THE ANGUS FIRM, PLC CAPTIVE INSURANCE REPORT 2014 – VOL. 1

INTRODUCTION

Vermont has remained at the forefront of domiciles by updating its statutes and implementing new and innovative ideas to meet the demands of the industry. This edition of The Angus Firm, PLC Captive Insurance Report summarizes the Vermont legislative and regulatory changes that occurred during 2014. Where appropriate, we have also highlighted the federal initiatives impacting captives.

VERMONT LEGISLATION - 2014

The Vermont Captive Insurance Association ("VCIA") continues to actively pursue the needs of its members by submitting legislative proposals for the 2014 Vermont General Assembly to consider. David Angus, as the Chair of the VCIA Legislative Committee, worked closely with the President of the VCIA and its lobbyists to help develop and shepherd these proposals through the Vermont State Legislature. On April 17, 2014, Governor Peter Shumlin signed the following amendments into law:

- **Dormant Captive Status**

  Recognizing that an owner of a captive insurance company which has ceased its insurance operations may wish to retain its license instead of dissolving, Vermont has developed a cost-effective dormant status. A captive insurance company meeting certain criterion is now permitted to elect dormant status (subject to the Department of Financial Regulations ("DFR") approval). Once approved, the dormant captive will be: (i) required to maintain a lower level of minimum capital; and (ii) subject to a lower minimum annual premium tax. If the need arises in the future to resume insurance operations, the dormant captive must petition the Commissioner of DFR for authority to return to active status.

- **Producer-Controlled Risk Retention Groups**

  In order to comply with the National Association of Insurance Commissioners ("NAIC") accreditation standards, Vermont eliminated the exemption for risk retention groups from the producer-controlled model act. This change results in additional licensing requirements for producers involved with producer-controlled risk retention groups.

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- **Reciprocal Assessments**

  Vermont continued its trend of updating and modernizing its reciprocal insurer statute. To provide DFR more flexibility, the Commissioner of DFR is now permitted to exempt a reciprocal insurer licensed as a captive from any provision of the statute relating to assessments, time limits for assessments, and aggregate liability restrictions.

- **Reciprocal as Incorporated Protected Cell**

  An incorporated protected cell of a Vermont sponsored captive insurance company is permitted to enter into contracts and undertake obligations in its own name and for its own account. As originally adopted, the definition of an incorporated protected cell did not include a reciprocal insurer as a permitted type of entity to establish a protected cell. Reciprocal insurers now, however, are a permitted form of entity for establishing an incorporated protected cell.

- **Delinquency of Separate Account**

  In 2013, the captive insurance statute was amended to permit the establishment of one or more separate accounts within an association or pure captive. This amendment, however, did not specifically address how the assets in these separate accounts would be treated in the event of a delinquency. As such, the statute was amended to specifically state that the assets of a separate account established pursuant to the captive law cannot be used to pay any expenses or claims other than those attributable to the separate account. This amendment provides greater certainty that the Commissioner of DFR and/or a receiver will respect the separate accounts in the event of an insolvency proceeding.

- **Risk-Based Capital for Risk Retention Groups**

  As mandated by the NAIC for accreditation purposes, Vermont risk retention groups are now required to comply with the risk-based capital provisions of Chapter 159 of Title 8 of the Vermont Statutes Annotated. This amendment does, however, provide the Commissioner of DFR with the authority to abstain from required regulatory action if certain conditions exist.

VERMONT LEGACY INSURANCE MANAGEMENT ACT ("LIMA")

Although not part of the captive insurance legislation, Vermont has led the way and enacted a law that creates a new type of company designed to address legacy insurance matters. LIMA permits the formation of specialized Vermont insurance companies to acquire closed blocks of commercial insurance / reinsurance from other insurance companies wishing to remove this business from their books. All transfers are subject to the review and approval of DFR and are limited to commercial insurance policies.

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FEDERAL UPDATE

Activity on the federal level continues to be of interest to the Vermont captive industry.

- **Liability Risk Retention Act Amendments.** The Risk Retention Modernization Act of 2011 (HR 2126) was introduced in the last legislative session of Congress, but it failed to pass. Although this bill has not been reintroduced, the risk retention group industry continues to seek amendments to the Liability Risk Retention Act of 1986 (the "LRRA") to expand the lines of business that risk retention groups can write and to establish a dispute resolution framework to resolve nondomiciliary state preemptions with respect to the regulation of risk retention groups.

- **Risk Retention Group Victory in the Second Circuit.** The Second Circuit Court of Appeals affirmed that the LRRA preempts a New York statute that permitted direct action law suits against risk retention groups.[1] In this case, a chiropractor sexually assaulted one of his patients. At the time of the incident, he was insured by Allied Professionals Insurance Company ("APIC"), an Arizona domiciled risk retention group. He eventually pled guilty to third-degree assault for his actions. The plaintiff then filed a civil suit against him and was ultimately awarded a judgment. The defendant did not pay the judgment, which led the plaintiff to seek to invoke New York's direct action procedure to collect the judgment from APIC.

  Section 3420 of the New York Insurance Law requires that every insurance policy issued in New York contain, among other required provisions, a provision that permits direct action against an insurer in the event that a judgment remains unsatisfied for 30 days. After removing the case to federal court, APIC successfully argued that the LRRA preempts the New York direct action statute. The plaintiff appealed this decision.

  A three judgment panel of the Second Circuit unanimously agreed with APIC's position. The opinion analyzed the limited situations where a non-domiciliary state can regulate certain actions of foreign risk retention groups and concluded that New York's law did not fall within one of these areas. The opinion correctly stated that certain provisions of the LRRA excuse risk retention groups from certain requirements that states may and typically do impose upon insurers licensed within the state. The Court went on to say that the legislative history of the LRRA makes it clear that Congress intended to exempt risk retention groups broadly from state law requirements that make it difficult for risk retention groups to form or operate on a multi-state basis.

- **Extension of TRIA.** The Terrorism Risk Insurance Act ("TRIA") is set to expire on December 31, 2014. Originally enacted in 2002, TRIA has been extended twice, most recently in 2007. Efforts to renew TRIA have stalled until this point. Although there have been various bills introduced to extend the program, none have had bipartisan support. This changed when Senator Charles Schumer (D-NY) and various co-sponsors

[1] *Wadsworth v. Allied Professionals Insurance Company, a Risk Retention Group, Inc.,* Docket No. 13-1163-cv (2nd Cir., April 4, 2014).

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from both parties introduced Bill S. 2244 on April 10, 2014. This bill was referred to the Committee on Banking, Housing, and Urban Affairs, which unanimously approved the measure on June 3, 2014. Now the full Senate will have the opportunity to take up this measure.

If it ultimately passes in its current form, the bill would accomplish the following: (i) extend the program by seven years; (ii) increase the co-pay from 15% to 20% – phased in over five years by increasing the co-pay by 1% each calendar year; and (iii) increase the mandatory recoupment threshold from $27.5 billion to $37.5 billion – phased in by $2 billion annual increments for five years. This bill appears to be the most likely measure to extend TRIA. It is a good sign that it is being introduced now and not sometime in the fall. That being said, the extension of TRIA may still come down to the wire.

TAX UPDATE

- **Revenue Ruling 2014-15**

The IRS issued its long awaited ruling arising out of a private letter ruling request made by Coca-Cola Co. with respect to Coke's proposal to utilize one of its captive insurance companies to fund health care benefits for more than 4,000 of its retirees in conjunction with a voluntary employee benefit association and a commercial insurer. Instead of issuing a private letter ruling (which can only be relied upon by the requesting party), the IRS issued Revenue Ruling 2014-15, which has precedential value and can be relied upon by other parties.

The ruling favorably held that the captive insurance company in question qualified as an insurance company for federal income tax purposes due to the fact that its reinsurance agreement (which made up more than half of its business) constituted insurance. Although the facts are fairly complex, the IRS presented the following scenario to reach its conclusion. Company X maintained a single-employer VEBA. Company X provided health benefits to a large group of named retired employees and their dependents. The VEBA entered into a contract ("Contract A") with an unrelated insurance company ("IC") to provide noncancellable accident and health coverage. Pursuant to Contract A, IC is obligated to make quarterly reimbursement payments to Company X. Prior to executing Contract A, neither Company X nor the VEBA were under any obligation to continue to offer health benefits to the covered retirees and their dependents. IC then entered into Contract B with Company X's wholly owned captive insurance company ("S1") to 100% reinsure IC's liabilities under Contract A. The premium charged for Contract B was determined at arm's length. Further, there were no guarantees that either the VEBA or Company X would reimburse S1 for its obligations under Contract B. Finally, none of the premium received by S1 for Contract B was loaned back to the VEBA or Company X.

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- ***Rent-A-Center v. Commissioner,* 142 T.C. No. 1 (2014)**

  In a 10-6 decision, the Tax Court ruled in favor of the taxpayer (Rent-A-Center) allowing federal income tax deductions for premium payments made by the taxpayer's subsidiaries to its Bermuda captive insurance company. The captive was formed in 2002 and made an election to be treated as a U.S. company for federal income tax purposes. The captive was formed for legitimate non-tax reasons and provided workers' compensation, automobile, and general liability coverage to the subsidiaries of Rent-A-Center.

  In order for a captive to qualify as an insurance company for federal income tax purposes, the captive must: (i) be formed for valid business reasons; (ii) meet risk shifting and risk distribution requirements; and (iii) provide insurance that resembles insurance in its commonly accepted sense. The Tax Court found that the captive was formed for valid business reasons and focused much of its analysis on the risk shifting and risk distribution requirements.

  The Tax Court examined the impact of the arrangement on the balance sheets of the insured subsidiaries. It noted that a loss would not affect the balance sheets of the insured. Further, the Tax Court found that a parental guarantee between the captive and its parent did not prevent risk shifting from the subsidiaries to the captive.

  Having found that the captive satisfied the risk shifting test, the Tax Court then analyzed whether or not this arrangement had sufficient risk distribution. Departing from how the IRS has recently analyzed risk distribution, the Tax Court focused on the number of risks at issue, not the number of legal entities insured. This is important due to the fact that one of the subsidiaries accounted for over 60% of the total risk and would fall outside of the safe harbor established by Revenue Ruling 2002-90.[2] It is also shifts the risk distribution analysis towards the more general insurance principle of the law of large numbers, which analyzes the number of independent risks instead of the number of insureds.

  Although this case affirms the position that the industry supports and believes to be the correct application of the law, the Tax Court was not unanimous in its decision and the IRS may appeal the decision. Should the IRS appeal this decision, the appeal will likely focus on the treatment of the parental guarantee that was made to convert deferred tax assets into general business assets for regulatory purposes. Another issue that the IRS may focus its attention on is whether the captive was adequately capitalized by meeting Bermuda's capitalization requirements.

[2] Revenue Ruling 2002-90 held that 12 subsidiaries, none with more than 15% of the total insured risk, were sufficient for finding risk distribution.

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THE ANGUS FIRM, PLC CAPTIVE INSURANCE SERVICES

The Angus Firm, PLC provides high quality service to meet the needs of your captive or risk retention group. Attorney David Angus works with your captive managers, auditors, actuaries, and corporate personnel to reach the desired result. David is experienced in the many legal facets facing captives and risk retention groups, including:

- Formations
- Vermont Compliance
- Corporate Governance
- Fronting Arrangements
- Deductible Reimbursement Policies
- Reinsurance Negotiations
- Redomestications
- Mergers
- Dissolutions
- Tax-Exempt Status Filings
- Risk Transfer and Risk Distribution Analysis
- Pure Captives
- Risk Retention Groups
- Reciprocals
- Sponsored Captives

Additionally, David is active with the Vermont Captive Insurance Association. Since 2007, he has served on the VCIA's legislative committee helping to assess federal and state regulation and issues impacting the VCIA's membership and to develop policy recommendations to present to the VCIA Board of Directors. David is currently the Chair of the legislative committee. In the past, he has also served on the VCIA's annual conference planning committee, a high-profile industry meeting drawing captive insurance owners and service providers from across the country for educational seminars and networking opportunities. David was selected for recognition in *Chambers USA 2014: America's Leading Lawyers for Business* for his work with captive insurance companies based on *Chamber's* in-depth interviews with clients and peers. He has been continuously recognized by this organization since 2011.

CONTACT THE ANGUS FIRM, PLC

Please contact David Angus at (802) 399-2260 to discuss how The Angus Firm, PLC may assist you with your captive insurance needs or visit us on the web at www.angusfirm.com.

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