

Captive Newsletter

A Newsletter from the Captive Practice Group

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VERMONT PROPOSES ADOPTION OF NAIC STANDARDS FOR RISK RETENTION GROUPS

On July 15, 2010, the Vermont Department of Banking, Insurance, Securities and Health Care Administration ("BISHCA") released a proposed regulation that would, if adopted, implement new regulatory requirements for Vermont-domiciled risk retention groups ("RRGs") in the areas of financial reporting, disclosures and filings related to insurance holding company systems, and credit for reinsurance. The regulation is intended to enhance BISHCA's financial surveillance of RRGs and addresses several recent actions by the National Association of Insurance Commissioners ("NAIC") to impose new RRG regulations on states accredited by it. The proposed regulation, designated as C-2010-01, will be posted for review on our firm's website: www.ppeclaw.com.

The NAIC mandates included in the proposed regulation would apply several traditional insurance company reporting requirements to RRGs, including the "Model Audit Rule," but with some changes: Vermont RRGs may still utilize GAAP accounting; RRGs with total annual written premium of less than \$1.0 million

and fewer than 1,000 policyholders or certificate holders may apply for an exemption; there is no fee for registering a CPA to conduct the annual audit; and the annual financial report is due on or before June 30 for each year ended on the preceding December 31. Enhanced audit committee obligations are not triggered until an RRG has annual written premium of \$300 million or more.

The regulation would, if adopted, also create holding company reporting and approval requirements as for traditional insurance companies. This has been the most concerning aspect of the proposal to date, particularly due to the possible cost and complication of compliance by RRGs which are typically smaller than traditional insurers. BISHCA has noted these concerns and continues to work with the Vermont Captive Insurance Association ("VCIA") and other RRG service providers to develop an appropriate approach. For example, under the holding company provisions, a presumption of control is created when any entity or individual owns 10% or more of an RRG. This is a common situation with certain small RRGs. BISHCA is considering a process for disclaiming control (thereby avoiding certain compliance obligations) for RRGs that are not in fact controlled by the

largest policyholders. Details of the disclaimer process have not been fully resolved.

The regulation would also change current discretionary Credit for Reinsurance standards applied to Vermont RRGs for many years. In essence, reinsurance with non-traditional unlicensed and unrated reinsurers not posting collateral to the RRG would be recognized only if it satisfies conditions set forth in the regulation. This provision could have significant impacts on Vermont RRGs that reinsure an affiliated company outside Vermont.

The proposed regulation would not impose NAIC governance standards for RRGs. While these have been adopted by the NAIC, they have not been implemented in any jurisdiction. One reason for not including the governance standards in the proposed regulation is that they would likely be included in any federal legislation to expand the scope of the Liability Risk Retention Act. We continue to advise clients to discuss but not implement complying changes until final standards are imposed due to the strong likelihood that the existing model would be changed slightly by adopting states.

EFFORTS TO EXPAND THE LIABILITY RISK RETENTION ACT

We have reported several times on efforts to expand the Liability Risk Retention Act of 1986 (“LRRRA”). No past initiatives bore fruit, but a new effort includes Bills in both the U.S. Senate and House of Representatives. The draft Bills, which are virtually identical, are sponsored by Representative Moore (D) Kansas, and

Senator Tester (R) Montana. These Bills have the broad support of RRG industry trade groups, the State of Vermont, and individual RRGs.

Each Bill would accomplish essentially three things. First, the Secretary of the Treasury would be charged with surveying and evaluating non-domiciliary state compliance with the preemptive provisions of the LRRRA, as well as establishing a related dispute resolution mechanism. Second, each Bill would incorporate corporate governance standards based on those promulgated by the NAIC, addressing such areas as the independence of RRG Directors, the documentation and review of service provider relationships, the general business conduct of RRGs, and their compliance with relevant statutes and regulations. Third, each Bill would authorize RRGs to issue commercial property insurance, as well as commercial liability insurance.

Senator Tester’s Bill would add a fourth component that would require the Comptroller General of the United States, who heads the Government Accountability Office (“GAO”), to conduct a study of instances where non-domiciliary states unlawfully regulate RRGs, whether through filing fees, filing requirements, information requests, waiting periods, or otherwise. In our view, this would address a longstanding problem made worse by some states’ lack of confidence in the effectiveness of regulation in many new RRG domiciles.

Representatives Moore, Kosmas (D) Florida and Campbell (R) California have recently written to the GAO requesting a similar study. Given the thoroughness,

and lack of bias, in the original 2005 GAO study of the RRG industry generally – entitled Risk Retention Groups: Common Regulatory Standards and Greater Member Protections are Needed (GAO - 05-0536) – we would welcome the GAO’s review of RRG state regulatory issues.

On August 5, 2010, a number of Vermont captive insurance representatives met with Vermont Congressman Peter Welch through the auspices of the Vermont Captive Insurance Association. He received a copy of the letter to the GAO and was apprised of the challenges RRGs encounter when non-domiciliary regulators ignore federal law. Congressman Welch acknowledged the serious concern raised by the actions of non-domiciliary regulators and invited further comment and information about both the possible GAO study and potential legislative efforts to address this critical deficiency in the LRRRA. We expect his continued support.

Addressing regulation by non-domiciliary states is long overdue. It has been almost twenty-five years since the enactment of the LRRRA, and many states continue to overstep limitations on their regulatory authority. Many charge excessive fees, others treat the simple registration of an RRG as a full company licensure, and some require unwarranted changes to business plans to comport with a narrow and incorrect construction of the LRRRA.

In some instances, most recently with Nevada, states have rejected the authority of RRGs to offer professional or automobile liability coverages to satisfy financial responsibility requirements, notwithstanding the anti-discrimination provisions in the LRRRA. Nevada issued a

cease and desist order to a risk retention group, concluding that it can lawfully preclude RRGs from writing first-dollar automobile liability coverage based on the lack of a Certificate of Authority issued by that State.

On this financial responsibility issue, we are encouraging Senator Tester and Representative Moore to consider adding a provision to their respective Bills that would clarify the existing Section 3905(d). It provides that the LRRRA shall not “be construed to preempt the authority of a State to specify acceptable means of demonstrating financial responsibility where the State has required a demonstration of financial responsibility as a condition for obtaining a license or permit to undertake specified activities.” That Section goes on to provide, however, that states may exclude coverage by a particular insurance company, excess lines company, or risk retention group, but does not authorize a categorical exclusion. Several states, have nonetheless interpreted this to mean that they can categorically preclude the issuance of such coverage by RRGs. We believe that position contravenes both the plain language of the LRRRA and Congressional intent.

We remain hopeful that these efforts will proceed, and will keep you posted as to their progress.

A CHANGING OF THE GUARD

On June 19, 2010, Michael S. Bertrand became Commissioner of the Vermont Department of Banking, Insurance, Securities and Health Care Administration (the “Department”). He succeeds Paulette Thabault, who served in this post since

January 2007 and resigned in order to take up an executive position with CVS Caremark MinuteClinic. “Commissioner Thabault has made BISHCA stronger, more efficient and more effective than ever,” said Bertrand. “I hope to build upon that foundation and continue the Department’s tradition of excellence.”

The Department is one of Vermont’s crucial regulatory agencies, and has responsibilities for all aspects of the financial services industry, including the captive insurance industry. In addition, the Department regulates the healthcare delivery system in Vermont.

Commissioner Bertrand formerly served as the Deputy Commissioner of the Insurance Division. Prior to that, he served as Deputy Secretary of Administration, Commissioner of the Department of Labor and Industry, and as deputy legal counsel and special assistant to Governor Jim Douglas. Among his many responsibilities as Commissioner, he has ultimate responsibility for the Captive Insurance Division.

As Governor Douglas has noted, “Mike is a strong leader with a wealth of experience throughout state government. I am confident that he will do an outstanding job and ensure a seamless transition taking over at the helm of the Department.”

In addition, on July 16, 2010, after twenty-two years of dedicated service in the captive insurance industry, Peter Raymond left his post as the Department’s Director of Captive Insurance to become a contract examiner and consultant for the Florida Hurricane Catastrophe Fund. He has been replaced

by Sandy Bigglestone, a 13-year veteran with the Captive Division. Prior to this promotion, Ms. Bigglestone served as the Department’s Director of Financial Examinations. She also has three years’ experience in public accounting, and two years’ experience working in the accounting department of a medical center.

David Provost, the Department’s Deputy Commissioner of Captive Insurance recently noted: “While we will obviously miss Peter, Vermont continues to have the most experienced, credentialed and able captive regulatory staff in the country, if not the world. Our team will maintain the regulatory continuity and momentum of the Captive Division.”

We wish Paulette, Michael, Peter and Sandy much continued success in their new roles.



**NEWS FROM THE
VERMONT STATE HOUSE:
VERMONT’S COMMITMENT
TO CAPTIVES CONTINUES
TO GROW**

In addition to the recent personnel changes within the Vermont Insurance Department discussed above, in November Vermont will elect a new Governor. For the past eight years, the State has been under the able and steady leadership of Governor Jim Douglas, and his departure from that office signals a new era in Vermont politics.

Although Vermont is among the handful of states with two-year terms for the Governor, recent history has shown that voters will return the incumbent to office more often than not. Vermont has had just

two governors for nearly the past twenty years. Douglas' decision to retire from the post has spurred a lively contest to elect his successor. The presumptive Republican candidate is eight-year Lieutenant Governor Brian Dubie. Democratic voters will select a nominee from among five prominent candidates: Secretary of State Deb Markowitz; State Senators Doug Racine, Peter Shumlin and Susan Bartlett, and former State Senator Matt Dunne. An August 24th primary will winnow the field of candidates and set the stage for a spirited race for Vermont's top office. Regardless of who emerges the victor, the captive insurance industry can expect continued support from the new Administration. All of the candidates have demonstrated support of the captive industry in the past.

With its licensure of seventeen new captive insurance companies in the first half of 2010, Vermont is fast approaching the issuance of its 900th captive license. Current growth sectors in Vermont's captive industry include health care, professional services, construction and traditional insurance companies.

In its last term, the Vermont General Assembly expressed its continued support of the captive industry by passing a package of improvements contained in S.278 (now Act 137), effective with the Governor's signature on May 29, 2010. While the overall bill contains some provisions unrelated to captive insurance, the following is a brief summary of the captive amendments:

- Chapter 132 (reciprocal insurers) is amended by defining the elements of a valid power of attorney. An accompanying amendment provides that the new

definition shall not affect the validity and binding effect of a power of attorney, according to its terms, which was duly executed before the Act's effective date.

- The reciprocal law is also revised to allow any entity legally authorized to form under Vermont law or the law of another jurisdiction to participate as a subscriber in a reciprocal.

- The minimum paid-in capital and surplus required for an association captive insurance company is reduced from \$750,000 to \$500,000, an amount equal to that required for industrial insured and sponsored captives.

- The Commissioner is granted specific authority to waive the notice and hearing requirements in a mutualization, to separate the Commissioner's authority to waive such requirements from the authority to modify those requirements, and conditions only the latter on the adoption of rules addressing categories of transactions. This section also grants the Commissioner authority to waive or modify certain requirements in a consolidation.

- Technical amendments make it clear that proxies may be obtained for members, subscribers and policyholders in an LLC, reciprocal and mutual captive, and that they are valid if executed according to the Vermont law applicable to corporate proxies. The proposal also allows such proxies to be obtained and submitted electronically, consistent with such authority already granted to corporations.

- Pure and industrial insured captives are now permitted to file annual

financial statements with the Department two weeks after they would otherwise be due.

- Authority is granted to the Commissioner to allow an insurer approved by the Commissioner to convert to or merge with and into a reciprocal insurer.

- A sponsored captive insurance company may now be formed as a non-stock mutual corporation.

The Department, with industry support, has also adjusted certain fees applicable to captives in the annual executive branch fee bill, H.759. That bill became Act 134 with the Governor's signature. The revisions eliminate the separate \$200 application fee and \$300 initial license fee and instead charge a combined \$500 application and initial license fee, increase the annual license fee from \$300 to \$500, and the \$300 annual fee for reinsurers is no longer collected. The fee adjustments took effect on July 1, 2010.

It is likely the next Legislature will consider a new package of amendments

to the captive laws that aim to keep Vermont responsive to the needs of industry and the regulators. As emphasized by Sandy Bigglestone, the Department's Director of Captive Insurance, "At a time when many states are cutting back, we are still improving our processes and enhancing our regulations." She credits the state's continued investment in its regulatory arm and responsive state government for Vermont's continued ranking as the largest captive insurance domicile in the United States, and the third largest in the world.

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

E-MAIL OPTION

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