DOWNS RACHLIN MARTIN PLLC

CAPTIVE INSURANCE GROUP

CAPTIVE INSURANCE UPDATE
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INTRODUCTION

This edition of the Downs Rachlin Martin PLLC ("DRM") *Captive Insurance Update* covers a variety of recent state and federal developments affecting the captive insurance industry. If you have any questions about this update or any other captive insurance developments, please contact Kathy Davis at kdavis@drm.com, Kevin Moriarty at kmoriarty@drm.com, or David Angus at dangus@drm.com.

DEVELOPMENTS IN VERMONT

New Democratic Administration, Same Commitment to the Captive Insurance Industry

Democratic Governor Peter Shumlin has appointed Steve Kimbell as the Commissioner of BISHCA and Susan Donegan as Deputy Commissioner of Insurance. Clifford Peterson has been named BISHCA General Counsel. Dave Provost will continue in his position of Deputy Commissioner of Captive Insurance. The Shumlin Administration is expected to continue Vermont's longstanding bipartisan commitment to maintaining Vermont as the premier onshore captive domicile.

2010 Captive Licensing

In 2010, the Captive Division licensed 33 new captives, pushing the total of captive licenses over 900. Of the new companies, nineteen are pure captives, four are risk retention groups, one is an industrial insured, and nine are special-purpose financial captives.

2011 Legislation

The annual BISHCA housekeeping bill was enacted, with its provisions going into effect on July 1, 2011. To summarize, the provisions affecting captives and risk retention groups are:

- The first-year $7,500 premium tax non-refundable credit for newly-licensed captives is made permanent.
- The annual maximum aggregate tax of $200,000 to be paid by a sponsored captive will be applied to the sponsored captive insurance company as a whole, and not to an individual protected cell.
- Two or more captive insurance companies that are special-purpose financial captives under common ownership and control will be taxed as though they were a single captive insurance company. Special-purpose financial captives, however, may not be consolidated with other captives that are not special-

purpose financial captives for purposes of calculating premium taxes due.

- The Commissioner will have the discretion to determine whether the business written by a sponsored captive, with respect to each cell, must be: (i) fronted by a licensed insurance company; (ii) reinsured by a reinsurer approved by the State of Vermont; or (iii) secured by a trust or funded by an irrevocable letter of credit or other acceptable security arrangement.

- Sponsored captives will have the option of forming a protected cell as a separate corporation or limited liability company.

- Risk retention groups will be subject to various provisions of the Vermont Insurance Holding Company Act, Title 8, Chapter 101, subchapter 13 of the Vermont Statutes. BISHCA is drafting a new regulation to implement the Holding Company Act, which is likely to take effect by the end of 2011.

RISK RETENTION GROUPS

New GAO Study Ordered

In July 2010, Representative Dennis Moore, chair of the House Oversight Committee on Financial Services, directed the U.S. Government Accountability Office (the "GAO") to examine instances where non-domiciliary states have attempted to improperly regulate RRGs through the use of filing requirements, information requests, fees, waiting periods, and other measures. The industry supports this study, as a number of states have taken the position that they can subject RRGs to such regulation consistent with the Risk Retention Act.

Proposed Federal Legislation to Amend the Risk Retention Act

On June 6, 2011, H.R. 2126, entitled "The Risk Retention Modernization Act of 2011," was introduced into the U.S. House of Representatives by Representatives Peter Welch (D-VT) and John Campbell (R-CA). The new bill includes essentially the same provisions that were included in H.R. 4802, which was introduced in March 2010 but was not enacted. The bill would: (i) give the Treasury Department authority to resolve disputes between states regarding state law preemption; (ii) impose new governance standards on RRGs; (iii) allow RRGs to write property insurance; and (iv) modify the provisions of the Risk Retention Act regarding financial statements and disclosure issues. We will monitor the status of H.R. 2126 and report on its progress in a future issue of *Captive Update*.

NAIC Finalizing Revisions to the Model Risk Retention Act

Vermont and other RRG domiciles are working with the NAIC to finalize revisions to the model Risk Retention Act, which include provisions regarding the governance and operations of RRGs. The issues being reviewed include the following:

- Independent Directors. Clarification that the independent-director requirement applies to the governing body of an RRG, since not all legal entities have boards of directors (e.g., limited liability companies).

- Service Provider Contracts. Recommendation to strike the reference permitting an RRG's owners/insureds the right to terminate any service provider, audit, or actuarial contract for cause. This power should be reserved for the RRG's board of directors.

- Written Charter. Recommendation to change the section heading to "Written Policy" and to strike the requirement that RRGs amend their bylaws to include the written charter. If this requirement remains, RRGs will need to amend their bylaws to incorporate their governance standards. Any changes to the governance standards would necessitate further amendments to the bylaws. Amending bylaws could

prove to be quite cumbersome for certain RRGs.

- Audit Committee. Recommendation to strike the responsibility of the audit committee to assist the board in the oversight of the performance of the captive manager, managing general underwriter, or other party or parties responsible for underwriting, determining rates, collecting premium, adjusting or settling claims, or preparing financial statements. These additional responsibilities go beyond the traditional role of an audit committee.

- Governance Standards. Recommendation to limit the access of the members/insureds to the procedures that are followed for conducting annual performance evaluations of the board or officers. The self-evaluations themselves should remain confidential.

- Reporting of Non-compliance. Recommendation to require the chief executive officer or board (instead of the captive manager) to report material non-compliance to the domestic regulator if the non-compliance is not cured within a reasonable period from detection, not to exceed sixty days.

- Enforcement. Recommendation to delete the enforcement section because it may conflict with the regulatory powers already granted to the Insurance Commissioners.

If incorporated into the final Model Risk Retention Act, these recommendations will greatly improve the application of the governance standards to RRGs. The NAIC has taken these suggestions into account in the current version of the Model Risk Retention Act, and we are cautiously optimistic that most of the comments will be reflected in the final version.

Adoption of Corporate Governance Standards for RRGs

In March 2009, BISHCA issued Memo #2009/03, which included a reminder that the NAIC has adopted Governance Standards for RRGs, and a statement that, although the NAIC has not yet prepared a Model Law for these standards, BISHCA encouraged early implementation of these standards. As noted in the previous section, the NAIC has since drafted the revisions to the Model Risk Retention Act for the governance standards, but the process is not yet complete. We anticipate that Vermont will adopt the corporate governance standards as soon as the NAIC has finalized them, but that RRGs in Vermont will be given adequate time to implement the standards.

Amendment of Regulation 81-2

BISHCA is in the first stage of amending Regulation 81-2 to clarify and update annual financial reporting requirements for all captives, including RRGs, and to add new provisions regarding RRGs taking credit for reinsurance. The new reinsurance guidelines reflect changes adopted by the NAIC.

Insurance Holding Company Regulation

As discussed above, under 2011 Legislation, RRGs domiciled in Vermont are now subject to Vermont's Insurance Holding Company Act. BISHCA is in the process of drafting regulations to implement the new requirements, including appropriate exemptions for qualified RRG programs.

FEDERAL TAXATION

Proposed Regulations Would Allow Protected Cells to Elect to Be Separate Taxable Entities

In our October 2010 *Captive Insurance Update News Flash,* we discussed proposed regulations issued by the U.S. Department of the Treasury that would allow a protected cell of a protected cell company, or a series of a series limited liability company, to elect to be treated as a separate entity for federal tax purposes (available

upon request or at http://www.drm.com/captive_insurance/articles). Public comments on the proposed regulations were due by December 13, 2010. We will continue to monitor the status of the proposed regulations.

Regulations on Disclosure of Uncertain Tax Positions Finalized

The proposed Treasury Regulation regarding disclosure of uncertain return positions became final on December 15, 2010, and it applies to affected corporations starting with the 2010 return. The Regulation amends Treasury Regulation 1.6012-2, by adding a new subsection (4)(a) that reads:

> *Disclosure of uncertain tax positions. A corporation required to make a return under this section shall attach Schedule UTP, Uncertain Tax Position Statement, or any successor form, to such return, in accordance with forms, instructions, or other appropriate guidance provided by the IRS.*

The Service drafted and took comments on Schedule UTP during 2010. The Service is implementing the rules regarding "uncertain return positions" by bulletin, notice, and other published guidance. The determination of what qualifies as an uncertain tax position would be based on essentially the same principles as FASB Interpretation No. 48, "Accounting For Uncertainty In Income Taxes" ("FIN 48"), which requires disclosure of uncertain tax positions for purposes of a business' audited financial statements.

STATE REGULATION OF CAPTIVES

Dodd-Frank Bill Includes Significant Changes With Respect to State Regulation of Nonadmitted Insurance

Last July, the federal Nonadmitted and Reinsurance Reform Act of 2010 ("NRRA") was enacted as Title IX, subtitle B of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203. NRRA includes significant changes to the state regulation and taxation of "non-admitted insurance," specifically surplus lines insurance and insurance independently procured by an insured from an unlicensed insurer without the use of an insurance producer. A full briefing on NRRA is available in the June 2011 *Captive Insurance Update News Flash* (available upon request or at http://www.drm.com/captive_insurance/articles). To summarize the two key provisions of NRRA:

Taxation: As of July 21, 2011, only the "home state" of an insured can impose a tax on the premiums paid by the insured for a policy placed with a nonadmitted insurer, regardless of whether the risks insured by the policy are located in other states. The home state is authorized to charge and collect taxes on the premiums allocable to such other states. NRRA requires the states to become parties to an interstate compact for the collection of taxes on premiums paid for nonadmitted insurance, The compact must be established before a home state can collect premium taxes on behalf of other compacting states. States are considering two alternative model laws to enact the premium tax compact: the Surplus Lines Insurance Multi-State Compliance Compact (or "SLIMPACT"), and the Nonadmitted Insurance Multi-State Agreement (or "NIMA").

Industry reports indicate it is unlikely most states will have legislation in effect when the prohibition on taxation by "non-home states" takes effect on July 21. New York has decided not to join the compact, and it has been reported that California, and possibly Florida and Texas, will also decline to join. If a state does not join the compact, it will still be permitted to tax surplus lines placements if the state is the home state of the insured under Dodd-Frank, but it will not collect surplus lines tax on behalf of other states if such placement insures risks in other states.

Regulation: Effective July 21, 2011, state regulation of the sale, solicitation, and negotiation of nonadmitted insurance is limited to regulation by the home state of the insured; the laws of any other state are preempted. (The only exception to this preemption is workers' compensation insurance.) For surplus lines placements, if an insured is purchasing coverage on risks located in multiple states, the surplus lines broker

placing such coverage is required to be licensed only in the insured's home state. Moreover, with respect to certain "exempt commercial purchasers," a surplus lines broker is not required to undertake any due diligence to determine whether coverage is available from an admitted insurer.

What does this all mean for captives, which are generally licensed only in their domicile state? A few things are clear:

- NRRA does not require a state to allow a nonadmitted insurer to place insurance on risks located in the state. A captive that insures risks outside of its state of domicile will still need to comply with existing state laws governing nonadmitted insurance.

- NRRA does not expand the taxing power of the states, nor does it require states to enact laws taxing surplus lines and independently procured insurance if they do not currently tax one or the other type of placement. We are monitoring state legislatures regarding enactment of independent procurement taxes and will report on this in a future *Captive Insurance Update*.

- NRRA applies only to "premium taxes" imposed by the states on nonadmitted insurance placements. It is not clear that the definition of "premium tax" would cover state income taxes. If not, the home state preemption with respect to the collection of premium tax would not apply to states that subject insurers to income taxes (including unitary business states).

Massachusetts Subjects Vermont Captive to Its Claims-Handling Law

In December 2010, a Massachusetts court of appeals ruled that a Vermont-domiciled captive is subject to Massachusetts laws governing unfair insurance claims and settlement practices. Electrolux North America had organized and operated Equinox Insurance Company, a Vermont captive, to provide various coverages, including general liability coverage. A consumer sued Electrolux for products liability and won a judgment at trial, and Equinox funded payment of the judgment through the GL policy. The consumer then sued both Electrolux and Equinox contending violations of the Massachusetts unfair settlement practices statutes. The trial court dismissed the claims on summary judgment, based on the conclusion that neither Electrolux nor Equinox as engaged in the business of insurance in Massachusetts, and as such neither was subject to the unfair practices statute.

The appeals court ruled that Equinox was, as a matter of law, engaged in the business of insurance and therefore subject to the Massachusetts unfair claims practice statute. *Lemos v. Electrolux North America,* No. 09-P-943 (Mass. App. Ct. 12-2-2010). Among the undisputed facts the court cited in favor of its conclusion: Equinox was separately incorporated, capitalized and licensed as an insurance company, operated as a business separate from Electrolux, and the general liability policy included typical policy provisions, including the insurer's right to approve any settlement. Though the court concluded that Equinox was in the business of insurance, there was no discussion of whether that insurance business had a sufficient connection to Massachusetts to justify extending the jurisdiction of the unfair claims law to Equinox. It appears that Equinox did not raise this issue in the trial court.

We recommend that any captive insurer that insures risks in states where it is not licensed carefully review its insurance program to identify potential exposure to taxation and regulation in such states. We have counseled many clients on these issues and have developed program and policy form revisions to limit this exposure.

BEST PRACTICES: ELECTRONICALLY STORED INFORMATION AND eDISCOVERY

Captive insurers and RRGs, like all businesses, must understand and effectively manage electronically stored documents and information ("ESI"). Prudent businesses have clear ESI and paper document retention and destruction policies and follow those policies, if for no other reason than to avoid the costs and burden of preserving stale information in closed files. However, changes in court discovery rules allow parties to conduct

"eDiscovery" of computer files and data, so ESI retention obligations are enhanced once litigation is threatened or is reasonably likely to occur or has occurred.

These changes in court rules alter ESI preservation obligations significantly, for potentially relevant ESI must not be altered or destroyed, even in the normal course of business. A recent study published in the Duke Law Journal shows that court sanctions for eDiscovery abuse are on the rise, and failing to preserve ESI in the first place is a commonly sanctioned offense. Penalties can be severe and may even include dismissal or a finding of liability in egregious cases. When litigation is known or threatened, it is important to alter standing policies

and practices with a "litigation hold," to ferret out and preserve potentially relevant ESI and to prevent its alteration.

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 for 25 years. DRM is a regional law firm, with offices in Burlington, Brattleboro, Montpelier, and St. Johnsbury, Vermont; Lebanon, New Hampshire; and Plattsburgh, New York. The firm has been serving individuals, businesses, and institutions for more than half a century.

DRM's 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, please contact Practice Group Chair Kathy Davis, Kevin Moriarty, or David Angus at (802) 863-2375, or at www.drm.com.

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