

# P & P CAPTIVE NEWSLETTER

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*This issue is being released later than we had hoped. We initially delayed publication in order to report on Vermont election results. During the delay, Congress passed the Terrorism Bill, the SEC released draft regulations under Sarbanes-Oxley, and the IRS announced it would challenge certain reinsurance captives. The backdrop for each of these important developments is the busiest captive year in Vermont's history. We hope you find something of interest below, and apologize for the delay.*



## **NEWS FROM THE VERMONT STATE HOUSE: 2002 ELECTION RESULTS**

The 2002 Vermont elections will be remembered as having defied many predictions and traditional logic. Past voting trends offered no indication of the surprising results, and independent polls conducted up to the eve of the election were in many cases contradicted by the final outcome. Many towns or regions that traditionally voted Republican or Democratic were a mixed bag this

November. For instance, some towns which traditionally voted Democratic continued to do so at the local level but voted Republican at the top of the ticket, while other towns which traditionally voted Republican at the local level rejected Republican incumbents.

Vermont will have a Republican Governor for the first time in over 10 years, a Republican Lieutenant Governor, a Democratic-controlled Senate that increased its majority by a significant margin, and a House whose control is now up for grabs and will not be determined until January. Captive insurance interests are anticipated to be warmly received by the new Administration and General Assembly, as both parties and their leaders have consistently praised this industry and the positive impact it has in Vermont.

In the Governor's race, Jim Douglas (R) emerged with 45% of the vote, Doug Racine gathered 42%, and Con Hogan (I) came in a distant third with 10%. Independent polls conducted in the final

week before the election showed Racine with a 6 to 10 percentage point lead over Douglas. However, they also showed a large number of undecided voters (up to 10%). In the end, it appears the undecided voters went with Douglas and his late theme of "Time for a Change," emphasizing the need for new ideas and people to address the issues facing Vermont. Third party candidate Hogan (I) may also have taken some votes from Racine, a departure from conventional wisdom as Hogan originally started his campaign as a Republican. The race, however, still requires a vote by the newly-seated Legislature since no candidate reached the 50% threshold required by Vermont's constitution. Nevertheless, in his concession speech Racine urged the new Legislature to vote for Douglas as the top vote-getter, which should make the voting in early January a mere formality.

With the Douglas administration, expect swift and comprehensive changes in agency and department commissioners, deputy commissioners and other appointed positions. A transition team has been appointed to undertake that process and to formulate a new budget for the Legislature to consider. In a move welcomed by the captive industry, Mike Smith of Yankee Captive Management has been named Secretary of Administration. From this senior position Mike will oversee key areas of state government including the budgeting process.

In the Lieutenant Governor's race, Brian Dubie (R) emerged in the lead, gathering 41% of the vote over Peter Shumlin (D) and Anthony Pollina (P), who received 32% and 25%, respectively. Independent pre-election polls showed a virtual three-way tie

in the Lieutenant Governor's race, but again with a fairly large bloc of undecided voters. In the end, Shumlin and Pollina achieved their forecasted results but Dubie vaulted to the top. This race featured a strong third-party candidate in Pollina. He and Shumlin vied for votes from the same base which allowed Dubie, in part, to emerge with the plurality. Because Dubie did not receive 50% of the vote, this race will also be sent to the Legislature in January as required by Vermont's constitution. Both Shumlin and Pollina have conceded and urged the Legislature to vote for Dubie.

Control of the Vermont Senate was apparently up for grabs in this election. Democrats held a slim 16-14 advantage, and several incumbents did not seek reelection. The number of open seats and closely contested races presented an opportunity for Republicans to emerge with the majority. Voters, however, not only returned all Democratic incumbents seeking reelection, but selected Democrats for most of the open seats and also defeated two Republican incumbents. Democrats now hold 19 of the 30 seats.

The Senate must elect a new President Pro Tempore for the upcoming biennium. This office is extremely powerful and controls the Senate's legislative agenda. The Pro Tem typically comes from the majority party and Sen. Richard Sears (D-Bennington), Sen. Peter Welch (D-Windsor) and Sen. Dick Mazza (D-Grand Isle) have all indicated they may seek the office. Expect this decision to be made behind closed doors in the coming weeks.

In a surprising development, leadership of the Vermont House is now up for grabs.

Going into the election, most observers expected the Republicans to maintain their sizeable majority from the last session (82-63-5-1) – the only question was by how much. However, the Republican majority now stands at 74-69-4-3. The 7 combined Progressives and Independents will now have a larger voice. There appeared to be little room for movement as there were few open or contested seats. The small number of contested races, however, allowed the political parties to focus their efforts. In all, 14 Republican and 3 Democratic incumbents lost their seats, and both parties won open seats. Overall, Democrats gained 7 seats and the Republicans lost 9.

Current Speaker Walter Freed (R-Dorset) and Minority Leader John Tracy (D-Burlington) have both announced their intentions to run for the Speaker's office, and additional candidates are possible. Look for the Progressives and Independents to be courted individually or as a bloc to join one party in the majority. The Speaker is enormously powerful in Vermont politics, with the power to make committee assignments and appoint the chairs and vice-chairs of committees.

The captive insurance industry and Vermont regulators are in the midst of preparing their legislative agendas for the coming session. We will report on this and other developments in future issues.

### **CONGRESS PASSES TERRORISM INSURANCE BILL**

The U.S. Congress adopted legislation during its recent lame duck session to establish a federal program of shared public and private compensation for losses

resulting from acts of terrorism. Now signed by the President, this enactment may offer captive insurance companies the opportunity to "opt-in" to the federal program, but not without first taking some affirmative actions.

Following the terrorist attacks of September 11, insurers faced losses reported to exceed \$40 billion, contributing significantly to financial market uncertainties. Reinsurers increased their premiums to cover increased exposure or excluded terrorism coverage from policies. Commercial insurers likewise sought exclusions for losses resulting from terrorist acts. While some insurers have recently reentered the marketplace, they offer limited insurance at high prices. As a result, Congress became convinced of the need to protect consumers and create a transitional period for the private insurance markets to stabilize.

The three-year program, to be administered by the Secretary of the Treasury, creates a federal backstop which is triggered if another terrorist event occurs. The federal government will pay 90% of an insured's losses in excess of the insurer's deductible, while the insurer pays 10%. Insurers may reinsure their deductible and 10% co-shares. The federal government will not cover any claims less than \$5 million, and payments are capped at \$90 billion the first year, \$87.5 billion the second year and \$85 billion in the final year of the program. Each insurer is required to pay out its deductible before the federal assistance becomes available. The insurer's deductible is based on a percentage of direct earned premiums from the previous calendar year and will be 1% for the remainder of 2002, 7% in 2003, 10% in 2004, and 15% in 2005.

The legislation provides for marketplace aggregate retentions of \$10 billion in the first year, \$12.5 billion in the second year, and \$15 billion in the final year. Any federal assistance within these retentions and the 10% insurer co-share must be recovered. The Secretary has discretion to determine if recovery is required for additional assistance. Mandatory recovery will be through surcharges paid by all commercial property and casualty policyholders, capped at 3% of the premium for the policy each year. The program requires mandatory participation by covered insurers, and any terrorism exclusions now in place are void.

With respect to captives, the Secretary may, in consultation with either the National Association of Insurance Commissioners or appropriate state regulatory authorities, apply the program to “classes or types of captive insurers.” Any opt-in to the program must occur before a terrorist event. The Act also requires that the provisions of the program will apply “comparably” to entities opting-in as it does to insurers required to participate. What is unclear is whether the Secretary will consider captives on a case-by-case basis, as a class or type, or as whole. Earlier versions of this section in the legislation required the provisions of the program to be applied “uniformly.” The change in the adopted version perhaps implies more flexibility and may grant the Secretary discretion in this regard.

Whether risk retention groups are insurers required to participate in the federal program or captives able to opt-in remains unclear, causing concern among groups currently excluding terrorism coverage and not wanting to take part in the program.

The ambiguity stems from “captive insurer” being an undefined term in the legislation.

Regulations further defining the administration and implementation of the program, which may include provisions regarding the treatment of self-insured entities, will be forthcoming from the Department of Treasury. We hope this will afford an opportunity to clarify that RRGs are captives for purposes of the Act and to implement a simple opt-in mechanism permitting individual decisions. We will continue to follow this evolving matter and report on developments in future issues.

## **A RECORD YEAR FOR VERMONT CAPTIVES**

With a month remaining until the final bell, 2002 is already a record year for Vermont captives. 57 new captive licenses have been issued since January 1<sup>st</sup>, compared to 38 in all 2001 – a 50% increase. This brings to 584 the total number of Vermont captives licensed since 1981 – an average of 26 per year. By year’s end, it is likely that close to 70 Vermont captives will have formed in 2002.

Increased market pressures, primarily those spawned in the wake of September 11, have spurred more and more companies to look to Vermont for alternative solutions to their risk management needs. While pure captives remain the most popular form of captive, a growing number of companies are utilizing risk retention groups and reciprocal risk retention groups to manage their risks. Recently, this trend has been especially noticeable in the arena of medical professional liability coverage.

The net result: Vermont's unique legislative and regulatory climate has once again ensured its preeminence among on-shore captive domiciles, and we foresee no diminution of Vermont's well-deserved position given current market conditions.

### **SARBANES-OXLEY: INCREASED OVERSIGHT OF CAPTIVE OPERATIONS?**

In a dramatic response to the plethora of recent corporate scandals, Congress has enacted and the President has signed the Sarbanes-Oxley Act of 2002 (P.L. 107-204). The Act seeks to improve the accuracy and dependability of public company financial information by regulating auditors and the auditing process, and by increasing corporate board and officer responsibility. The Act also expands the penalties for some "white collar" crimes and grants the SEC additional powers and resources in some areas. Although the Act does not directly apply to captive insurance companies since they are not "issuers" as defined in the Act, captive owners, officers, and directors should view it as a signal of increasing scrutiny of subsidiary activities, governance, and financial reporting.

Of particular concern to captives, one portion of the Act forbids contemporaneous performance of audit and non-audit services by the same outside entity without approval of the client's audit committee. In the past, captives commonly contracted for audit, actuarial, and consulting services simultaneously from the same firm. Many of our captive clients are now separating these services, though not required to do so. Several have made the change in response to parent company policies revised in response to the Act.

Another portion of the Act requires CEOs and CFOs to certify the "appropriateness" of financial statements accompanying an audit report, causing senior executives to pay greater attention to subsidiary activities, including those of their captive insurance companies.

We will examine recently proposed SEC regulations implementing the Act to estimate its impact on our clients. Let us know if we can help you sort out the Act's potential impacts on your program.

### **IRS TO CHALLENGE "PORC" ARRANGEMENTS**

In a recent publication, the Internal Revenue Service has announced its intention to begin challenging the tax status of certain Producer Owned Reinsurance Company (or "PORC") arrangements on the basis that they result in an impermissible sheltering of income. PORCs are a form of captive typically owned by the producer of the reinsured policies.

According to IRS Notice 2002-70, the typical PORC structure involves a taxpayer selling insurance incidental to sale of another product, and receives from the insurer a portion of premium as a commission. The insurer with whom the insurance is placed then reinsures taxpayer-originated policies with the taxpayer's wholly-owned (often foreign) insurance subsidiary, minus a fronting fee. The taxpayer's captive often elects to be taxed under § 501 (c) (15) or § 831 (b). Section 501 (c) (15) exempts non-life insurance companies from tax for years during which the insurer collects less than \$350,000 in premiums, and § 831 (b) allows non-life insurance companies with

net premiums between \$350,000 and \$1,200,000 to elect to be taxed solely on investment income. With either election, the taxpayer's reinsurance subsidiary pays little tax. The IRS believes many PORC structures are now used to divert taxable income from the taxpayer to the reinsurance subsidiary. It intends to challenge these transactions on three grounds.

First, the IRS might argue that the wholly-owned reinsurer is not an insurance company for tax purposes. To maintain the status, a company's primary and predominant business activity must be insurance or reinsurance. Factors the IRS will consider in determining whether a PORC meets this requirement are the size and activities of company staff, whether the company engages in other trades or business, the company's sources of income, and any other relevant facts.

Second, the IRS may reallocate income pursuant to § 482 or § 845 from the PORC to the taxpayer. Section 482 allows reallocation of income among controlled companies if the relationship between the companies is less than "arm's length." Section 845 allows reallocation of income between related parties to a reinsurance agreement.

Finally, the IRS has announced that it might refuse to recognize the insurance and reinsurance relationships of the parties and thereby force the taxpayer to recognize as income a portion of premiums paid to the insurer. This will occur if the insurance relationship between the parties is a "sham in substance," determinable by examining the economic substance of the transaction apart from tax consequences and the

underlying business purpose of the transaction.

The IRS now treats PORC arrangements as "listed transactions," subjecting them to the tax shelter registration requirements of § 6111. Failure to register could result in fines, even if a PORC arrangement is not otherwise scrutinized. Tax consultants are in the process of determining the practical effects of this ruling, as well as which captives might be affected, and we will keep you advised as we learn more. If you would like a copy of IRS Notice 2002-70 in the meantime, please let us know.

## **FURTHER DEVELOPMENTS IN RESPA CLASS ACTION SUITS**

We have reported previously on challenges under the federal Real Estate Settlement and Procedures Act ("RESPA") to certain business practices involving mortgage guaranty insurers, including the reinsurance of mortgage guaranty policies by lender-owned captives. Like many, we have been frustrated that these actions have proceeded even though plaintiffs have been unable to demonstrate any actual damages. After all, the rates paid for mortgage guaranty insurance do not increase by even a penny as a result of these reinsurance arrangements.

We were therefore pleased by a recent ruling by a federal judge in the United States District Court for the Eastern District of Texas, dismissing a RESPA action in that state due to the lack of standing of the plaintiffs, who could not demonstrate damages. We had hoped that the case – together with the filed-rate doctrine, the industry's widespread adoption of the Freddie Mac guidelines, and the

proliferation of actuarial opinions supporting captive reinsurance arrangements – would give our MI captive clients considerable comfort under RESPA. However, not long after the issuance of the Texas ruling, the Georgia court which has been overseeing several related class action matters denied a motion by Triad Guaranty Insurance Corporation. There, the court rejected Triad’s argument that the plaintiffs lacked standing for failure to demonstrate damages, taking a fundamentally different view of plaintiffs’ rights under the federal statute.

In the Texas case – Fred M. Moore, et al. v. Radian Group, Inc., et al. – the court flatly rejected plaintiffs’ contention that they need not demonstrate actual damages. The court emphasized that the reinsurance of mortgage guaranty policies by lender-owned captives had no impact on rates paid by borrowers. Because the plaintiffs could not show damages, the court held that the plaintiffs lacked standing under Article III of the Constitution. The court ruled that RESPA does not confer standing to civil litigants based solely upon alleged illegal kick-backs. It pointed out that the plaintiffs had not made any allegations that they had either paid too much for coverage, or had purchased coverage of lesser quality than they would have obtained without the alleged violation. The court distinguished Havens Realty Corp. v. Coleman, 455 U.S. 363 (1982), emphasizing that case’s dependence upon a specific right conferred to private plaintiffs by Congress under a different act. It found no similar provision in RESPA, and instead concluded that violations not involving damages to consumers are for HUD, not private plaintiffs, to enforce. The court therefore dismissed the case for lack of standing,

without which the court lacked jurisdiction.

In the Georgia case, Janet G. Patton, et al. v. Triad Guaranty Insurance Corporation, the judge denied Triad’s motion to dismiss, concluding that RESPA plaintiffs have standing to sue based upon an alleged RESPA kick-back violation. It concluded that the correct measure of damages in such cases should be based upon the entire amount paid for the settlement service in question, and not limited to an overcharge resulting from the alleged illegal activity. In so holding, the court specifically rejected Triad’s reliance on the filed-rate doctrine, stating that statutory damages available to plaintiffs constitute a “bounty” to litigants who come forward demonstrating that their rights have been violated.

If you would like a copy of either case – Fred M. Moore, et al. v. Radian Group, Inc., et al., No. 2:01CV23, United States District Court for the Eastern District of Texas, Marshall Division (September 10, 2002) or Janet G. Patton, et al. v. Triad Guaranty Insurance Corporation, No. CV100-132, United States District Court for the Southern District of Georgia, Augusta Division (October 10, 2002) – please let us know.

## **USA PATRIOT ACT**

Several clients have recently asked us what effect, if any, the USA PATRIOT Act (Public Law 107-56) anti-terrorism legislation (the “Act”) has on captive insurers. Most concerns surround Section 352 of the Act, which requires all “financial institutions,” a term which includes “insurers,” to develop anti-money laundering policies, designate a compliance officer to deal with money

laundering issues, put in place an ongoing employee training program, and establish independent audits to test programs once in place. The Act leaves the Treasury the option of exempting certain institutions not previously subject to such requirements.

Fortunately, most captives are – at least for now – exempt from these requirements. Proposed rules applying this section of the Act to insurance companies were issued by the Department of the Treasury in September (67 FR 60625 (Sept. 26, 2002)). The proposed rules limit the scope of “insurance company,” to which the rule would apply, to:

*“any person engaged within the United States as a business in: (A) The issuing, underwriting, or reinsuring of a life insurance policy; (B) The issuing, granting, purchasing, or disposing of any annuity contract; or (C) The issuing, underwriting, or reinsuring of any insurance product with investment features similar to those of a life insurance policy or an annuity contract, or which can be used to store value and transfer that value to another person.”*

Since Vermont captive insurers do not generally issue or reinsure life insurance or annuities, they will not have to develop the anti-money laundering measures required by the Act if the proposed rule is adopted. The interim rule currently exempting all insurance companies from the Act extends through April. We will keep you posted.

### **PRIMMER & PIPER EXPANDS**

Primmer & Piper is pleased to announce its recent expansion. On November 11<sup>th</sup> the firm opened its newest office at 150 South Champlain Street, 4<sup>th</sup> Floor, in Burlington,

Vermont. To celebrate this event, we cordially invite you to an open house at our Burlington office, including a tour of our suite and refreshments, on Wednesday, December 11, 2002 from 4:00 to 7:00 p.m.

Primmer & Piper is also pleased to announce the addition of Randall (“Randy”) Wachsmann and Jonathan Wolff to the firm. Randy, a recent graduate of Northeastern University School of Law, has joined the firm’s litigation and captive insurance teams as an Associate. Prior to law school, Randy was a Senior Claims Representative with State Farm Insurance in metropolitan Philadelphia. Jonathan has joined our Government Relations team as a Government Relations Specialist. He will no doubt become another fixture at the State House as he pursues the interests of our clients. Jonathan has returned to his native Vermont following employment in Washington, D.C. as a government relations coordinator for a health care entity and, most recently, in Chicago as a senior marketing analyst for Arthur Andersen.

### **E-MAIL OPTION**

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