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GAO RELEASES RISK RETENTION GROUP REPORT

On August 15, the U.S. Government Accountability Office (“GAO”) issued its long-awaited report on the implementation of the Liability Risk Retention Act (“LRRR”). The report, GAO-05-536, is titled “Risk Retention Groups: Common Regulatory Standards And Greater Member Protections Are Needed” (the “Report”), and is available at www.gao.gov.

This article provides an overview of the Report, an analysis of its potential implications for Vermont risk retention groups and captives in general, and a discussion of how recommendations contained in the Report may be implemented. Although the Report will be of greatest interest to our RRG clients, it may also have implications for other captives who may wish to consider the RRG option

– particularly in light of continued interest in expanding the LRRR to allow lines of coverage other than commercial liability.

We first thank Lawrence D. Cluff, Assistant Director for the Financial Markets and Community Investment Division of the GAO, and Sonja J. Bensen, Senior Analyst in the Division, for their work over the past year and a half. The Report is the product of their extensive investigation, including interviews with RRGs, regulators, the National Association of Insurance Commissioners (“NAIC”), and thorough analysis of failed groups. We commend their efforts, and find the Report to be comprehensive and thoughtful. Its recommendations suggest a path to regulatory improvements that should benefit the entire industry.

The Report focused on three areas: the LRRR’s impact on the availability of commercial liability insurance, the adequacy

of the current regulatory environment, and the adequacy of LRRRA measures designed to protect the interests of RRG members.

Impacts on the Availability of Coverage.

The GAO concluded that although the percentage of liability coverage provided by RRGs is small relative to the traditional market, the LRRRA has had a positive impact consistent with its objectives. The GAO emphasized that many RRG members enjoy price stability, custom coverage terms, and enhanced loss prevention services. Despite the small impact in terms of percentage, many Vermont RRGs have emerged as market leaders in their respective niches, including Attorneys' Liability Assurance Society, Inc., A Risk Retention Group ("ALAS"); United Educators Insurance, A Reciprocal Risk Retention Group ("UE"); Housing Authority Risk Retention Group ("HARRG"); Controlled Risk Insurance Company of Vermont, Inc. (A Risk Retention Group) ("CRICO"); and Ophthalmic Mutual Insurance Company ("OMIC"). And there are, of course, many more.

Adequacy of the Regulatory Environment.

The GAO identified widely varying requirements in the states where RRGs are domiciled. Specifically, they noted that accounting, reporting, and capital requirements vary significantly by state. For example, a lack of accounting consistency makes non-domiciliary state financial review difficult, and reduces confidence in the existing regulatory structure.

Member Protections and Governance. The GAO noted that not all RRGs require capital contributions from their members,

and that some allocate control to third parties whose interests may not always be in line with those of the group or its members. The Report analogizes to the mutual fund industry, where measures were imposed to mitigate inherent conflicts of interest between managers and customers.

GAO Recommendations. Based on these observations, the GAO developed a series of recommendations, the most significant of which encourage Congress to tighten certain governance issues, and encourage the NAIC to develop baseline regulatory standards. Specifically, the GAO recommends that Congress consider requiring all RRG members to make a financial contribution to the group's capital or surplus. (While we applaud the desire for all RRG members to have true ownership attributes, we wonder whether this requirement would be appropriate in all cases. Many mature programs have no further need to raise capital from new members, and many have returned initial capital contributions out of retained earnings.) The GAO also recommends that Congress consider (i) clarifying that insureds at all times retain the right to nominate and elect members of the RRG's governing body, (ii) limiting the oversight of service provider relationships to member-directors, and (iii) imposing a fiduciary duty upon third-party service providers to ensure that the best interests of the members and the group remain paramount.

The GAO also suggests enhancing the current required disclosure to more explicitly describe the consequence of not having state guaranty fund protection, as well as requiring the use of that disclosure in the

application as well as the policy. They also suggest a modified version of the disclosure for consumers whose extended service contracts may be insured by an RRG of which the obligor is a member.

The most intriguing recommendation is that Congress step in should the NAIC not develop – and states adopt – acceptable baseline regulatory standards within a certain time frame. RRGs domiciled in states which have not adopted those standards would lose the beneficial preemptive provisions of the LRRRA. Although it would be unusual for Congress to specifically direct the NAIC on insurance matters, we find precedent for this approach in Gramm Leach Bliley. In that instance, Congress directed the NAIC to develop a uniform regulatory approach for the licensure of insurance agents and brokers.

Baseline Standards. The greatest controversy is likely to involve the extent to which existing “Part A” NAIC accreditation standards should be applied to RRGs. Although many of those standards already apply, the Credit for Reinsurance Act, the Holding Company Act, the Risk-Based Capital requirements, and certain accounting protocols are not currently applicable. For example, in the accounting arena, many RRGs currently report on a statutory basis as is required for traditional companies, while others report on a GAAP basis. We are hopeful that the NAIC will recognize the great success that Vermont has had with its flexible yet responsible approach and formally recognize either accounting basis.

Vermont Impact. We believe the Report’s impact on the Vermont regulatory environment will be minimal. Most, if not all, Vermont-domiciled RRGs operate in compliance with the principles expressed in the Report. Governance rests with the members, members are true owners who exercise control over the operation of the group, and Vermont regulatory requirements are effective and consistently applied. Given the successful track record of the Vermont regulatory approach, we hope that it will be reflected in any NAIC baseline standards that emerge.

Next Steps. It is now up to the NAIC and Congress to respond to the Report. The NAIC Risk Retention Group Task Force (E) will meet again in early December in Chicago. Vermont is well represented on that Task Force, with both Len Crouse and Derick White taking active roles. We understand that they will strongly advocate continued flexibility, and will work hard to preserve the terrain that has been defined in Vermont over the past twenty years. Other captive and RRG domiciles will also be represented, and we will report on the ensuing debate and developments at the NAIC. At present, there is preliminary discussion about a process analogous to the accreditation program for traditional companies.

The U.S. House Committee on Financial Services, chaired by Representative Michael G. Oxley, is in the process of developing a bill to address the governance and ownership issues. Although the Report is silent on the topic, some believe that there may yet be an opportunity to expand the Act to permit RRGs to write all lines of

commercial liability coverage other than workers' compensation. Although not a direct *quid pro quo*, the willingness of the industry to adopt baseline standards may become a key element in Congressional willingness to support the expansion of the LRRRA. We will closely monitor the creation and progress of any bill, and keep you informed as developments occur.

Overall, we believe that implementation of the GAO's recommendations will strengthen an already vital industry here in Vermont. We had begun to develop concerns that the great proliferation of captive domiciles, some with unsuitably low regulatory standards, might result in a credibility problem for the industry. Well-capitalized, well-run RRGs, with a commitment to membership control, should help assure the long-term success of RRGs.

PRIMMER & PIPER TO MERGE

Primmer & Piper, P.C. is pleased to announce its merger with the Burlington law firm of Eggleston & Cramer, Ltd. effective January 1, 2006. Primmer & Piper is an eighteen-lawyer firm with offices in Burlington, Montpelier and St. Johnsbury. Eggleston & Cramer is a twelve-lawyer firm with offices in Burlington. With thirty lawyers, Primmer Piper Eggleston & Cramer will be the second largest law firm in Vermont.

Primmer & Piper has long been a leading provider of corporate, regulatory and legislative lobbying services to the captive insurance, insurance, electric utility,

telecommunications, banking, and financial services industries in Vermont. For several years, we have explored ways to provide additional legal services to our existing clients. We have also considered new areas of regulated entity representation, including a health care practice and an expanded banking practice.

Eggleston & Cramer, with its strong health care, corporate tax, bankruptcy and transactional practices, presents these opportunities. Together, we will continue to provide our existing clients with top-level regulatory, corporate transactional and corporate legal representation. We will also be able to offer a complete range of corporate tax, bankruptcy (creditor rights), corporate finance, merger and acquisition, and corporate litigation services.

Because Eggleston & Cramer offers complementary practice areas, we foresee no changes in the way that our captive insurance practice will operate. It will remain the largest, most experienced, and most dedicated captive team in Vermont. We look forward to you coming to know the Eggleston & Cramer attorneys, particularly if your legal needs include taxation issues.

We feel a strong sense of loyalty and gratitude to our existing clients for having made Primmer & Piper a successful law firm over the past twenty-three years. We remain dedicated to our clients' legal needs and fiercely protective of their rights and interests. All of that will continue following the merger. Although our firm will grow, as it has in the past, we will continue to work with you personally and directly to make sure that your legal needs are fully met. In any

event, we would be pleased to hear your thoughts about the merger.

VERMONT MEETING REQUIREMENTS

The Captive Insurance Division of the Vermont Department of Banking, Insurance, Securities and Health Care Administration has recently issued new guidance on what constitutes a meeting “in Vermont” for purposes of satisfying the annual in-state meeting requirement contained in 8 V.S.A. § 6002(b)(2). This topic generates continuing questions, and this guidance provides welcome clarification regarding the State’s position on captive annual meetings.

Traditionally, a meeting in Vermont has been understood to require that a quorum of directors (or, in the case of a reciprocal, subscribers advisory committee members) physically hold a meeting on the ground in Vermont. If permitted by a company's bylaws or rules and regulations, other directors could participate via teleconference or other technology. Recognizing the economic development policy underlying the statutory requirement, the State has occasionally deemed physical presence in Vermont to be satisfied by an equivalent number of owner representatives other than directors, provided a sufficient number of directors also participate in the meeting via

teleconference to constitute a quorum. Most often, companies pursuing this course obtained a written waiver from the State in advance of the meeting.

The new guidance makes clear that representative presence in Vermont in lieu of directors (or subscribers advisory committee members) is permissible, and that no waiver will be required for the practice in the future. In all cases, of course, quorum requirements must be met.

E-MAIL OPTION

If you would prefer to save a tree and receive your copy of the P&P Captive Newsletter by e-mail, please contact Kurt Lutes at (802) 223-2102 or by e-mail at klutes@primmer.com.

Primmer & Piper's captive team is comprised of: Jeffrey P. Johnson, James E. Clemons, Gary H. Barnes, Russell A. Young, Randall L. Wachsmann, Cassandra C. Larae-Perez, James F. Feehan, Laura J. Daudelin, Kurt A. Lutes, Lisa P. Geer, Vikki S. Soutiere, Angelina L. Buzzi, and Benjamin W. Begins.

John L. Primmer is now of counsel to the firm, and remains active with Primmer & Piper's captive team.