

# Captive Newsletter

*A Newsletter from the Captive Practice Group*

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## **SPECIAL FEATURE – MANAGING THE PERSONAL LIABILITY OF RRG BOARD MEMBERS**

Attached to this edition of the *Captive Newsletter* is a Special Reprint of RRG BOARDS' BEST PRACTICES from the May 2009 edition of *The Risk Retention Reporter – Volume 23, Number 5*.

## **EFFORTS UNDERWAY TO LIMIT INSURERS' EXEMPTION FROM FEDERAL ANTITRUST LAWS**

States regulate the business of insurance by virtue of the authority set forth in the McCarran-Ferguson Act, 15 U.S.C.A. §1011 et seq. (1945). This grant of power to the states is only limited when the federal government specifically acts to regulate the business of insurance. Federal antitrust laws apply today to the business of insurance only to the extent that activities are unregulated by a state. The federal antitrust law exemption is also limited in that the state regulation of the business of insurance does not protect "any agreement to boycott, coerce, or intimidate, or any act of boycott, coercion, or intimidation."

On February 24, 2010, the U.S. House of Representatives overwhelmingly passed the Health Insurance Industry Fair Competition Act (HR 4626). If this legislation is ultimately enacted it will eliminate McCarran-Ferguson's federal antitrust law exemption for health insurance companies. For good measure, health insurers would also be subject to the enforcement activities of the Federal Trade Commission.

Since relatively few captives and risk retention groups are in the health insurance business, it is possible to characterize this legislation as marginally relevant. However, other legislation introduced in the House of Representatives and the Senate would have a broader reach. HR 3962 would restrict the federal antitrust exemption for health insurers and hospital and medical professional liability carriers. The insurers identified in the bill would only have an antitrust exemption for data collection, the use of such data and the actuarial determination of loss development data. An unanswered question exists concerning the safe harbor's applicability to the activities of the statistical organizations used by insurers.

Efforts to limit the federal antitrust exemption are also underway in the U.S. Senate. S.1618 is designed to prohibit price fixing, bid rigging and market allocation by health insurers and medical and hospital professional liability carriers. There is risk that S.1618 will move forward or that HR 4626 will be expanded by the Senate to include medical and hospital professional liability insurers. The broader risk in 2010 and beyond for all insurers, including risk retention groups, is that Congress will support outright repeal of the McCarran-Ferguson Act anti-trust exemption. During the HR 4626 debate, testimony indicated that no state antitrust proceedings have been initiated against any insurer for the past five years. In fact, Speaker Nancy Pelosi's website contains several statements critical of state insurance antitrust regulation (e.g. "state enforcement is episodic and can only repair a problem involving a single company in a single state.").

The loss of the antitrust exemption would present very serious problems for captives, risk retention groups and smaller insurers that are all far more dependent on the ability to use industry loss data and common policy forms than large insurance companies. Given the actions taken by Congress to date and the rationale for its actions, captives, risk retention groups and small insurers need to pay close attention to McCarran-Ferguson related legislation. Although such legislation may be limited to health insurance today, the potential for broader Congressional restriction of the insurance industry's limited antitrust exemption should not be discounted.

## **MORTGAGE GUARANTY CAPTIVE UPDATE**

Most Vermont captives formed to reinsure mortgage guaranty policies remain in run-off. Although a few are participating in quota share deals, the large majority are running-off existing books of excess-of-loss ("XOL") business. In many cases, the captives and/or their parents are seeking final settlement of remaining liabilities through negotiated commutation arrangements with ceding carriers. As we reported in April of last year, the MI industry had retreated as a whole from offering XOL terms to captive reinsurers. The one exception, United Guaranty, has now ceased offering such programs.

The run-off of these contracts has not been wholly without challenge. In some cases significant adverse loss development has led to additional reserve and capital funding demands by ceding carriers. Some of these demands have been met by the captive and/or its parent company, but in other cases the captive has resisted the additional funding, sometimes in part relying on the "Vermont Termination Rule." This rule, found in most Vermont captive reinsurance contracts, states that a ceding carrier may look only to the trust assets for loss payments. Exactly how that provision affects funding obligations remains a matter of some debate.

As the mortgage guaranty captives wind down their MI business, many owners are looking for other uses of those facilities. Several of our clients have introduced new business plans and discussed with Vermont regulators and managers alternative risk management strategies. We have seen companies evaluate the

use of their captives for traditional property and casualty business, possible access to the Federal Home Loan Bank, and other more exotic risk transfer programs. Please be in touch if you would like to discuss options for your MI captive.

We have regularly reported on the ongoing investigation by the State of Minnesota and a Minneapolis HUD office. In response to information requests, the MI companies have provided volumes of material for review. Based on the nature of the investigation, it seems that the underlying theory is that the reinsurance pricing has not been commensurate with the risk assumed. Recent loss experience and the significant increase in assumed reinsurance liabilities seem to confirm the appropriateness of that pricing, but we understand the investigation is not concluded.

Recently, additional subpoenas and document requests were submitted by Minnesota to at least some of the MI companies. When we last reported, in April 2009, the MI companies had offered a global settlement proposal, to which they have not received a formal response. It is hard to know where this new round of inquiries will lead. It seems to continue the pattern of asking multiple times for the same basic information, and the MI companies continue to fund the investigation with growing frustration.

We have also recently learned of subpoenas being issued to a handful of MI captive reinsurers by the Vermont Assistant U.S. Attorney's office. These subpoenas seek information related to actuarial analysis and pricing. We do not know whether this inquiry is related to the Minnesota investigation, but suspect a

different source. Again, it appears that the underlying theory is the improper pricing of the reinsurance arrangement. We are not sure of the status of this investigation.

Finally, we had earlier shared our opinion that the ongoing class-action suits were likely dead. This is apparently not the case, as the Third Circuit reversed a lower court in October 2009, (Alston v. Countrywide, 3<sup>rd</sup> Cir., No. 08-4334, October 28, 2009.). The Third Circuit concluded that Article III federal court standing does not require an allegation of a fee overcharge, only "injury and fact." The Court accepted the alleged violation of statutorily protected rights under RESPA as meeting the injury in fact standard. The Court also rejected Countrywide's reliance on the filed rate doctrine, as it viewed the Plaintiffs as not challenging the rate paid for mortgage guaranty insurance, but rather the underlying reinsurance scheme. Lower court proceedings in this case allege the receipt by Countrywide's captive of over \$892 million in reinsurance premium, without the captive having paid any claims. That is of course dated information, and significant loss emergence in the Countrywide captive will likely have implications at trial if this case moves forward. We continue to believe that recent events will more than demonstrate the transfer of significant risk at a reasonable premium.



**NEWS FROM THE  
VERMONT STATE HOUSE:  
LEGISLATURE CONVENES  
TO CONCLUDE BIENNIUM**

The Vermont General Assembly reconvened in January to begin the second year of the biennium. 2010

represents a significant challenge for the Legislature and Administration as Vermont continues to grapple with a stagnant economy and a budget deficit in excess of ten percent of the total General Fund. Though much debate and decision-making has yet to occur, this deficit likely will be met and a balanced budget passed sometime before adjournment this Spring.

In contrast, the captive industry has brought welcomed news to the State House this year. According to the Captive Division of the Vermont Department of Banking, Insurance, Securities and Health Care Administration (the "Department"), the number of new captives formed in 2009 is the sixth highest number in the State's history. In addition, premium taxes paid by captives will contribute approximately \$25 million to Vermont's General Fund. These trends are markedly different from those in other sectors of the economy and underscore the industry's positive reputation in the Executive and Legislative branches.

2010 will feature a series of proposed amendments to Vermont's captive statutes. A coordinated effort among regulators and industry has produced proposals that are largely transaction-related, but also some intended to attract new captive formations and to promote Vermont as a leading captive domicile. Among the proposals under consideration is an amendment that would reduce the minimum paid-in capital and surplus for an association captive insurance company from \$750,000 to \$500,000, an amount equal to what is required of industrial-insured and sponsored captives. If approved, this will further augment Vermont's position among competing

domiciles when group programs compare jurisdictions prior to formation.

In addition, Vermont continues to receive inquiries from companies that maintain captives in other domiciles but are looking to bring their programs to the State. A series of amendments related to mergers and consolidations are proposed that would streamline and clarify that process. A variety of technical amendments would update the reciprocal insurer statute enacted several decades ago to permit certain legal entities, such as limited liability companies, to participate in reciprocals; to clarify that a sponsored captive insurance company may be formed as a mutual corporation, consistent with other member entities authorized to form sponsored captives, such as nonprofits and manager-managed limited liability companies; and to clarify the process of obtaining lawful powers of attorney and proxies.

The Department also proposes a slight restructuring of certain fees it charges in connection with the formation of captives. The \$200 application fee and \$300 initial license fee would be replaced by a combined \$500 application and initial license fee. Also, the annual license fee would be increased from \$300 to \$500, and the Department would cease collecting a confusing and inconsistent \$300 annual fee for reinsurers. The net sum of these changes would produce a nominal increase in revenue to the Department but would also represent a welcomed simplification of the fee structure. The industry is supportive of the proposed fee changes.

The proposed amendments will be subject to further evolution before they are

presented for review and approval by the Legislature, and it is anticipated that a bill will reach the Governor's desk prior to adjournment.

We will continue to report on the General Assembly and the status of captive insurance initiatives in future issues.

### **MMSEA SECTION 111 REPORTING – DEFINITION OF RRE RELAXED**

On February 24, 2010, the Center for Medicare and Medicaid Services (“CMS”) issued an Alert containing a new, substantially revised Section 7.1 (Who Must Report) of the Non-Group Health Plan Users’ Guide, which implements Section 111 of the Medicare, Medicaid and SCHIP Extension Act of 2007 (“MMSEA”), that replaces that section of the original July 31, 2009 draft. The Alert explained that while the definitions set forth in the draft language would have reduced the number of Responsible Reporting Entities (“RREs”) in situations involving a deductible, they still allowed for the possibility of both the insured and insurer reporting in certain situations involving deductibles. CMS also conceded that the RRE definitions in the draft had created confusion with respect to use of third-party administrators and what constituted “payment” as opposed to “funding” of claims.

The new Section 7.1 makes clear that insureds with deductible policies for liability and workers’ compensation will not be considered RREs, and that insurers writing such policies will be responsible for reporting Medicare-eligible claims. This revision is meant to supersede, in this limited context, the general rule that the party that physically

makes the “payment” to a claimant will be the RRE. To the extent that a captive owner has concluded that it would need to register as an RRE and report claims within the deductible of a policy issued by its captive, on the basis of the general rule that deductibles are self-insurance and trigger a reporting obligation, that conclusion should now be re-evaluated. The same is true for captives with deductible reinsurance policies the payment mechanics of which they believe trigger an RRE registration obligation.

In connection with the foregoing Users’ Guide revisions, CMS also agreed to delay the mandatory data collection start date (April 1, 2010) until January 1, 2011.

### **RICHARD SMITH – NEW PRESIDENT OF THE VCIA**

On October 15, 2009, Richard Smith took over leadership of the Vermont Captive Insurance Association (“VCIA”). Mr. Smith replaces Molly Lambert as President and Chief Executive Officer of the VCIA. After seven years of leading the VCIA, Ms. Lambert was nominated by President Obama, upon the recommendation of Vermont Senator Patrick Leahy, to be the U.S. Department of Agriculture’s State Director for Rural Development for Vermont and New Hampshire.

Prior to heading the VCIA, Mr. Smith held several positions in Vermont state government under both Democratic and Republican administrations. For the past five years, he had served as Deputy Commissioner of the Vermont Public Service Department. During his time there, Mr. Smith was the primary liaison with Vermont’s General Assembly on energy and telecommunications issues. In

addition to policy development, Mr. Smith also managed the day-to-day operations of the Vermont Public Service Department. From 1998 to 2005, Mr. Smith served as Deputy Commissioner of the Vermont Department of Economic Development. He has also served as a policy analyst in the office of the Governor.

Mr. Smith holds a Bachelor of Arts in Political Science from the University of Massachusetts, Amherst. He also completed a Strategic Leadership for State Executives program from Duke University in 1999 and the Snelling Center's Vermont Leadership Institute in 2000.

#### **GOVERNOR DOUGLAS NOT RUNNING FOR RE-ELECTION**

Vermont Governor Jim Douglas has decided he will not run for a fifth term in 2010, so that he can spend more time with family.

Governor Douglas has spent his entire career in public service. After graduating

from college, he was elected to the Vermont House of Representatives. He then worked in the administration of Governor Richard Snelling, prior to seeking statewide elective office. He has served as Vermont's Governor for the past eight years and prior to that served as Secretary of State and State Treasurer.

To date, five Democrats have announced that they will seek the Governor's office. They include Secretary of State Deborah Markowitz and State Senators Peter Shumlin (President Pro Tem of the Senate), Doug Racine, and Susan Bartlett, as well as former State Senator Matt Dunne. On the Republican side, Lieutenant Governor Brian Dubie is the only announced candidate to date.

#### **E-MAIL OPTION**

To receive Primmer Piper Eggleston & Cramer's *Captive Newsletter* via e-mail, please contact Kurt Lutes at 802-223-2102 or [klutes@ppeclaw.com](mailto:klutes@ppeclaw.com).

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# Risk Retention Reporter

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## Managing the Personal Liability of RRG Board Members

*James E. Clemons, Shareholder-Director  
Primmer Piper Eggleston & Cramer*

Recent turmoil in financial markets has focused increased attention on issues of director liability, and particularly on directors of financial institutions. Since risk retention groups (RRGs) are not immune to financial difficulties, this article discusses the potential exposure to personal liability faced by members of RRG boards of directors.

### **Fiduciary Duties of Directors**

A director's duties to a corporation derive from principles of agency law, but have evolved over time from a general fiduciary duty to the corporation's shareholders and assets to more specific responsibilities. Under modern corporate statutes, a director is required to discharge his or her duties in good faith, with the care of an ordinarily prudent person, and in a manner the director reasonably believes to be in the best interests of the corporation. Significantly, in fulfilling these duties, a director is entitled to rely on information, opinions, reports and statements prepared or presented by qualified corporate officers, employees, and outside consultants.

As a general rule, the performance of a director's duties in a manner that complies with the statutory standards of conduct protects the director against personal liability. On the other hand, failure to meet the statutory standards of conduct may expose a director to personal liability.

The vast majority of claims against directors are brought by shareholders (or 'members' in the case of a mutual corporation) of the corporation. The law has long recognized the right of shareholders to bring suit on behalf of the corporation, so-called 'shareholder derivative lawsuits.' The right to enforce director obligations to the corporation resides almost exclusively with the shareholders. Recent attempts to broaden the constituent base to include employees and creditors have generally not been successful.

The types of claims that are asserted by shareholders are often grounded in major transactions (sale, merger, etc.), illegal or imprudent distributions of corporate assets, or failure to make (or cause to be made) appropriate securities disclosures in connection with the sale of shares.

### **Potential Liability for RRG Board Members**

Although RRGs function much like any other corporate entity, they do enjoy some special attributes that serve to reduce the risk environment for directors. In addition, carefully drafted organizational documents further reduce the risk of personal liability for RRG directors.

The Federal Liability Risk Retention Act of 1986 (LRRRA) requires that all insureds of an RRG also be owners of the group, and that all owners be insureds. This inherent mutual structure somewhat reduces, but does not eliminate, the director liability risk equation. And for most RRGs, the primary mission is to provide a stable source of fairly priced insurance coverage for their members, rather than maximizing profits for investors. When an owner is looking for rationally priced liability coverage rather than investment style return, there is less potential tension between a board of directors and the shareholders.

Notwithstanding a reduced risk environment, RRG directors must be ever mindful of their duties of care, loyalty and good faith in furtherance of the best interests of the corporation. The January 2008 and July 2008 issues of the *Risk Retention Reporter* provide good overviews regarding current governance challenges for RRG directors.

### **Reducing RRG Director Liability**

Properly drafted organizational documents further reduce the exposure to personal liability for directors of RRGs. First, all state corporate statutes permit a corporation to indemnify its directors. This authority has greatly expanded over the decades, and now allows indemnification of directors and officers in many different circumstances. Indeed, most corporate statutes mandate indemnification when the director prevails on the merits of litigation. And unless the director has knowingly violated the law, or received an impermissible personal financial benefit, the corporation has discretion to indemnify even if the director does not prevail in court. We encourage our RRG clients to adopt the strongest and broadest possible indemnification authority in their bylaws, in order to provide maximum coverage for directors and officers.

Most state corporate statutes also allow the adoption of so-called 'exculpatory' provisions in Articles of Incorporation. These provisions eliminate personal liability of a director to the corporation and its shareholders, other than in certain egregious circumstances. These types of provisions are relatively new to corporate law, and emerge from the recognized need to allow directors to freely carry out their duties. These optional provisions should be adopted by all RRGs, in addition to robust indemnification provisions. The limitation on liability, is not complete: a director remains personally liable for improper personal financial benefit, the intentional infliction of harm to the corporation, unlawful distributions, and criminal conduct.

Despite the reduced risk for RRG directors, there remains a role for Directors and Officers (D&O) insurance. Even in the face of an exculpatory clause shareholders may bring a claim and, if the RRG is financially challenged, there may not be sufficient corporate assets available to cover defense costs. And, financial difficulty itself may increase the likelihood of challenges by insureds.

### **Understanding D & O Insurance coverage**

Simply stated, D&O coverage provides a backstop for directors behind standard indemnification provisions, and a means for reimbursing the corporation for funds expended in meeting its indemnification obligations.

There are three categories of D&O insurance available, the first two of which are commonly referred to as 'Side A' and 'Side B' coverage. Side A coverage provides individual protection for directors and officers, for covered exposures for which they are not indemnified by the corporation. This is the backstop to indemnification, and serves to fill any gaps that may exist under the statutory indemnification scheme. Side B coverage reimburses the corporation for any indemnification funds advanced to directors or paid to resolve a claim. (More recently, additional coverage has become available, that insures the corporation for claims made directly against it rather than against directors and officers. This functions as a form of errors & omissions coverage for the corporation.)

As with any insurance coverage, the devil is in the details. It is imperative to carefully review coverage proposals to fully understand what is covered, what is excluded, as well as the limits and deductibles. Typical exclusions in Side A coverage include civil or criminal fines and penalties, punitive damages, acts found contrary to public policy, acts resulting in personal gain to the director, fraud and dishonesty, and claims for which other insurance coverage is available. Most policies also contain the so-called 'insured vs. insured'

exclusion, designed to avoid collusive suits among different insureds under the same policy.

One issue that may be relevant to whether D&O coverage is needed for a particular RRG is availability of coverage from other sources. Some members of the board may have coverage through other policies that extend coverage to service on 'outside' boards. We recommend that the board be surveyed to determine whether its members have D&O coverage available from the entity they represent.

### **Appropriate D&O Coverage for RRG Directors**

When it comes to purchasing D&O coverage for RRGs, one size definitely does not fit all. It is important that an RRG identify an insurance broker who understands the reduced risk attributes of RRGs. In our experience, pricing may vary dramatically depending on the level of sophistication by the broker and the underwriter, and how well they understand the RRG environment. Make sure that your broker has a full understanding of the identity between members and owners of the group, and has familiarity with applicable indemnification and exculpatory provisions in the group's organizational documents.

There is no science to the question of appropriate limits, and the broker will need to have a good understanding of the financial condition of the group, as well as its operational structure, in order to suggest limits sufficient to protect corporate assets and cover defense costs in the unlikely event of a suit.

### **Other Considerations**

As mentioned, a director of a corporation is entitled to rely on information obtained from third parties in situations when the director does not have personal knowledge of a particular matter. Most RRG directors will know much about their underlying business but very little about insurance, particularly in the early years of operation. RRGs are usually surrounded by various service providers including actuaries, auditors, lawyers, financial managers, and investment managers. Given the high degree of reliance on such industry experts, a prudent RRG will confirm that these providers have errors and omissions coverage at appropriate limits.

*About the author: Jim Clemons is a Shareholder-Director based in Primmer Piper Eggleston & Cramer's Montpelier, Vermont office. The bulk of his practice is spent advising various types of entities on the formation and operation of captive insurance companies, with an emphasis on risk retention group issues.*

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