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DAVID PROVOST TO SUCCEED LEN CROUSE

After seventeen years of dedicated, energetic and colorful service to the State of Vermont, Len Crouse has announced his retirement as Deputy Commissioner of Captive Insurance, effective June 1, 2008. As his decision followed Derick White's departure in January, Vermont captive owners and managers have been keenly interested in the continuity of leadership at the Captive Division.

Fortunately, as Len himself often noted, the talent pool at the Captive Division is deep. After a short but concentrated search, Commissioner Thabault looked within the Captive Division, selecting David Provost, a senior member of the Vermont captive regulatory team, as Vermont's next Deputy Commissioner of Captive Insurance. David is well regarded by the industry. He is a Certified Financial Examiner with extensive in-house experience, and has also worked in a senior capacity as a Vermont captive manager. He is a graduate of Champlain College and the University of Vermont.

David will be directly supported by Peter Raymond, Director of Captive Insurance,

and Sandra Bigglestone, Director of Financial Examinations. In short, the Vermont Captive Division remains intact as the largest, most experienced captive regulatory operation in the world.

While many qualified individuals were undoubtedly considered for the role, David brings a strong technical background and skill set to the position, as well as extensive experience in the industry. Vermont captives will be well served by David and his team. We congratulate David, and wish him the best of luck in his new role.

MORTGAGE REINSURANCE UPDATE

Turmoil in the mortgage markets has had its impacts on mortgage guaranty captive reinsurance, even though very few if any subprime loans are the subject of reinsurance. Nonetheless, the significant increase in foreclosures and general economic stresses are affecting this segment of the captive industry.

Perhaps the most immediate effect comes from the recent announcements by Freddie Mac and Fannie Mae of revisions to their mortgage insurer eligibility rules, capping premium sessions to captive

reinsurers at 25% of gross premium, effective June 1, 2008. Currently, the guidelines permit so-called “deep cede” programs with up to 50% of premium for certain well-capitalized captives. Although the majority of lender-owned captives already cap premium at 25%, deep cede captives are not unknown. In its February 14, 2008 press release, Freddie Mac states the “change is intended to allow mortgage insurers to retain more insurance premiums to pay current claims and re-build their capital base.”

The downturn in the housing and mortgage markets has also caused some mortgage companies to change practices. *American Banker* recently reported that MGIC will restrict coverage in a way that will likely impact borrowers with lower credit scores and other higher risk borrowers. *American Banker* also reported that Genworth is reducing its exposure to low documentation loans and other alternative products that expose the insurer to higher risk. Interestingly, Genworth has indicated its increased reliance on reinsurance coverage for mortgages issued over the last three years.

Despite the increasing reliance on reinsurance by the mortgage industry, class action plaintiffs’ attorneys are not dissuaded. Cases against Countrywide, GMAC, Washington Mutual and Wells Fargo move forward, all now in the U.S. District Court for the Eastern District of Pennsylvania, as *Kay v. Wells Fargo* (N.D. California) was dismissed in November of last year. That dismissal was predicated primarily on the inability of the plaintiffs to extend RESPA’s one year statute of limitations. We remain of the opinion that plaintiffs will have a difficult

time based on a variety of factors, including the absence of damages, the statute of limitations, the inability to demonstrate a “hidden scheme,” and – most importantly – the increasing difficulty demonstrating the absence of risk transfer. As has been made abundantly clear by recent market conditions, existing reinsurance agreements are increasingly seen as providing significant capital relief to the ceding carriers, consistent with the Standard & Poor’s report issued last year. Indeed, we are aware that some captive insurers are now projecting possible exposure for their full risk layer.

We are also aware that the State of Minnesota has recently renewed its request for information regarding the reinsurance of mortgage guaranty policies. Direct requests have been made to the MI companies, as well as at least one management company here in Vermont. We believe Minnesota lacks jurisdiction over reinsurers domiciled in this state, and have urged our clients to carefully consider the latter request. The document request is extremely broad, and in our view would impose considerable burden on reinsurers for production. The timing of this renewed effort by Minnesota is odd, as extensive recent losses suggest more than ample risk transfer.

PROPOSED IRS REGULATION WITHDRAWN: WHERE TO FROM HERE?

On February 25, 2008, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (“IRS”) withdrew proposed Regulation Section 1.1502-13(e) which would have treated certain intercompany insurance transactions on a single entity basis. The withdrawal followed significant industry comment, but

before a scheduled public hearing. Nevertheless, the IRS and Treasury indicated they would continue to study whether revisions to the rules remain necessary to recognize taxable income of a consolidated group of companies. So, where does this action leave members of a consolidated group with a captive insurance company?

The people at Treasury and the IRS who proposed the withdrawn regulation may continue to harbor suspicion that some groups with a captive insurance company are avoiding the current recognition of taxable income. The proposed regulation suggested a further attempt by the IRS to move away from a “facts and circumstances” test to a more mechanical test (more than 5% of the insurance premiums arise from members of the consolidated group) to determine whether there was sufficient risk distribution to constitute insurance. The proposed regulation also revealed an attempt to advance – through regulation – an approach the IRS had reportedly lost in courts, the “economic family” theory.

If experience is any indication, the challenges presented by the proposed regulation will not go away. First, it is possible that the single entity theory may be advanced in a legislative proposal put forward by a new administration. It is also possible the IRS could internally depart from the use of the facts and circumstances test, and apply the 5% test advanced in the proposed regulation when issuing Revenue Rulings and Private Letter Rulings. It is not uncommon for the IRS to use the ruling process to attempt to create new law.

The IRS might also more vigorously audit consolidated groups which have captive

insurance companies. The IRS could use the audit exercise to look for poor fact patterns it could exploit by forcing the taxpayer to pay or contest the disallowance of the deduction in court. The IRS has demonstrated patience in developing favorable case law. The proposed regulation – although withdrawn – may signal a renewed commitment to contest certain structures now accepted as true insurance.

The IRS and Treasury could renew the effort to issue new regulations. If so, they will carefully consider the public comments received in their most recent attempt. The captive industry should remain vigilant, as the IRS and Treasury may only see the withdrawal of the proposed regulation as the loss of a small battle in a much larger war.

GARY BARNES BECOMES “OF COUNSEL” TO PRIMMER PIPER EGGLESTON & CRAMER

Effective January 1, Gary H. Barnes, formerly a partner in Primmer Piper Eggleston & Cramer, became “of Counsel” to the firm. Admitted to practice in Vermont and Massachusetts, Gary, practicing as a professional corporation, will continue to practice exclusively for Primmer Piper Eggleston & Cramer, serving its insurance, accounting, and business litigation clients.

Gary has over 35 years experience, and with Gary Karnedy leads our claims and coverage practice. We recently have represented captive insurance clients nationwide in the following types of engagements:

- settlement of large claims involving attempts to “stack” multiple years’

insurance coverage and to assert claims of bad faith;

- drafting insurance policies and endorsements;
- advising on professional engagement procedures to limit risk;
- drafting and advising on claims handling protocols;
- advising insurers as to duty to defend, coverage obligations and reservations of rights; and
- assisting with the resolution of reinsurance coverage questions.

Our insurance claims and coverage team, in conjunction with the firm's captive insurance and litigation attorneys, provides ongoing coverage advice, as well as litigation and claims support services to captives throughout the United States.

Gary Barnes and Gary Karnedy can be reached through the Burlington office.



**ASK THE EXPERTS:
EVIDENCE-BASED RISK
ASSESSMENT FOR MEDICAL
MALPRACTICE CAPTIVES**

Vermont is home to many large, sophisticated risk retention groups addressing the professional liability needs of their members, whether they be lawyers, doctors and hospitals, or accountants. We have often observed that these companies have in many cases developed truly state-of-the-art loss prevention and claims management programs.

The following article, authored by Robert B. Hanscom, Vice President of Loss Prevention and Patient Safety for the Risk Management Foundation of the Harvard Medical Institutions and RMF Strategies, exemplifies the expertise that has developed in the alternative insurance arena.

CRICO/RMF is the patient safety and medical malpractice captive owned by and serving the Harvard medical community since 1976. Insurance coverage is provided by Controlled Risk Insurance Company Ltd., founded in 1976, and Controlled Risk Insurance Company of Vermont, Inc. (a Risk Retention Group), founded in 1995. Risk Management Foundation was incorporated by the Harvard Medical Institutions in 1979 as a charitable, medical and educational membership organization. Today, CRICO/RMF is continuing to build its evidence-based risk management and serves nearly 11,500 physicians and 23 hospitals, including such premier entities as Massachusetts General Hospital, Beth Israel Deaconess Medical Center, Brigham and Women's Hospital, Boston Children's Hospital, and the Dana-Farber Cancer Institute.

With a consistent history of fewer claims than the national average, CRICO/RMF is able to offer policy limits that are among the highest in the country, and predictable premiums that fall significantly below local market rates. The strength of the program comes from disciplined claims management – with vigorous, yet fair, malpractice defense strategies – and a board-supported commitment to leading edge patient-safety enhancements.

A key element in CRICO/RMF's success is its long-standing adherence to using data to drive change. In 1987 CRICO/RMF developed a clinical coding taxonomy to strengthen its ability to identify and then aggregate root causes in malpractice events. In the past 20 years, this taxonomy has been tested, enhanced, and applied to each and every malpractice case within the Harvard Medical Community. The result has been a rich repository of malpractice data and the underlying themes that have contributed to these cases. Using sophisticated analytical tools, CRICO/RMF is able to mine this information, and share with its constituents a unique view of their clinical areas of vulnerability and financial loss. Triangulating this root-cause analysis data with knowledge of the institution's specific environment, CRICO/RMF is able to help entities appropriately focus on specific quality improvement efforts targeted to improve patient safety and mitigate risk. Similarly, this data is used to spread change across the Harvard system to ensure that each member benefits from the experience and learning of the other.

It was this desire to "learn from data" that compelled CRICO/RMF in 1998 to form a small division, RMF Strategies, with the mission of expanding its data universe and its "learning community" beyond the Harvard medical community.

RMF Strategies now serves 500 hospitals, 40,000 physicians and 2,400 corporate entities in 40 states, and has a comparative database of more than 25,000 medical malpractice cases. Participating in this database enables RMF Strategies' customers to benchmark their organization's medical malpractice experience against similar groups'

experience nation-wide. Participation in this database brings together a community of similar organizations who have a commitment to learn not only from data, *but from each other*.

RMF Strategies provides services and products that stem from the same six-step methodology used for many years by CRICO/RMF's Loss Prevention and Patient Safety Department:

- Contemporaneous capture, analysis, coding, and aggregating of malpractice claims *as they are asserted*;
- Putting context to the malpractice data, through appropriate denominators and peer-based comparative data;
- Assessment of risk in the present-day environments;
- Identification of models/solutions that best address the themes contributing to malpractice scenarios, particularly those with high-severity injury outcomes; this includes dedication of grant dollars to promote research of new approaches;
- Support of interventions (new models, education, and training) through CRICO/RMF funds; these become demonstration initiatives for the entire Harvard system; and
- Measurement of interventions in the short-term, with a predictive assessment of how the interventions may alter an institution's future malpractice profile.

In a fast-paced world, the CRICO/RMF model is one of patience. Clinical environments prone to high risk injuries are often not easily or quickly fixed. There are frequently numerous variables

interplaying with each other that appear to be at the root of many tragic outcomes, and it is challenging to understand what should take the highest priority. Yet, when the themes underlying the malpractice cases are clearly laid out, the answer has frequently emerged for CRICO/RMF. For example, in the late 1990s, a spike in the anesthesia malpractice cases – when analyzed and the factors aggregated – revealed that the most problematic area was crisis response by individual providers. This led to CRICO/RMF designing a premium incentive program that gave a modest amount of dollars back to anesthesiologists who underwent simulation training. In a relatively short period of time (two years), nearly every anesthesiologist in the Harvard system took advantage of this offering and signed up for simulation training. The results of this program have been dramatic: in 2006, because of an improved malpractice experience CRICO/RMF actuaries recommended a 25 percent premium decrease for all anesthesiologists who had been trained.

Among its several offerings, RMF Strategies makes available:

- CRICO/RMF's home-grown I.T. suite of products (EIS, CMAPS, UMAPS), allowing for malpractice entities to manage and analyze their malpractice claims in the same way that CRICO/RMF does;
- coding services, whereby RMF Strategies staff will analyze and code other institutions' malpractice data consistent with how it is done in the CRICO/RMF system;
- participation in its data services community, which provides customers the

ability to benefit from RMF Strategies' growing malpractice comparative database;

- risk appraisals, which RMF Strategies staff will perform for an organization or system as a whole, or – in a more tailored manner – for high-risk clinical services; and
- access to its educational content, most notably its library of 28 online CME programs and team training initiatives for labor and delivery units.

RMF Strategies' focus on comparative data emanates from a solid belief that malpractice data – if displayed in an appropriate context – can compel action and process improvement like no other data set.

In 2007, CRICO/RMF hosted symposia focused on practical models to reduce diagnostic errors, obstetrical errors, and surgical errors. At these conferences issues, challenges, and potential solutions related to some of the most worrisome malpractice themes were actively discussed and vetted. For CRICO/RMF, bringing together a “community of learning” is a key vehicle for the sharing of effective practices, and promoting the adoption and spread of successful processes and methodologies. It is a primary mission of CRICO/RMF and RMF Strategies to grow this community, and to use data to catalyze initiatives that lead to an increasingly safer healthcare environment.

NAIC UPDATE

We have been reporting on two undertakings by the National Association of Insurance Commissioners (“NAIC”)

which could have significant impacts on risk retention groups. The NAIC has now approved governance standards for RRGs, however, it did so without providing a mechanism to require RRGs to comply with the standards. Options include promulgating model laws which would have to be enacted by individual state legislatures, adding the governance standards to NAIC accreditation standards, and suggesting that Congress enact the standards as part of amendments to the Liability Risk Retention Act. NAIC staff recently noted the governance standards represent a “statement in principle.” The Property and Casualty Insurance (C) Committee will discuss the standards again at the upcoming NAIC Spring meeting. We continue to counsel that clients “wait and see” before implementing the standards in their organizational documents in order to assure that the drafting of Bylaw changes, policies, committee charters and other documents does not have to occur twice.

The Risk Retention Group Task Force appears close to rolling out credit for reinsurance guidelines structured as a model regulation. The most recent issue has been whether offshore reinsurers would be required to submit to the jurisdiction of U.S. courts in order for ceding RRGs to receive statement credit. Several Task Force members noted the possibility of resulting significant negative tax consequences to some offshore reinsurers. Compromise appears to have been reached whereby individual states could waive the submission requirement so long as an RRG was not functioning as a front for an offshore captive and so long as the waiver is noted in annual statements or business plans filed with non-domiciliary states. The Task Force will produce a final draft for consideration

at the NAIC Spring meeting, then return to its broader review of whether other Part A accreditation standards should apply to RRGs and, eventually, whether Part B standards should apply. The Task Force’s work in this area might include consideration of governance standards if they have not already been implemented.

CONGRESS EXTENDS TRIA

The Terrorism Risk Insurance Program Reauthorization Act of 2007 (“TRIPRA”) was signed into law and became effective on December 26, 2007.

TRIPRA makes four significant amendments to the Terrorism Risk Insurance Act of 2002 (“TRIA”) that will impact covered insurers, including most direct writing captives other than those covering professional liability. First, TRIPRA continues the Terrorism Risk Insurance Program created under TRIA for an additional seven years (through December 31, 2014). Second, TRIPRA expands the definition of “act of terrorism” such that insurers must now offer coverage for losses caused by domestic acts of terrorism, as well as foreign terrorist acts. Third, insurers must provide disclosure of the annual \$100 billion cap on aggregate insured losses under the Terrorism Risk Insurance Program. Lastly, TRIPRA eliminates the 3% cap on terrorism loss risk-spreading premiums for mandatory recoupments.

Treasury guidance published after the enactment of TRIPRA focused on compliance with TRIA’s disclosure requirements. Specifically, initial offers of coverage, or offers of renewal of existing policies, made on or after December 26, 2007, must be consistent with the revised definition of “act of terrorism.” Further,

insurers must continue to provide required disclosures on a separate line item in the policy at the time of offer, purchase and renewal of the policy, including disclosure of the existence of the \$100 billion cap for insured losses under TRIA. Treasury expects that insurers will make compliant disclosures no later than March 31, 2008. No new offer or disclosure is required for pre-TRIPRA policies written in 2007 that have policy terms expiring in 2008.

The following key provisions of TRIA were not changed by TRIPRA:

- Covered lines of insurance;
- Insurers covered by TRIA;
- Mandatory availability requirements;
- \$100 million program trigger;
- 20% insurer deductible for remaining program years;
- 85% federal share of insured losses exceeding insurer deductible for remaining program years;
- \$100 billion annual cap on aggregate insured losses; and
- \$27.5 billion industry aggregate retention for mandatory recoupment of federal payments of insured losses within that layer.

Congress clarified and modified other provisions of TRIA related to liability for insured losses under TRIA and mandatory recoupments. For example, section 103 was amended to clarify that an insurer's aggregate liability for insured losses under TRIA is capped at the amount of its insurer deductible plus its share of any

insured losses. TRIA's mandatory recoupment provisions were also amended to require the collection of terrorism risk-spreading premiums equal to 133% of any mandatory recoupment amount related to a program year. The Secretary of the Treasury's discretion to delay a mandatory recoupment was eliminated. Instead, Congress established specific time frames by which the Secretary must collect mandatory recoupment amounts. The Secretary of the Treasury must issue regulations by June 2008 describing the procedures to be used for collecting mandatory recoupment amounts.

Additionally, TRIPRA requires ongoing reports to Congress on the allocation of pro rata payments for insured losses exceeding \$100 billion; the availability and affordability of insurance coverage for losses under TRIA involving nuclear, biological, chemical or radiological materials; and any unique capacity constraints on the availability of terrorism insurance within U.S. markets.

Please contact us if you have questions regarding compliance with TRIPRA.



NEWS FROM THE VERMONT STATE HOUSE: LEGISLATURE HALF-WAY TO ADJOURNMENT

Although the Vermont Legislature is typically unable to affect the actions of Congress or the federal government, it occasionally expresses its will in the form of a resolution to the Vermont Congressional delegation. This recently occurred in connection with proposed regulations from the Internal Revenue Service that would have adversely affected Vermont's captive industry. (See

article above.) Legislators quickly mobilized in response to the IRS effort and developed Joint House Resolution 46. Led by Rep. Rick Hube (R-Londonderry) and Rep. Kathie Keenan (D-St. Albans), nearly all of the 150 members of the House of Representatives co-sponsored the resolution advocating withdrawal of the proposed regulations. The resolution received unanimous support both in committee and in the full House. Just as the Senate was poised to act in similar fashion, the IRS withdrew the proposed regulations.

On another front, the captive industry is closely watching the progress of Senate Bill 284 as it makes its way through the legislative process. This bill was taken up in the early days of the session by the Senate Finance Committee and passed by the Senate. The omnibus bill contains several technical amendments to the laws overseen by the Vermont Department of Banking, Insurance, Securities and Health Care Administration. The bill would expand the scope of financial institutions permitted to issue the minimum capital and surplus required by law for captive insurance companies. Other provisions would streamline the process for merging, consolidating or converting a captive corporate entity to a limited liability company, and revise the requirements for an attorney's bond for reciprocal insurers. The bill would further secure Vermont's position as the leading on-shore domicile for captive insurance companies.

MONTANA DOMICILED RRG GETS PRELIMINARY INJUNCTION AGAINST NON-CHARTERING STATE

Montana-based Auto Dealers Risk Retention Group ("ADRRG") is suing California's Insurance Commissioner after

the California Department of Insurance ordered ADRRG to cancel its existing policies and discontinue all business in the state. The cease-and-desist order, issued in December 2007, prompted ADRRG to seek a permanent injunction against the Department, which is pending a merits hearing in federal district court in California.

The central issue in the case concerns whether the medical stop-loss insurance coverage ADRRG provides its 13 members falls within the definition of "liability" as the term is defined under the Liability Risk Retention Act, 15 U.S.C. §§ 3901-3906 ("LRRR"). Thirteen California automobile dealers formed ADRRG to provide excess coverage for their independently-funded employee health benefits plan. ADRRG obtained licensure from the State of Montana in April 2007 and, thereafter, began writing coverage in California where all of its members reside.

The California Department of Insurance maintains that ADRRG does not qualify as a "risk retention group" within the meaning of the LRRR because the "contractual liability" ADRRG is issuing is not the type of insurance contemplated by the federal law.

The captive industry has taken strong issue with California's attempt to limit ADRRG's coverage options. If successful, California's position would have serious negative impacts on the ability of RRGs to issue legitimate liability coverage authorized by Congress. An amicus brief filed by the National Risk Retention Association ("NRRR") contends that California, as the non-chartering state, is overstepping its authority, as its efforts to reject the RRG's registration in this manner are preempted by the LRRR. In

its brief, the NRRA further argues that the legislative history of the LRRRA clearly contemplates the type of liability coverage ADRRG seeks to provide.

On March 7, 2008, the court granted ADRRG's request for a preliminary injunction, noting that "the structure and purpose of the LRRRA seemingly do not allow such 'second-guessing' by a non-chartering state." The preliminary injunction is significant insofar as it is an acknowledgement by the court that, given

the likelihood of ADRRG's success on the merits, fairness dictates allowing the RRG to stay in business as the parties seek resolution of the underlying 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.