

# Captive Newsletter

*A Newsletter from the Captive Practice Group*

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## NEWS FROM THE VERMONT STATE HOUSE: CAPTIVE LAWS AMENDED

After a new Administration settled in, the General Assembly efficiently worked through a number of issues and adjourned May 6, a full week ahead of schedule. Barring problematic revenue decisions made in Washington, the Legislature will reconvene in January to conclude its two year session.

The timely adjournment is a reflection of the current homogenous political environment. The 2010 general election left state government firmly in Democratic hands; bucking national trends and marking the first time in over a decade Vermont has had one-party rule. This translated into realization of a wish-list of legislative issues mirroring Governor Shumlin's campaign platform. The following was accomplished with the help of the Legislature:

- A balanced budget purporting to erase a \$176 million deficit without tapping rainy day funds or raising "traditional" broad-based taxes.
- An energy bill emphasizing renewable sources of power.

- A broadband and cellular infrastructure bill that aims to make both available to all Vermonters by 2013.

- And, the signature policy initiative – a health care bill that lays the foundation for Vermont to adopt a single-payer system.

Regardless of political stripes, the Legislature responded to the captive insurance industry's request for amendments to Vermont's captive laws. All the amendments were contained within H.438. That bill was signed into law as Act 21 by the Governor on May 11, 2011. The captive insurance provisions became effective July 1, 2011. Specifically, Act 21:

- Makes permanent a first-year \$7,500 tax credit for new formations, retroactive to captives formed on January 1, 2011 and thereafter. (Doing so at a time when the State continues to need every penny of revenue demonstrates the commitment policymakers have to keeping Vermont the gold standard in captive domiciles.)
- Clarifies and restates premium tax language related to the minimum and maximum tax; calculation of the tax paid by sponsored captives, their cells, and by special purpose financial captives; and consolidation of companies for tax

purposes. (The amendments do not change the tax obligation.)

- Clarifies that captives are subject to Vermont's meals and rooms and sales and use taxes.
- Permits sponsored captives to separately incorporate each protected cell when forming the captive.
- Makes permissive and subject to the discretion of the Vermont Insurance Department the former requirement that business written by sponsored captives be fronted by an insurance company, reinsured by a reinsurer, or secured by a trust fund or funded by an irrevocable letter of credit.
- Revises the qualifications of sponsors of a sponsored captive insurance company by removing the list of approved entities set forth in statute in favor of a general standard for use by the Vermont Insurance Commissioner (the "Commissioner") when considering an application.
- Grants authority to the Commissioner to promulgate rules related to application of the model Holding Company Act to risk retention groups, but also specifically exempts RRGs from any rule applicable to traditional insurers.

The Legislature also responded to Dodd-Frank provisions related to collection of surplus lines and direct procurement taxes. Act 49 authorizes Vermont to join the compact envisioned by the National Conference of Insurance Legislators ("NCOIL") Surplus Lines Insurance Multistate Compliance Compact ("SLIMPACT"). See our article below.

## **RISK RETENTION GROUPS – REGULATORY UPDATE**

*Holding Company Act for RRGs*: National Association of Insurance Commissioners ("NAIC") Accreditation Standards for state insurance departments include an obligation to regulate the relationship between an insurance company and affiliated organizations. The NAIC model Holding Company Act ("HCA") generally requires insurers to ask for permission to enter into certain transactions with affiliates and requires filings to clarify control and other important relationships between insurers and their affiliates. The HCA creates a rebuttable presumption of control, and thus reporting, when any single party owns a 10% or greater interest in either an insurer or a holding company. This specific provision has generated a great deal of interest and concern on the part of RRGs because some RRGs – especially those sponsored by medical systems and hospitals – have one or more owners in excess of the 10% threshold.

Since 2009, the NAIC has taken the position that the Holding Company Act should apply to RRGs. However, the requirement has not applied to Vermont RRGs. 2011 legislation aimed at NAIC compliance removed the exemption for Vermont RRGs, but it avoided wholesale application of the traditional insurer regime. The Vermont Insurance Department has indicated its willingness to provide RRGs with so-called "disclaimers of affiliation" and other exemptions in appropriate circumstances. While the full scope of Vermont's approach will be announced with development of regulations in the area, Deputy Commissioner of Captive

Insurance David Provost has affirmatively stated that any “non-entrepreneurial” RRG (or RRG holding company) with individual owners holding a 10% or greater interest should request a waiver from the requirements. Vermont regulators hope to avoid increased costs of compliance for Vermont-domiciled RRGs. Given the need to promulgate and implement specific regulations, we do not expect the requirements to be effective before January 1, 2012, and will report details.

Credit for Reinsurance Standards for RRGs: On April 14, 2011, the Vermont Insurance Department released proposed revisions to Captive Insurance Financial Regulation 81-2 intended to comply with credit for reinsurance standards for RRGs that have been incorporated into the NAIC Accreditation Standards. After a comment period including our review of the standards, the Vermont Insurance Department is in the regulatory adoption process. The key revisions of this regulation are set forth in Section 9 and concern the financial treatment of reinsurance purchased by Vermont RRGs from unlicensed and unaccredited reinsurers. Exceptions exist for rated companies and for use of the Commissioner’s discretion in granting credit. We expect this will most impact RRGs with offshore affiliated captives from which they purchase reinsurance.

Governance Standards for RRGs: The NAIC’s proposed Governance Standards have not yet been adopted by any state. At its March 2011 meeting, the NAIC Risk Retention Working Group agreed that the Governance Standards should be incorporated into the Model RRG Act. It is reasonable to assume that the Model RRG Act will be amended and that these

governance standards will then be adopted by Vermont and other RRG domiciles. This may change if federal legislation for RRGs includes similar standards. See our article below.

Risk Focused Exams for RRGs: State insurance departments, including the Vermont Insurance Department, are in the process of implementing a new risk-focused examination process mirroring changes in the auditing world and best-practice corporate management techniques. The requirement to move to risk-focused exams comes from the NAIC’s Financial Condition Examiners Handbook which is included by reference in examination statutes in most states.

The NAIC RRG Task Force formed a subgroup to consider possible exemptions for RRGs from aspects of these new examination procedures. The concern was that the full-scope examination process could be too costly and inefficient given the size and special characteristics of RRGs. On March 15, 2011, the subgroup announced that it had rejected specific examination exemptions for RRGs. They concluded instead that there is sufficient flexibility in existing examination procedures to accommodate RRGs.

Several Vermont RRGs have already undergone the new-style exams. The costs have increased slightly, but overall the Vermont Insurance Department’s in-house examination staff has made the change as painless as possible, highlighting one of the great benefits of Vermont as a domicile. The new examination procedures are primarily a reordering of prior Handbook processes. New features RRGs may experience

include management interviews and high-level conversations by regulators with several directors of RRGs during exams.

## **UPDATE ON DODD-FRANK AND THE NONADMITTED AND REINSURANCE REFORM ACT**

The Nonadmitted and Reinsurance Reform Act (the "NRRA") was enacted July 21, 2010 as part of the massive Dodd-Frank Wall Street Reform and Consumer Protection Act. As previously reported, the NRRA creates a uniform system for non-admitted insurance taxation where, as of July 21, 2011, only an insured's "home state" may collect tax on surplus line and direct procurement premium.

The NRRA directed the states to enter into an interstate compact which would create nationwide requirements, forms and procedures for reporting, paying, collecting and allocating premium taxes among states. Two competing models for an interstate compact subsequently emerged: the Nonadmitted Insurance Multi-State Agreement ("NIMA") and the Surplus Lines Insurance Multistate Compliance Compact ("SLIMPACT").

Endorsed by the National Association of Insurance Commissioners, NIMA is designed to address only the tax collection and allocation aspects of the NRRA. This narrower compact model creates a central clearinghouse for reporting, collecting and distributing surplus taxes, and prescribes uniform allocation and reporting methods. The following states and territories have enacted legislation permitting their respective insurance commissioners to enter into the NIMA compact: Florida,

Mississippi, Hawaii, Connecticut, Louisiana, South Dakota, Alaska, Nebraska, Nevada, Utah, Wyoming, and Puerto Rico.

Endorsed by the National Conference of State Legislatures, the National Conference of Insurance Regulators and the Council of State Governments, SLIMPACT is the more comprehensive of the compact models with respect to satisfying the reforms provided in the NRRA. In addition to addressing the tax collection and allocation issues, it provides for the creation of a governing commission made up of the compacting states that will make decisions in connection with surplus lines regulatory policy issues, such as insurer eligibility and insured "home state" determinations. The commission will become effective for purposes of adopting rules and creating the clearinghouse when there are a total of ten (10) compacting states or, alternatively, when compacting states represent greater than 40 percent of the surplus lines insurance premium volume. Currently, the following nine states have enacted SLIMPACT: Alabama, Indiana, Kansas, Kentucky, Rhode Island, Tennessee, Vermont, New Mexico, and North Dakota.

At present, no allocation of premium taxes is occurring between states as neither compact model is yet in force. Once this begins, and as we earlier reported, there may be an increased risk that states will more diligently enforce direct procurement provisions, impacting many captive programs which do not currently pay direct procurement tax. We will continue to follow this issue for our clients as further information develops.

## **RENEWED EFFORT TO EXPAND THE LIABILITY RISK RETENTION ACT**

On June 3, 2011, Representatives John Campbell (R) California and Peter Welch (D) Vermont introduced The Risk Retention Modernization Act of 2011 in the U.S. House of Representatives (the "Act"). The Act aims to expand and modernize the Liability Risk Retention Act of 1986 (the "LRRRA").

As proposed, the Act would provide the Director of the Federal Insurance Office ("FIO") the power to survey and evaluate the extent to which each state is in compliance with the LRRRA's prohibitions against state regulation of risk retention groups. Recently formed pursuant to Title 5 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the FIO is a new office within the U.S. Department of the Treasury.

In addition to evaluating state compliance, the Act also puts the FIO in charge of providing a mechanism for resolving disputes whereby the FIO would provide determinations of federal preemption issues upon the request of a state or RRG. The Act provides that a party to such a dispute would have the right to seek review of a FIO order in the U.S. Court of Appeals for the D.C. Circuit.

The Act proposes to incorporate new NAIC corporate governance standards (see article above), addressing such areas as the independence of RRG directors, the documentation review of service provider relationships, the general business conduct of RRGs, and their compliance with relevant statutes and regulations.

Currently, RRGs are limited to providing commercial liability coverage. The Act proposes to broaden the scope of coverage to permit RRGs to write commercial property insurance, long a goal of RRGs serving industries where such coverage presents challenges in hard markets.

The Act also aims to clarify the meaning of Section 3905(d) of the LRRRA. This provision currently states that the LRRRA shall not "be construed to preempt the authority of a state to specify acceptable means of demonstrating financial responsibility where the state has required a demonstration of financial responsibility as a condition for obtaining a license or permit to undertake specified activities." Several states interpreted this provision as a means to categorically preclude the issuance of coverage by RRGs. The bill's proposed revision would add language clarifying that states may not require that risk retention groups be licensed or admitted by the state as a demonstration of financial responsibility.

The bill has received a positive initial response and we are hopeful that the political climate may finally be right for passage of this long-sought legislation. We will keep you posted on further news regarding this bill as it develops.

## **REVIVAL OF THE CORPORATE DUTY OF OBEDIENCE**

Once a mainstay of corporate law, the duty of obedience was, until recently, largely forgotten.

Many recent high-profile cases have exposed corporations to massive liability, but corporate directors have largely

escaped liability for their breaches made on behalf of the corporation. As a result, some courts have used the principles underlying the duty of obedience as a legal rationale for holding directors personally liable for failing to affirmatively monitor and oversee the actions of their corporations.

Such failures most often occur when a board of directors is dominated by one or more directors with respect to board actions and decisions. In some cases this involves a dominant director whose decisions are merely rubber-stamped by subordinate directors who have little or no actual involvement in corporate decision making. See ATR-KIM ENG Financial Corp. v. Araneta, et al., 2006 Del. Ch. LEXIS 215 (finding directors subordinate to dominant director personally liable as a result of being “supine” to the dominant director). In other instances, directors may find themselves beholden to a dominant director and thus unable to act independently without professional risk. See In re Cooper Companies, 2000 Del. Ch. LEXIS 158, 18-19 (finding that where one director was in a position to exercise “considerable influence” over other directors these directors were beholden to the dominant director); Teachers’ Retirement System v. AIG, Inc., 2006 Del. Ch. LEXIS 121, fn 15 (considering what level of a relationship creates beholdenness between a dominant director and the rest of the board).

In today’s legal climate, individual directors – including captive board members – need beware that they risk exposing themselves to personal liability if they fail to actively and independently engage themselves in their corporate role. Directors should scrutinize their own

independence with respect to the board, especially in instances where director conflicts of interest exist or a director is in any way beholden to another director. Boards should also establish systems and safeguards to prevent board dominance and encourage directors to remain independent and actively engaged with respect to company business and board decisions. Ask us for advice if you need help doing this for your captive.

### **UPDATE ON MEDICARE, MEDICAID AND SCHIP EXTENSION ACT COMPLIANCE REQUIREMENTS**

Enacted in 1980, the Medicare Secondary Payer Act (“MSPA”) establishes recovery rights for Medicare in situations where another entity could be a primary payer. Section 111 of the Medicare, Medicaid and SCHIP Extension Act of 2007 (“MMSEA”) is the mandatory reporting requirement which helps to enforce the MSPA. The MMSEA requires certain insurers to provide information for any claim involving a Medicare beneficiary where medicals are claimed and/or released.

Under the MMSEA, any liability insurer (including self-insurers) that qualifies as a Responsible Reporting Entity (“RRE”) is required to report information to the Centers for Medicare and Medicaid Services (“CMS”) when a claim made by a claimant who is eligible for Medicare benefits is resolved by way of a settlement, judgment or other payment by the liability insurer (regardless of whether or not there is a determination or admission of liability). The RRE is generally the party that has the obligation to pay the claim. However, it should be noted that with respect to deductible

policies for liability and workers' compensation, the RRE for reporting Medicare-eligible claims is the insurer writing such policy and not the insured. Any liability insurer that is uncertain whether they are required to act as an RRE should carefully review the CMS Alert: "Who Must Report" at [www.cms.gov/MandatoryInsRep/Downloads/NGHPAlertRREsWhoMustReport.pdf](http://www.cms.gov/MandatoryInsRep/Downloads/NGHPAlertRREsWhoMustReport.pdf).

It should be noted that while an RRE may appoint a third party to prepare and file reports as its agent, it may not contract with a third party to assume its responsibility for complying with reporting requirements.

Pursuant to the MMSEA, settlements completed before October 1, 2011 are not required to be electronically reported. If the date of Total Payment Obligation to the Claimant ("TPOC") is on or after October 1, 2011, then it is required to be reported during the first calendar quarter of 2012 (per the CMS Alert issued November 9, 2010, which changed the reporting date for liability insurance, including self-insurance, RREs from October 1, 2010 to October 1, 2011). Reporting is also necessary when an RRE

has assumed "ongoing responsibility for medical payments" on or after July 1, 2009.

Liability insurers that qualify as RREs but have not yet registered should do so at [www.section111.cms.hhs.gov](http://www.section111.cms.hhs.gov) as soon as possible to ensure their RRE account is established well in advance of January 1, 2012. The penalty for failure to comply with the MMSEA is \$1,000 for each day of non-compliance with respect to each claimant. These penalties are in addition to any Medicare secondary payer claims. Although the penalty exists, there is still no set process regarding how CMS will enforce the penalty.

Implementation of this regime has been delayed several times already and may be again. Nonetheless, many RREs still have not implemented ways to comply and should do so as soon as possible.

#### **E-MAIL OPTION**

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