



2007 Legislative Memo

We offer the following summary of legal issues affecting the captive insurance industry. 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. While some of the information in our report may not directly affect the Company, we offer this memorandum to keep you apprised of the most pertinent industry developments and initiatives.

NEW COMMISSIONER

As of January 22, 2007, Paulette Thabault became the Commissioner of the Vermont Department of Banking, Insurance, Securities and Health Care Administration, replacing John Crowley, who retired after serving as Commissioner since 2003. Leonard Crouse, the Deputy Commissioner of Captive Insurance, who has primary responsibility for regulating Vermont’s captive insurers, reports to the Commissioner. Ms. Thabault, who holds degrees in both nursing and law, has worked primarily in the area of health care. She served as Deputy Commissioner for Health Care Administration at the Vermont Department from 2003 through 2005 and has worked for many years as a health care consultant. Ms. Thabault’s appointment is viewed as a positive event for Vermont’s captive insurance community.

VERMONT LEGISLATIVE DEVELOPMENTS

General Legislation:

With support from the Vermont Captive Insurance Association (“VCIA”), the Vermont Department of Banking, Insurance, Securities and Health Care Administration again this year proposed amendments to the Vermont captive insurance legislation as a part of the Department’s annual legislative package. The proposals appear in Senate Bill 91, which has now been signed into law. In addition to various housekeeping matters (such as correcting references and ensuring that definitions contemplate the formation of captives as limited liability companies), the Bill makes the following changes to the captive insurance legislation:

- Expands the underwriting authority for industrial insured group captives to allow an industrial insured group to underwrite the controlled unaffiliated risk of any one of the participating industrial insured entities.
- Clarifies that an association captive insurance company may insure the risk of the sponsoring association in addition to the risk of members of the association. This clarification confirms what has occurred as a regulatory practice.

- Allows cells of a sponsored captive insurance company to be aggregated (for the purposes of the graduated premium tax rates and the maximum premium tax) with each other, with the sponsor and with other captives under common ownership and control, if the sole participant in the cell is the sponsor or an affiliate of the sponsor.
- Broadens the allowable sponsors of a sponsored captive insurance company to include any entity “approved by the commissioner in the exercise of his or her discretion, after finding that the approval of a person as a sponsor is not inconsistent with the purposes of this chapter.”

The bill was signed into law on May 25, 2007 and became effective on July 1, 2007.

Securitization:

A new subchapter to the Vermont captive insurance statutes was proposed by the Department to facilitate securitization transactions by Vermont captive insurance companies. The securitization legislation was made a part of Senate Bill 91 and, thus has become law. The securitization provisions relate exclusively to the situation of an insurance company reinsuring risk to a Vermont captive. This is typically done so that the ceding insurance company can relieve the pressure on its surplus caused by required life insurance reserves.

In a typical transaction the ceding insurer would reinsure a specific book of life policies to the captive, known as a Special Purpose Financial Captive (“SPFC”), which would then issue securities (a “securitization”) to finance the reserves. Because the reserves ceded to the SPFC are secured by the proceeds of the securitization, the ceding insurer can take credit for the ceded risk, relieving the pressure on its capital. The securities are then repaid from the capital acquired in the securitization as augmented by the performance of the book of insurance business.

The new subchapter to the Vermont captive insurance legislation provides the express authority for securitization transactions through Vermont captive insurers and also serves to provide additional solvency safeguards for SPFCs. The legislation brings under its purview existing Vermont captive insurers that are currently operating as SPFCs as well as those formed after its enactment. Under the legislation, an SPFC may insure or reinsure the risks of a ceding insurer only. Subject to the prior approval of the Commissioner, an SPFC may purchase reinsurance to cede the risks assumed under a reinsurance contract.

In addition to the licensing requirements applicable to all captive insurance companies pursuant to 8 V.S.A. §6002, SPFCs must meet some additional requirements and include additional information in their business plan. Certain officers of the SPFC must also submit an affidavit stating the proposed organization and operation of the SPFC complies with all applicable provisions of the captive insurance laws and that the SPFC’s investment policy reflects and takes into account the liquidity of the assets and the reasonable preservation, administration, and management of those assets with respect to the risks associated with the transactions. An SPFC’s application will also have to include an opinion of qualified legal counsel that the offer and sale of SPFC securities complies with all applicable federal and state securities laws.

IRS CONSOLIDATED RETURN PROPOSED REGULATIONS

On September 28, 2007, the IRS issued proposed regulations that, if adopted, would dramatically alter the taxation of most captive insurance companies that file federal income tax returns with their insureds under the consolidated return rules.

The proposed regulations would amend Treas. Reg. § 1.1502-13(e). Under present regulations, a captive that is providing insurance (under the federal income tax definition of “insurance”) to other members of its consolidated group and is considered an insurance company (under the federal income tax definition of the term) can calculate its taxable income under the insurance company provisions of the tax code. For example, this rule allows the captive to deduct its discounted unpaid losses (i.e., reserves) attributable to insurance it provides to other members of its consolidated group.

Under the proposed regulations, a captive insurance company would no longer be entitled to apply the insurance company tax rules with respect to insurance transactions between the captive and other members of its consolidated group. As a result, a captive insurance arrangement within a consolidated group would be taxed more like a loss reserve arrangement or “self-insurance” than like an insurance arrangement. The same rule will apply to arrangements in which a captive provides reinsurance for risks of members of its consolidated group.

The proposed regulations provide an exception for captives that obtain less than five percent of their business from insuring or reinsuring the risks of the other members of the consolidated group to which the captive belongs. Additionally, the proposed regulations do not affect arrangements in which the captive is not included as a member of a consolidated group for income tax purposes, as is the case with many captives formed outside the United States.

The proposed regulations will not affect the current tax year. If finalized, they will become effective for consolidated return years that begin on or after the date on which the regulations are published as final regulations in the Federal Register. For example, if the regulations are published in final form on March 1, 2008, they would not apply to a consolidated group operating on a calendar year until January 1, 2009. In that example, however, the regulations would apply immediately to a consolidated group filing on a consolidated fiscal return year beginning on or after March 1.

The IRS has requested comments regarding the proposed regulations. The comments are due by December 27, 2007. In addition, the IRS will schedule a public hearing regarding the proposed regulations if requested. The IRS must consider the comments it receives and, if requested, hold a hearing before it can finalize the proposed regulations.

A number of groups within the captive insurance industry, including the Vermont Captive Insurance Association, have already announced their intent to submit comments regarding the proposed regulations. After considering such comments, it is possible that the IRS will withdraw or substantially change the proposed regulations. It is also possible that the IRS will finalize the regulations without substantial changes. It is very difficult to predict the extent to which changes will be made or when the IRS might finalize the regulations.

TERRORISM RISK INSURANCE REVISION AND EXTENSION ACT OF 2007

The Terrorism Risk Insurance Extension Act of 2005 (“TRIEA”) is scheduled to sunset on December 31, 2007. Prior to the Congressional elections of November 2006, there was little optimism that TRIEA would be extended or that a successor to the current Terrorism Risk Insurance Program (the “Program”) would be implemented. Nonetheless, with the Democrats having taken over control of Congress, it appears likely that the Federal government will continue as a reinsurer of terrorism risk beyond 2007.

On June 18, 2007, Representative Michael Capuano and the Chairman of the House Financial Services Subcommittee on Capital Markets, Barney Frank, introduced H.R. 2761, the Terrorism Risk Insurance Revision and Extension Act of 2007 (“TRIREA”). TRIREA was passed by the House of Representatives on September 19, 2007 by a vote of 312 to 110. Legislation to extend the Program has not yet been introduced in the Senate, however, the Senate Banking Housing and Urban Affairs Committee has been conducting hearings on the issue.

If enacted, TRIREA would extend the current Program until December 31, 2022 and amend the Program in several substantial ways. The most significant changes include:

- Coverage of Domestic Terrorism: The Program would be expanded to include domestic acts of terrorism.
- Adjustment of Program Trigger: The Program trigger would be reduced from the current level of \$100 million to \$50 million in aggregate industry sustained losses.
- Coverage of Group Life Insurance: Group life insurance would be added to the list of insurance lines covered by the Program. “Group life insurance” would be defined to include term life, group universal life, group variable universal life and accidental death. Corporate Owned Life Insurance and Business Owned Life Insurance (both as defined under the Internal Revenue Code of 1986) would not be subject to the Program. The calculation of insurer deductibles for group life insurance would differ from that applicable to property-casualty insurance and would be designed to equate economically with the 20 percent of direct earned premium calculation applicable to property-casualty lines. In addition, separate provisions regarding government recoupment would be applicable to group life insurance. “Amount at risk,” which is defined as death benefits less any cash value, would be used as the metric for calculating deductibles and recoupment amounts rather than prior year’s direct earned premium.
- Coverage for Nuclear, Biological, Chemical and Radiological Events: Unlike the current Program, insurers would be prohibited from relying on state-approved exclusions for losses caused by nuclear, biological, chemical and radiological (“NBCR”) events beginning on January 1, 2009. As of that date, insurers would thus be required to make available coverage for acts of NBCR terrorism for all lines included in the Program. When certifying an event as an act of terrorism, the Secretary of the Treasury would also be required to determine whether the event constitutes an act of “NBCR terrorism.” For NBCR certified events, insurers would

be subject to a special deductible of 3.5 percent of direct earned premium, which would increase 0.5% each year after 2009. Also, a step-down mechanism would be employed to increase the government's quota share of the loss (beginning at 85 percent for losses below \$10 billion and rising to 95 percent for losses above \$60 billion) as the size of the NBCR event increases. Small insurers, defined as insurers with less than \$50 million of direct earned premium, would be permitted to apply to Treasury for exemption from the NBCR make available requirements.

- Cap for Annual Governmental Liability: The Program's current \$100 billion annual cap applies to total payments made by insurers and the federal government and serves to extinguish both insurer and government obligations under the Program when a total of \$100 billion has been paid in a single year. Under TRIREA, insurer obligations would cease when combined payments by the federal government and insurers reach \$100 billion during an annual period, but the government obligation would continue for that year until the government, itself, had paid \$100 billion.
- Reset Mechanism for Areas Previously Impacted by Significant Act of Terrorism: Lower insurer deductibles and triggers would be available for insurers that incur losses resulting from subsequent attacks on an area designated as a "previously impacted area" by the Secretary.

Shortly after TRIREA was introduced in the House, the Bush administration stated its objections to many of the bill's provisions. In testimony delivered on June 21, 2007 before the House Financial Services Subcommittee on Capital Markets, David Nason, Treasury's Assistant Secretary for Financial Institutions, remarked that TRIREA "does not meet" the administration's three objectives for TRIA extension legislation: (1) that the extension Program be temporary and short-term; (2) that insurance industry retentions be increased before coverage under the Program is triggered; and (3) that the Program not be expanded. The Administration reiterated its objections on September 17, 2007 when the Office of Management and Budget issued a policy statement indicating that senior administration officials would advise President Bush to veto TRIREA if Congress approves the legislation in its current form.

TRIREA does not alter current law regarding captive insurer participation in the Program. Accordingly, it appears that captives would continue to be subject to the Program upon the bill's enactment, unless Treasury issues guidance or regulations providing otherwise. Given the 15 year duration of TRIREA and its expanded coverage features, we would expect an increased number of captive owners to seriously consider using their captives to write coverage for terrorism risk upon the enactment of TRIREA. We will continue to monitor legislative developments on this subject, particularly with an eye towards the role, if any, captives will play beyond 2007.

NEW CHALLENGES AGAINST MORTGAGE GUARANTY CAPTIVES

Three new class action suits were filed in December 2006 against mortgage lenders Countrywide, GMAC and Washington Mutual and their respective captive insurers. The suits, all filed by a single law firm, allege that the reinsurance premiums paid to the captives constitute illegal kickbacks or referrals under RESPA.

As with previous challenges, these lawsuits allege that the reinsurance contracts at issue involve insufficient risk transfer, or the risk transfer is not commensurate with the premiums paid to the captives. As such, the plaintiffs allege violations of the RESPA anti-kickback provisions and the ban on accepting a percentage of settlement service fees other than commensurate with the value of the services actually performed. In addition, the plaintiffs allege that the reinsurance transactions were not disclosed to, or were concealed from, the mortgage borrowers. This latter argument is made in dispute of the application of the RESPA one year statute of limitations.

It is unclear how these new actions will affect the captive mortgage reinsurance business, if at all. The plaintiffs face several legal hurdles arising from prior filed similar law suits. We believe the risk of a successful challenge in this area is greatly reduced when the captive mortgage reinsurer adheres to the following established guidelines:

- a) Guidance provided by the “Countrywide Letter” issued in 1997 by HUD. In this letter, HUD concludes that captive reinsurance arrangements, whereby a mortgage lender forms an affiliated captive reinsurance company to reinsure a third party (non-affiliated) mortgage insurer, are permitted under RESPA provided certain criteria are met. These provisos include: the reinsurance services are bona-fide; payments do not exceed the value of the services; the reinsurance contract meets risk transfer requirements; the deal cannot be tied to the referral of business; and the captive must be adequately capitalized and establish adequate reserves. In addition, the consumers of the insurance must be given meaningful disclosure and meaningful choice in the matter; namely, that the related nature of the captive and the lender be disclosed, the fact that the lender stands to gain financially in the transaction is disclosed, and the consumer is given the choice to have the insurance provided by another provider not tied to the captive program.
- b) Compliance with the Fannie Mae and Freddie Mac requirements for captive reinsurance arrangements.
- c) A professional opinion supporting adequate risk transfer and premiums commensurate with the risk ceded under the reinsurance contracts is implied, if not required, to meet the guidelines set forth in a) and b) above.

PRIVATE LETTER RULING BY INTERNAL REVENUE SERVICE

On November 3, 2006, the Internal Revenue Service published a private letter ruling (PLR200644047) examining whether a captive insurance company was exempt from paying taxes under 501(c)(15) (insurance companies with net written premiums of \$350,000 or less). A private letter ruling is a ruling issued by the IRS to a particular taxpayer and is binding only on that taxpayer. The basis for the ruling is whether the captive was providing “insurance” in the tax sense. The captive was wholly-owned by X, “a corporation that contracts with physicians

and other medical service providers, as independent contractors, in providing their services to clients.” In each of the years at issue, the captive issued one policy identifying X as the “Named Insured” and various categories of other persons as “Insureds,” including managed care organizations owned by X, employees of any insured, joint ventures in which the named insured has an ownership interest, and others. An endorsement also included as insureds approximately 30 physicians, who were covered for “amounts they may be required to pay others as damages for bodily injury resulting from a medical incident arising out of medical services provided.” X paid the premium each year on behalf of all insureds.

The brief analysis in the ruling focuses on whether there was adequate risk distribution, placing great emphasis on Rev. Rul. 2005-40, which held that adequate risk distribution is not present if one insured accounts for 90% or more of the risks insured. The ruling states that “it appears likely that a claim against any Insured would necessarily entail a claim against the Named Insured as well,” and that the captive “provided no basis for distinguishing between, on the one hand, the risks of the various Insureds other than the Named Insured and, on the other hand, the risks of the Named Insured.”

The important point to take away from this ruling is that it is not sufficient for risk distribution purposes simply to name an adequate number of insureds in the policy. The captive should be able to show the proportion of risks attributable to each insured. This is especially important in an arrangement where one insured pays all of the premiums on behalf of all insureds and where it appears likely from an examination of the policy alone that one insured accounts for the vast majority of the risks.

Finally, it is important to note that each private letter ruling issued by the IRS is binding authority only with respect to the taxpayer to which it is issued. The IRS has no obligation to follow any private letter ruling when dealing with other taxpayers, and other taxpayers are not bound by the conclusions or arguments found in the ruling.

REINSURERS MAY RESIST CLAIM PAYMENT

We have noticed what may be an increased tendency of some reinsurers to challenge claims presented by captive cedents. Most of these challenges appear to be based on either: (1) the reinsurer’s allegation that the captive failed to follow procedural steps in presenting and managing the reinsurance claim; or (2) the reinsurer’s belief that the underlying claim is not covered by the captive’s insurance policy and/or the reinsurance agreement. Because reinsurance disputes are often complex and expensive to resolve, it is important for captive owners to be aware of the typical circumstances surrounding such claim denials by reinsurers.

The first type of claim denial, based on alleged procedural deficiencies, may arise when the reinsurer concludes that procedures stated in the reinsurance agreement have not been followed by the captive, most often because of a blurring of the distinction between the captive and its insured. In such cases, the reinsurer may argue that the captive, as an independent entity, has not taken procedural actions called for in the reinsurance agreement, regardless of whether those same actions were taken by the captive’s parent or insured. Although the captive may view this as procedural “nitpicking,” it is best to avoid opening the door to such behavior by the reinsurer. Accordingly, when it becomes apparent that a claim for reinsurance may be asserted by a

captive, it is important to review the reinsurance agreement and recognize the entities that are parties to it. In most instances, the reinsurance agreement is between the captive and the reinsurer. If the reinsurance agreement calls for the captive to take certain procedural steps in presenting and managing the claim, trouble may be avoided by ensuring that the captive, itself, carries out the required actions. Such actions should be taken in the name of the captive by those persons or entities specifically authorized to act on its behalf. Entities related to the captive, but that are not parties to the reinsurance agreement, such as the captive's insured or parent, should not supplant the captive in its dealings with the reinsurer. In sum, the captive may deprive the reinsurer of one of the weapons in its claim denial arsenal by recognizing and respecting the distinct nature of the parties associated with reinsurance agreement.

The second type of reinsurance claim denial arises when the reinsurer concludes that the underlying claim is not covered by the captive cedent's insurance policy and/or the reinsurance agreement. Although the reinsurer's ability to contest the cedent's coverage determination on the underlying claim and policy may depend significantly on the language of the reinsurance agreement and the law of the jurisdiction governing the agreement, the captive should be prepared to demonstrate the soundness of its coverage determination to the reinsurer. In particular, the reinsurer may ask the captive to provide evidence that the captive took reasonable, arms-length steps to assess the nature of the claim and to determine whether it is covered by its policy. In situations where coverage is not fully certain under the captive's policy, the captive should recognize that the reinsurer may ask whether the captive obtained a coverage opinion from the captive's legal counsel before agreeing to cover the underlying claim. Such an opinion may be useful in supporting the captive's argument that it acted in good faith and in a commercially reasonable manner in making its coverage determination.

CAPTIVE UPDATE ON CLOSURE/POST-CLOSURE FINANCIAL RESPONSIBILITY

The Audit Division of the U.S. Office of the Inspector General ("OIG") concluded an audit in 2002 of financial assurance for closure and post-closure costs under the federal Resource Cost Recovery Act of 1976 ("RCRA"). Hazardous waste facilities regulated under the Act must develop a plan for closing their facilities to assure that funds will be available to pay for potentially costly facility closures and post closure ground water monitoring of the facility. Similar requirements apply to Municipal Solid Waste Landfills. Financial assurance regulations were developed by the U.S. Environmental Protection Agency ("EPA") but are primarily implemented by states.

The OIG concluded that the strength of financial assurance lies in the use of third party assurance mechanisms, which depends largely on independence between risks of financial failure of the facility and the third party providing the mechanism. On this basis, and specifically citing the long dead IRS economic family theory for federal income tax cases, it specifically concluded that captive insurance policies do not meet the intent or requirements of RCRA financial assurance regulations. It recommended to the EPA that policies and guidance be developed to eliminate situations, i.e. captive insurance arrangements, where independence is not maintained.

After considerable delay, the Environmental Financial Advisory Board of the EPA, now charged with reviewing this issue, convened a meeting last summer on the use of captive insurance companies as a financial assurance tool for solid waste landfill closure and post-closure costs.

Derick White, the Director of Captive Insurance of the State of Vermont was present at the meeting and offered his comments in favor of allowing captive insurers to write this coverage. Mr. White indicated that the majority of the Vermont captives covering closure/post closure write this coverage for their own manufacturing sites. There are also a few solid waste companies which use their wholly owned captives to write the coverage. The debate still focuses on the issue of whether captive insurers are separate enough from their parent companies to provide meaningful financial assurances in the form of insurance. On the other hand, captive insurers are often used as an alternative to the commercial market when, as in this case, the market is not interested in providing this coverage at affordable rates. The decision of whether or not to accept captive insurance as a means of closure/post closure financial assurance is currently made on a state-by-state basis. Several states prohibit the use of captive insurers, some states are more restrictive when captives are involved, and some states admit that they never know whether the coverage is written by a captive or a commercial carrier. The EPA is looking for a more uniform approach on the use of captives to write this coverage. In recognition of the variance in regulation practices among captive domicile states, there was also discussion of whether one answer to the problem is to require captives writing this coverage to obtain a minimum rating from an independent rating service such as A.M. Best.

ANTI-TRUST EXEMPTION FOR INSURERS

In the aftermath of Hurricane Katrina, Mississippi Senator Trent Lott, whose house was destroyed in the storm, proposed a bill in the Senate that would abolish the limited antitrust exemption afforded to the insurance industry through the McCarran-Ferguson Act. This is not the first time that Congress has attempted to revoke the anti-trust exemption under the McCarran-Ferguson Act of 1945, however this year the attempt appears to be gaining considerably more attention than past attempts. Senator Lott has garnered bipartisan support for the bill (S. 618) with Senator Patrick Leahy (D-Vt.), Senator Arlen Specter (R-Pa.), Senator Mary Landrieu (D-La.) and Senate Majority Leader Harry Reid (D-Nev.) as co-sponsors of the proposed legislation. The bill would give the Department of Justice and the Federal Trade Commission the authority to apply antitrust laws to anti-competitive behavior of insurance companies.

The insurance industry and agent trade groups have strongly opposed the measure claiming that the limited anti-trust exemption in the McCarran-Ferguson Act improves the accuracy of pricing models as insurers of all sizes benefit from the data collected and shared throughout the industry. This may be particularly true in the captive insurance context and for risk retention groups as the sharing of loss data, rates and other similar information in the insurance industry is often the only way these companies can set rates, plan for their financial needs and evaluate their relative performance. Without such data competition may actually be decreased as many companies would be faced with increased operating expenses.

The United States Senate Judiciary Committee began hearings on S. 618 in March. Susan E. Voss, the Commissioner of Insurance for the State of Iowa, testified before the Committee on behalf of the National Association of Insurance Commissioners (“NAIC”). She suggested that Congress should identify the precise offensive conduct that Congress wants to prohibit but cannot because of the current exemption. Commissioner Voss noted that the limited antitrust exemption under the McCarran-Ferguson Act only applies to activities that (i) constitute the

business of insurance. (ii) are regulated by state law, and (iii) do not constitute an agreement to boycott, coerce, or intimidate or [an] act of boycott, coercion, or intimidation. She also expressed the NAIC's concern that an outright repeal could end certain pro-competitive practices. Voss urged the Senators to carefully evaluate unintended consequences that could result from an outright repeal of the exemption.

A similar bill, introduced in the House (H.R. 1081) has been referred to the House Judiciary, Energy and Commerce and Financial Services Committees. At this time it is unclear if or when either bill will be voted on in their respective committees and if they will make it to a vote before the entire Senate and House. We will be monitoring the status of this important matter.

OPTIONAL FEDERAL CHARTER LEGISLATION

In recent years and particularly since the passage of the Gramm-Leach Bliley Act in 1999, some in the insurance industry have made claims that U.S. insurance companies are at a competitive disadvantage due to the difficulties and costs associated with separate regulatory requirements in each of the 50 states. In an attempt to address these concerns, the National Insurance Act of 2007, (the "NIA") was introduced in the United States Senate on May 24, 2007 as S. 40, and in the United States House of Representatives on July 25, 2007 as H.R. 3200. The NIA would allow insurance companies to elect to be regulated by a newly established Office of National Insurance in the Department of the Treasury headed by a Commissioner of National Insurance. The NIA would establish a dual regulatory structure similar to how banks are regulated in the United States. Funding for the Office of National Insurance would be by assessments on those regulated under the NIA and by fees for examinations and processing applications.

The NIA fully encompasses the regulation of insurance companies, establishing (a) a federal bureaucracy to regulate and examine National Insurers and to enforce the federal insurance laws (Title I of the NIA), (b) rules for the organization, licensing and operation of National Insurers (Title II of the NIA), (c) a federal holding company regime (Title IV of the NIA), and (d) a federal receivership/insolvency regime (Titles V and VI of the NIA). The NIA also requires that a National Insurer become a member of the state guaranty association, and thus pay assessments to the association, in each state in which it does business. State guaranty associations must meet certain criteria so that the state is determined to be a "qualified state" by the Commissioner. An alternative National Insurance Guaranty Association would be established if one or more states are deemed to be not qualified. See Title VI of the NIA.

There are no provisions in either the Senate or House of Representatives versions of the NIA which specifically reference captive insurance. This is not surprising as the purpose of the proposed federal charter is to address the numerous concerns and shortcomings that many insurance industry participants have claimed to exist with the current state regulatory systems, the most common of which is the need for an insurer doing business in multiple states to obtain regulatory approval for its rates, forms and activities in each of the states in which it does business. This is not a concern for most captive insurance companies which are regulated by the insurance regulator in their choice of domicile. Thus, should a current version of the NIA be enacted, no direct effect should be felt by captive insurance domiciled in the United States and abroad.

Furthermore, even if a provision allowing for the establishment of a nationally chartered captive insurance company were added to the NIA, the effect on captive insurance domiciles would be negligible. It is likely that such a provision would simply create another potential captive domicile for a parent corporation to consider. Given that the main premise behind the NIA is to reduce the regulatory hoops that an insurance company operating in numerous states must jump through, an optional federal charter would not appear to be an attractive option for a captive insurance company, which is usually not subject to regulation by multiple jurisdictions. With the captive statutes in most domiciles being very similar, the main considerations when choosing a domicile for a captive insurance company are typically not based on the actual captive laws, but rather on expense factors, the experience of the regulators, the availability and expertise of service providers, and the responsiveness of the domicile to the changing needs of the captive insurance industry.

On October 3, 2007, the House Financial Services Committee held a hearing on the NIA. The Committee received testimony from numerous people both supporting and opposing the NIA. For example, Walter Bell, the Commissioner of Insurance in Alabama and President of the National Association of Insurance Commissioners (NAIC) testified on behalf of the NAIC. Commissioner Bell discussed the NAIC's recent attempts to modernize the regulation of insurance and its belief that insurance regulation is best left to the states. Testifying on behalf of the American Council of Life Insurers (the "ACLI") was Christopher Condron, CEO of AXA Financial, Inc. and Chairman and CEO of its principal insurance operating subsidiary, AXA Equitable Life Insurance Company. Mr. Condron expressed ACLI's support for the NIA citing a need to remedy the duplication, inconsistency, and inefficiency it believes stems from the current regulatory system. It is clear from the hearing that strong advocates exist both for and against the NIA. No additional hearings or votes are currently scheduled before the House Financial Services Committee or the Senate Committee on Banking, Housing, and Urban Affairs (to which S.40 was referred to after introduction).

FOCUS ON RISK RETENTION GROUPS

THE REGULATION DEBATE

The National Association of Insurance Commissioners ("NAIC") continues to discuss and debate the regulation of risk retention groups. The 2005 GAO Report revealed a lack of uniform regulatory standards among the domiciliary states and the resulting difficulty for non-domiciliary states which rely on the domicile regulators to protect the policyholders located in their states. While most agree that proper regulation of risk retention groups does not rise to the level of traditional insurance company regulation, the NAIC is striving for more uniform charter state regulation and is debating in turn which "Part A, B and C" NAIC accreditation standards should apply. The Part A standards govern required laws and regulations to ensure proper regulation of insurers, the Part B standards govern regulatory practices and procedures related to enforcing these laws, and Part C governs state insurance department organization and personnel practices. The discussion regarding the Part B and C standards is expected to occur this summer. Highlights of the "Part A" standards debate includes:

GAAP v. SAP

Traditional insurance carriers are required to file annual audited financial statements prepared in conformance with Statutory Accounting Principles (“SAP”). Most captive domiciles allow (and some require) captives, including risk retention groups, to file in accordance with Generally Accepted Accounting Principles (“GAAP”). GAAP focuses on investor needs and is designed for public company reporting while SAP, by contrast, was developed by the NAIC to focus on insurer solvency. Some major differences between GAAP and SAP occur in the areas of loss reserve discounting, investment valuation, accruals and recognition of letters of credit and surplus notes as capital. State insurance regulators well versed in SAP have difficulty reviewing GAAP statements filed by non-domiciliary risk retention groups and applying their usual solvency ratios in any meaningful way.

Currently the NAIC seems satisfied that captive risk retention groups may continue to report using GAAP as long as a reconciliation to SAP is included in the footnotes. The deviation from SAP excuses GAAP filers from strictly complying with other Part A standards as well, such as the NAIC Accounting Practices and Procedures Manual, the standards for preparing the NAIC annual statement blank and the application of certain risk based capital analysis.

The 10% Rule

Traditional insurance regulation requires that the largest net retained risk should not exceed 10% of a property and casualty insurer’s capital and surplus. The NAIC has generally agreed with the Vermont Insurance Department that this limitation should not apply to risk retention groups. The Vermont Department cited other solvency safeguards in its position with the NAIC, including the use of reserves to surplus ratios, triennial examinations of risk retention groups, annual audits and actuarial certifications, and a general expectation that the risk retention group’s sponsoring owners will support the group.

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 is recommending that risk retention groups be subject to the Insurance Holding Company System laws in their states of domicile. Vermont risk retention groups are currently not subject to these laws.

The Insurance Holding Company System statutes regulate the investment by insurers in subsidiaries and the nature of business that may be conducted by these subsidiaries, changes in control of the insurer, procedures for merger between an insurer and a company which is not an insurance company, surplus adequacy, dividends, and diversification among lines of insurance and geographically among insureds. The most onerous aspect of such statutes is that they require insurers to file annual registration statements (with a duty to update throughout the year) reporting financial, ownership and management information about each affiliate of the insurer. These statutes also seek to regulate and review all contracts and transactions between an insurer and its affiliates.

The VCIA has taken the position, and PF+C agrees, that the Vermont Insurance Holding Company System statutes and regulations should not apply to risk retention groups domiciled in

Vermont. Most of the transactions regulated under the Holding Company laws and specified above are already properly regulated under the Vermont captive statutes. (Indeed, whole parts of the Holding Company System statutes were copied verbatim into the captive laws and regulations). In addition, Vermont captive laws require disclosure to the Department of the identity of all persons who will act as managing general agent or reinsurance intermediary for, provide significant administrative services to, or otherwise influence or control the activities of, a risk retention group. Summary descriptions of the services provided by these persons are also required by the Department, with a duty to update the department of material changes in this information. Formalizing these requirements to the extent required by the Insurance Holding Company System laws, and to the extent of requiring annual form filings, will be duplicative, and will unnecessarily burden risk retention groups contrary to the spirit and purpose of their existence.

Credit for Reinsurance

The NAIC has recommended a more uniform approach by captive domiciliary states to allowing credit for reinsurance ceded by a risk retention group, perhaps by requiring states to adopt the NAIC's Credit for Reinsurance Model law as part of the NAIC accreditation process. As of December 31, 2006 this matter was referred to the Financial Conditions Committee of the NAIC RRG Working Group.

CORPORATE GOVERNANCE

The GAO Report raised corporate governance issues related to risk retention groups. The Corporate Governance subgroup of the NAIC has now issued proposed Corporate Governance Standards which it intends to incorporate into its "Part A" accreditation standards. The proposed standards are currently in draft form pending comments from the industry. The standards as currently proposed are summarized below. The captive manager and the CEO of a risk retention group have the duty to report in writing to the domestic regulator of the group any material non-compliance with these standards, and the regulator may initiate an enforcement action against any director or officer of a risk retention group or its captive manager if the risk retention group or captive manager violates these corporate governance standards.

1. Independent Directors. The board of directors of a risk retention group shall have a majority of independent directors, and the group must report annually to its domestic regulator on which directors are independent and which are not. A director is not independent if he or she has a "material relationship" with the group; provided that representatives of persons who are owners and insureds of the group shall be considered independent. A "material relationship" includes but is not limited to: a) the receipt of compensation or any other value by a director, a member of a director's immediate family or any business with which the director is affiliated from the risk retention group or a consultant or service provider of the risk retention group of more than five percent (5%) of the risk retention group's gross written premium or two percent (2%) of its surplus per year; b) a relationship with an independent auditor of the group; and c) a relationship with a "related entity" which is an entity where the director or immediate family member of a director is employed as an executive

officer and where any of the risk retention group's present executives serve on that company's board of directors.

2. Service Provider Contracts. The term of any service provider contract shall not exceed five years. All service provider contracts and their renewals must be approved by a majority of the independent directors of the group and the group must have the right to terminate these contracts at any time for cause, upon adequate notice. A service provider contract shall include contracts with captive managers, auditors, accountants, actuaries, investment advisors, lawyers, managing general underwriters or other parties responsible for underwriting, determination of rates, collection of premium, adjusting and settling claims and/or the preparation of financial statements. "Material" service provider contracts must be submitted for approval by the domestic regulator of the group at least 30 days prior to its effective date. A "material service provider contract" means any contract involving a "material relationship" as defined above.
3. Written Charter. The board of directors of the group must have a written charter which requires the board to: a) assure that all owner/insureds of the risk retention group receive evidence of ownership interest; b) develop a set of corporate governance principles applicable to the risk retention group; c) oversee the evaluation of the risk retention group's board and management; d) review all service provider contracts; e) approve the compensation for all service providers; and f) review and approve, at least annually: i) the corporate goals and objectives relevant to the compensation of directors, officers, and service providers; ii) evaluate the directors', officers', and service providers' performance in light of those goals and objectives; and, iii) either as a committee or together with the other independent directors (as directed by the board), determine and approve the continued engagement of the directors, officers, and service providers.
4. Audit Committee. The group must have an audit committee consisting of at least three members. Only independent directors qualify as members of such committee. The committee must have a written charter which meets certain detailed minimum standards set forth in the NAIC Corporate Governance Standards. The domestic regulator of the group may waive this requirement if the group can show that it is impracticable to form such a committee and the risk retention group's board of directors is able to satisfy the committee's specified duties.
5. Corporate Governance Standards. The risk retention group shall adopt and disclose corporate governance standards which shall include: a) a process by which the directors are elected by the owner/insureds; b) director qualification standards; c) director responsibilities; d) director access to management and, as necessary and appropriate, independent advisors; e) director compensation; f) director orientation and continuing education; g) management succession; and h) annual performance evaluation of the board.
6. Business Conduct and Ethics. The risk retention group shall adopt and disclose a code of business conduct and ethics for directors, officers and employees and promptly disclose any waivers of the code for directors or executive officers. The NAIC

suggests that the code include the following topics: conflicts of interest, corporate opportunities, confidentiality, fair dealing, protection and proper use of company assets, compliance with all applicable laws, rules and regulations, and encouraging the reporting of any illegal or unethical behavior which affects the operation of the risk retention group.

ARE STATES ABUSING YOUR RISK RETENTION GROUP?

The federal Liability Risk Retention Act of 1986 (“LRRA”) clearly sets forth the items which must be filed in the non-domiciliary states before a risk retention group may write business in these states. This list is limited to a copy of the group’s plan of operations or feasibility study filed in its charter state, copies of revisions to the plan if additional lines of liability coverage are to be offered, and copies of the group’s annual audit and certification of loss reserves. The states are preempted from requiring risk retention groups to file more information than is required by the LRRA, and must instead rely on the charter state to properly regulate the groups. The state registration filings are clearly meant to be information filings. No formal approval may be required, and waiting periods are unlawful. Even the NAIC Risk Retention Group and Purchasing Group Handbook states that the registration process is not intended to increase the state regulation powers beyond the limited powers granted by the LRRA, and the states may not unduly delay the process.

The concept of the risk retention group under the LRRA is that this streamlined insurance vehicle be regulated by only one state, its state of domicile, and it may then write insurance in all states without being licensed, admitted or authorized in those states. It is well settled that non-domiciliary states may not charge registration filing fees, annual fees, impose minimum capital or rating requirements or require policy form filings. The states may collect applicable premium taxes assessed on a non-discriminatory basis.

Despite the clear preemption under the LRRA of state-by-state regulation of risk retention groups, abuses by non-domiciliary states are rampant. We urge our risk retention group clients to consult us when faced with these unlawful requirements. While we are sensitive to our clients’ political concerns, we find that many states, when properly challenged (usually by a well written letter outlining the preemption provisions and supporting case law) cannot find the legal justification for their requirements and often relent.

More recently, risk retention groups have challenged the ability of states such as Washington and Connecticut to impose onerous closed medical malpractice claim reporting requirements upon risk retention groups writing coverage in these states. Washington has recently conceded federal preemption and has redesigned its legislation to collect the claims information through the health care provider owners of the group which are properly regulated by the state.

Please let PF+C know if we may assist your risk retention group with any of these matters.

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 tax analysis
- 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.