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VERMONT TO CONSIDER CAPTIVE SECURITIZATION LEGISLATION

In February, the Vermont Department of Banking, Insurance, Securities and Healthcare Administration ("BISHCA") released an exposure draft of proposed legislation designed to authorize the formation and operation of Special Purpose Financial Captive Insurance Companies ("SPFC"). After review of comments and questions, BISHCA will seek to have this legislation formally introduced in the Senate on or about the Ides of March. Notwithstanding the fact that the legislation is being introduced mid-session, Vermont regulators have received indication that the key legislative committees in both the House and Senate will take up the legislation in this session.

To date, Vermont has licensed five captives authorized to reinsure life insurance reserves. Primarily such captives have been formed to reinsure the redundant reserve requirements imposed on both term life products (the so-called XXX reserves) and the secondary obligation of life insurers to undertake premium payments on universal life policies (the AXXX reserve requirement). After such risk has been ceded, the reinsurance captive then obtains funds

through the sale of securities to third parties or through receipt of a letter of credit issued on behalf of an investment bank. BISHCA will permit this type of LOC to be treated as an asset by the reinsurance captive without a corresponding liability.

There is an expression in Vermont, "if it ain't broke, don't fix it." And, on the surface, it appears that the existing captive law works quite well. However, if life insurance securitization and LOC transactions (both referred to as "securitizations" under the proposed legislation) are to take root in Vermont, there must be a statutory framework in place.

Several interested parties have expressed concern about the Rogue Regulator Risk ("RRR") (and no reference to Len Crouse is intended). The RRR arises from the fact that these transactions involve third parties that either extend credit to or purchase securities from the reinsurance captive (or its immediate parent). They do so relying on the approval of the Business Plan and issuance of a Certificate of Authority by BISHCA. Since these transactions and the captives involved will continue for many years, it is essential that commitments made by Regulators

today are honored in their totality tomorrow.

If enacted, the law would subject all existing securitization captive programs, as well as those formed after enactment, to the requirements contained therein. There is a provision by and through which the Commissioner will retain discretion to exempt an SPFC from any aspect of the statute or related regulation if determined inappropriate with the SPFC's Business Plan.

The legislative language also contains detailed requirements concerning each SPFC's plan of operation. There would be a requirement that an SPFC's President, Vice President, Treasurer or CFO submit an affidavit certifying compliance with all applicable provisions of the state law, federal and state securities law, the adequacy of the investment policy and the compliance of key documents, such as the trust agreement and reinsurance contract, with Vermont law. Similar to other captives in Vermont, all Business Plan changes require the prior written permission of the Commissioner. In addition, there are also provisions concerning an SPFC's securities, reinsurance, disposition of assets, permitted investments and the form and operation of the trust agreement.

A draft of the proposed legislation is accessible via our firm's website at <http://www.ppeclaw.com/CM/Custom/TOC/CaptiveNewsletter.asp>.

NEW CLASS ACTIONS CHALLENGE MORTGAGE GUARANTY CAPTIVES

In late December 2006, at least three class action complaints were filed against large mortgage lenders and their captives,

alleging violations of the Real Estate Settlement Procedures Act of 1974 ("RESPA"). The suits against Countrywide, GMAC, Washington Mutual and their respective captives claim that reinsurance premiums paid to the captives constitute illegal referral payments and kickbacks under Section 2607 of RESPA. See, e.g., Allston v. Countrywide Financial Corporation (Central District of California, December 22, 2006).

Multiple mortgage borrowers, who reside in various states, are represented in each case by Schiffrin & Barroway, LLP. At the heart of each complaint is the allegation that the reinsurance contracts at issue involve little or no risk transfer, or risk transfer not commensurate with the premium paid. For example, plaintiffs allege that Countrywide's captive, Balboa, has received nearly \$676 million in premium since the year 2000, while "bearing little or no risk of loss." In addition, plaintiffs argue against a strict application of RESPA's one-year statute of limitations, and allege that the reinsurance programs constitute "complex, undisclosed and self-concealing" schemes, such that "plaintiffs and the Class could not reasonably have discovered the underlying basis for the claims alleged" in the suits. The pleadings also allude to recent challenges to title reinsurance, suggesting analogous problems.

It is as yet unclear how these suits may impact the mortgage guaranty reinsurance business generally. However, we believe the comparison to title reinsurance entirely misses the mark, based on the fundamentally different nature of the mortgage guaranty business. Unlike title insurance, mortgage

guaranty insurance is sensitive to economic downturns, and has in fact suffered significant losses within the last twenty years. In addition, unlike the title reinsurance arrangements, mortgage guaranty reinsurance is typically supported by actuarial analyses and opinions upholding the appropriateness of the premiums paid.

We also believe that court rulings issued in earlier class action suits pose significant obstacles for these new plaintiffs. As we have previously reported, the Court in *Moore v. Radian* (Eastern District of Texas, 2002) dismissed a similar class action complaint due to lack of damages, concluding that a civil litigant has a duty to plead actual injury under Article III of the U.S. Constitution, or otherwise lacks standing. As in that case, here the plaintiffs have not suggested that they paid more premium than would have been paid in the absence of the reinsurance arrangements.

And in 2003, the Court in *Patton v. Triad* (Southern District of Georgia, 2003) ruled that plaintiffs would have great difficulty demonstrating which individual borrowers were part of the allegedly illegal referrals, given the numerous lenders involved and their many different relationships involving the MI companies. The Court ultimately rejected the plaintiffs' motion to certify separate classes, because the issues requiring individual treatment predominated over common issues. We believe this applies in these new cases as well.

With respect to the allegations that the reinsurance transactions represent "complex, undisclosed and self-concealing" schemes, we believe nothing could be further from the truth. First and

foremost, as required by the so-called "Countrywide Letter" from HUD providing guidance on reinsurance programs, each borrower received a disclosure of the reinsurance relationship and has been provided a meaningful opportunity to opt out. In our view, this disclosure should negate any arguments against tolling of the one-year statute of limitations. It is hard to imagine an activity that has been exposed to more regulatory daylight. All of the reinsurance arrangements with which we are familiar are conducted in compliance with all applicable insurance laws, the Countrywide guidelines, the requirements of Freddie Mac and Fannie Mae, and are supported by actuarial opinions on risk transfer and pricing. Moreover, bank lenders have sought and obtained regulatory approval from the Comptroller of the Currency, the Office of Thrift Supervision, and in some cases the Federal Reserve. In addition, the reinsurance companies and the ceding carriers are subject to approval and ongoing regulation by state insurance authorities.

We will keep you apprised as these cases move forward. If you have any questions or concerns in the meantime, do not hesitate to contact us.

TRIA UPDATE

The insurance industry appears poised to invest significant resources to achieve the extension of the Terrorism Risk Insurance Act of 2002 ("TRIA"), as amended by the Terrorism Risk Insurance Extension Act of 2005 ("TRIAEX"). Although traditional insurers sought early action by Congress in 2006 without success, it appears increasingly likely that TRIA may be reauthorized in some form prior to its December 31, 2007 expiration.

Some observers have suggested that an extension of TRIA is now more likely as a result of the November elections and Democratic control of Congress. Senator Christopher Dodd, D-Conn., has become the Chairman of the Senate Banking, Housing and Urban Affairs Committee, which has jurisdiction over TRIA. Senator Dodd prefers a permanent solution to the terrorism insurance issue, including a permanent extension of TRIA. Additionally, Representative Barney Frank, D-Mass., has become Chairman of the House Financial Services Committee and has also expressed interest in extending TRIA. However, unlike Senator Dodd, Representative Frank does not support a permanent program.

The insurance industry has been actively involved in various proposals concerning the extension of TRIA. For example, Swiss Re, the Reinsurance Association of America, and the Mortgage Bankers Association have all advocated for the extension of TRIA. In addition, the Risk and Insurance Management Society, Inc. ("RIMS"), has expressed its interest in working with public and private entities to develop and present to Congress a proposal regarding the reauthorization of TRIA.

Although RIMS has not submitted a legislative proposal, it believes that to develop a long-term solution to the availability and affordability of terrorism risk insurance: 1) a private/public partnership should be developed to respond to provide terrorism coverage; 2) that the proposal should address the long-term availability and affordability of insurance coverage for nuclear, biological, chemical and radiological ("NBCR") events caused by terrorism; 3) that all commercial property, workers' compen-

sation, and liability insurance lines should be included in the proposal; and 4) that all insurance companies writing commercial lines should be required to participate in the program and make coverage available for acts of terrorism.

Many other groups are also weighing in on terrorism risk. At the September 11, 2006 meeting of the Terrorism Insurance Implementation Working Group of the National Association of Insurance Commissioners, a representative of the CEO Roundtable outlined a proposal for a program where the federal government would act as reinsurer for losses resulting from acts of terrorism involving NBCR events. A separate program, similar to TRIA, would also be established for workers' compensation losses and other types of insurance policies. The American Insurance Association has submitted a proposal similar to the CEO Roundtable's approach, with the addition of possible tax incentives and limits on state insurance coverage requirements and oversight of rates.

The Real Estate Roundtable has proposed a program modeled after the United Kingdom's Pool Reinsurance Company, Ltd. The entity would be organized as a mutual reinsurer and would provide reinsurance for all types of policies currently covered by TRIAEX, plus the addition of group life coverage. It would cover both foreign and domestic terrorism events and insurers would only gain access to the federal program if they participate in the mutual insurance company established under the program. The federal government would act as a reinsurer to the mutual insurance company. The ability of the mutual insurer to retrocede coverage to the federal government would expire after six years

or when the capacity of the mutual insurer exceeds \$30 billion, whichever comes first. The program would also require all insurers to make terrorism coverage available for covered lines of insurance on the same terms and conditions as required under TRIAEX. The proposal also includes amendments to the Internal Revenue Code ("IRC") that would allow the mutual insurance company to voluntarily accumulate pre-tax dollars in reserve for handling terrorism losses and to receive tax exempt status under Section 501(c) of the IRC on income related to the program.

The insurance industry's efforts to reauthorize TRIA will take place amid the backdrop of a report to Congress issued by the President's Working Group on Financial Markets ("PWG"). The PWG reported, in part, that the availability and affordability of terrorism risk insurance has improved since September 11, 2001. It noted that the price of terrorism insurance has declined while the purchase rate has increased since TRIA was enacted. However, the PWG and the Government Accountability Office, in a separate report, have both observed that there has been little development in the private insurance market for terrorism risk related to NBCR risks. As a result, it is not anticipated that a significant private market expansion for NBCR risks will occur in the near term.

On December 7, 2006, Catlin Insurance Company Ltd., a Bermuda insurer, announced that it would offer a limited NBCR product, restricted to a specified geographic area that would be predefined by the insured or cedant. The coverage is designed to be used as a supplement to national terrorism insurance frameworks, such as TRIA, and includes coverage for

both foreign and domestic acts of terrorism.

It is too early to predict how this issue will unfold, but it appears that the federal government may continue to have a role in the provision of terrorism risk insurance after 2007. We will continue to monitor efforts by the insurance industry, and Congressional action during the year, and will provide updates as appropriate. If you have any questions concerning the application of TRIA to your insurance program, please contact us.



NEWS FROM THE VERMONT STATE HOUSE: A NEW LEGISLATURE IS UNDERWAY

The 2007-2008 Vermont General Assembly convened in January. New and returning lawmakers are well into the process of considering numerous legislative proposals and acting on those they believe are worthy. This first session of the two-year biennium is expected to last well into May.

As a result of the 2006 election, Democrats enhanced their majorities in both the House and Senate. However, the voters also expressed their preference for a balanced government by re-electing Republican Governor Jim Douglas. Although this division could result in some partisan bickering or gridlock, a cooperative session is expected.

In the spirit of cooperation, legislation containing a series of modest amendments to the captive insurance statutes has been introduced. First, a clarifying amendment to the definition of an association captive is proposed to provide that the association captive has

authority to insure the risks of affiliated companies of the member organizations and the risks of the association itself. Second, existing authority for pure captives to write controlled unaffiliated business may be expanded to allow industrial insured captives to write third-party business under the same general terms as those in place for pure captives. Third, a proposed amendment would clarify the rules for sponsored captives and captives formed as limited liability companies in regard to consolidation of such captive insurance companies for purposes of calculating premium tax. In the case of an LLC, common ownership and control will mean direct or indirect ownership of 80 percent or more of the membership interests in the LLC. In the case of sponsored captives, a protected cell would be treated as a separate captive owned and controlled by the protected cell's participant where the participant is the only participant with respect to the protected cell, and the participant is the sponsor or is affiliated with the sponsor of the sponsored captive through common ownership and control. Finally, a clarifying amendment is proposed that would expressly provide the Commissioner authority to require, approve, or accept financial reports using statutory accounting principles.

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

BIFURCATION OF INSURANCE CONTRACTS

In May 2006, the Financial Accounting Standards Board ("FASB") issued an invitation for comment on its preliminary bifurcation of insurance contracts into insurance and financing components –

the latter requiring deposit accounting treatment. The goal of the project is to address perceived weaknesses in financial statements of insurers and reinsurers with contracts that may contain terms limiting risk transfer. Most often, these contracts are so-called "finite risk" arrangements.

The invitation made clear that new or revised standards requiring bifurcation would apply to all insurers, including captives. Although consideration of risk transfer is already part of accounting as required by Financial Accounting Standard ("FAS") 113, a bifurcation system would likely add substantial costs to captive formations and ongoing operations in the form of increased fees for actuarial, accounting and audit professionals.

When the invitation period closed in August, sixty-three comments had been received, primarily from insurers, industry groups and accounting professionals. Among these were joint comments submitted by the Captive Insurance Companies Association ("CICA") and the Vermont Captive Insurance Association ("VCIA") addressing cost and complexity concerns for their members.

FASB considered these comments at a December 2006 meeting. It decided to continue the bifurcation project, focused on three areas: first, to consider editorial changes to FAS 113 clarifying the minimum level of risk necessary for a contract to be treated as insurance; second, to improve disclosure requirements contained in financial statements, including additional information substantiating the treatment of a contract as insurance; and third, to require non-insurance entities to evaluate

accounting for subject contracts with criteria similar to FAS 113.

FASB is currently developing proposals in each area for further review by the Board in the first quarter of 2007. A joint International Accounting Standards Board (“IASB”) and FASB project will also get underway in 2007, which will likely result in a further invitation to comment. FASB project materials on the Web make clear that any new FAS will not be issued for at least three years, with the effective date of implementation at least three years beyond the issuance.

We will continue to monitor this issue and work with our colleagues toward a common-sense approach for captives.

EMPLOYEE BENEFITS: CHAPTER TWO

The use of captives to insure employee benefits is now well established. The standard approach – the reinsurance of ERISA benefits provided by a traditional A-rated carrier – is utilized by several large captives to achieve the desired risk distribution that may improve tax treatment for the overall insurance program of the parent. This approach requires the approval of the U.S. Department of Labor (“DOL”), which in some cases may be expedited based on prior rulings. In all cases, the DOL looks for enhanced benefits to plan participants, generally in the form of additional benefits.

In addition to this standard ERISA reinsurance approach, we see other uses of captives related to employee benefits, essentially divided into two categories. First, some captives are providing stop-loss protection for a parent’s self-funded

benefit plan. Second, some captives are being used to provide or reinsure non-ERISA benefits.

With respect to stop-loss protection, the most common approach we have seen involves self-funded health benefit programs. In that case, the employer typically establishes a Voluntary Employees’ Beneficiary Association (“VEBA”) trust for purposes of funding the plan. For losses above plan assets, the parent organization purchases stop-loss protection directly from its captive. When properly structured, the stop-loss protection is not considered a plan asset and is exempt from ERISA considerations. Some care must be taken to ensure the proper structure in order to avoid the need for DOL approval.

The use of a captive for non-ERISA benefits may take one of two forms. Some organizations, notably governmental entities, are exempt from ERISA altogether and may use their captives in a variety of ways to either provide or reinsure benefits without concern for DOL approval. The second avenue for non-ERISA benefits involves the use of a captive to provide or reinsure benefits that, because of their specific attributes, are not subject to ERISA. For example, some entities provide certain supplemental retirement benefits that may be outside the scope of ERISA.

We look forward to addressing questions you may have about any of these approaches.

A CHANGE AT THE TOP

On January 22, 2007 Paulette Thabault became Commissioner of the Vermont Department of Banking, Insurance,

Securities and Healthcare Administration (“BISHCA”). She succeeds John Crowley who served in this post for the preceding four years. BISHCA is one of Vermont’s crucial regulatory agencies, and has responsibilities for all aspects of the financial services industry, including our favorite – the captive insurance industry. In addition, BISHCA regulates the healthcare delivery system in Vermont.

Commissioner Thabault formerly served as the Deputy Commissioner of the Healthcare Administration. Prior to her involvement in the state government, she was a Vice President of The Vermont Health Plan. She is a registered nurse and an attorney. Among her many responsibilities as Commissioner, she has ultimate responsibility for the Captive Insurance Division, which has approximately 560 operating entities under supervision. (Over the past several years the Captive Division has seen the formation of 35 to 40 new captives annually.) We understand that Commissioner Thabault enjoys a very positive working relationship with Deputy

Commissioner of Captive Insurance Len Crouse and his staff. Her appointment to this important position is good news for Vermont captive insurers.

E-MAIL OPTION

If you would prefer to receive Primmer Piper Eggleston & Cramer’s *Captive Newsletter* by e-mail, please contact Kurt Lutes at (802) 223-2102 or by e-mail at klutes@ppeclaw.com.

Primmer Piper Eggleston & Cramer’s captive team is comprised of: Jeffrey P. Johnson, James E. Clemons, Gary H. Barnes, Russell A. Young, Randall L. Wachsmann, James F. Feehan, David P. Hall, Lagretta Nickles, Kurt A. Lutes, Vikki S. Soutiere, and Angelina L. Buzzi.

John L. Primmer is now of counsel to the firm, and remains active with the captive team.