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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 (including 199 cells)
Industrial Insured	23
Association	14
Branch	4

2018 Aggregate Data

The aggregate amount of gross premium written by all Vermont captives for the year 2018 was $22.6 Billion; total net written premium was $20 Billion. Aggregate total capital and surplus as of December 31, 2018 was $81 Billion and total assets were $195 Billion. Total Vermont premium tax paid on gross written premiums was approximately $24 Million, a slight increase over 2017.

Superior Court Reverses Johnson & Johnson Self-Procurement Tax Decision

On September 25, 2019 the Appellate Division of New Jersey's Superior Court reversed a decision of the New Jersey Tax Court (the "Tax Court") finding that Johnson & Johnson ("J&J") was responsible for paying self-procurement tax on all of the premiums that it pays to its captive insurer, not merely the portion of such premiums attributable to risk located in New Jersey.

For an in-depth description of the Tax Court's decision, please click here.

The Tax Court's decision was based on its (mistaken) conclusion that the enabling legislation adopted by New Jersey to implement various provisions of the federal Nonadmitted and Reinsurance Reform Act of 2010 (the "NRRA") applied to independently procured insurance (such as the policies purchased by J&J). In fact, that legislation only refers to surplus lines policies, and not independently procured policies. The Tax Court had glossed over that omission by concluding that the legislature must have inadvertently omitted independently procured lines from the NRRA enabling legislation.

The Appellate Division disagreed. Following the well-established canon of statutory construction that the best indicator of legislative intent is the plain language of a statute, the court found that the legislature's failure to include independently procured insurance in the NRRA enabling legislation must mean that it was not intended to apply to independently procured insurance. So, independently procured insurance should continue to be taxed under the pre-NRRA regime, which only provides for a tax on the portion of the premiums attributable to risk actually located in New Jersey.

While this decision is undoubtedly a win for J&J and other New Jersey-based owners of captives in that it limits self-procurement taxes and removes an anomalous precedent, it is not likely to have a significant impact on the broader industry. The failure of New Jersey's legislature to include independently procured insurance in the NRRA enabling legislation may well have been an oversight and could easily be corrected in the coming years. Additionally, in the unlikely event that other states have similar deficiencies in their NRRA enabling legislation, this decision can be expected to encourage corrective amendments.

Captives in all jurisdictions may want to view this decision as an opportunity to evaluate their operations to ensure that they are practicing good captive hygiene, and to review the self-procurement tax statutes in the domiciles of their insureds to confirm compliance.

Alaska Airlines Challenges the Washington State Insurance Commissioner

Continuing his aggressive pursuit of the captive arrangements of companies domiciled in the state of Washington, the Washington state insurance commissioner (the "Commissioner") issued an order (the "Order") on September 6, 2019 purporting to impose a fine and assess unpaid premium taxes on ASA Assurance, Inc. ("ASA"), the Hawaii-domiciled captive of Alaska Airlines.

Alaska Airlines has three operating subsidiaries: Alaska Airlines, Horizon Airlines, and McGee Air Services. These operating subsidiaries have employees located throughout the United States. The parent company does not have employees.

Each operating subsidiary handles its own workers' compensation risk in each state in which it has employees, either through a high-deductible insurance program or, as in the case of Washington state, a self-insurance program.

The high-deductible policies are issued by Chubb, which remits premium taxes to each state depending on the amount of risk located in that state.

ASA was formed in 2016, and issued deductible reimbursement policies to the operating subsidiaries for liabilities related to the Chubb high-deductible program. These policies covered the 2016-2017, 2017-2018, and 2018-2019 policy years (the "Policies"). Additionally, in 2017 the operating subsidiaries transferred legacy workers' compensation-related liabilities from the 2000-2016 years to ASA through a loss portfolio transfer (the "LPT").

During the course of 2019, ASA provided information to the Commissioner in connection with the Commissioner's captive insurance self-reporting plan. During the course of its discussions with the Commissioner regarding the applicability of Washington state's premium tax statutes to ASA's insurance program, it became clear to ASA that the Commissioner intended to take the position that all of the operating subsidiaries' out-of-state workers' compensation risks would be treated as "risks or exposures" located within Washington state, and thus subject to Washington state premium tax.

The Commissioner's position appears to be based on his conclusion that the relevant risk isn't the risk relative to workers located outside of Washington, but instead the risk of financial loss suffered by the operating companies, all of which are located in Washington state.

ASA disagreed with the Commissioner's position and, on August 30, 2019, ASA filed a demand for hearing in which it raised four issues: (i) whether the Commissioner has authority to regulate self-insurance; (ii) whether ASA qualifies as an insurer under Washington statutes; (iii) whether ASA is exempt from Washington state's tax and regulatory authority under the McCarran-Ferguson Act and related Supreme Court decisions; and (iv) whether the Commissioner has authority to impose a premium tax that relates to risks insured outside of Washington.

1. Authority to Regulate Self-Insurance

ASA cites decisions from Washington state courts finding that self-insurance is not insurance and statutes that exclude captives from the definition of insurer. Presumably, the import of this argument is that if ASA is not providing insurance, premiums paid to it are not subject to premium tax.

2. Qualification as an Insurer

Similar to the above, ASA argues that Alaska Airline's self-insurance program is not insurance and, accordingly, that it does not meet the statutory definition of insurer.

3. Exemption Under McCarran-Ferguson

ASA cites a number of older United States Supreme Court decisions for the proposition that a state lacks the authority to tax an insurance contract entered into outside of its jurisdiction by an entity domiciled within its jurisdiction and covering risk located within its jurisdiction. Presumably, ASA's policies were entered into in Hawaii.

4. Risks Insured Outside Washington

ASA cites a number of cases and statutes for the proposition that policies may cover risk located in multiple locations and that a state may only tax that portion of the risk that is actually located within its borders. While there does appear to be support for that position in the precedents, the Commissioner's position may be more nuanced. He is taking the position that the relevant risk in this analysis is the financial risk (e.g., the risk that one of the operating companies will have to pay under one of the high deductible policies or self-insured arrangements), not the casualty risk (e.g., the injury to the employee). If the Commissioner is correct, then most or all of the risk could be located in Washington state, since that is the primary place of business for the operating subsidiaries. The Commissioner's position, however, is novel and contrary to the expectations of the national insurance market.

A hearing on this matter can be expected in 2020 and will be closely watched by the captive industry.

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

As we have reported in previous *Captive Insurance Updates*, the U.S. 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.

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On September 16, 2019, the IRS issued 1R-2019-157, announcing a time-limited settlement offer for certain taxpayers who participated in what the IRS calls "abusive micro-captive insurance transactions."

This news release follows the three U.S. Tax Court victories for the IRS, described above. Taxpayers currently under exam who are deemed eligible for the settlement will receive notices from the IRS outlining settlement terms; these terms will include "substantial concession of the income tax benefits claimed by the taxpayer" and appropriate penalties. The IRS stated that "up to 200" letters will be going out, and that it plans to continue to open additional exams in this area.

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.

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