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Captive Newsletter

A Newsletter from the Captive Practice Group

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IMPLICATIONS OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

In July, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The Act, most parts of which are scheduled to go into effect on July 21, 2011, includes provisions targeting the insurance industry and intended to promote uniformity in insurance regulation – the Federal Insurance Office Act of 2010 (the "FIOA") and the Nonadmitted and Reinsurance Reform Act (the "NRRA").

The FIOA creates a new federal insurance office within the U.S. Department of the Treasury (the "Treasury Department") that will monitor the U.S. insurance industry, identify insurers that could pose a threat to financial stability, and report to Congress annually on both topics. Despite some calls for direct federal insurance regulation, the states will continue as the primary insurance regulatory authority. Nevertheless, the Act calls for a study of the costs and benefits of regulating insurance at the federal level.

The NRRA aims to create a new uniform system for surplus lines and procurement tax regulation intended to eliminate the regulatory inefficiencies of the current individual state-based system. Pursuant to the NRRA, an insured's home state will have exclusive authority to tax the insured's placements with out-of-state, nonadmitted insurers.

The NRRA requires the states to enter into an interstate compact which would determine forms and procedures for reporting, paying, and collecting premium taxes, and a method by which taxes would be shared between states where risks are located. The sharing of tax revenue will motivate states to finalize details of the regime quickly.

The NRRA also introduces uniform national standards for surplus lines eligibility by requiring insurers to conform to standards issued by the National Association of Insurance Commissioners (the "NAIC"), prohibiting states from denying surplus lines brokers the ability to do business with out-of-state, nonadmitted insurers listed by the NAIC, and preempting state due diligence requirements for certain exempt commercial purchasers (generally industrial insureds), provided the surplus lines broker has disclosed to the purchaser that such insurance may be available from an admitted insurer and the purchaser has requested direct placement in writing.

The NRRA's likely impact on captives is significant and mixed. It is a positive development for captives now issuing nonadmitted policies and paying direct procurement or surplus lines taxes, as current administration and filing costs are significant. But for captives that currently do not pay such taxes, attention by state regulators to this relatively back-corner area of insurance taxation could result in renewed interest in enforcing on captives the involved tax provisions.

PROPOSED IRS REGULATION REGARDING SERIES AND CELL CAPTIVES

In September, the U.S. Department of the Treasury (the "Treasury Department") issued a notice proposing regulations regarding the classification for federal tax purposes of a domestic series limited liability company, a cell of a domestic cell company, or a foreign series or cell that conducts an insurance business. If adopted, the proposed regulations would generally treat these entities as separate bodies for federal tax purposes, regardless of whether they are considered separate under corporate law. The regulation is intended to clarify the federal tax status of the growing number of series and cell entities. The proposed regulation, designated REG-119921-09, is available for review at www.irs.gov/irb/2010-45_IRB/ar11.html.

The determination of whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law. Although series and cell entities are not generally considered separate under state law, and the state statutes enabling such entities do not permit all of the attributes of independence that entities under state law generally possess (i.e., cannot convert into another type of entity, merge with another entity, domesticate in another jurisdiction independent of the parent organization, survive the dissolution of the parent organization), the Treasury Department has concluded the factors supporting a separate status for series and cell entities outweigh the factors for not doing so. Specifically, the Treasury Department notice states that managers and equity holders are "associated with" series and/or cell entities; their rights, duties and powers with respect to such entities are direct and specifically identified; and individual series and/or cells may have separate business purposes and investment objectives.

The Treasury Department accepted written and electronic comments and requests for public hearings regarding the proposed regulations. Although many captive insurance advocates have made such submissions, much greater interest has been demonstrated from within the financial services industry, including those using non-insurance series limited liability companies for investment purposes.

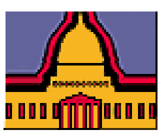
FREDDIE MAC TO REVISE "PRIVATE MORTGAGE INSURER ELIGIBILITY REQUIREMENTS"

Based on discussions with Freddie Mac representatives, we believe there are changes underway – likely to be enacted in the first quarter of 2011 – to the "Private Mortgage Insurer Eligibility Requirements" (the "Requirements"). The anticipated changes will expressly limit reinsurance activity by primary mortgage guaranty insurers to quota-share arrangements, and impose a cap of twenty-five percent (25%) of underlying premium.

Because MI companies need to certify ongoing compliance with the Requirements, any current captive arrangements involving excess-of-loss ("XOL") will either need to convert to a quota share basis or go into run-off. (We are note aware of any XOL arrangements not already in run-off.)

It is unclear whether Fannie Mae will follow suit, but as a practical matter, each of the MI companies will need to adhere to the revised Freddie Mac Requirements in order to remain in good standing with that entity.

We are also told that the revised Requirements will eliminate the current "Type I" and "Type II" distinctions. Currently, a Type I insurer is an entity that is rated by at least two financial rating agencies at AA– or higher. A Type II insurer, on the other hand, is rated by less than two agencies or rated lower than AA–. Only Type I insurers are eligible to participate in reinsurance activity. This system will be replaced by a requirement for an independent annual actuarial analysis, conducted across the industry by an independent contractor.



NEWS FROM THE VERMONT STATE HOUSE: *A SEASON OF TRANSITION*

After eight years under Republican Governor Jim Douglas, Vermonters have sent a Democrat to the Governor's office in the person of former Senate President Pro Tempore Peter Shumlin, further cementing Vermont's status as the bluest of blue states. U.S. Senator Patrick Leahy and U.S. Representative Peter Welch were each re-elected by substantial majorities. In addition, the Vermont House and Senate remain strongly controlled by Democrats.

One-party control will bring its own set of challenges. New responsibility will be placed on the Democrats in shaping legislation. In the past, divided government tended to forge compromise between the parties and produce legislative outcomes that gravitated toward the political center. That may not continue, as Republicans will be hard-pressed to alter legislation. The relationship between the Governor and his administration and the Legislature will develop over time. Senate leaders, in particular, have emphasized their independence and predicted that the Senate will not be controlled by the new Governor, despite his experience in that body.

Among the spoils of victory is the ability of the Governor to form a new cabinet and change many professionals within the administration. Governor-elect Shumlin has begun a wholesale change of most appointees, made even more pronounced because of the change in party control. This is true for the Department of Banking, Insurance, Securities and Health Care Administration ("BISHCA"), the primary regulator for captives.

Steve Kimbell, a former Kunin administration official and then long-time lobbyist, will become the next BISHCA Commissioner. It is important to note that despite dramatic personnel changes elsewhere, David Provost will remain the

Deputy Commissioner of Captive Insurance. The captive industry has taken great care over the years to work with policymakers of all political stripes in the Governor's office and the Legislature. Governor-elect Shumlin and his team recognize the importance of the captive industry to Vermont, and their efforts will continue to enhance the state as a leading captive domicile.

Discussions are underway regarding further amendments to Vermont's captive statutes. Among the areas of interest are incentives to attract new captive formations to Vermont, improvements to the sponsored captive laws (to reflect the increased maturity of that form of entity and to provide greater flexibility in their formation), as well as the possible authorization of new options for programs looking to Vermont as their choice of captive domicile. These and other possibilities are expected to evolve in the coming months.

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

RISK RETENTION GROUPS – REGULATORY UPDATE

Although there has been considerable discussion of newly proposed risk retention group ("RRG") regulatory requirements throughout 2010, both in Vermont and at the National Association of Insurance Commissioners ("NAIC"), such proposals have not yet been implemented in Vermont. The lack of final action should not suggest that all the proposals have been discarded. Rather, after their introduction, Vermont regulators engaged in numerous discussions with the Vermont Captive Insurance Association ("VCIA"), captive owners, managers and lawyers, all in an effort to "get right" whatever is ultimately done.

Application of the Holding Company Act to RRGs will be considered by the Vermont Legislature sometime in early 2011. Given Vermont's new team at the top, it is possible that previous ideas will be modified. However, with the support of David Provost, Deputy Commissioner of Captive Insurance, and Sandy Bigglestone, Director of Captive Insurance, introduction and passage of the Holding Company Act provisions in 2011 remains the likely outcome.

There has been broad concern that the Holding Company Act requirements will be onerous for Vermont-regulated RRGs. One of the most controversial aspects is the presumption of control if any one owner of an RRG has a 10% or greater ownership interest. (Many RRGs have owners with a 10% or greater ownership interest.) Unless control is disclaimed on application to BISHCA, a number of regulatory requirements would be triggered, primarily involving mandatory approval of transactions among an RRG and its affiliates. BISHCA has taken these matters seriously and is considering many suggestions to reduce the potential regulatory burden.

Other regulatory initiatives, largely those driven by the NAIC, are the application of credit for reinsurance requirements and Audit Rule Standards to RRGs. BISHCA has indicated these new standards will be implemented through amendment of existing captive Regulation 81-2. The credit for reinsurance standards will impact RRGs that utilize unaccredited reinsurance from unrated companies, especially off-shore affiliated captives. The proposed standards could be complex, depending on the size and solvency level of the specific reinsurer used by an RRG. The best advice is to evaluate the proposed standards closely (and sooner rather than later) if an unaccredited reinsurer is part of an RRG's insurance program.

In terms of the application of Audit Rule Standards to RRGs, the path of least resistance would be to name an audit committee (which can also be the RRG's entire board of directors or finance committee), then establish basic responsibilities for such committee related to the audit function. Many Vermont-domiciled RRGs have already created audit committees in anticipation of the new requirements or mimicking prevailing best practices in other corporate governance contexts.

Please contact any member of our captive team if you have questions or concerns related to the proposed RRG requirements.

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.