Downs Rachlin Martin PLLC

Captive Insurance Update | Spring Edition | 2019

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Developments in Vermont

Vermont's Leadership Team

There were no significant changes in Vermont's leadership team during the last election cycle. Governor Phil Scott, a Republican, was re-elected in November 2018 for another two-year term. Michael Pieciak, the Commissioner of the Department of Financial Regulation ("DFR"), remains in that position, as does David Provost, the Deputy Commissioner of Captive Insurance, and Sandy Bigglestone, Director of Captive Insurance. Deputy Commissioner Provost has served in this role for 12 years. Since the captive enabling legislation was enacted in 1981, he is only the third individual to serve as Vermont's top captive regulator. This consistency has created predictability of regulatory actions.

2019 Captive Legislation

As is done in most years, the Vermont Captive Insurance Association, the Vermont Department of Economic Development, and the DFR worked together to pass legislation to amend the Vermont captive insurance statutes. The amendments include:

- clarification that incorporated protected cells organized as nonprofit entities are eligible to pay dividends (subject to DFR approval);

- an expansion of the type of entity available for use by captives to any organizational form allowed by Vermont law;

- an exemption from bonding requirements for an attorney-in-fact of a captive organized as a reciprocal;
- a change in the examination frequency to “not less frequently than once every five years;”
- increased flexibility for captives to develop their own investment policies (subject to DFR approval);
- clarification of the definition of “independent director” for purposes of the governance standards that apply to risk retention groups; and
- application of the requirements for an Own Risk and Solvency Assessment (“ORSA”) to risk retention groups (note that risk retention groups with less than $500 million in annual premium will be exempt from the ORSA requirement).

New Guidance Issued For Sponsored Captives

On May 14th, the DFR issued a new application form and guidance to assist with the formation of new protected cells. The application form should streamline the process for requesting approval of the addition of new cells. The guidance provides welcome clarity on a number of protected cell-related issues including:

- Required provisions in participation agreements;
- Minimum capital and surplus requirements;
- Annual reporting requirements;
- Formation of incorporated protected cells; and
- Requirements around incorporated protected cell governance.

2018 Vermont Formations

In 2018, 25 new Vermont captives were licensed, bringing the total to 1,137 captives licensed, of which 558 were active as of December 31, 2018. The types of active captives break down as follows:

Pure	350
Risk Retention Groups	87
Special Purpose Financial	45
Sponsored	34
Industrial Insured	23
Association	14
Branch	4

2017 Aggregate Data

The aggregate amount of gross premium written by all Vermont captives for the year 2017 was $21.7 Billion; total net written premium was $18 Billion. Aggregate total capital and surplus as of December 31, 2017 was $79.8 Billion and total assets were $194 Billion. Total Vermont premium tax paid on 2017 gross written premiums was approximately $24 Million.

Aggregate data for the year 2018 will likely be published during the Summer of 2019.

Additional Developments in Washington State

During 2018, the Washington state insurance commissioner issued a cease and desist order against Microsoft Corp.'s Arizona-domiciled captive insurer to stop the captive from issuing unauthorized insurance in Washington and penalize the captive for failing to pay a 2-percent premium tax to the state of Washington.

In March 2019, an Arizona-domiciled captive owned by Costco Wholesale Corp. (headquartered in Washington) self-reported its activity as part of the Washington state insurance commissioner's project to identify all captives that insure risk in Washington. The commissioner has decreed that captives that self-report before June 30, 2020, will be eligible for reduced fines and penalties. The Costco captive paid $2.4 million in unpaid premium taxes and $1.2 million in fines, penalties and interest.

More on Section 831(b) "Microcaptive" Tax Cases: the IRS Wins Again

As we have reported in previous Captive Updates, the US Tax Court's decisions in *Avrahami* and *Reserve Mechanical* found that the "microcaptives" at issue did not constitute "insurance in its commonly accepted sense," and disallowed the microcaptives' election to be taxed only on investment income under Section 831(b) of the Internal Revenue Code.

Syzygy Insurance Co., Inc. v. Commissioner of Internal Revenue

On April 10, 2019, the Internal Revenue Service continued its winning streak with a decision by the U.S. Tax Court disallowing the §831(b) election by Syzygy Insurance Co., Inc. ("Syzygy"). Syzygy is a microcaptive formed in Delaware in 2008 by a subsidiary of Highland Tank & Manufacturing, a family-owned business in Pennsylvania. Syzygy entered into reinsurance pools with other captive insurers and used a fronting carrier to insure the Pennsylvania manufacturing enterprise.

Citing *Avrahami* and *Reserve Mechanical*, the U.S. Tax Court found that Syzygy did not qualify as an insurance company because its insurance program did not include risk distribution, nor did it constitute insurance in the commonly accepted sense. This finding was based, primarily, on five factors: (i) Syzygy's insurance transactions were not negotiated at arms-length; (ii) the premiums it received were not actuarially determined; (iii) the reinsurance pools it participated in did not include enough risk distribution to constitute insurance risk transfer; (iv) its insurance policies were not timely issued and included vague terms; and (v) the one claim submitted during the years at issue was handled improperly.

As a result, Syzygy's Section 831(b) election was ruled invalid and it was forced to recognize the premiums it received as taxable income. Additionally, since Syzygy did not qualify as an insurance company, payments made to it by its policyholders could not be for insurance and, therefore, were not deductible as ordinary and necessary business expenses.

While Syzygy does not really cover any new ground, it is another example of the importance of properly structuring captive insurance programs and following corporate formalities.

Validity and Enforceability of Arbitration Provisions

Some DRM clients include arbitration provisions in their policies to lower costs, save time, avoid the burden of discovery and escape the vagaries of jury verdicts. The arbitration clauses generally apply to coverage disputes and first-party claims for coverage. Many states prohibit or give only limited effect to arbitration provisions in insurance policies. This raises the issue of what effect contrary state law will have on the arbitration provision when the dispute or the insured is located in such a state.

Risk Retention Groups will usually avoid the effect of anti-arbitration statutes or regulations due to the preemptive effect of the Liability Risk Retention Act, 15 U.S.C. § 3901, et seq. ("LRRA"). Thus, in Speece v. Allied Professionals Ins. Co., 289 Neb 75, 78, 853 NW2d 169, 173 (2014), the Nebraska Supreme Court held that the LRRA preempted a Nebraska statute barring insurance arbitration provisions. A number of similar decisions in other states have favored RRG usage of arbitration provisions. *But see* Nat'l Home Ins. Co. v. King, 291 F. Supp. 2d 518 (E.D. Ky. 2003) (holding that Kentucky's anti-arbitration statute was not preempted by the LRRA).

Our non-RRG captive clients do not enjoy LRRA protections, and must look elsewhere to blunt the effect of contrary state laws. For example, the Speece court, while upholding LRRA preemption, held also that the Federal Arbitration Act, 9 U.S.C. §1, et seq. ("FAA"), which preempts state laws prohibiting enforcement of arbitration contracts generally, does not preempt the Nebraska statute. That is because the McCarran-Ferguson Act, 15 U.S.C. § 1012 (b), gives states the primary and plenary authority over the regulation of the business of insurance. Unless a federal law refers specifically to the business of insurance, like the LRRA, the McCarran-Ferguson Act exempts any state law governing the business of insurance from FAA preemption—in effect, a carve out or a "reverse preemption" in favor of the state law.

But for Vermont non-RRG captives, the analysis is a bit more nuanced. While the Vermont Arbitration Act supports enforcement of arbitration clauses, it excludes all insurance contracts from its scope. Vermont common law barred enforcement of all arbitration provisions at any time prior to the publication of a final award. However, the Vermont Supreme Court has held that the FAA does preempt Vermont's common law bar because the common law does not apply specifically to the business of insurance, and thus Vermont common law is not "reverse preempted" by the McCarran-Ferguson Act. *See* Little v. Allstate Insurance Co., 167 Vt. 171, 705 A.2d 538 (1997). A Vermont governing law clause coupled with the arbitration provision gives the captive the strongest argument for enforcement against the effect of contrary state law outside Vermont.

Our Team

Kathleen Davis, Director
kdavis@drm.com

Zaw Win, Director
zwin@drm.com

Bruce Palmer, Director
bpalmer@drm.com