PRIMMER PIPER EGGLESTON & CRAMER PC

ATTORNEYS AT LAW

Captive Newsletter

A Newsletter from the Captive Practice Group *May 2018*

Captive Team

Jeffrey Johnson
jjohnson@primmer.com

Russell Young
ryoung@primmer.com

Denise Deschenes
ddeschenes@primmer.com

Randall Wachsmann
rwachsmann@primmer.com

Jesse Crary
jcrary@primmer.com

Nicole Bodoh
nbodoh@primmer.com

R. Ryan Gadapee
rgadapee@primmer.com

Jamie Feehan, Government Relations Director
jfeehan@primmer.com

Kurt Lutes, Paralegal
klutes@primmer.com

Vermont Offices

Burlington:
30 Main Street
Suite 500
Burlington, VT 05401
PH: (802) 864-0880
FAX: (802) 864-0328

Montpelier:
100 E. State Street
Montpelier, VT 05602
PH: (802) 223-2102
FAX: (802) 223-2628

CYBERSECURITY UPDATE

New York DFS Cybersecurity Requirements for Financial Services Companies (23 NYCRR 500). New York's cybersecurity regulation went in to effect March 1, 2017 with transitional periods for initial compliance ranging from 180 days to two years. It sets forth minimum cybersecurity standards for financial services companies operating under New York licenses, including charters, certificates, permits, accreditations or similar authorization under New York banking, insurance, or other financial services laws.

The regulation allows companies to develop a cybersecurity program protecting customer information and critical systems while allowing some degree of flexibility based on the risk and relevant characteristics of the company. Captive insurers may also qualify for limited exceptions that would further reduce compliance requirements. Requirements not exempted for captives include the completion of a risk assessment, implementation of a policy to ensure security when third party service providers have access, establishment of data retention policies, and required notices to the Superintendent of breach events and annual compliance certifications. Should a company elect to use a limited exemption, it must file a Notice of Exemption with the New York Department of Financial Services ("DFS") within thirty days. As an additional alternative to developing independent policies for a captive, the company may rely on all or a portion of the cybersecurity program of its parent or affiliate. This reliance must provide compliance with the requirements of the regulation and the company must make the relevant documentation and information of the affiliate's cybersecurity program available to DFS upon request. This has been a concern to some programs where affiliates are not now regulated by DFS.

NAIC Insurance Data Security Model Act. In October 2017, the National Association of Insurance Commissioners ("NAIC") adopted the Insurance Data Security Model Law. Similar to New York's cybersecurity regulation, but styled as a statutory provision to be adopted by individual states, it would require entities licensed by a state insurance department to evaluate data security risks and take necessary steps to protect consumer information and the company's information systems. The NAIC intends that compliance with the New York regulation would result in compliance with the model law as well. An important difference between the two is that New York has a specific limited exemption for captive insurers, where the Model Law only exempts companies with less than ten employees (calculated to include independent contractors serving the company), or those already required to maintain an information security program in compliance with HIPAA laws.

At this point, the Insurance Data Security Model Law is not an NAIC accreditation requirement. However, at the Fall National Meeting and in subsequent published material, the NAIC has emphasized the response from the U.S. Treasury Department urging its prompt adoption by the states. The U.S. Treasury's comments were included in its report on the asset management and insurance industries and noted the ongoing efforts of the NAIC as a basis for its continued support of the state-based system of regulation in this regard. Treasury indicated a five year review period to confirm adoption of the Model Law prior to considering recommending any Congressional action.

The Model Law has not been introduced during this Vermont legislative session but will likely arrive in some form next year, perhaps including captives. If that occurs, we expect exemptions or limited compliance requirements similar to New York's regulation and in keeping with Vermont's longstanding regulatory framework. Legislation similar to the Model Law has been introduced but not yet adopted in other jurisdictions, including South Carolina.

NEW TAX LAW IMPACT ON CAPTIVES

The 2017 tax reform legislation contains numerous provisions impacting captive insurance programs paying U.S. taxes. Traditional insurers and most captives pay taxes as "C corporations" under Subchapter L of the Internal Revenue Code, making the most significant change the corporate tax rate, which moved from graduated rates with a maximum rate of 35% to a ***flat*** tax of 21%. While tax benefits should never be the sole reason to implement a captive program, the lower tax will make them less important to those considering new programs or the benefits of existing programs.

Other significant provisions affecting captives include the elimination of the corporate alternative minimum tax. Changes have also been made to the manner in which companies must discount loss reserves. Under the new law, taxpayers will use IRS prescribed rates for discounting, based upon corporate bond yield. Under the old law, if a taxpayer paid a marginal rate of 35%, the taxpayer's loss reserves were reduced by about 15%. Under the new law, the taxpayer's rate will be 21%, but the reduction to loss reserves much higher, at approximately 25%, making the total impact closer to revenue neutral.

For Boards considering 2017 year-end financials, the biggest immediate impact is a change in value to tax assets and liabilities already on the books. Because the new law passed in 2017, accounting rules mandate revaluation of deferred tax assets and liabilities in 2017, even though the new rate will not apply to income until 2018. For many companies, this meant year-end surprises as both write-ups and write-downs drove significant profits and losses, in some cases requiring new attention to surplus adequacy.

While the causes are beyond the scope of this article, we're aware of several offshore programs dramatically impacted by the tax law change. Beyond more attractive rates onshore, other provisions suggest the costs of some offshore programs will go up in the future, or that moving onshore now could produce significant benefits. If they have not already, captive owners in all jurisdictions should consult their tax advisors to determine the impact of the new tax law on their programs and determine whether they warrant responsive action.

NEWS FROM THE VERMONT STATE HOUSE

CAPTIVE LEGISLATION AMENDED

The Vermont General Assembly continues toward an expected May adjournment. With this being the second half of the biennium, a bill failing to pass by adjournment means it has to start all over again next January with a new Legislature. This adds to a sense of urgency, especially in the final weeks of the session.

We can also expect the rhetoric and intensity to increase on a number of issues as adjournment nears. The State's Education Fund is not keeping up with K-12 spending and the gap leaves the Governor and lawmakers with the challenge of raising property taxes to close that gap or curtail spending and growth trends. In addition, because of the way Vermont's tax code is tied to the Federal code, or not, many would see an increase in their State tax liability as a result of the recent federal tax reform law. The Governor has said he wants to negate that increase from occurring by cutting individual tax rates, among other proposed revisions to the personal income tax code. The Legislature, however, may have different ideas on whether or not to negate such tax increases (at least for certain tax brackets) and use the money for other purposes. With elections for all offices in November, we can also expect the Democratic-controlled Legislature to challenge the Republican Governor on a number of issues they feel may play better at the polls, such as an increase in the State's minimum wage or providing for paid family leave for employees. Politics as usual.

There are, of course, a number of bills and issues addressed outside of this rhetoric. This includes several which the captive insurance industry is supporting or monitoring. For the first time in recent memory, a bill containing amendments to the captive laws passed both chambers and reached the Governor prior to mid-term "crossover." While the Legislature is always responsive to captive insurance bills, the speed in which this one was addressed is noteworthy, and in part a reflection of the technical nature of this year's package. H.694 is the consensus product of the Vermont Department of Financial Regulation ("DFR") and the captive industry, and represents the latest example of continuous tweaking to ensure Vermont's law remains fresh and responsive. Included among the bill's provisions are those that:

- Allow all captives, now including association and sponsored captives, to file their annual reports on March 15, or seventy-five days after year-end for fiscal year filers.
- Allow captives to pay their premium taxes on March 15 to coincide with the annual reports.
- Clarify that self-insurance portfolio transfers are excluded from the premium tax.
- Authorize a branch captive to designate the Commissioner of DFR as its agent for service of process, and also remove the requirement that a branch captive obtain a Certificate of General Good from the Department as no Vermont corporation is formed.
- Further amend governance standards for risk retention groups to require annual certification of director independence (the determination of independence was already required).

The Governor signed H.694 into law on March 8 and its provisions became effective as of that date.

In addition, a new tax credit may be available to captives and other financial service entities. The Legislature is considering a new program in which municipalities may sell tax credit certificates for qualified rehabilitation expenditures, defined to mean construction-related expenses for rehabilitation of a qualified building, including design fees, labor, materials, capital improvements, and rehabilitation or construction of an accessory housing unit. Captives would be eligible to purchase such certificates for credit against premium tax liability. The Legislature continues to focus on the new program, including the source of revenue to support it.

We will continue to report on these and other captive insurance legislative and regulatory matters in future issues.

RRG GOVERNANCE STANDARDS COMPLIANCE UPDATE

Since May 7, 2016, when Vermont's Governance Standards for Risk Retention Groups became binding on every Vermont risk retention group ("RRG"), questions have frequently arisen regarding aspects of compliance and annual duties. Some of the more commonly asked questions relate to analysis of the materiality threshold with respect to review and approval of the amounts to be paid under material service provider contracts, as well as the renewal provisions of such contracts.

Pursuant to Sec. 9 8 V.S.A. §6052(g)(D) "Material service provider" includes a captive manager, auditor, accountant, actuary, investment advisor, attorney, managing general underwriter, or other person responsible for underwriting, determination of rates, premium collection, claims adjustment or settlement, or preparation of financial statements, whose aggregate annual contract fees are equal to or greater than five percent (5%) of the RRG's annual gross written premium or two percent (2%) of its surplus, whichever is greater. It does not mean defense counsel retained by a RRG, unless his or her annual fees have been equal to or greater than five percent (5%) of a RRG's annual gross premium or two percent (2%) of its surplus, whichever is greater, during three or more of the previous five years.

Any material service provider contract or amendment to it should be approved by the Vermont Department of Financial Regulation ("DFR") before it becomes effective. From a practical standpoint, because gross written premium and surplus change over time with the operation of an RRG, this is not always possible. We therefore believe there has to be some flexibility on this point. (Indeed, DFR has acknowledged that since newly-formed RRGs do not have the premium and surplus history needed to make such materiality calculations, it will allow RRGs in their first two years of licensure to instead calculate their applicable materiality thresholds in accordance with the pro forma financial statements on file with DFR.) Best practice would be to notify DFR and seek approval of the contract as soon as it is clear a service provider has become material for any reason.

In addition, and in accordance with DFR's clarifying Memo #2016/6, when a material service provider contract with a five-year term (the maximum term permitted under the Governance Standards) contains an "evergreen clause" the contract must terminate at five years to be compliant with the contract requirements. Annual terminations with renewal are also permitted, though no contract with an "evergreen clause" may automatically renew for a period exceeding five years. The idea is always to permit the RRG's management and Board the right to consider the service provider and its work for the RRG.

As we have previously noted, compliance with the Governance Standards is not a one-time exercise. Policies, procedures and practices developed for compliance should be revisited periodically and changes should be made to reflect practical approaches developed by staff, management and Boards as they work through the first few years of Governance Standards compliance. Additionally, we expect that industry practice, as refined by the expectations of DFR examiners first reviewing RRG compliance, will further develop over time. Please contact us for assistance with both regular compliance and the streamlining you will need.

UPDATE ON TREASURY TRIA DATA REPORTING/ NAIC TERRORISM DATA CALL

On November 28, 2017, the US Department of the Treasury ("Treasury") published a request for comments on the proposed consolidation of 2018 data reporting calls under the Terrorism Risk Insurance Act of 2002, as amended ("TRIA"). Treasury and the Federal Insurance Office ("FIO") coordinated with state insurance regulators, through the National Association of Insurance Commissioners ("NAIC"), to streamline the separate federal and state data calls regarding terrorism risk insurance and the proposed data collection forms. Treasury commented that the consolidated data call will significantly reduce the burden to collect data given the similarity of the information sought by Treasury and state insurance regulators.

The proposed consolidated approach will likely not result in significant changes for Vermont captive insurance companies. Captives domiciled in Vermont, including risk retention groups that file with the NAIC, were exempted from the 2017 state data calls which the New York Department of Financial Services collected on behalf of the states. Treasury confirmed that captive insurers will again be required to complete a tailored template which will be accompanied by separate instructions providing guidance on each data element.

Treasury identified the following global changes to the proposed reporting templates for 2018 that will impact reporting by captive insurers:

- All templates will now include a standalone cyber insurance worksheet;
- The reinsurance worksheet will include a new modeled loss question;
- The exposures worksheet will request information concerning policyholder deductibles and retention amounts, in addition to insurer exposure under policies subject to the Program; and
- The reporting templates no longer seek premium information on terrorism risk insurance for years prior to the reporting period.

Similar to 2017, Treasury confirmed that captive insurers: (a) that write policies in TRIP-eligible lines of insurance are required to report in 2018, unless they do not provide their insureds with any terrorism risk insurance subject to the TRIA Program, and (b) are not eligible for the reporting exemption available to certain small insurers. Of note, Treasury indicated that captive insurers will no longer be required to complete a separate worksheet for workers' compensation deductible policies. Treasury will collect this information on the general premium worksheet. Further, the reporting template for captive insurance companies will include a column requesting disclosure of the captive insurer's state of domicile.

Treasury indicated that the data portal is now open for reporting and that required data must be submitted no later than May 15, 2018. The proposed data collection forms and instructions for use in the 2018 data call are available for electronic review at **https://www.treasury.gov/resource-center/fin-mkts/Pages/program.aspx**. Treasury is also making available online the webcasts of training sessions that were held on April 10 and 11, 2018.

VERMONT CAPTIVE GROWTH STRONG IN 2017

Vermont Governor Phil Scott best summed up the health of Vermont's captive insurance industry in 2017: "It's great to see another strong year of growth for captive insurance in Vermont. This industry continues to be an incredible example of how our state can support growth in important business sectors. As my Administration focuses on growing the economy and making Vermont more affordable, we recognize the important role the captive industry plays in those efforts and remain committed to strengthening our 'Gold Standard' reputation."

Twenty-four new Vermont captive insurance companies were licensed in 2017, comprised of 11 pure captives, 5 sponsored captives, 3 risk retention groups, 3 special purpose financial insurers, 1 branch captive and 1 industrial insured captive. This brought to 1,112 the total number of Vermont captives formed since the State's passage of the Special Insurer Act in 1981, with 566 of those captives currently active.

Healthcare represents Vermont's largest industry sector for captive insurance, with 100 active captives (5 of which were formed in 2017). Vermont is also home to 90 active risk retention groups (over 60% of all risk retention group premium volume is written by Vermont companies). Growth sectors of the captive insurance industry include professional medical malpractice coverage for doctors and hospitals and the continued trend of small and mid-sized companies forming captive insurance companies for corporate lines of insurance such as property, general liability, products liability, or professional liability.

Vermont's captive insurance expertise and pro-active, efficient regulatory structure continues to evolve to meet the risk management needs of diverse industries, as further evidenced by it being awarded "US Domicile of the Year" for the fourth straight year. Vermont officials were also recognized by *Captive Review Magazine* on the "Power 50" list, ranking the 50 most influential people in the world of captive insurance as voted by industry peers.

As the State looks forward to 2018 and beyond, David Provost, Vermont's Deputy Commissioner of Captive Insurance, notes: "Vermont's focus will always be licensing quality companies and regulating them in an appropriate manner commensurate with their risk."

E-MAIL OPTION AND ARCHIVE

To receive Primmer's *Captive Newsletter* via e-mail, please contact Kurt Lutes at **klutes@primmer.com** or at 802-223-2102.

This edition of the *Captive Newsletter* is also available on our website at **www.primmer.com/publications-and-presentations**.

www.primmer.com