P & P CAPTIVE NEWSLETTER

LAW OFFICES OF

PRIMMER & PIPER

PROFESSIONAL CORPORATION

www.primmer.com

December 2004 **Vol. 10, Issue 3**

MONTPELIER OFFICE:
100 EAST STATE STREET
P.O. BOX 1309
MONTPELIER, VT 05601-1309

TELEPHONE 802-223-2102
FACSIMILE 802-223-2628

BURLINGTON OFFICE:
150 SOUTH CHAMPLAIN STREET, SUITE 4
P.O. BOX 1488
BURLINGTON, VT 05402-1488

TELEPHONE 802-862-2512
FACSIMILE 802-862-3286

ST. JOHNSBURY OFFICE:
421 SUMMER STREET
P.O. BOX 159
ST. JOHNSBURY, VT 05819

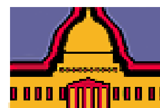
TELEPHONE 802-748-5061
FACSIMILE 802-748-3976

THE SPITZER INVESTIGATION

New York State Attorney General Eliot Spitzer's ongoing investigation of certain insurance practices, focused primarily on Marsh and AIG, has triggered questions from our clients regarding potential impacts on Vermont captives. Marsh and AIG both have captive management affiliates here, and between them manage a significant share of the Vermont captive business.

Many of our clients have, of course, broader relationships with these entities, involving much more than Vermont captive management. Spitzer's allegations focus primarily on undisclosed contingent brokerage commissions and price-fixing, primarily in the commercial insurance marketplace, and we encourage close scrutiny of any brokerage relationship to ensure fairness and transparency.

With regard to Vermont management services, it is our view that the Marsh and AIG Vermont operations are far removed from the operations currently under investigation in New York. Vermont management services typically include accounting, regulatory compliance, and claims oversight. Rarely in Vermont are brokerage services related to fronting or excess reinsurance provided by the manager. We work closely with Marsh and AIG on numerous programs, and know that their Vermont captive management teams are led and staffed by people of integrity and competence. Both organizations would welcome questions regarding compensation arrangements, which in most cases are on a fixed annual fee basis.



NEWS FROM THE VERMONT STATE HOUSE: *MANDATE OR STALEMATE?*

Vermonters turned out at the polls in large numbers on November 2nd, and once again displayed an inclination to vote for the person and not the party. The mottled election results defy clear explanation. The state's residents voted for the Democratic candidate for President, the Republican candidate for Governor, the Democratic candidate for U.S. Senate, the Independent (Progressive) candidate for U.S. House, the Republican candidate for Lieutenant Governor, and unseated the incumbent Democrat in the usually sleepy race for Auditor of Accounts.

Copyright © 2004 by Primmer & Piper, P.C.
All Rights Reserved

The Democrats increased their majority in the Vermont Senate to a veto-proof 21-9, and ended four years of Republican control of the Vermont House by gaining a sizeable 23-seat majority. The result: a Republican administration with a Democratic General Assembly. This will mean either two more years of political gridlock and the possibility of numerous vetoes, or an opportunity for nonpartisan cooperation for the greater good of Vermont.

Looking ahead, Gov. Jim Douglas' political skills will be fully engaged as he faces the Democratically controlled Legislature. While the Governor can rightly claim he was reelected with a clear mandate (59% of the vote), he will be working with a legislative body that is likely to have a contrasting legislative agenda. Conversely, Democrats in the House and Senate are claiming their own mandate given their sizeable gains in both legislative bodies.

Health care will be among the major issues to be considered in the upcoming session, since most candidates included it among their platform priorities. The proposals for reform, however, reveal philosophical differences. The Governor favors a combination of revisions to the current system, including efforts to attract more health insurers to Vermont in order to reinvigorate competition, and emphasizing more individual responsibility in health lifestyle choices and spending. Democrats, however, favor universal access to health care in Vermont that may include a larger role for state government. In addition, energy-related issues are expected to be considered by Vermont lawmakers and may include renewable energy resources, the state's possible acquisition of certain hydroelectric generation facilities, and the siting of commercial wind generation facilities. Finally, the budget is always an issue in Vermont's legislative sessions and this year will be no different. The state's projected revenue, while fairly healthy at present, will have a hard time meeting budget pressures. The Douglas Administration is again pushing a sustainable fiscal plan. The difficulty will be funding existing and new programs without additional sources of revenue.

Vermont's captive insurance industry, assisted by its supporters in state government, has worked hard over the years fostering bipartisan support for captive insurance. That positive relationship is expected to continue in the wake of the 2004 election, while the industry and the regulators will work together to introduce captive insurance to newly-elected legislators. In addition, regulators and representatives of the captive insurance industry are currently considering a series of modest amendments to the captive statute which involve the minimum capital and investment requirements for certain captives, and a series of technical amendments to the recent law permitting direct formation of nonprofit captives in Vermont. To the extent consensus is reached among interested parties, a package of amendments may be brought to the Legislature for its consideration and debate.

We will continue to report on the new General Assembly and any captive legislative initiatives in future issues.

COMING ASHORE

Over the past few years, we have been involved with the relocation of several captives from offshore domiciles to Vermont. These decisions are sometimes driven by a desire for greater operational

Copyright © 2004 by Primmer & Piper, P.C.
All Rights Reserved

efficiency, and sometimes by the recognition that the tax advantages that originally fueled the choice to form offshore no longer hold. And in today's world of increasing corporate scrutiny, parent companies are sometimes more comfortable with a domestic subsidiary rather than an entity domiciled in a more exotic offshore location.

In nearly all cases, redomesticating captives tell us that the responsiveness of regulators and service providers is better in Vermont, and that the costs of doing business are consequently lower than in other domiciles. Any decision to redomesticate must of course be preceded by a thorough analysis of several different issues, including tax treatment, the relative regulatory environments, and the costs of moving.

Relocation transactions can take one of many forms, including merger into an onshore affiliate or newly formed merger shell. This is generally an efficient alternative, as it avoids the need for dissolving or otherwise winding-up the offshore company. This efficiency may, in some cases, be offset by relatively more complex transactional and regulatory considerations. Another alternative involves the transfer of existing assets and liabilities pursuant to an assumption reinsurance (or "loss portfolio transfer") arrangement. The transfer could either be to an existing affiliated company, or to a newly formed onshore captive shell. If the transfer is done on a novation basis, it allows for the final winding-up of the offshore company once the transfer becomes effective.

A third alternative is to "redomesticate" pursuant to statutory provisions that permit the simple relocation of an existing entity. (In Bermuda, the terminology is a bit different and these transactions are referred to as "discontinuances.") In essence, this would involve picking up the existing company by its roots and setting it down in the new onshore domicile.

Each of the above methods involves regulatory approval on both sides of the equation, as well as legal representation in both jurisdictions. As a general rule, these types of transactions are not particularly expensive, assuming there are not significant tax consequences related to the transfer of assets. For some group programs, particularly where the insureds are nonprofit entities, tax effects can be substantially mitigated by a simultaneous conversion to the reciprocal form.

MORTGAGE GUARANTY REINSURANCE: CAPITAL REQUIREMENTS

A couple of our lender-owned mortgage guaranty reinsurance clients have brought to our attention an interesting situation regarding ongoing capital requirements. They have identified somewhat unusual reinsurance contract provisions that have resulted in significantly higher funding requirements, in some cases amounting to millions of dollars.

Typically, mortgage guaranty reinsurance contracts require the reinsurer to maintain certain amounts in trust, roughly the greater of 20% of the risk in force or the contingency reserve based on 50% of assumed premium. In some cases, however, there is a third test based on claims activity in the primary layer, introduced by some companies or their auditors to better demonstrate risk transfer.

Copyright © 2004 by Primmer & Piper, P.C.
All Rights Reserved

In some cases, the mechanism is styled as a comparison of a "pro forma cumulative claim termination rate" to an "actual cumulative claim termination rate." In other cases, the reinsurance agreement contains a definition of "excess loss" that functions in a similar manner. We understand that the significant erosion of some book years, due primarily to high refinancing activity, is resulting in unexpectedly high claims activity in the first loss layer. This in turn is triggering higher than expected capital requirements for the captive.

We encourage our mortgage guaranty reinsurance captives to review their contract provisions, particularly if they have recently seen higher capital requirement calculations. We understand that the MI companies will not necessarily oppose the removal of these provisions, but will likely want an opportunity to evaluate the appropriateness of any proposed amendments on a case by case basis.

As mentioned, these contract provisions were driven by the desire to demonstrate risk transfer, as required by both RESPA and GSE guidelines. Their removal may weaken underlying risk transfer analysis, particularly in the absence of alternative language related to ongoing capital requirements or distributional delays. If you have any questions regarding this issue, do not hesitate to contact us to discuss your particular situation.

STATE MODERNIZATION AND REGULATORY TRANSPARENCY ACT (SMART)

A draft federal Oxley-Baker bill called the State Modernization and Regulatory Transparency Act ("SMART") is being circulated for comment. (It is available at http://www.fsround.org/statemodandregtransparencyact.html.) As drafted, SMART would fundamentally change the way insurance companies are regulated. For example, the Act would permit an insurer domiciled in an accredited state to write coverage in all other states without having to undergo each state's cumbersome licensing procedures. It would also provide that rates and forms approval by one accredited state would constitute approval by all other states. Other aspects of insurance, such as agency licensing, reinsurance approval and anti-fraud provisions are also addressed.

Although there would be no federal insurance regulator created, SMART would establish a panel that would include federal participation to oversee the program.

In its current form, SMART could have a substantial impact on captives. For example, a captive doing business nationwide through a fronting arrangement might then be able to begin writing directly, without having to clear licensing or other regulatory hurdles imposed by the states in which it is not domiciled.

This past Fall there seemed to be substantial interest in the bill, with strong industry support. However, NCOIL and NAIC have both expressed strong concerns, and the Spitzer effect may make the industry's voice somewhat less persuasive to Congress at this time. We'll keep you posted.

TRIA UPDATE

In our July newsletter we reported that legislation had been introduced in the U.S. House of Representatives to extend the term of the Terrorism Risk Insurance Act of

Copyright © 2004 by Primmer & Piper, P.C.
All Rights Reserved

2002 (the "Act") until the end of 2007. A Senate bill, the "Terrorism Risk Insurance Extension Act of 2004" (S.2764), was later introduced on July 22, 2004. Although the House Committee on Financial Services approved the "Terrorism Insurance Backstop Extension Act of 2004" (H.R. 4634) on September 29, 2004, the House of Representatives did not pass the bill before it adjourned. The extension of the Act is certain to be a key legislative issue in 2005.

It is unclear whether or not Congress is likely to extend the Act next year. Senator Richard Shelby (R-AL), Chairman of the Banking Committee, has indicated that he would like to hold hearings on this issue and consider a study being prepared by the Treasury Department due in June 2005. As such, even if there is sufficient support in the House of Representatives to extend the Act early next year, it is unlikely that the Senate will be prepared to take similar action before mid-year. In addition, the Treasury Department has not expressed a position favoring extension of the Act.

The "make available" provisions of the Act extend through December 31, 2005. Captive insurers that have issued or may issue commercial property and casualty insurance policies that extend beyond December 31, 2005, should consult with their service providers regarding the use of conditional endorsements to exclude coverage in the event that the Act is not extended.

We will continue to monitor and report on developments regarding the extension of the Act.

E-MAIL OPTION

If you would prefer to save a tree and receive your copy of the P&P Captive Newsletter by e-mail, please contact Cara Griswold at (802) 862-2512 or by e-mail at cgriswold@primmer.com.

Primmer & Piper's captive team is comprised of: John L. Primmer, Jeffrey P. Johnson, James E. Clemons, Gary H. Barnes, Russell A. Young, Randall L. Wachsmann, Cassandra C. Larae-Perez, James F. Feehan, Stephen J. Odefey, Cara Griswold, Laura Daudelin, Kurt Lutes, Angelina Buzzi, and Lisa Geer.

Copyright © 2004 by Primmer & Piper, P.C.
All Rights Reserved