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Captive Insurance Legislative Update

April 25, 2011

Paul Frank + Collins, the Vermont Captive Insurance Association ("VCIA") and the Vermont Department of Banking, Insurance, Securities and Health Care Administration continue to work to maintain Vermont as the premier onshore captive domicile. The Paul Frank + Collins Captive Insurance Team of Alan D. Port, Stephanie J. Mapes, William D. Riley, Christopher J. Leff, Peter J. McDougall and Benjamin L. Gould offer this summary of legal and legislative issues to keep you apprised of the most pertinent industry developments and initiatives from Vermont and nationally.

CHANGES IN LEADERSHIP AT VERMONT DEPARTMENT OF BANKING, INSURANCE, SECURITIES AND HEALTH CARE ADMINISTRATION

Vermont Governor Peter Shumlin assumed office on January 6, 2011 following his electoral victory over Republican Brian Dubie on November 2, 2010. Governor Shumlin, who is a Democrat, takes over for Republican Jim Douglas, who chose not to seek reelection after serving four consecutive terms in office. Governor Shumlin recently expressed his strong support of the captive insurance industry during remarks delivered to the Vermont Captive Insurance Association ("VCIA") at the Association's Legislative Day event held on January 19, 2011.

With respect to insurance issues, it is expected that Governor Shumlin will focus his attention on reforming Vermont's health insurance system. Toward that end, Governor Shumlin announced on December 13, 2010 that he would appoint Steve Kimbell to serve as the Commissioner of the Vermont Department of Banking, Insurance, Securities and Health Care Administration ("BISHCA"). Commissioner Kimbell, who has extensive experience as a lawyer and lobbyist in Montpelier, confirmed during remarks to the VCIA Board of Directors at Legislative Day that he would be spending the majority of his time on health insurance matters. Despite making several significant personnel changes among BISHCA staff, Commissioner Kimbell emphasized his strong support of the Captive Insurance Division and noted that the existing leadership team of the Division would remain in place. Accordingly, David Provost remains as the Deputy Commissioner for Captive Insurance, Sandy Bigglestone continues as Director of Captive Insurance and Dan Petterson stays on as the Director of Financial Examinations. We fully expect the Captive Division to continue as the preeminent captive regulatory body during the term of the new administration.

VERMONT LEGISLATIVE DEVELOPMENTS

The changes to the captive insurance legislation this year appear in House Bill 438, the omnibus bill of the Vermont Department of Banking, Insurance, Securities and Health Care Administration.

The bill will revise the law in three areas – premium taxation, sponsored (protected cell) captive insurers, and risk retention groups. The risk retention group provisions will be discussed later in this memorandum in the section focused on risk retention groups.

The changes with respect to premium taxation are as follows:

- Clarifications will be made regarding the application of the minimum annual premium tax ($7,500) and the maximum annual premium tax ($200,000) to sponsored captive insurers:
  - The minimum premium tax applies to a sponsored captive insurance company as a whole and not to each cell separately.
  - The maximum premium tax applies to each cell of a sponsored captive insurance company separately and not to the sponsored captive insurance company as a whole.
- Two or more captive insurance companies under common ownership and control are considered a single captive insurance company for the application of the premium tax. The statute will specify the following limitations:
  - Captives, other than special purpose financial captives, may be combined with each other.
  - Special purpose financial captives may be combined with each other.
  - Special purpose financial captives may not be combined with captives that are not special purpose financial captives.
- Vermont captive insurers are exempt from all other Vermont taxes except real and personal property taxes. The exception will be broadened to include meals and rooms tax and sales and use tax. That is, the change will make it clear that captives are not exempt from meals and rooms tax or from sales and use tax.
- For much of 2009 and all of 2010, newly formed Vermont captive insurers benefitted from a first-year $7,500 credit against premium taxes. The first-year tax credit will be made permanent for captives formed on and after January 1, 2011.

The law regarding sponsored (protected cell) captive insurers will be broadened to allow separately incorporated (or separate LLCs) as protected cells. Vermont's regulators believe that the protections afforded to each protected cell prior to this change are more than adequate. However, incorporated protected cells have been authorized in other domiciles where they are marketed as more secure than unincorporated protected cells. Vermont will now be able to compete for sponsored captive insurer business where the sponsor feels that incorporated (or LLC) protected cells are important. Specifics of the change include:

- The legislature will state its intent that the addition of incorporated protected cells to the legislation should not be construed to limit any rights or protections applicable to unincorporated protected cells. I.e., unincorporated protected cells will still provide segregated risk protection.
- The organization documents for the incorporated protected cells must refer to the sponsored captive of which it is a part, and the Department's approval of the cell must accompany the filing of the cell's organization documents.

In addition, the new law relaxes the current requirement that business written with respect to each cell be fronted by a licensed insurance company, reinsured by an approved reinsurer or secured by a trust or letter of credit. The Commissioner will be granted authority to impose such requirements where appropriate, but the imposition of the requirements will be discretionary.

Finally, the law currently limits the sponsor of a sponsored (protected cell) captive insurer to insurance companies, certain types of financial institutions or "any other person[s]" approved by the Commissioner. A proposed change will streamline the definition of sponsor by removing the specific references to insurance companies and financial institutions and retaining the broad "any person approved by the Commissioner" catch-all language. The new law, however, mandates that the Commissioner consider several factors when deciding whether to approve an entity's request to serve as a sponsor of a sponsored captive insurer. Specifically, the Commissioner is directed to consider the type and structure of the entity, its financial sophistication and strength, its business reputation and any other relevant factors.

If enacted, the above changes would take effect on July 1, 2011.

DODD-FRANK ACT INSURANCE PROVISIONS

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "DFA"). This much debated and politically polarizing legislation is over 2,300 pages long and, according to the United States Chamber of Commerce, requires agencies to create more than 500 rules, conduct 81 studies and submit 93 reports in the coming years. Although much of the impact of the Act will only be apparent when the rulemaking process is complete, there are certain provisions of the Act which are of particular interest to captive insurance companies.

The DFA establishes a Federal Insurance Office ("FIO") within the Treasury Department. In March of 2011, Treasury Secretary Timothy Geithner named Michael McRaith, director of the Illinois Department of Insurance, to head the FIO. The FIO will be responsible for monitoring the insurance industry and reporting back to Congress concerning how the regulation of insurance could be improved. The FIO is also required to assist the Treasury Secretary in the administration of the Terrorism Risk Insurance Program. Additionally, the FIO can collect data from Federal and state regulatory agencies to permit the FIO to analyze the insurance industry and provide reports to Congress. The FIO can also require insurers to submit certain reports and the FIO Director has the ability to issue subpoenas to obtain such information. There is an exception from these reporting requirements for small insurers or affiliates of small insurers that meet a minimum size threshold to be established by the FIO. Although the minimum size threshold has not yet been established, it is likely that some captives may fall below this threshold.

Also included as part of the DFA is the "Nonadmitted and Reinsurance Reform Act of 2010." The portion of this subtitle concerning nonadmitted insurance specifically provides that "[n]o State other than the home state of the insured may require any premium tax payment for nonadmitted insurance." This is of particular importance to insureds that purchase surplus lines and/or independently procured insurance for risks spread across multiple states. Under the DFA, only the insured's home state may collect a premium tax on such risk. A "Home State" is defined in the DFA as the state in which an insured maintains its principal place of business or, if 100% of the insured risk is located out of the state where the insured maintains its principal place of business, the state to which the greatest

percentage of the insured's taxable premium for that insurance contract is allocated. This provision is currently scheduled to take effect on July 21, 2011.

The DFA also provides that states may enter into an agreement or compact to establish a manner of collection and allocation of premium taxes paid on nonadmitted insurance. There are currently two competing proposals for an interstate agreement or compact. The National Association of Insurance Commissioners ("NAIC"), which is the entity that typically takes the lead on drafting model insurance laws, has drafted proposed compact language titled the "Nonadmitted Insurance Multi-State Agreement" or NIMA. NIMA has been described as a "bare bones" approach to implementing the Nonadmitted and Reinsurance Reform Act of 2010. It has been criticized by numerous property/casualty industry groups for falling short of what certain groups claim is the spirit of the Nonadmitted and Reinsurance Reform Act of 2010 by failing to address uniformity in forms and regulation of nonadmitted insurance. Many trade groups argue that it took years to get Congress to take action on nonadmitted insurance and argue that the NAIC's proposal fails to advance that progress made in passing the Nonadmitted and Reinsurance Reform Act of 2010.

The National Conference of Insurance Legislators ("NCIL") has drafted its own proposed compact known as the Surplus Lines Insurance Multi-State Compliance Compact ("SLIMPACT"). The SLIMPACT proposal would establish a commission that would devise a means of allocating premium tax revenue and develop uniform forms and reporting requirements among the states subscribing to the compact. SLIMPACT has the support of the surplus lines industry and members of the industry are urging that states adopt SLIMPACT instead of NIMA. Two bills currently pending in the Vermont legislature propose adoption of the SLIMPACT compact. Each of those bills (House bill No. 164 and Senate bill No. 36) are currently pending in committee.

While it is unclear whether NIMA or SLIMPACT will prevail as the preferred compact, it is likely that no compact will be in place before July 21, 2011 when the home state of the insured becomes the only state that can regulate nonadmitted insurance transactions and collect premium taxes. Multiple requests have been made to Congress to extend the July 21, 2011 deadline for one year to allow the states to agree to a compact for allocation of the premium taxes among the states. Pending some movement as to which compact may be advanced by the states, there continue to be many more questions than answers as to the potential impact on captives. The VCIA continues to monitor developments concerning these competing compact proposals and evaluate whether any action is required to protect the captive industry.

In addition to the creation of the FIO and provisions concerning nonadmitted insurance, the DFA also includes provisions concerning reinsurance that may be of interest to captives. Under the DFA reinsurance provisions, if a ceding insurers' state of domicile is accredited by the NAIC or has solvency requirements substantially similar to those necessary for NAIC accreditation, and that state recognizes credit for reinsurance for the insurer's ceded risk, then no other state can deny such credit for reinsurance. Furthermore, if the state of domicile of a reinsurer is NAIC accredited or has solvency requirements substantially similar to those necessary for NAIC accreditation, the state of domicile shall be solely responsible for regulating the financial solvency of the reinsurer. Other states may, however, require the filing of copies of financial statements submitted to the state of domicile. For a Vermont domiciled captive ceding reinsurance, a determination on credit for such reinsurance rests solely with Vermont as Vermont is accredited by the NAIC. Similarly, for a Vermont domiciled captive that assumes reinsurance, Vermont is the only state responsible for regulating the financial solvency of the captive.

We will continue to monitor these matters and the potential impact on captives and will update our analysis as appropriate.

MEDICARE REPORTING REQUIREMENTS

The mandatory reporting requirements under Section 111 of the Medicare, Medicaid, and SCHIP Extension Act of 2007 ("MMSEA") continues to be an ongoing saga. Initially, the reporting obligation was scheduled to begin during the first quarter of 2010. This was later extended by the Center for Medicare and Medicaid Services ("CMS") which is part of the United States Department of Health and Human Services that is responsible for implementing the MMSEA, to that first quarter of 2011. The deadline was recently extended again to begin during the first quarter of 2012 for liability settlements which are considered total payment obligation to the claimant or "TPOC". Any settlements involving ongoing responsibilities for medicals ("ORM") must still be reported during the first quarter of 2011 if the obligation is assumed on or after January 1, 2010.

Additionally, a Direct Data Entry reporting system ("DDE") is in the process of being implemented. An entity may report under the DDE system if it has fewer than 500 claims to report each year. The DDE system permits the entity to submit individual claim reports over a secure website rather than through quarterly submissions which greatly reduces the administrative burden on these entities. However, DDE filers do not have ability to use the query system for Medicare beneficiaries. Submissions under the DDE system that are not for Medicare beneficiaries count against the 500 claim limit.

Finally, the Center for Medicare and Medicaid Services ("CMS") which is part of the United States Department of Health and Human Services that is responsible for implementing the MMSEA, has recently stated that it continues to explore a possible exemption from the MMSEA reporting requirements for professional liability lines. The proposed exemption would apply only to payments to Medicare beneficiaries where bodily injury is not included in the allegations. If approved, this exemption would be welcomed as general releases typically include language releasing "all claims." Without an exemption, these blanket releases would trigger a reporting obligation even if there is no Medicare interest at stake.

On March 14, 2011, Representative Murphy (R-PA) introduced legislation (H.R. 1063) that proposes to amend the MMSEA by creating a threshold amount below which reporting is not required, making the fine imposed for non-compliance discretionary, creating of a safe harbor for which sanctions would not be imposed for failing to report, and instituting a three year statute of limitations for enforcement of the reporting obligations. The bill, named The Strengthening Medicare and Repaying Taxpayers Act of 2011, was referred to the House Ways and Means Committee and the Committee on Energy and Commerce. Although it is not clear if this bill will advance through Congress, its introduction is a positive development for those concerned about MMSEA reporting obligations.

PROPOSED DISALLOWANCE OF DEDUCTION FOR EXCESS NON-TAXED REINSURANCE PREMIUMS PAID TO AFFILIATES

For the past several years, Representative Richard Neal (D-Massachusetts) has introduced legislation aimed at amending the Internal Revenue Code to disallow federal income tax deductions for a portion of the reinsurance premiums with respect to U.S. risks paid by an insurer subject to U.S. federal income tax directly or indirectly to a foreign corporation that is affiliated with that insurer. The "Neal Bill" as it has come to be called has not garnered much traction in Congress, but has generated considerable attention from the insurance industry amid calls that the impact would be to increase the cost and availability of insurance to consumers. In the 2011 White House budget proposal (introduced in 2010), the Obama Administration proposed a provision similar to the Neal Bill. Like the Neal Bill, no action was taken by Congress on the affiliated reinsurance provision in President Obama's 2011 budget.

The White House's 2012 budget proposal introduced on February 14, 2011, also contains a provision concerning affiliated reinsurance. However, the FY 2012 proposal has significantly more bite than the Neal Bill or the proposal contained in the administration's FY 2011 budget. By comparison and to quantify the increased impact of the FY 2012 proposal, the FY 2011 proposal was estimated by the Obama Administration to generate approximately $519 million in additional revenue over ten years. The FY 2012 proposal is reportedly estimated to generate $2.6 billion in additional revenue over ten years. One main difference is that the FY 2012 proposal would deny deductions for all excess reinsurance premiums paid to affiliates not subject to U.S. taxes. The FY 2011 proposal sought disallowance of the deduction for a portion of reinsurance premiums paid to certain affiliates with respect to U.S. risks and only to the extent those reinsurance premiums exceed a specific threshold.

At this time, it is unclear if the proposal in the White House's 2012 budget will be included in any legislation to be considered by Congress. Many insurance industry groups strongly oppose the proposal and, if such a provision is included in any legislation, it is very likely that the VCIA will voice its opposition as well.

CODIFICATION OF THE ECONOMIC SUBSTANCE DOCTRINE

Effective as of March 31, 2010, a provision of the Health Care and Education Reconciliation Act of 2010 codified the economic substance doctrine, which has long been recognized under federal income tax law. On September 13, 2010, the IRS issued Notice 2010-62 to provide some clarification regarding that statutory provision.

Under the new statute, if the economic substance doctrine is relevant to a transaction entered into after March 30, 2010, that transaction will have economic substance only if it meets both of the following criteria:

(1) The transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position; and
(2) The taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.

Potentially, the most significant change imposed by the new statute is the penalty provision. Under the new law, a penalty of either 20% or 40% of an underpayment of tax required to be shown a return applies to the extent the underpayment is attributable to a disallowance of claimed tax benefits as a result of a transaction lacking economic substance. The penalty is 20% if the taxpayer adequately discloses on a timely filed tax return the relevant facts affecting the tax treatment of the transaction. Otherwise, the penalty is 40%. The IRS so far has issued very limited guidance regarding adequate disclosure, although it has indicated that the disclosure may be made on Form 8275 or 8275-R or on Schedule UTP.

The economic substance doctrine is not new. It has always been a potential line of attack regarding the tax treatment of captive insurance arrangements. However, the economic substance test applied by courts in some jurisdictions may have been more favorable to taxpayers than the recently enacted statutory test. In addition, the new penalty regime may provide extra incentive for the IRS to challenge the economic substance of some captive insurance arrangements. It is now more important than ever to be aware of the requirement that a captive insurance arrangement must have both a meaningful effect on the participants' economic positions and at least one substantial nontax purpose as prerequisites for favorable federal income tax treatment.

EMPLOYEE BENEFITS

In March 2011, *Business Insurance* reported on a program of The Coca-Cola Company that involves reinsurance, to an affiliated captive reinsurer, of fronted annuities that support European pension benefits. The program, which requires the blessing of the pension regulators in the affected country or countries, allows the parent organization to gain more control over the investment of the assets supporting the pension benefits and allows the parent organization flexibility to avoid overfunding, which can occur in some instances. According to *Business* Insurance, The Coca-Cola Company is using its Dublin, Ireland based captive to reinsure group annuity products purchased by Coca-Cola pension plans in Europe. Although there are only two reported instances of this type of program coming to fruition, Paul Frank + Collins has been involved in the negotiation and documentation of two similar programs – one from the perspective of the captive insurer and one from the perspective of the reinsurer retroceding to the captive reinsurer. The new program follows last year's news that The Coca-Cola Company received Department of Labor approval to reinsure retiree health care benefits from a VEBA trust.

FOCUS ON RISK RETENTION GROUPS

TROUBLE IN NEVADA
-ANOTHER EXAMPLE OF NON-DOMICILIARY STATE OVER-REACHING-

The Nevada Department of Insurance (NDI) issued a cease and desist order that would require the Alliance of Non Profits for Insurance Risk Retention Group (ANI-RRG), a Vermont risk retention group which has for years written auto liability insurance for non-profit associations, to obtain a fronting arrangement with an insurance company that holds a Nevada Certificate of Authority in order to do business in the State. In an Amicus Brief, the National Risk Retention Association ("NRRA") sought an injunction against enforcement of the cease and desist order on the grounds that "Limiting the provision of statutory minimum liability coverage to 'authorized insurers' as defined by the Nevada

Insurance Code categorically excludes all RRGs from providing such coverage. The plain language of the LRRA, the case law in the Ninth Circuit Court of Appeals interpreting the LRRA, and the LRRA's legislative history support the conclusion that such discrimination against RRGs is prohibited. In addition, NRRA asserted that the NDI does not have the authority to issue the cease and desist order against ANI. Under the federal Liability Risk Retention Act "if a state is to challenge an RRG, it cannot do so by way of a state administrative order but must do so by proceeding in a state or federal court." This litigation is currently pending a decision on the parties' respective motions for summary judgment. . This is one example of the over-reaching that risk retention groups routinely experience in dealing with non-domiciliary regulators.

SECOND GAO REPORT ON RISK RETENTION GROUPS

At the formal request of the congressional representatives who sponsored HR 4802 (discussed below), the federal Government Accountability Office (the "GAO") has announced it will conduct another study of risk retention groups and issue its report in two years' time. The focus of this study is on the inconsistent regulatory treatment and persistent "over-reaching" that risk retention groups face in the states in which they are entitled to do business but are not chartered. Several industry groups have weighed in with very positive reactions to the new study, especially given the Nevada example cited above. Many are hoping that the GAO will see the need for uniform compliance with the federal Liability Risk Retention Act and that, as a result, Congress will be inclined to pass revised federal legislation such as HR 4802 which includes a federal dispute resolution process designed to address some of the long standing abuses of risk retention groups by non-domiciliary states attempting to regulate risk retention groups beyond the authority granted in the federal Liability Risk Retention Act.

EXPANSION OF THE LRRA TO INCLUDE PROPERTY INSURANCE AND CODIFICATION OF CORPORATE GOVERNANCE STANDARDS

The Risk Retention Modernization Act of 2010 (HR 4802) was introduced on March 10, 2010 by Rep. Dennis Moore (D-KS) and Rep. John Campbell (R-CA). The legislation mandates the adoption of NAIC-type corporate governance standards discussed below. It also calls for a dispute resolution process among the states and risk retention groups through the Treasury Department, designed to address some of the long standing abuses of risk retention groups by non-domiciliary states attempting to regulate risk retention groups beyond the authority granted to the states in the federal Liability Risk Retention Act. The bill also calls for a study by the Comptroller General of the United States of instances where non-domiciliary states attempt to unlawfully regulate risk retention groups through unilateral "cease and desist" orders or other means. Finally, the bill expands the ability of risk retention groups to provide commercial property as well as commercial liability insurance. This bill never emerged from the House of Representatives last year, but there are efforts underway to reintroduce the bill during 2011.

UPDATE ON NAIC REGULATION OF RRG'S THROUGH ACCREDITATION REQUIREMENTS

Through its accreditation requirements, the NAIC can require states to adopt certain model NAIC laws and standards. As a result, the NAIC has the ability, at least indirectly, to regulate traditional insurers and risk retention groups. The NAIC has spent the last several years debating which NAIC accreditation standards should apply to risk retention groups. These standards apply to the regulation of traditional insurance companies, and the debate surrounds the issue of whether these standards

should also govern risk retention group insurers or whether these insurers, given their closely held nature and other differences from traditional insurers, should be regulated with more flexibility.

A summary of the model laws which have been debated and impact risk retention groups appears below. We have reported on these laws in past communications, but we report them again to update you on the status of the debate and to alert you of the laws which may become enforceable during 2011.

I. MODEL AUDIT RULE

In June 2009, the NAIC voted to add as accreditation requirements, applicable to insurers effective January 1, 2010 and risk retention groups effective January 1, 2011, certain amendments to the NAIC Model Audit Rule ("MAR"). The amendments to the MAR were derived from the Sarbanes-Oxley Act ("SOX") and were designed to subject privately held insurance companies to SOX-like requirements. The requirements generally relate to auditor independence, corporate governance and internal control over financial reporting. The MAR provisions contain substantial exceptions for companies which write gross premiums of $300 million or less. We believe that the impact of MAR on risk retention groups will be fairly mild because all but a few risk retention groups in the country write less than $300 million in annual premiums. MAR provisions that impact all risk retention groups include mandated audit partner rotation requirements (every five years with a five year cooling off period), an expanded list of prohibited services by the auditor to ensure auditor independence (generally mirroring the SOX restrictions), and provisions precluding the auditor and insurer from agreeing to an indemnification or limitation of liability agreement with respect to the audit. Relief is available under MAR from the partner rotation and prohibited auditor service provisions in some circumstances where hardship can be shown. The MAR also requires the creation of an audit committee to oversee the independent auditor of the risk retention group, but provides for the possibility that the full board may continue with these responsibilities in lieu of forming a separate audit committee. Requirements for independent directors serving on the audit committee under the MAR only apply to risk retention groups writing $300 million or more in annual premiums.

II. RISK BASED CAPITAL

At the December 2009 meeting of the NAIC, it was agreed that home state regulators should require, effective January 1, 2011, that risk retention groups file Risk Based Capital financial solvency test ("RBC") data, but that such data be reviewed using a sensitivity tool for regulatory analysis that makes sense for evaluating risk retention groups. A sub-group of the NAIC Risk Retention Group Task Force (which included Vermont regulators) has been appointed to work on this tool and, despite the proposed January 1, 2011 effective date, continues its work into 2011. Vermont already requires Vermont domiciled risk retention groups to file a RBC data report, but it uses this data as an analytical tool. Vermont does not require risk retention groups to pass the RBC financial solvency tests and does not require affirmative action if tests are failed. The current debate seems to be around whether the NAIC will require all states to mandate RBC filings for risk retention groups and whether the NAIC will standardize how this data must be used. Currently the sub-group is recommending modifications to the NAIC risk based capital instructions to provide guidance on how to apply the RBC calculations in light of the fact that most risk retention groups report their financial statements using Generally Accepted Accounting Principles and not Statutory Accounting Principles generally used by traditional insurance companies. In addition, the sub-committee is proposing language which makes it clear that the domiciliary regulator may use reasonable discretion in deciding appropriate action to be taken in light

of RBC test results and that non-domiciliary regulators, in the states where the risk retention group does business, are not permitted to take action based upon the RBC test results.

III. INSURANCE HOLDING COMPANY SYSTEMS

An Insurance Holding Company System is defined as two or more affiliated persons, one of which is an insurance company. A person is an affiliate if it is controlled by or under common control with another, and control is presumed by ownership of 10% or more of the voting securities. The NAIC has determined that states must apply their Insurance Holding Company System laws to risk retention groups, effective January 1, 2011, in order to achieve accreditation.

The Vermont Department of Banking, Insurance, Securities and Health Care Administration sponsored bill (discussed above in the Vermont Legislative Developments section of this memo) incorporates the Vermont Insurance Holding Company System laws into the captive laws, applicable only to risk retention group captives. Most of our closely held risk retention group clients will be impacted by this change in law because the owners hold more than 10% of the voting stock or control of the risk retention group. This is ironic since the regulators are often least worried about the oversight of smaller closely held groups. We are working with the Vermont insurance regulators to draft regulations which clarify the process for disclaiming affiliation under these laws, and which define various exemptions for certain types of risk retention group captives from holding company law filing requirements that would not benefit the regulators due to the nature of the business written by the group.

IV. CREDIT FOR REINSURANCE

The Vermont Insurance Department has a history of good, flexible regulation of credit for reinsurance requirements, which must be observed before a captive insurer (including risk retention groups) may take balance sheet credit for risks ceded to reinsurance companies. As we have previously reported, the NAIC is now requiring as a condition of NAIC accreditation that states adopt certain model Credit for Reinsurance laws. With the leadership of the Vermont Insurance Department, the NAIC agreed that a risk retention group not in compliance with the Model Act may nonetheless take credit for reinsurance ceded if it meets certain guidelines set forth by the NAIC. Risk retention groups which cede reinsurance to related offshore reinsurers represent the class of risk retention groups most likely to be impacted by this change.

We reported to our clients in 2008 and in 2010 that the final NAIC guidelines would allow credit for reinsurance ceded by a captive risk retention group. Because many of these standards became effective January 1, 2011, we report them again in this memorandum.

A risk retention group may take credit for reinsurance ceded if the reinsurer:

A. Meets the Model Act guidelines; or
B. Maintains an A- or higher A.M. Best rating or other comparable rating from a nationally recognized rating agency, maintains minimum surplus acceptable to the domiciliary Commissioner and is licensed and domiciled in a jurisdiction acceptable to the Commissioner; or
C. Satisfies all of the following requirements and any others deemed necessary by the Commissioner: (1) the RRG files the audited financial statements of the reinsurer with the Commissioner annually; (2) the reinsurer maintains a ratio of net written premium, wherever

written, to surplus and capital of not more than 3:1; (3) the affiliated reinsurer* shall not write third party business without the written approval of the Commissioner; (4) the reinsurer shall not use cell arrangements without the written approval of the Commissioner; (5) the reinsurer shall be licensed and domiciled in a jurisdiction acceptable to the Commissioner; and (6) the reinsurer shall submit to the examination authority of the Commissioner. [*this is the only place where "affiliated" reinsurer is referenced]

The Commissioner may waive either, but not both, of the requirements set forth in C (2) or (6) above under certain circumstances. This waiver is considered a part of the risk retention group's plan of operations under the limited definition of such plan contained in the federal Liability Risk Retention Act and, as such, must be filed in each state where the risk retention group is registered to do business.

The Commissioner shall either require that a reinsurer not domiciled in the U.S. agree to submit to U.S. jurisdiction in the event of the reinsurer's failure to perform under the reinsurance agreement, or provide a letter of credit, trust, funds-held agreement or other acceptable collateral based upon unearned premiums, loss and LAE reserves and IBNR. The Commissioner may waive these requirements in his or her discretion under certain circumstances. Any such waiver must be disclosed in Note 1 of the risk retention group's annual statutory financial statement.

Risk retention groups may not take credit for reinsurance if all policies are ceded through 100% reinsurance arrangements, or a lower percentage required by the domiciliary commissioner. As such, risk retention groups must retain some level of risk and may not serve as a mere front.

Each risk retention group will have 60 days from the effective date of the guidelines to report whether they are in compliance with the guidelines. Failure to do so will result in an examination of the group by the Commissioner. A twelve month grace period may be granted by the domiciliary Commissioner if he or she is satisfied that the delay in compliance will not cause a hazardous financial condition or harm the member policyholders.

V. RISK FOCUSED STATE EXAMINATIONS

Similar to the new Model Audit Rules, regulators are now required to examine risk retention groups using a "risk focused approach." This is very similar to the procedures imposed under Sarbanes-Oxley, where the focus is on governance and internal controls. The Vermont examiners began applying this new approach to their state examinations of risk retention groups in late 2010.

VI. CORPORATE GOVERNANCE

The NAIC began debating corporate governance standards for risk retention groups in 2003 in response to a report issued by the federal Government Accountability Office. It completed its work in 2008 when it issued proposed Governance Standards for Risk Retention Groups. However, as of last year there was still no mechanism in place to enact these standards.

In order to enact these standards, the NAIC has recently proposed that the Model Risk Retention Act imposed on all accredited states be amended to include the governance standards. In the process of proposing this amendment to the model act, the NAIC has solicited comments on the standards. We have worked with both the VCIA and the National Risk Retention Association to submit comments and the NAIC has been receptive to our proposed changes. It is possible that these standards will

become requirements for NAIC accreditation effective during 2011. We have examined the NAIC proposed governance standards, in detail in prior years' versions of this memo, and we do not repeat them here. However, because the impending effective date, we summarize the main points below.

1. Requirement for the governing body to have a majority of "independent" directors. A director is independent if it has no "material relationship" with the risk retention group. A person who is an owner or representative of an owner of the group is independent unless some other position held by the person constitutes a "material relationship."
2. Regulation of Service Provider contracts.
3. Requirement for the board to have a written charter, code of business conduct and ethics and governance policy.
4. Requirement for an audit committee with a written charter including certain defined purposes, unless the Commissioner agrees that the full board may carry out these functions.

PAUL FRANK + COLLINS P.C. – ADDITIONAL SERVICES

Paul Frank + Collins offers a number of services ancillary to our primary captive insurance company representation, including among others:

- Claims management
- Coverage analysis
- Claims and underwriting audits
- Federal and state tax analysis and compliance with FIN 48
- Impact analysis relating to the solvency issues of parent companies/members.

If any of the foregoing services might be of interest to you, please let us know how we may be of service.