax purposes. As in the prior decisions we discussed here and here, the court's legal analysis did not break any new ground (though it is a good read), but the facts of the case provide a reminder of potholes to avoid in structuring a captive insurance program.

Caylor Construction and its affiliates run a construction business in Arizona. After many years of placing its insurance program in the commercial market, Caylor Construction formed an Anguilladomiciled captive insurance company in 2007. The captive, Consolidated, Inc. ("Consolidated") elected to be taxed under Section 831(b) of the Code.

Consolidated's business practices were irregular. For example, on the day it was incorporated, it received $1.2 million in premiums (the maximum allowed at the time for an 831(b) captive) from Caylor Construction, which deducted the same amount as an insurance expense on its 2007 tax return. The Tax Court found this deduction troubling since the risks purportedly covered by Consolidated had not been underwritten, Consolidated did not actually issue a policy until 2008, and the policy provided for claims-made coverage, meaning that for 2007, Caylor Construction paid $1.2 million for 10 days (or less) of coverage. These practices largely continued in the following years.

Additionally, for the policy years from 2007 - 2010, Consolidated only paid four claims in the aggregate amount of $43,000 (on premium of $4.8 million). And no support was ever provided for those claims—Caylor Constructions' principals, acting in their capacity as Consolidated's owners, simply ordered the management company to pay the claims.

The Tax Court began its analysis by considering whether Caylor Construction's captive arrangement satisfied the test for risk distribution. Risk distribution is typically established in one of three ways: (i) insuring a large enough number of unrelated risks to allow for the law of large numbers to accurately predict losses; (ii) insuring at least 12 non-parent affiliates, each of which represents between 5% and 15% of the total risk assumed by the captive; or (iii) ensuring that at least 30% of the captive's risk comes from unrelated third parties.

Consolidated did not meet any of these standards. With respect to the first test, the Tax Court found that the number of risks Consolidated covered by the insurance program was smaller than the number of risks in other recent cases by several orders of magnitude. It also found that the risks were not independent—they were all related to the performance of Caylor Construction. Accordingly, Consolidated's insurance program failed the test for risk distribution.

The Tax Court also examined whether Consolidated's insurance program constituted insurance in the commonly accepted sense. Unsurprisingly, the court found that it did not. In support of this finding, the Tax Court referenced Consolidated's practice of issuing claims-made policies *after* the expiration of the covered policy period, its irregular handling of claims, and Caylor Construction's practice of determining how much premium it wanted to pay and then creating policies to fit the premium.

While this was not a close case, it is instructive in that it reinforces the need for sound business practices in all captive arrangements and provides additional data points in the analysis of risk distribution and insurance in the commonly accepted sense.

Potential Modifications to TRIA

On November 10, 2020, the U.S. Treasury (the "Treasury") requested feedback on several questions related to the usage of the TRIA program by captive insurers. This request appears to have been in response to a report from the Advisory Committee on Risk-Sharing Mechanisms ("ACRSM") comparing reimbursement for losses of a similar size between captive and traditional insurers and recommending that the Treasury require further transparency concerning the participation of captive insurers in the TRIA program.

The Vermont Captive Insurance Association (in conjunction with several other captive insurance associations) responded with a letter disputing the premise of the ACRSM report and reaffirming the critical role that captives play in the terrorism insurance marketplace.

To date, the Treasury has not taken any action on captives' usage of the TRIA program, but we will be following this matter closely over the coming months.

State Issues

VT DFR v. Global Hawk

On November 12, 2020, the DFR filed a federal lawsuit against several individuals and entities associated with Global Hawk Insurance Company Risk Retention Group ("Global Hawk"). Global Hawk, a Vermont-domiciled risk retention group that provided insurance coverage to commercial trucking companies, was placed into liquidation on June 8, 2020.

The lawsuit alleges that the defendants engaged in a scheme to defraud Global Hawk through the misappropriation of its assets and the submission of false reports to the DFR intended to conceal Global Hawk's financial condition allowing it to continue to operate after it had become insolvent.

This matter remains in its preliminary stages.

Johnson and Johnson Tax Court Decision

On December 7, 2020, the New Jersey Supreme Court reaffirmed a 2019 decision from Appellate Division of New Jersey's Superior Court finding that the enabling legislation adopted by New Jersey to implement various provisions of the federal Nonadmitted and Reinsurance Reform Act of 2010 applied only to surplus lines coverage, and not to self-procured insurance. A detailed discussion of the Superior Court's decision is available here.

Washington Premium Tax Legislation

Beginning in 2018, the Washington State Insurance Commissioner (the "OIC") has been engaged in a series of disputes with certain large, Washington-based companies over the usage and taxation of such companies' captive insurance arrangements. Further information about this dispute can be found here and here.

In 2021 Washington enacted a new law intended to resolve these disputes and establish a framework to permit Washington-based companies and public institutions of higher education to utilize captive insurance arrangements. The law does not provide for the establishment of a captive insurance industry in Washington, it merely establishes a legal framework to tax the captive insurance arrangements of Washington-based businesses.

Under the new law, an eligible captive insurer, defined as an insurance company that, among other things, (i) includes among its insureds at least one person or entity whose principal place of business is in Washington; and (ii) has assets that exceed its liabilities by at least $1 million, is eligible to provide property and casualty insurance to its owner and its owner's other affiliates (it is also permitted to assume unrelated risk from other insurers as a reinsurer).

In order to provide this coverage, the eligible captive insurer must register with the OIC. The OIC will then approve a registration if the captive (i) establishes that it meets the surplus criteria described above (verified by audited financials); (ii) is in good standing with its domiciliary jurisdiction; and (iii) pays a fee of $2,500. Registrations must then be renewed annually, for a further fee of up to $2,500.

A registered eligible captive insurer will be required to pay a 2% premium tax on all Washington-based risks. This new premium tax is applied retroactively for any premiums written after January 1, 2011, but such back taxes will not be subject to penalties or interest.

"Washington risk" is defined as "the share of risk covered by the premiums that is allocable" to Washington, "based on where the underlying risks are located or where the losses or injuries giving rise to the covered claim arise." Registered eligible captive insurers have some discretion in determining the methodology for allocating risk, but such methodology must be reported to the OIC.

Eligible captive insurers that fail to register are subject to fines and penalties applicable to unauthorized insurers.

Unfortunately, this legislation leaves many questions unanswered such as (i) whether authorized captive insurers are permitted to provide coverages other than property and casualty for risk located outside of Washington; (ii) how companies that are headquartered outside of Washington with subsidiaries domiciled in Washington will be treated; and (iii) whether Washington's efforts to tax and regulate captive transactions are permissible under the *Todd Shipyards* line of cases.

We are available to assist captives in analyzing their exposure to the new tax.

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