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Captive Insurance Update | Spring Edition | 2021

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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 is on track to pass its annual captive "housekeeping" bill, which was jointly proposed by the DFR and the Vermont Captive Insurance Association. The current version of the bill 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 are consolidated and additional language is 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 is eliminated. Executed copies will be sufficient.

- Minimum Capital and Surplus. The minimum capital and surplus requirement will become 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 will be 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 Groups	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.

2019 Aggregate Data

The aggregate amount of gross premium written by all Vermont captives for the year 2019 was $25.4 Billion; total net written premium was $20.5 Billion. Aggregate total capital and surplus as of December 31, 2019 was $82.6 Billion and total assets were $213 Billion. Total Vermont premium tax paid on 2019 gross written premiums was approximately $25 Million.

Aggregate data for the year 2020 will likely be published during the summer of 2021.

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 the 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

A case is pending before the U.S. Supreme Court 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, which is 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.

If the U.S. Supreme Court rules in favor of the IRS by upholding the Sixth Circuit Court's ruling, then taxpayers challenging an IRS notice imposing penalties would have to violate the notice and

be assessed a penalty before the taxpayer could dispute the validity of the notice. If the Court reverses the lower courts and rules in favor of CIC Services LLC, thereby allowing preemptive taxpayer challenges to IRS notices that impose penalties, a taxpayer could seek court review of the validity of such penalties before they are assessed and paid.

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.

Potential Modifications to TRIA

On November 10, 2020, the U.S. 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.

Earlier this year a bill (SB 5315) was introduced to resolve these disputes and establish a framework to permit Washington-based companies and public institutions of higher education to utilize captive insurance arrangements, which would be subject to premium tax in Washington. The bill 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.

SB 5315 allows for 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, to

provide property and casualty insurance to its owner and its owner's other affiliates (they are 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.

The bill's prospects for 2021 are uncertain, but it does appear to have the support of the OIC and a group of large, Washington-based captive owners.

Unfortunately, SB 5315 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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