Captive Insurance Legislative Update

April 18, 2014

Paul Frank + Collins, the Vermont Captive Insurance Association ("VCIA") and the Vermont Department of Financial Regulation ("DFR") continue to work to maintain Vermont as the premier onshore captive domicile. The Paul Frank + Collins Captive Insurance Team of Stephanie J. Mapes, William D. Riley, Christopher J. Leff, Peter J. McDougall and Benjamin L. Gould offer this summary of legal and legislative issues to keep you apprised of the most pertinent industry developments and initiatives from Vermont and nationally.

VERMONT LICENSES ITS 1,000TH CAPTIVE

On October 10, 2013, the State of Vermont celebrated the issuance of a license to its 1,000th captive insurance company. This is a significant milestone and a proud moment for Vermont's captive insurance industry. Governor Peter Shumlin attended a ceremony at the Vermont State House announcing the 1,000th captive and noted "[w]e are proud to celebrate this significant accomplishment, but we will not be resting on our laurels. My administration is committed to keeping Vermont at the forefront of all domiciles and keeping Vermont's reputation as the 'Gold Standard' of captive domiciles."

Vermont's status as the "Gold Standard" of captive domiciles is further apparent in the number of licenses issued to new captives in 2013. In total, 29 new captives were formed in Vermont in 2013, bringing the total number of licenses issued since inception of the domicile to 1,013, with 588 captives active as of December 31, 2013.

VERMONT LEGISLATIVE DEVELOPMENTS

As is the custom, each year the Vermont captive insurance industry, led by the VCIA and the DFR, proposes changes to Vermont's captive insurance law in an effort to respond to industry needs and to remain a leader in captive insurance. This year's changes to the Vermont captive insurance laws (often referred to as the captive housekeeping bill) are contained in Vermont House Bill 563 (H.563), introduced in the Vermont House of Representatives on January 8, 2014. The House Ways and Means Committee and the Commerce and Economic Development Committee each reviewed the bill, and on January 30, 2014, the Vermont House of Representatives passed it. H. 563 was passed by the Vermont

Senate on March 28, 2014 and was signed into law by Governor Shumlin on April 15, 2014. The bill was effective upon passage.

The most notable aspect of H. 563 is the creation of a "dormant captive insurance company" status. A pure captive insurance company that is domiciled in Vermont can apply to the Commissioner of the DFR for a certificate of dormancy if the captive (1) has never insured controlled unaffiliated business; (2) has ceased issuing new policies; and (3) has no remaining liabilities associated with insurance business, transactions or policies.

A captive that receives a certificate of dormancy must maintain unimpaired, paid-in capital and surplus of $25,000 (as opposed to a minimum of $250,000 for a pure captive); provide a report of its financial condition, verified under oath by two of its officers, to the DFR on an annual basis (as opposed to providing audited financial statements); and is not subject to the payment of Vermont minimum premium tax. A dormant captive is required to pay the annual license renewal fee of $500.

The benefit to the owner of a dormant captive is the ability to keep the captive structure in place at a reduced cost, pending resurrection of a captive insurance program. For example, at some point in the lifecycle of a captive, the parent may determine that it is no longer desirable to have a captive. Perhaps the market has softened and the coverage provided by the captive is available at a reasonable cost in the commercial market. Instead of dissolving (and provided the criteria above are satisfied), the captive could apply to the Commissioner of the DFR for a certificate of dormancy. At some point, (perhaps upon a hardening of the commercial market) the captive can petition the DFR to permit the surrender of the certificate of dormancy and resume conducting the business of insurance.

In addition to the creation of a dormant captive, the captive housekeeping bill also includes several other changes intended to clarify and improve Vermont's captive laws. These changes include a clarification on the application of aspects of Vermont law applicable to producer-controlled insurers to risk retention groups, the inclusion of reciprocal insurer among the types of entities that can be established as an incorporated protected cell, the codification of the ability of the Commissioner to exempt a reciprocal insurer from certain statutory provisions, and clarification that assets of a separate account cannot be used to pay any expenses or claims other than those attributable to such separate account.

FEDERAL TAX DEVELOPMENTS

Issuance of *Rent-A-Center* Decision

On January 14, 2014, the United States Tax Court issued a long-awaited decision in the *Rent-A-Center* case. The decision is clearly pro-taxpayer and represents a loss for the Internal Revenue Service, but its significance in the development of captive insurance tax law has yet to be determined.

The case involved a Bermuda captive that provided workers' compensation, automobile, and general liability insurance to a small number of corporations owned by the same parent company as the captive. Both the captive and the insureds took the position that the arrangement between them constituted insurance for federal income tax purposes. The insureds deducted premiums paid to the captive, and the captive reported its taxable income as an insurance company. The IRS disputed that the arrangement constituted insurance under federal income tax principles and asserted that the

premiums paid to the captive were not deductible. It assessed annual deficiencies over a five-year period ranging from just under $3 million to nearly $15 million.

The test for whether an arrangement constitutes "insurance" for federal income tax purposes is independent of whether it constitutes insurance for other purposes, such as state regulatory laws. To be insurance for federal income tax purposes, an arrangement must involve insurable risk, the risk must be shifted from the insured to the insurer, the insurer must distribute risk, and the arrangement must "meet commonly accepted notions of insurance." In this case, the IRS did not dispute the first element of the definition was satisfied, but it did contend that the remaining elements were not present.

The court affirmed previous cases that have held that it is possible for sister companies to shift risk to a captive in which they do not hold an ownership interest. The court stressed that when the captive covers a loss of a sister company, the sister company's balance sheet is not affected by the reduction in the captive's value.

The court also ruled that the fact that the captive's parent guaranteed the captive's obligations did not negate the shifting of risk under the policy. Again, the court cited the fact that the parental guaranty did not impact the balance sheets of the insureds. Also of significance to the court were the facts that "the parental guaranty in this case did not shift the ultimate risk of loss, did not involve an undercapitalized captive, and was not issued to, or requested by, an unrelated insurer." The purpose of the guaranty was to obtain favorable accounting treatment under Bermuda's solvency requirements.

It is important to note that a parental guaranty may be a negative factor in determining whether an arrangement results in sufficient risk shifting to be considered insurance for tax purposes. In this case, the parental guaranty was not fatal, but in other situations it might be considered by a court to be a significant factor against finding that an arrangement constitutes insurance. All of the facts and circumstances of each case must be examined.

One of the biggest surprises of this case was the court's analysis of risk distribution. The IRS has contended for a number of years that risk distribution is present only if both (i) the insurance company covers a sufficient number of independent random risks to allow the insurer to make reasonably accurate predictions and smooth out losses over time, and (ii) the insurer covers a sufficient number of separate insureds so that no single insured is essentially paying for its own losses. The IRS argued that the second element of risk distribution was missing in this case because all of the risks covered by the captive were heavily concentrated in three subsidiaries, and one of those subsidiaries accounted for almost two-thirds of all risks covered by the captive.

Observers of this case expected the court to expressly rule on the issue of whether there were a sufficient number of insureds. Instead, the court completely ignored that part of the IRS's argument and merely concluded, with almost no discussion in the opinion, that the captive in this case covered a sufficient number of risks to achieve adequate risk distribution. While the court noted that the captive insured three types of risk (workers' compensation, automobile, and general liability) and identified the number of stores owned by subsidiaries of the parent of the captive (between 2,623 and 3,081), the number of employees (between 14,300 and 19,740), and the number of insured vehicles (between 7,143 and 8,017), the court did not even mention the number of insureds or the proportion of their risks.

Finally, the court concluded that the arrangement in this case constituted "insurance in the commonly accepted sense." The court noted that the captive "was adequately capitalized, regulated by [Bermuda], and organized and operated as an insurance company. Furthermore, [the captive] issued valid and binding policies, charged and received actuarially determined premiums, and paid claims."

The IRS also asserted that the captive in this case was a sham rather than a bona fide insurance company. The court concluded that the captive had been formed for legitimate nontax reasons, was more than a mere "accounting device," that the captive's premium-to-surplus ratios were reasonable, and that the captive was operated as a bona fide insurance company.

This case may be appealed by the IRS, but it is unclear whether it will do so. The opinion is captioned *Rent-A-Center, Inc. and Affiliated Subsidiaries v. Commissioner of Internal Revenue*, 142 T.C. 1 (2014).

Validus and Federal Excise Tax

On February 5, 2014, the U.S. District Court for the District of Columbia issued another decision that was eagerly awaited by the captive insurance community. This case, captioned *Validus Reinsurance, Ltd. v. United States of America*, involved application of U.S. federal excise tax to reinsurance premiums paid to a foreign reinsurer that covers risks located in the U.S.

The court noted that both parties raised "arguments relating to whether Congress intended to impose the excise tax extraterritorially and to Executive Branch enforcement policies regarding the excise tax, as well as whether imposing the tax on plaintiff comports with international law and the Due Process Clause of the Fifth Amendment." Observers of this case hoped the court would rule on those issues, but it did not.

Instead, the court ruled that under the plain language of the statute that governs the excise tax, the tax does not apply to premiums paid for reinsurance that covers other reinsurance contracts, as was the case here. Accordingly, this case does not impact application of the excise tax to insurance premiums or to premiums paid for reinsurance that directly covers insurance contracts. In view of the *Validus* opinion, companies that have paid the FET on a retrocession should consider filing protective claims for refund with the IRS before the applicable period of limitations expires, i.e., generally three year from the date that the original return was filed or two years from the date that the FET was paid, whichever is later.

STATE TAX DEVELOPMENTS

An Illinois appellate court issued a ruling on October 7, 2013 concerning the treatment of a captive insurance company for state tax purposes. The case involved a Vermont captive insurance company established by Wendy's International, Inc. ("Wendy's") to insure Wendy's and its affiliates. Wendy's excluded its Vermont captive insurance subsidiary, Scioto Insurance Company ("Scioto"), from its Illinois unitary business group and did not include Scioto's income in the group's combined income tax return.

The Illinois Department of Revenue claimed that Scioto was not a true insurance company for three reasons: (1) it did not satisfy the risk shifting and risk distribution requirements for an insurance company; (2) the majority of Scioto's income derived from royalties from Scioto's ownership of certain intellectual property; and (3) Scioto was not regulated in all states in which it wrote coverage. As a result, the Illinois Department of Revenue issued notices of deficiencies, penalties, and interest in a total amount of approximately $2.5 million.

Wendy's challenged the Department's claims. An Illinois trial court agreed with the Department of Revenue and found that Scioto was not an insurance company for Illinois income tax purposes. Wendy's appealed the decision.

The Illinois Fourth District Appellate Court explored each of the arguments noted above. First, the Court addressed the State's argument that Scioto was not an insurance company because its royalty income far exceeded its income from insurance activities. Scioto was the sole member of Oldemark LLC, a limited liability company which owned certain of Wendy's trademarks. Oldemark was a disregarded entity and the income received from Oldemark was included on Scioto's tax returns. Oldemark licensed this intellectual property to Wendy's in exchange for royalty payments. Despite the fact that the vast majority of Scioto's income was from activities other than insurance, the Court determined that Scioto was a licensed insurance company whose "only business was to furnish insurance to Wendy's and other affiliates. Its ownership of Oldemark does not alter this conclusion since Scioto, unlike Oldemark, was not engaged in the business of licensing intellectual property." Although not a fact considered by the Appellate Court, this conclusion begs the question of whether the Appellate Court would have reached the same conclusion had Scioto owned the intellectual property directly, rather than through a wholly-owned subsidiary.

With regards to risk shifting and risk distribution, the Appellate Court did not conduct its own analysis of Scioto's insurance activity to determine whether the arrangement satisfied risk shifting and risk distribution requirements. Instead, the Court noted that Wendy's underwent a federal income tax audit for some of the same years at issue in the instant action. The IRS determined that Scioto was a *bona fide* insurance company for federal tax purposes. Additionally, the Appellate Court noted that Scioto is a *bona fide* insurance company under Vermont law. The Court concluded that "[c]onsidering the advantages of predictability and certainty, Scioto should be treated as an insurance company for Illinois income tax purposes in a similar fashion as it has been treated by Vermont and the IRS."

The Court reversed the trial court's decision and remanded the case back to the trial court for the issuance of an order granting Wendy's motion for summary judgment. While this case is of limited precedential value outside of the state of Illinois, it is a positive result for a Vermont captive insurance arrangement.

RENEWAL OF TERRORISM RISK INSURANCE ACT

Recognizing that the Terrorism Risk Insurance Program Reauthorization Act of 2007 ("TRIPRA") is scheduled to expire on December 31, 2014, supporters of the federal Terrorism Risk Insurance Program (the "Program") are ramping up legislative efforts in support of reauthorization. There are currently four reauthorization bills that have been introduced in Congress. On February 5, 2013, a bipartisan group of members of the U.S. House of Representatives led by chief sponsors Rep. Jeff Grimm (R-N.Y.) and Rep. Carolyn Maloney (D-N.Y.) introduced the TRIA Reauthorization Act of 2013, H.R. 508, which calls for the Program to be extended in its current form until the end of 2019. On May 9, 2013, Rep. Bennie Thompson (D-Miss.) introduced the Fostering Resilience to Terrorism Act of 2013, H.R. 1945, which would extend the Program through 2024 and designate the Department of Homeland Security as the lead agency for determining whether an event should be certified as an act of terrorism covered by the Program. On May 23, 2013, Rep. Michael Capuano (D-Mass.) and Rep. Peter King (R-N.Y.) introduced the Terrorism Risk Insurance Program Reauthorization Act of 2013, H.R. 2146, which would extend the Program through 2024 without any significant changes. On April 10, 2014, a bipartisan group of senators, including Sen. Charles Schumer (D-N.Y.), Sen. Dean Heller (R-Nev.), Sen. Mike Johanns (R-Neb.), Sen. Mark Kirk (R-Ill.), Sen. Christopher Murphy (D-Conn.) and Sen. Jack Reed (D-R.I.), introduced S. 2244, which would extend the Program through 2021, with two significant modifications that would be phased in over five years. First, the U.S. government's quota share following satisfaction of the insurer deductible would decrease from 85% to 80%. Second, the Program's threshold for mandatory recoupment of federal payments, which currently requires recoupment when the insurance industry's aggregate uncompensated loss is less than $27.5 billion, would increase to $37.5 billion. The bills are facing significant opposition from legislators and others opposed to government involvement in the reinsurance market. Most observers agree that the Program is likely to be reauthorized, but that such action will not occur until late in 2014 and that the Program will be modified to reduce the financial exposure of the U.S. government in a manner similar to the measures proposed in S. 2244.

Given the risk that the Program may be allowed to sunset, captive insurers that write TRIPRA coverage as part of a policy that extends beyond December 31, 2014 should be careful to use a conditional terrorism exclusion either within the body of the policy or through an endorsement. The conditional exclusion would either revoke the policy's TRIPRA coverage as of December 31, 2014, in the event that Congress fails to extend the Program, or modify the coverage to match any material changes made to TRIPRA as part of its reenactment. Please let us know if you would like our assistance in drafting an appropriate conditional terrorism exclusion.

FUNDING EMPLOYEE BENEFITS PROGRAMS THROUGH CAPTIVES

A number of companies have sought to use their captives in order to fund their employee benefits programs. Such an arrangement is normally considered a prohibited transaction under the Employee Retirement Income Security Act ("ERISA"), though the United States Department of Labor (the "DOL") can approve what would otherwise be a prohibited transaction on a case-by-case basis. The DOL previously allowed for expedited approval of a prohibited transaction exemption ("PTE") if the applicant cited two substantially similar individual applications that the DOL had granted within the previous five years, or one substantially similar individual application granted within the past ten years and another granted through the expedited process within the past five years. This expedited PTE

application process was known as EXPro and could be accomplished in approximately two-and-a-half months. In late September 2012, however, the DOL temporarily suspended the EXPro process so that regulators could review the criteria that a captive would have to satisfy. Employers could still apply to the DOL for an individualized PTE, but would be subject to the standard application process, which could take in excess of a year to complete.

While the DOL has not officially confirmed that the suspension of EXPro has been lifted, two recent DOL approvals, along with statements from a DOL spokesperson, suggest that EXPro has been reinstated. In March 2013, the DOL approved Coca-Cola's proposal to use its captive to reinsure group term life insurance and accidental death and dismemberment policies written by a commercial carrier. In April 2014, the DOL gave final approval to a similar proposal by Intel Corporation. A DOL spokesperson stated that future applicants for PTE's involving funding of employee benefits through a captive should review the criteria in the Coca-Cola and Intel approvals. The spokesperson also stated that new criteria to protect plans and their participants and beneficiaries were developed during the course of the Coca-Cola and Intel approval processes, suggesting that the stated reason for suspension of the EXPro process has now been resolved.

With these two recent approvals on record, new PTE applicants whose plans otherwise satisfy DOL criteria should be able to provide the necessary citations to qualify for EXPro and minimize the cost and time required to obtain DOL approval to fund employee benefits through their captives. It remains unclear, however, whether EXPro is currently limited to applicants who are seeking to replicate the Coke and Intel programs, though observers note that other precedents frequently relied upon by past EXPro applicants will soon fall outside of the specified lookback period and therefore become stale.

VERMONT LEGACY INSURANCE MANAGEMENT ACT

Although not a captive insurance issue, we also want to report on a Vermont insurance law that has received attention this year. On February 19, 2014, Governor Peter Shumlin signed into law the Legacy Insurance Management Act ("LIMA"). LIMA provides a mechanism whereby a Vermont insurance company can be formed to assume blocks of non-admitted commercial insurance policies and reinsurance agreements. LIMA is somewhat akin to Part VII transfers in the United Kingdom, and is being touted as the first such statute in the United States.

Only policies from non-admitted insurers can be assumed pursuant to LIMA. Furthermore, workers' compensation, health, life, and all other personal lines of insurance are specifically excluded from LIMA.

The assuming company would submit an application to the DFR to approve the transfer of the policies. LIMA establishes a procedure for notification to be provided to policy holders and reinsurers and gives policy holders or reinsurers an opportunity to "opt out" of the transfer. If a policy specifically includes a provision prohibiting the transfer of the policy without the consent of the policyholder, the policy cannot be transferred under LIMA unless the policyholder provides written consent to the transfer. After the submission of an application, the DFR Commissioner is required to hold a hearing on the plan. Within 30 days of the hearing (or 60 days if additional time is necessary), the Commissioner is to issue an order approving or disapproving the plan in whole or in part. A party aggrieved by the Commissioner's order may appeal it to the Vermont Supreme Court.

Many insurance industry representatives had significant concerns about the LIMA proposal when first introduced in 2012. Changes were made in the bill to satisfy some of these concerns, which permitted the final version of LIMA to pass with little, if any, opposition. It is yet to be seen whether Vermont's LIMA statute leads to the inception of a new insurance industry sector in the State of Vermont. Nonetheless, LIMA is viewed as an example of Vermont's desire to parlay its status as the premier on-shore captive domicile to expand its attractiveness to traditional insurers.

FOCUS ON RISK RETENTION GROUPS

Risk Retention Groups Compare "Extremely Favorably" to Commercial Market

In a report it issued in August 2013, A.M. Best found that the U.S. captive and risk retention group marketplace compares "extremely favorably" with the commercial casualty market, again debunking the myth that risk retention groups are less solvent, less reliable, or more likely to fail than their traditional insurance company counterparts. Citing excellent underwriting expense and combined ratios, their analysis found that the focused approach of risk retention groups has resulted in aggregate operating performance consistently better than that of their peer group of commercial insurers. Paul Frank + Collins can attest to the success of our risk retention group clients, many of which are now greater than ten years old. Most risk retention groups focus on their niche business, with which they are intimately familiar. They are carefully managed with in-house claims management personnel and require their members subscribe to robust claims management and prevention practices. As a result of their success, many are able to make policyholder returns to their members, reminding us all of the reason we create risk retention groups to begin with.

Federal Appeals Court Confirms LRRA Preemption of New York Direct Action Statute

In an April 2014 opinion, the United States Court of Appeals for the Second Circuit confirmed that the Liability Risk Retention Act ("LRRA") categorically preempts a New York state law granting claimants a direct action right against a liability insurer. The case involved a chiropractor who sexually assaulted one of his patients. The patient obtained a judgment against the chiropractor, and in order to collect, filed a lawsuit against the chiropractor's insurer, Allied Professionals Insurance Company, a Risk Retention Group ("APIC"), which is domiciled in Arizona.

Section 3420 of the New York Insurance Law, among other provisions, mandated that liability insurers writing coverage in New York include a provision in their policy granting claimants the right to maintain a direct action against an insurer if a judgment they have obtained against the insurer's policyholder remains unsatisfied for a period of 30 days. At the trial court level, APIC successfully argued that the LRRA preempted any construction of New York law that would impose the direct action requirement on a foreign risk retention group.

On appeal, the Second Circuit agreed. The unanimous opinion of the three-judge panel stated that the LRRA vests the domicile state with the authority to regulate the formation and operation of a risk retention group, while non-domicile states can only require risk retention groups to comply with certain basic registration, capitalization, and taxing requirements, along with various claim settlement and fraudulent practice laws. The LRRA excuses risk retention groups from any other requirements that states may impose upon traditional insurers admitted to write coverage therein. Requiring risk retention groups to include a direct action provision in their New York policies, the court found, would

constitute impermissible regulation by a non-domicile state under the LRRA, and would undermine the LRRA's intent by constraining a risk retention group's ability to maintain uniform and efficient underwriting, administration, claims handling, and dispute resolution processes across all states where it writes coverage. As a result, the Second Circuit upheld the trial court decision and held that the claimant could not maintain a direct action against APIC.

The case is captioned *Wadsworth v. Allied Professionals Insurance Company, a Risk Retention Group*, Docket No. 13-1163-cv (2nd Cir., April 4, 2014).

LRRA Preemption of State Laws: Non-Domiciliary State Regulators Remain Inconsistent

Although the Liability Risk Retention Act, the NAIC Handbook on Risk Retention Groups, and much of the pertinent case law (including the recent decision mentioned above) are clear on the limited authority granted to the non-domiciliary states where risk retention groups do business, many states cannot resist the urge to overreach. If your risk retention group encounters any of the following, and you would like to discuss your options, please give us a call:

- Opposition to mandatory arbitration clauses in insurance contracts.
- Refusal to register the risk retention group in the state for any reason, including claims that the insurance written does not constitute "liability" insurance (such as contractual liability or medical stop loss), or does not meet the state's financial responsibility laws.
- Claims that your risk retention group may not reinsure a commercial insurer (a "front").
- Issuance of a cease and desist order by a non-domiciliary regulator.
- Fees for state registrations or registration renewals, registration denials, onerous document filing requests in connection with registration, or mandatory waiting periods for registration.

PAUL FRANK + COLLINS P.C. – ADDITIONAL SERVICES

Vermont is now well into its fourth decade as a captive insurance domicile, and Paul Frank + Collins has been among the leading captive insurance law firms since the inception of the domicile in 1981. Today, we advise clients with captive insurance companies not only in Vermont, but also in several other domiciles throughout the United States, including Missouri, New York, New Jersey, Arizona, and South Carolina, as well as offshore domiciles including Bermuda, the Cayman Islands and Guernsey. In addition, Paul Frank + Collins offers a number of services ancillary to our primary captive insurance company representation, including, among others:

- Claims management
- Coverage analysis
- Claims and underwriting audits
- Federal and state tax analysis
- Impact analysis relating to the solvency issues of parent companies/members
- Immigration, including legal counsel on a broad range of immigration matters such as foreign investments, immigrant and non-immigrant visas, and corporate compliance

If any of the foregoing services might be of interest to you, please let us know how we may be of service.

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