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Developments in Vermont

Changes at the Top

Republican Phil Scott was elected Governor of Vermont in November 2016, having previously served as Lieutenant Governor for six years.

Governor Scott has re-appointed Michael Pieciak to serve as the Commissioner of the Department of Financial Regulation. David Provost continues to serve as Deputy Commissioner of Captive Insurance, having been appointed in 2008. No changes in Vermont's consistent and predictable regulation of captives is expected as a result of these changes at the top. In fact, since Vermont originally passed its captive insurer legislation in 1981, only three individuals have served as Vermont's top captive regulator.

2016 Formation Data

Vermont licensed 26 new captives during 2016, and has licensed 4 new captives year-to-date in 2017. While the 2016 aggregate financial statistics have not yet been published, as of year-end 2015, Vermont captives' 2015 gross written premium totaled $27.6 billion, which was a significant increase over the prior year. Aggregate data for 2016 will likely be released in June.

2017 Captive Legislation

On May 1, 2017, Governor Scott signed the 2017 captive legislation into law. Significant changes include:

- Captives will have additional flexibility with respect to the accounting standards used for financial statements;
- The dormancy provisions will be expanded to include any type of captive;
- The rotational requirement applicable to the auditors of a risk retention group will be relaxed and the Commissioner will be authorized to grant waivers from the rotation requirement.

Additionally, the provisions governing the types of captives that can be formed in Vermont will be expanded to include Agency Captives—captives that are owned by existing insurance agencies or brokerages that only insure the risks of policies placed through such agencies or brokerages.

Separately, the legislature is considering a modification to the premium tax credit available to newly formed captives. If enacted, the premium tax credit will be reduced from $7,500 to $5,000, but it will be available for each of a captive's first two years, resulting in an overall savings to the captive.

Affordable Housing Tax Credits

The legislature is also considering a bill that would allow captives to participate in Vermont's affordable housing tax credit program. Essentially, a captive could invest in affordable housing projects in Vermont, use the resulting tax credits to offset a portion of its premium taxes that would otherwise be due to Vermont, and potentially receive a return on its initial investment.

TRIA Data Call

On December 21, 2016, the U.S. Treasury published its final rule on the data collection mandated by the Terrorism Risk Insurance Program Reauthorization Act of 2015 ("TRIA"). For captives, there are three key points:

- Data collection will vary depending on the type of insurer participating in the program, meaning that captives will be subject to a data collection template that is less comprehensive than what is applicable to traditional insurance companies.
- Only captives that are actually providing TRIA coverage will be required to participate in the data collection program. This is a marked improvement over the previous guidance, which suggested that any insurers that wrote TRIA-eligible lines would be required to participate.
- Captives are specifically excluded from the definition of small insurers, meaning that smaller captives that provide TRIA coverage are not likely to be exempted from data collection by future rules.

The deadline for compliance with the new rule is May 15, 2017.

Section 831(b) Captives / IRS Notice 2016-66

The IRS recently issued Notice 2016-66 (the "Notice") which designates the election by certain captives under Section 831(b) of the Internal Revenue Code as transactions of interest.

The Notice defines a Section 831(b) transaction of interest as follows:

- A party ("X") owns an interest in an entity conducting a trade or business ("Insured");
- A captive ("C") owned by X or Insured enters into a contract with Insured that C and Insured treat as an insurance contract, or that reinsures risks that Insured initially insured with a fronting carrier (the "Front");
- C makes the 831(b) election;
- At least 20% of the voting power or value of the outstanding stock of C is owned by X or Insured; and
- One or both of the following apply:
    1. The amount of liabilities incurred by C for insured losses and LAE during the computation period is less than 70% of the following:
        a) Premiums earned by C during the computation period, less
        b) Policyholder dividends paid by C during the computation period; or
    2. C has, at any time during the computation period, made a loan to (or similar financial arrangement with) Insured.

With respect to any Section 831(b) transaction of interest, C, Insured, X, and the Front are generally required to file Form 8886, which must, among other things: (i) describe the transaction of interest in sufficient detail for the IRS to understand the tax structure of the transaction of interest and the identity of all parties involved; (ii) describe the amount and nature of the expected tax treatment and expected tax benefits generated by the transaction of interest; and (iii) identify each service provider to whom the taxpayer paid a fee with regard to the transaction of interest if the service provider promoted, solicited, or recommended the taxpayer's participation in the transaction of interest, or provided tax advice related to the transaction of interest.

In addition to the above, C is required to disclose: (i) whether it is reporting because it meets the criteria under 1. (insufficient liabilities) or 2. (loan back), above; (ii) its domicile; (iii) the types of coverages it provides; (iv) its methodology for calculating premiums and the identity of any actuary or underwriter who assisted in such calculations; (v) information about its claims payment history and reserves; and (vi) information about its assets.

Substantial reporting requirements are also imposed on material advisors.

Penalties for non-compliance are substantial and filings are due by May 1, 2017.

New Cyber Regulations (NY and NAIC)

On March 1, 2017, the New York Department of Financial Services ("NYDFS") issued a new regulation mandating cybersecurity measures for financial services companies. Early drafts of the regulation indicated that it would apply to risk retention groups domiciled in other states that were registered in New York. Following discussions with industry representatives, NYDFS modified the regulation to exempt foreign risk retention groups.

Cybersecurity regulation, however, will continue to be a hot button issue and the NAIC is currently working on a model law that will likely become an accreditation standard. While mandated cybersecurity requirements will add to the administrative expenses of operating a risk retention group, they are becoming an increasingly important part of any business and, for risk retention groups, regulation by the domiciliary regulator will at least avoid the prospect of becoming subject to a hodge podge of divergent, and potentially conflicting, regulatory regimes in the states where the risk retention group is registered.

Impact of "Other Insurance" Clause on Policies Offering Cyber Coverage

Captives writing general liability ("GL") coverage should consider whether their GL policy form provides redundant and possibly conflicting coverage for cyber liability. The conflict may arise when one event is covered, wholly or partially, under the overlapping coverages of both the GL (typically, the "advertising injury" coverage) and the cyber liability forms. The problem may be enhanced when the GL form is a custom form tailored to the particular circumstances of the captive. Any resulting conflict can create uncertainty as to which policy is primary, and the conflict may have to be resolved by a comparison of the respective "other insured" clauses in each policy. This can be a very challenging task, as those clauses may themselves conflict. Finally, in most instances, the desire will be to have the cyber liability policy, for which a premium is typically paid to a commercial carrier, take the lead.

One solution is to draft a GL policy exclusion to separate the liability coverages it affords from liability coverages provided by separate cyber liability policies. This is becoming the trend with respect to standard insurance policies outside the captive realm. Such exclusions can be crafted so that, where there is no coverage under the cyber liability policy, any existing liability coverage under the GL will be read without exclusion and will remain in place, and the exclusion can further provide that it does not apply where there is no cyber policy coverage. This avoids any redundant coverage and is designed to obviate the need to consult "other insurance" clauses.

Wisconsin Decision Challenges Prevailing View of the Authority of Risk Retention Groups to Do Business in States in which they Are Registered

For many years, the prevailing view in the captive industry has been that risk retention groups that are registered in a state are "authorized" to do business in that state. However, a recent decision of a federal district court has challenged that view, at least in Wisconsin.

Restoration Risk Retention Group, Inc. v. Ross involved a Vermont-domiciled risk retention group registered in Wisconsin that provided general liability insurance to its Wisconsin-based member/insureds. Each member/insured was required to obtain a certificate of financial responsibility from the Trades Credentialing Unit of the Wisconsin Department of Safety and Professional Services (the "Department"), and these certificates were issued only to entities that provided proof of insurance by an insurer authorized to do business in Wisconsin.

After treating the plaintiff (the "RRG") as an authorized insurer for many years, the Department began to take the position that the RRG was not an authorized insurer, despite the fact that it was properly registered. The Department based its new position on the fact that the RRG did not have a certificate of authority from Wisconsin's insurance commissioner even though, under the LRRA, it was not required to obtain same.

The district court in *Restoration* upheld the Department's position based upon precedent established by the Seventh Circuit in *Ophthalmic Mutual Ins. Co. v. Musser*. *Ophthalmic* addressed the issue of whether the LRRA preempted a Wisconsin law requiring health care providers to have liability insurance from an insurer authorized by the State of Wisconsin. The Seventh Circuit found that the law was not preempted because (i) it fit within the LRRA's exemption for laws governing financial responsibility; and (ii) in order to establish that a state law is discriminatory under the LRRA, a risk retention group would have to demonstrate that the state specifically intended to discriminate against risk retention groups as a class.

Relying on the reasoning in *Ophthalmic*, the district court upheld the Department's position, effectively barring the RRG's operations in Wisconsin.

Other courts have been much less deferential to the states. For example, the Ninth Circuit has found that discriminatory intent on the part of state legislators is not required in order for a state financial responsibility law to be discriminatory. A showing of the law's discriminatory effects is sufficient. More recently, it also found that, in order to avoid preemption, state financial responsibility laws must be applied on a case by case basis—categorical exclusion of risk retention groups is not permissible.

Restoration is currently under appeal.

Proposed Amendment to Unfair Claim Settlement Rule Jeopardizes Claims-Made Policies in Virginia

The Virginia State Corporation Commission has issued a Notice with a Proposed Amendment to the Rules Governing Unfair Claim Settlement Practices, which, if adopted, would require that all insurers demonstrate prejudice in order to deny coverage based on an insured's failure to comply with time-limited notice provisions, even in the case of "claims made and reported" policy forms.

In an “occurrence” based policy, notice of a potentially compensable event during the policy period is not a condition of the coverage. Accordingly, it makes sense that prejudice would be required before a claim could be denied for failure to strictly follow required notice procedures since the notice requirement is only a mechanism to facilitate the involvement of the insurer in the claims management process at an early juncture. So long as there is no prejudice caused by late notice, the purpose of the reporting requirement is fully vindicated. In addition, occurrence-based policies are priced with the understanding that a covered event could occur long after the policy period expires, and that multiple policies could be triggered when the occurrence spans more than one policy period. Because of the nature of occurrence-based coverage, the large majority of U.S. jurisdictions require a demonstration of prejudice before an insurer may deny coverage under an occurrence-based policy for late notice of a potentially compensable event.

With claims-made policies, on the other hand, it is the claim itself and its timely report during the policy period that triggers coverage. Unlike coverage under an occurrence-based policy, the accident or resulting injury under a claims-made policy could have occurred long ago, but it is only the subsequently asserted claim that triggers the coverage. Because of this triggering mechanism, only one and not multiple policies are required to respond with coverage for the claim. Once the policy term expires, all potential exposure is limited to the claims that were actually made and reported before expiration. For this reason, underwriting considerations and resulting pricing for the next successive period of coverage can be applied knowing that all exposures have been discovered, resulting generally in lower overall premiums. Virginia’s proposed amendment is therefore plainly inappropriate for claims-made policies.

To date, despite comments from insurance trade associations, the Virginia Corporation Commission has provided no indication that it will change course.