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Captive Newsletter

A Newsletter from the Captive Practice Group *August, 2015*

SPONSORED CAPTIVES: THE NEW NORMAL FOR FORMATIONS

This year's Vermont captive insurance law amendments made substantive and clarifying changes to rules for sponsored captive insurance companies. Along with significant amendments over the last few years, new comfort on the ability of cells to be independent taxpayers, and better understanding by industry professionals of the flexibility of sponsored captive arrangements, a substantial portion of new captive programs begin life as a protected cell. This activity usually falls into two groups.

First, programs which would otherwise be pure captives or small group captives find it quicker and easier to organize by accessing an existing sponsored captive program. This "turn-key" approach can shorten the process of identifying service providers, developing governance structures, achieving critical mass in regard to expense loads and even raising initial capital and collateral. Different than earlier sponsored captive programs, separate incorporation for cells results in real involvement by program participants at the cell level, with many cells today becoming as complex and multi-faceted as the largest group captives.

Second, companies anticipating future captive programs for diverse purposes find it advantageous to start out with the ability to add them to the infrastructure to be built. Recent examples include property and casualty programs looking forward to medical stop loss, group programs anticipating members which "grow up" to finance risks on their own, and the possibility of segregating in time and against future risks pools of program participants or policy years the surplus resulting from their loss control success.

Whether you wish to build a structure for the future or are considering a "turn-key" option available today, we are happy to help.

GOVERNANCE STANDARDS ARRIVE FOR RISK RETENTION GROUPS

We have long reported that the NAIC Governance Standards for risk retention groups ("RRGs") promulgated nearly a decade ago would one day become law. In Vermont, that day was May 7, 2015, when the Governor signed this year's captive insurance law amendments.

Effective immediately for new RRGs, and on May 7, 2016 for existing programs, the Governance Standards present a mix of challenges for every Vermont-domiciled

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 Jacobson
njacobson@primmer.com

Jamie Feehan, Government Relations Director
jfeehan@primmer.com

Kurt Lutes, Paralegal
klutes@primmer.com

Vermont Offices

Burlington:
150 S. Champlain St.
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

RRG. Primarily, the Standards seek to improve director oversight of RRG activities and strengthen the link between RRG owner/insureds and each company's management and activities.

Much of the effort hinges on key definitions. An "independent director" is a director that the RRG's board determines has no "material relationship" with the RRG. The RRG is required to determine annually the independence of each of its directors, and a board must have a majority of independent directors. Though very different than similar terms in the traditional corporate context, any representative of an owner/insured of the RRG is "independent."

A "material relationship" of a person with the RRG includes provision of services to the RRG in return for fees equal to 5% of the RRG's annual gross written premium for such 12-month period or 2% of its surplus, whichever is greater. Additional details of the test relate to family and corporate relationships and a rolling period in which a test of "material" occurs. Determined by a similar premium/surplus test, a "material service provider" contract cannot exceed a term of five (5) years and must be approved by both a majority of the RRG's independent directors and the Vermont Department of Financial Regulation ("DFR").

Additionally, the Standards create requirements for RRGs to reduce many of their practices to writing and to formalize much of the governance process. This includes:

- Board adoption of a written plan of operation that requires the board to:
  - assure that RRG owner/insureds receive evidence of ownership;
  - oversee the evaluation of the RRG's management;
  - review and approve material service provider compensation; and
  - review and approve, at least annually:
    - goals and objectives relevant to the compensation of officers and service providers;
    - officer and service provider performance in light of those goals and objectives; and
    - continued engagement of the officers and material service providers.

- Board adoption of a Code of Business Conduct and Ethics for directors, officers and employees which includes the following topics:
  - conflicts of interest;
  - the corporate opportunities doctrine under the state of domicile;
  - confidentiality;
  - fair dealing;
  - protection and proper use of RRG assets;
  - compliance with all applicable laws, rules and regulations; and
  - required reporting of any illegal or unethical behavior which affects the operation of the RRG.

- Establishment of an audit committee, or board service as an audit committee (after waiver), composed of at least three independent board members, with a written charter that defines the committee's purpose, which, at a minimum, must be to:
  - assist board oversight of (i) the integrity of the financial statements, (ii) the compliance with legal and regulatory requirements, and (iii) the qualifications, independence and performance of the independent auditor and actuary;
  - discuss the annual audited financial statements and quarterly financial statements with management;
  - discuss the annual audited financial statements with the independent auditor and, if advisable,

discuss the quarterly financial statements with the independent auditor;
    - discuss policies with respect to risk assessment and risk management;
    - meet separately and periodically, either directly or through a designated representative of the committee, with management and the independent auditor;
    - review with the independent auditor any audit problems or difficulties, and management's response;
    - set clear hiring policies of the RRG as to the hiring of employees or former employees of the independent auditor;
    - require the independent auditor to rotate the lead (or coordinating) audit partner having primary responsibility for the RRG's audit, as well as the audit partner responsible for reviewing that audit, so that neither individual performs audit services for more than five (5) consecutive fiscal years; and
    - report regularly to the board.

- Board adoption and disclosure to members of RRG governance standards which include:
    - owner/insured election of directors;
    - director qualification standards;
    - director responsibilities;
    - director access to management and, as necessary and appropriate, independent advisors;
    - director compensation;
    - director orientation and continuing education;
    - the policies and procedures that are followed for management succession; and
    - the policies and procedures that are followed for annual performance evaluation of the board.

Most of our RRG clients have begun the process toward compliance. Because of the incredible mix of sizes, structures, governance practices, earlier adoption of written policies and resources, one size will not fit all. We have begun working with RRG clients to review what they have in place now in order to identify what they need to comply, including possible new policies, charters and annual board actions. This has been a healthy process as our clients revisit sometimes longstanding practices and procedures. Despite the number of seemingly new requirements, most RRGs nearly comply as they operate today. At the very least, they already perform many of the tasks required by the Standards without having reduced them to writing. The process of doing so will be the biggest challenge. While the Governance Standards were aimed at curbing RRG abuses already unacceptable in Vermont, we nonetheless expect every RRG will make at least modest changes to comply.

DFR representatives continue to consider whether they will promulgate rules interpreting the broad language in the Standards. In the meantime, we understand that consistent with Vermont's long tradition of cooperation with and support of the RRG industry, compliance verification will be a flexible and collaborative process, with RRGs able to demonstrate how their own approach meets the requirements.

If your RRG has not begun the evaluation and compliance process, please call on us.

APPEALS COURT AFFIRMS *VALIDUS* DECISION – WHOLLY FOREIGN REINSURANCE CONTRACTS NOT SUBJECT TO FET

On May 26, 2015, the U.S. Court of Appeals for the District of Columbia affirmed the result of the lower court decision in *Validus Reinsurance, Ltd. v. U.S.*, 19F. Supp. 3d 225 (2014), a case involving the imposition of the federal excise tax (FET) on reinsurance of reinsurance (known as "retrocession").

Background. Section 4371 of the Internal Revenue Code imposes the FET at a rate of 1% on contracts of reinsurance issued by foreign insurers covering insurance policies insuring casualty or life.

In Revenue Ruling 2008-15, the IRS said it would impose the FET on reinsurance premiums on a "cascading" basis. As a result, the excise tax would apply to: (1) premiums paid by a U.S. insurer to the first non-U.S. reinsurer and (2) premiums paid by the first non-U.S. reinsurer to the second non-U.S. reinsurer. The *Validus* case involved the imposition of the excise tax on transaction (2).

Validus is a Bermuda-based reinsurer with no place of business in the U.S. It sometimes buys reinsurance for liabilities under the reinsurance contracts it sells. The IRS assessed excise taxes against Validus for portions of its retrocession transactions during 2006 totaling $326,340. Validus paid the assessment, then filed claim for refund. When the IRS did not respond, Validus sued.

In 2014, the D.C. District Court found in favor of Validus. It based its holding on the language in Section 4371(3), which limits application of the excise tax to contracts of reinsurance covering property or life contracts. It emphasized that retrocessions cover reinsurance contracts, not property or life contracts. Based on the "plain meaning" of the statute, the court held that Section 4371 does not apply to retrocession transactions. The IRS appealed.

Holding. The D.C. Appeals Court found that the language in Section 4371 is ambiguous as to whether the FET applies to retrocessions. The Code taxes reinsurance contracts "covering" property or life contracts. The Code does not state whether the coverage must be direct or indirect. Notwithstanding this ambiguity, the court held that the excise tax under Section 4371 does not apply because the case involved wholly foreign retrocession transactions, and there is no clear Congressional intent to give Section 4371 extraterritorial application. The court noted the Supreme Court's instruction that a court must presume that a statute has no extraterritorial application "unless there is the affirmative intention of the Congress clearly expressed to give extraterritorial effect."

Noteworthy is that, although the *Validus* case involved a retrocession transaction, the reasoning behind the holding suggests that all transactions in which a foreign insurer makes a premium payment to another foreign insurance company are exempt from the FET.

NEWS FROM THE VERMONT STATE HOUSE:

NEW CAPTIVE LAW ENACTED AMID CHANGING POLITICAL LANDSCAPE

The Vermont General Assembly adjourned the first year of the biennium in May but not before another bill updating Vermont's captive insurance laws was passed. Introduced as S.98, the bill became Act 20 when Gov. Peter Shumlin (D) signed it into law, effective as of May 7.

This year's legislation was again a consensus package brought to the Legislature from the captive industry and captive regulators, and featured a number of substantive and technical amendments. These include:

- New flexibility for captives and risk retention groups to manage their liquidity by holding minimum capital and surplus in marketable securities; an additional option to the existing ones of cash, a trust in favor of the Commissioner, or an irrevocable letter of credit. The Captive Division has since issued Bulletin No. C-2015-01 to provide further guidance for meeting the minimum requirements.
- New governance standards for risk retention groups (discussed above). To address Vermont law and

practice, the final version varies slightly from models long discussed in Vermont and at the National Association of Insurance Commissioners (NAIC). The standards apply now to new RRGs (from May 7 onward) and will apply to existing RRGs on May 7, 2016.

- A series of amendments related to sponsored captives, which continues a multi-year effort to keep Vermont's sponsored captive laws at the forefront. These include a reduction of minimum capital and surplus from $500,000 to $250,000, adoption of creditor protection provisions from the NAIC's Protected Cell Company Model Act, a requirement that an incorporated protected cell have its own distinct name which includes the words "Incorporated Cell" or the abbreviation "IC," and some general and technical amendments addressing interpretation and clarity.
- Reducing the number of incorporators or organizers needed to form a captive from three to one (or more), but retaining the requirement that the incorporator or organizer be a resident of Vermont.

Governor Shumlin recently surprised many by announcing that he will not seek reelection next November. This has ignited a scramble among gubernatorial hopefuls in a state which for more than a century has reelected incumbents of any political stripe. While no one has officially announced a candidacy, rumors and media reports are rampant with speculation about contenders. No fewer than four prominent Democrats have signaled their intentions (including the Speaker of the Vermont House, a Shumlin Agency head, and a former legislator and statewide aspirant). On the Republican side, the party and individuals are awaiting word from its titular head (Phil Scott, the incumbent Lieutenant Governor). Also potentially in the mix are third party candidates that can influence the eventual outcome by taking votes away from a major party candidate. Depending on how this race unfolds, the possibility exists for significant movement among other political offices, such as Lieutenant Governor and legislative leadership positions.

Political developments will play a significant role in the next legislative session beginning in January, shaping legislative agendas as leaders actively run for Governor, to say nothing of other incumbent legislators jockeying for other offices. The relationship between what is essentially a lame-duck Administration and the Legislature is another unknown.

Universal support for the Vermont captive insurance industry has remained constant throughout changes in the political composition of the Executive and Legislative branches over the years. All parties recognize the importance of the industry to the State, and the State to the industry. With Vermont on pace to be the least populous state soon, nowhere else in the United States (and perhaps even the world) does captive insurance mean so much to political leaders.

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