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IRS PROPOSES NEW RULES FOR CAPTIVES

In September, the IRS issued proposed regulations which, if finalized, would extinguish the favorable federal income taxation presently enjoyed by some single parent captives. The proposal would amend Treas. Reg. § 1.1502-13(e) to eliminate an existing exception from single entity treatment for intercompany insurance transactions between members of a consolidated group.

Current regulations look upon certain insurance transactions between a captive and other members of its corporate family as "insurance" for tax purposes and thus except such transactions from single entity treatment. Accordingly, for purposes of filing a consolidated income tax return, members may determine and account for premiums, reserve increases and decreases, and other items under the separate entity method of accounting which permits them to accelerate deductions to the time reserves are posted rather than when claims are paid.

The proposed regulations would limit separate entity treatment to intercompany insurance transactions only if ninety-five

percent (95%) or more of a captive's business derives from unrelated entities. Otherwise, the captive arrangement would be taxed like "self-insurance" rather than insurance, and claims could only be deducted when paid. This initiative appears to be motivated by the growth of captive insurance arrangements within U.S. corporate families, and the effect of such growth on consolidated taxable income and tax revenue.

Although the proposed regulations would change the cost-benefit analysis underlying many pure captive insurance arrangements, it is unclear whether they will be implemented. The IRS and the Treasury Department are accepting comments on the proposed regulations through December 27, 2007.

The Vermont Captive Insurance Association (VCIA) and the Captive Insurance Companies Association (CICA) have formed the "Coalition for Fairness to Captive Insurers" to fund and coordinate an industry response to the proposed regulations. For further information about the Coalition, or to join the effort, contact Molly Lambert of the VCIA (www.vcia.com) or Dennis Harwick of CICA (www.captiveassociation.com).

REGULATORY TRANSITIONS

The Vermont Department of Banking, Insurance, Securities and Health Care Administration (“BISHCA”) is comprised of five Divisions. Each Division, including the Captive Insurance Division, is headed by a Deputy Commissioner who has great discretion and authority in regard to their Division’s duties. We are pleased to report that Len Crouse, who serves at the pleasure of the Governor, will remain Vermont’s Deputy Commissioner of Captive Insurance for an additional two to three years (or more, we hope). Len has successfully combined his engaging personality and great business acumen with well-honed regulatory instincts during his sixteen-year tenure at BISHCA.

Much of Vermont’s success as a leading captive domicile is due to Director of Captive Insurance Derick White. After more than fifteen years with BISHCA, Derick has decided to pursue a new private-sector career in captive management. Among Derick’s many accomplishments are his tenure as President of the Society of Financial Examiners, a national association comprised of insurance department examiners, being designated a Certified Financial Examiner, and licensure as a Certified Public Accountant. With this background, Derick has provided a great deal of sophisticated analysis on captive insurance matters, including Vermont’s recent initiative with securitization captives. We congratulate him on a job well done and wish him the very best in his new endeavors.

Luckily, BISHCA has a deep bench. Without missing a beat, it announced the appointment of Peter Raymond, the current Director of Financial Examination,

as Derick’s successor. We asked Peter to reveal something about himself not commonly known in the captive community. He proudly stated that he is an Aquarius, and that he intends to discharge his new responsibilities with love and inner peace. Peter is a Certified Public Accountant and Certified Financial Examiner with more than fourteen years of experience serving as a captive regulator. He has been responsible for the operations of the Division’s examination function, and also has several years of experience working for a captive management company. We congratulate him on his well-deserved advancement.

In turn, Peter will be replaced by Sandra Bigglestone, currently the Captive Division’s Chief Examiner. Sandra is a Certified Public Accountant and Certified Financial Examiner. She now supervises the Division’s examination staff and enjoys direct responsibility for the financial well-being of Vermont’s captives. Sandra has more than ten years of experience with the Division, and the confidence of all who have worked with her.

So, we thank Len, wish Derick well, and welcome Peter and Sandra to their new positions.

THE USE OF A RISK PURCHASING GROUP FOR EXCESS COVERAGE

Participants in a group captive often consider joining together to purchase excess liability coverage, many times on a shared limit basis. In some cases, participants use their captive insurance company as the named policyholder under a group excess policy with certificates of coverage issued to each participant. Although the captive is the policyholder, it does not actually benefit

from the excess coverage and does not assume risk from the excess carrier. It solely serves as a common link among its participants and as a facilitator of the group purchase.

Importantly, this approach may not comply with a body of state laws prohibiting the purchase of casualty insurance on a group basis. Under the laws of several states, underwriting property and casualty insurance for a so-called “fictitious group” is prohibited. State regulators have perceived little actuarial difference in experience for policies underwritten on a group and individual basis and have been concerned about rate discrimination against entities with similar risk profiles not permitted to join the group. A “fictitious group” is commonly defined as an association or other entity formed for the principal purpose of permitting its members to buy insurance coverage. However, laws are broadly worded such that legitimate groups formed for unrelated purposes (perhaps including a captive) could be construed to be prohibited from purchasing group insurance.

Group excess arrangements may also lead to confusion regarding the captive insurance company’s role in the excess insurance program and responsibility for premium taxes. To avoid these problems, it may be advantageous for the captive participants to form a risk purchasing group (“RPG”) to facilitate the purchase of excess liability coverage to benefit its members.

Although some states do not have laws that prohibit underwriting on a group basis, even these states have implicitly prohibited such action by adopting safe harbor statutes authorizing the formation

of RPGs. The federal Liability Risk Retention Act (“LRRRA”), which authorizes RRGs, also authorizes the formation of RPGs to facilitate the group purchase of commercial liability insurance. It preempts state laws that would otherwise prohibit the coverage structure.

In any state, the formation of an RPG under the LRRRA reduces a number of risks associated with the group purchase of casualty insurance. By eliminating the captive insurance company as policyholder under a group excess liability insurance policy, any potential confusion by participants or regulators regarding the captive’s role is eliminated. This approach also reduces potential confusion with regard to the payment of premium taxes and any funds flowing through the captive to its participants. Additionally, forming an RPG ensures that the excess program is structured in a manner that cannot be challenged under the laws of each of the states in which the participants reside. It is important to note, however, that the broad preemption of other state insurance laws enjoyed by RRGs under the LRRRA is not available to RPGs.

Please contact us if you have questions regarding the possible benefits of forming an RPG for your excess casualty insurance program.

RUSTY YOUNG BECOMES A PARTNER

We are pleased to announce that Russell (“Rusty”) A. Young will become a partner in the firm beginning January 1, 2008. Those of you who know him are aware of the many strong contributions he has made to our captive practice and clients. Rusty possesses a combination of legal skill, judgment, personality, integrity, and

commitment that make him a superb lawyer and colleague. Please join us in congratulating Rusty for his well-deserved advancement.

TITLE REINSURERS SETTLE WITH HUD

In late October of this year, the U.S. Department of Housing and Urban Development (“HUD”) announced Settlement Agreements with six builder-owned title reinsurance captives. As we have previously reported, HUD had alleged violations of Section 8(a) of the Real Estate Settlement Procedures Act of 1974 (“RESPA”), involving illegal referral fees and kickbacks. The recent settlements involve payments ranging from approximately \$50,000 to \$450,000.

In addition to requiring payments, the Settlement Agreements prohibit further engagement in the reinsurance of title policies. They also set forth an agreement by HUD to take no further action against the involved parties, a statement of no admission of wrongdoing, and HUD’s express agreement to allow the unwinding or runoff of the existing captive programs.

We emphasize that the Reinsurance Agreements entered into by Vermont domiciled captives were in strict adherence with HUD guidelines issued in the mortgage guaranty context and specially extended to title insurance. Indeed, in the so-called “Countrywide Letter,” HUD established a RESPA safe harbor for reinsurance programs entered into on a quota share basis. All of the title reinsurance programs with which we are familiar were quota share, with the captive paying its proportionate share of each and every loss incurred by the primary carrier.

Moreover, none of these captive arrangements resulted in any additional costs to consumers who, in each case, paid rates approved by insurance regulators directly to the primary title company. For these and other reasons, we believe HUD’s efforts in this regard were misdirected, and that the real issue remains whether the primary rates charged by title insurers (and approved by state regulators) are appropriate to the underlying risk.

NAIC UPDATE

Our last Newsletter reviewed recent NAIC activity in two areas which could have significant impacts on risk retention groups (“RRGs”): the imposition of governance standards and the application of traditional credit for reinsurance rules. Since then, there has been no further action toward implementing governance standards, although several large RRGs are considering voluntarily adopting the standards in Bylaws and board policies in advance of a requirement to do so. Many others are discussing the standards and considering what, if any, actions they would take to comply with the standards if mandated. We recommend this “wait and see” approach in order to assure that Bylaw changes, policies, committee charters, and other drafting, review and approval doesn’t have to occur twice should the NAIC (or Vermont) implement a version different from the current draft.

The possibility of applying traditional-insurer credit for reinsurance rules to RRGs is of more concern because of the effect this could have on RRGs reinsured by offshore affiliates and those accessing affordable reinsurance from small (and often offshore) reinsurers. Several successive NAIC conference calls and

meetings have focused on a draft regulation put forth by D.C. regulators as an alternative to traditional credit for reinsurance rules. The regulation would permit RRGs credit if a reinsurer is rated by a recognized rating agency or if it complies with a list of six fundamentals, including requirements to be licensed in at least one jurisdiction, to maintain a 3:1 surplus ratio, and to submit audited financials. The hottest debate involves whether a Commissioner should have discretion to waive these requirements. Current exposure drafts would permit a waiver of any one requirement, with others of the six already incorporating Commissioner discretion. For example, an affiliated reinsurer would not be permitted to write third-party risk unless permitted by the Commissioner of the credit-granting domicile, even without the exception.

Vermont's representative on the Task Force, Peter Raymond, continues to support full Commissioner discretion, which Vermont exercises now. However, concern over other domiciles' current exercise of discretion makes it uncertain other representatives will go along. We are watching this closely and will provide updates. If you have questions about how this issue could impact your program, please call us.

SECURITIES ISSUES FOR GROUP CAPTIVES

We have previously reported on the importance of considering securities laws when designing and implementing group captive structures. As captives become more widely used alternative risk financing mechanisms for smaller businesses, securities laws take on even greater importance.

Clients are often surprised that programs face challenges caused by the very nature of captive insurance companies – that insureds are also owners. Federal securities laws and analogous state provisions impose restrictions on the issuance of ownership interests in all types of entities, including captive insurance companies. Most critical of these is registration – a requirement that some companies, under both federal and state law, file with securities regulators information about all aspects of their programs. Fortunately, there are several exceptions to these requirements.

Section 5 of the federal Securities Act of 1933 (the "Act") requires registration of any security sold by any person or entity, unless the sale is made pursuant to an available exemption. All state securities laws contain analogous provisions. Because registration involves significant costs, delays, possibly negative regulatory interactions and ongoing regulatory burdens, most captive programs seek to avoid the process.

Certain captives enjoy blanket freedom from securities registration requirements. An interest in a mutual company is generally not considered a security, and is therefore exempt from securities regulation. Pure captives easily qualify for exemptions because of their single owner structure. The federal Liability Risk Retention Act exempts risk retention groups ("RRGs") from federal and state registration requirements. Exemptions for non-RRG group programs are sometimes more difficult.

Commonly available exemptions for group programs involve those applicable to the sale of a limited amount of securities, the sale to a limited number of investors, the

sale through non-public channels, and the sale to certain sophisticated investors for whom the protections of the Act are less important. For example, Section 4(2) of the Act exempts so-called “private placements,” not involving any “public offering.” And Section 4(6) of the Act provides an exemption from registration for sales of less than \$5 million solely to “accredited investors.” Section 3(b) of the Act allows the SEC to exempt from registration by rule certain transactions in securities that, because of the small amounts involved or the limited nature of public offering, do not require the public protections of registration. No transaction exempted by such rules may exceed \$5 million. Each of these exemptions is further defined through regulation.

Most important is Regulation D, consisting of Rules 504, 505, and 506. It provides a safe harbor for defining the exemptions outlined in Sections 4(2) and 3(b). If an issuer meets the requirements of Rule 506, it is deemed to have complied with the exemption in Section 4(2). Rules 504 and 505 provide exemptions under Section 3(b) for offerings to accredited investors and a limited number of non-accredited investors.

The definition of “accredited investor” is central to the exemptions under Section 4(6) and Regulation D. The term includes, among others, banks, insurance companies, or certain other financial institutions; corporations, trusts and non-profits with more than \$5 million in assets; directors, executive officers, or partners in the issuer; individuals with net worth greater than \$1 million; individuals with incomes of at least \$200,000 in each of the two prior years; and any entity in which all of the equity owners are accredited investors.

State exemptions from registration generally mirror those available under federal law. Unfortunately, key terms vary among states’ so-called “blue sky” laws. For instance, in some states “limited offering” exemptions permit sales to up to ten individuals in the state, while others permit sales to up to ten individuals *in any state*. Some state exemptions may be relied on without filing with state securities regulators, while others require filing and payment of modest fees. Understanding blue sky laws in each participant’s home state is important, as it is central to compliance.

Even when offering securities pursuant to federal and state registration exemptions, groups should nonetheless provide participants with disclosure information similar to that provided in registration materials. Both federal and state securities laws contain anti-fraud provisions that may serve as a cause of action for disenchanted participants who claim they were not fully informed at the time of their securities purchase. Providing complete, accurate disclosures makes such suits less likely and less meritorious. Often, these disclosures are relatively brief, and consist largely of risk factors and materials already developed to explain the captive program to prospective participants.

Importantly, the blanket registration exemption provided to RRGs does not include exemption from anti-fraud laws. Although RRG organizers need not address exemptions from registration, they should nonetheless provide thorough disclosures to prospective participants.

Group captives should pay careful attention to the impact of securities laws on their programs. Of chief concern is

finding an exemption from federal and state registration requirements, which is often available. And providing full disclosure of program information to prospective participants is essential to avoid claims based on anti-fraud laws.



NEWS FROM THE VERMONT STATE HOUSE: SECOND HALF OF BIENNIUM APPROACHES

Legislators will return to Montpelier in January to begin the second half of the biennial Legislative session. Prior to adjourning sometime next May (we hope!), the General Assembly will address a host of issues. However, divided government is expected to play a large part in the election-year session, with a Democratically-controlled Senate and House facing a Republican Governor and Administration.

Among the larger issues on the General Assembly's agenda will be a renewed attempt to pass energy and global warming-related legislation, the signature provision of which is a comprehensive all-fuels "efficiency utility" intended to reduce energy consumption and result in savings on consumers' heating bills. Also on the agenda is the replacement of campaign finance reform laws struck down by federal courts, including limitations on campaign contributions. (Both initiatives were vetoed last year.) An expansion of Catamount Health, the new insurance program for some uninsured Vermonters, the creation of affordable housing, and an effort to address Vermont's aging transportation infrastructure are all anticipated to share space on the agenda.

Preliminary discussions are underway regarding captive insurance legislation that would further support Vermont's position as a leading domicile. While some time remains before a final "package" rolls out, under consideration are amendments to: streamline the process for merging, consolidating or converting a captive corporate entity to a limited liability company; reconsider current requirements for an attorney's bond for reciprocal insurers; consider measures to further enhance the segregation of risks among participants in a sponsored captive; and review the universe of financial institutions permitted to issue a letter of credit. Of course, other proposals may be included to address any new developments.

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

E-MAIL OPTION

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

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