THE NONADMITTED AND REINSURANCE REFORM ACT AND ITS UNINTENDED CONSEQUENCES ON THE VERMONT CAPTIVE INSURANCE INDUSTRY: VIOLATING DUE PROCESS AND HOLDING PREMIUM TAXES "CAPTIVE"

INTRODUCTION

> The [Vermont] captive insurance industry has generated almost $350 million in direct taxes and fees to Vermont's coffers since its inception in 1981 . . . . It is exactly the type of industry that is a priority of my administration. It creates high paying jobs, has minimal impact on our environment, creates tourist traffic and generates much needed tax revenue.[1]

Vermont has been an international leader in the captive insurance industry for thirty-one years.[2] According to 2011 figures, Vermont was number one in the world in gross written premiums and total assets while ranking third in total number of captive companies.[3] Currently, Vermont is home to approximately 600 active captive insurance companies.[4] Additionally, the Vermont captive industry provides approximately 1,400 jobs and accounts for 2% of Vermont's general fund revenue.[5] The Vermont captive industry is recognized as the "gold standard" due to its captive laws, experienced regulators, and infrastructure.[6] Further, Vermont is home to the Vermont Captive Insurance Association (VCIA), the largest captive insurance trade association in the world.[7] The VCIA hosts an annual captive conference every August in Burlington, Vermont, which is the "world's largest captive insurance conference" with over 1,200 attending in 2011.[8] Vermont has benefited greatly from its captive industry.

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1. *Vermont Celebrates 1000th Licensed Captive Insurance Company*, VERMONT.GOV (Oct. 10, 2013), http://governor.vermont.gov/NEWSROOM-CAPTIVE-SIGNUP-RELEASE (quoting Vermont Governor Peter Shumlin) (internal quotation marks omitted) (announcing that Vermont's Department of Financial Regulation licensed its 1,000th captive insurance company).
2. Dan Towle, *The 'Gold Standard' Continues to Shine*, *in* CAPTIVE REV. VT. REP. 2012, at 6, 6 (Matthew Broomfield ed. 2012), *available at* http://www.captivereview.com/article_assets/articledir_3469/1734627/CR_Vermont_2012.pdf.
3. *Id.*
4. *See id.*
5. *Id.* at 7.
6. *Id.*
7. *Id.* at 6.
8. *Id.*; *see also* Rich Smith, *Creative Corner: Captive Insurance Industry in Vermont Like Switzerland with Better Cheese*, BURLINGTONFREEPRESS.COM (Aug. 8, 2012, 9:42 AM), http://www.burlingtonfreepress.com/article/20120808/BUSINESS08/308080006/Innovate-Creative-Corner-Vermont-s-captive-insurance-industry-Switzerland-cheese (explaining the depth of the Vermont captive industry and the benefits to domiciling in Vermont).

Consequently, uncertainty surrounding the application of the Nonadmitted and Reinsurance Reform Act (NRRA) is a serious concern for the Vermont captive industry.

Vermont would not be able to benefit from state regulation of captives had Congress not expressly left insurance regulation largely to the states. It is unusual for Congress to declare that an industry clearly immersed in interstate commerce is generally subject only to state regulation and taxation. Congress, however, took exactly that course when it enacted the McCarran-Ferguson Act in 1945.[9] The roots of this declaration may be found in the 1868 United States Supreme Court decision that held an insurance contract is not a matter of interstate commerce.[10] For seventy-six years thereafter, the individual states regulated and taxed the business of insurance without any involvement of the federal government.[11] The states could not have done so, however, without the coordination of the National Association of Insurance Commissioners (NAIC).[12] Then, in 1944, the United States Supreme Court reversed *Paul v. Virginia*, concluding that insurance is within the scope of interstate commerce and therefore subject to regulation by the federal government, ffectively precluding state regulation and taxation of insurance.[13]

As a well-developed state regulatory infrastructure for insurance was in place, Congress saw no benefit to supplanting state regulation with federal

9. McCarran-Ferguson Act, Pub. L. No. 79-15, § 2, 59 Stat. 33, 34 (1945) (codified as amended at 15 U.S.C. § 1012 (2012)).

10. *See* Paul v. Virginia, 75 U.S. (8 Wall.) 168, 183, 185 (1868) (holding that insurance is not commerce and that the Commerce Clause did not prevent Virginia from taxing and regulating insurance companies domiciled in New York that were doing business in Virginia), *overruled by* United States v. Se. Underwriters Ass'n, 322 U.S. 533 (1944). The Supreme Court found that insurance contracts are not "articles of commerce" and do not have "an existence and value independent of the parties to them." *Id.* at 183. The Court further noted that although such contracts are interstate transactions, because the parties are domiciled in different states, the policies do not take effect until delivered in Virginia—"They are, then, local transactions, and are governed by the local law." *Id.*

11. *See* PETER M. LENCSIS, INSURANCE REGULATION IN THE UNITED STATES: AN OVERVIEW FOR BUSINESS AND GOVERNMENT 2 (1997) (recounting that, after *Paul*, the states regulated and taxed the business of insurance).

12. The NAIC, established in 1871 "for the primary purpose of helping state regulators supervise the financial condition of interstate companies," has played a critical role in the coordination of state insurance regulation at the national level. Earl R. Pomeroy, *State Insurance Regulation: A Blueprint for the Future*, *in* THE STATE OF INSURANCE REGULATION 1, 7 (Francine Semaya & Vincent J. Vitkowsky eds., 1991). The NAIC works with state regulators to maintain a uniform system "for the supervision of interstate companies" while remaining "sufficiently decentralized to provide a high degree of responsiveness to insurance consumers and a sensitivity to the diverse regulatory needs of the nation." *Id.* Most importantly, the NAIC drafts model laws and regulations and "serves a valuable function for the development of uniform legislative and regulatory approaches to [insurance] regulation." *Id.* at 8–9.

13. *See Se. Underwriters Ass'n*, 322 U.S. at 552–53 (1944) (holding that insurance is commerce and can be regulated by Congress).

regulation.[14] The express language of the McCarran-Ferguson Act clearly establishes the primacy of the several states to regulate and tax the business of insurance.[15] Only when Congress acts specifically to preempt state regulation and taxation of insurance does federal law prevail in this area.[16] Such preemption occurred in 2010 when Congress enacted the NRRA to modify, among other things, the manner in which states regulate and tax nonadmitted insurance.[17]

Nonadmitted insurance is different from "traditional" admitted insurance. Unlike admitted insurance, nonadmitted insurance is provided by an insurer not licensed to provide insurance in a given state.[18] Consistent with applicable constitutional requirements, states allow an insured within their borders to procure insurance from a nonadmitted insurer.[19] State laws vary regarding their citizens' right to purchase insurance policies from outside their borders. Often, states publish "white lists" of eligible, nonadmitted insurers approved to provide insurance within that state.[20] Surplus lines insurance is generally synonymous with nonadmitted insurance.[21] Captive insurance differs from both admitted and surplus lines insurance. Captives are authorized insurers only within their domiciliary state and are subject to that state's taxation and regulation.[22] Most states have enacted different laws for these three forms of insurance.[23]

Unfortunately, the NRRA's ambiguous definition of nonadmitted insurance has led some to believe its provisions also apply to captive insurance. This construction is problematic. If captives are included within the scope of nonadmitted insurance, then the NRRA creates the potential

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14. *Cf.* LENCSIS, *supra* note 11, at 2. "For more than 70 years after the *Paul* decision, the state legislatures continued to develop insurance regulatory schemes and to put into place most of the basic licensing, examination, and solvency-testing requirements that still exist today." *Id.*; *see also id.* at 3 (explaining the McCarran-Ferguson Act dictates that federal laws such as the Sherman Antitrust Act shall apply to the business of insurance only to "the extent that such business is not regulated by State law" (quoting 15 U.S.C. § 1012 (1945) (internal quotation marks omitted).

15. 15 U.S.C. §§ 1011-1015.

16. *Id.*

17. The Nonadmitted and Reinsurance Reform Act, Pub. L. No. 111-203, 124 Stat. 1589, 1589–96 (2010) (codified at 15 U.S.C. § 8201-8232 (2011)).

18. LENCSIS, *supra* note 11, at 87.

19. KATHRYN A. WESTOVER, CAPTIVES AND THE MANAGEMENT OF RISK 205 (2d ed. 2006); *see also infra* Part II.A.2 (discussing the constitutional limitations on state authority to tax and regulate insurance transactions).

20. LENCSIS, *supra* note 11, at 89.

21. *Id.* at 87.

22. WESTOVER, *supra* note 19, at 4–5.

23. *Compare* VT. STAT. ANN. tit. 8, ch. 138 (2013), *with* VT. STAT. ANN. tit. 8, ch. 141 (2013) (containing different provisions for surplus lines insurance and captive insurance, especially conditions for procurement and placement of insurance, licensing, and taxation).

for unconstitutional results.[24] This Note argues that if the NRRA is so interpreted, it violates longstanding Supreme Court precedent construing the Due Process Clause of the Fourteenth Amendment.

Captives do not operate in the same way as surplus lines insurance. Unlike surplus lines insurance companies, a captive is only admitted and authorized to operate in its domiciliary state.[25] Captives cover risk in other states without directly operating in such jurisdictions.[26] Captives do not appear on published white lists identifying them as eligible to do business in one or more foreign domiciles.[27] A captive insurance company only does business in the state where it is domiciled.[28] In contrast, surplus lines companies are not licensed in states other than their domicile state,[29] and each surplus lines company must obtain authority to do business outside its domicile.[30] Insureds may purchase surplus lines policies through a surplus lines broker if the policy meets certain minimum state standards for the coverage.[31]

This Note discusses the potential unreasonable consequences should the NRRA be construed to apply to captive insurance companies. It highlights facts demonstrating that the NRRA was never intended to apply to captive insurance. Part I reviews insurance regulation in the United States and explains the forms of insurance relevant to this Note: admitted, surplus lines, and captive. Part II describes the NRRA and presents the case that the NRRA was not intended to apply to captive insurance. It also addresses the potential impact that misapplication of the NRRA may have on the captive insurance industry in Vermont.

I. BACKGROUND

A. Insurance Regulation in the United States

Since 1868, insurance regulation had been left to the states.[32] In 1944, however, the Supreme Court rejected the notion that insurance is not

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24. One must also keep in mind the well-understood canon of constitutional avoidance: where one of two possible constructions of a statute raises a number of constitutional issues, the other should prevail. Clark v. Martinez, 543 U.S. 371, 380–82 (2005).

25. WESTOVER, *supra* note 19, at 4–5.

26. LENCSIS, *supra* note 11, at 92 (discussing that captives are only licensed in their domiciliary state).

27. *See infra* Part I.B (explaining the functions of captive insurers).

28. *See infra* Part I.B.

29. *See infra* Part I.B (discussing surplus lines insurance companies).

30. *See infra* Part I.B.

31. LENCSIS, *supra* note 11, at 89.

32. *See* Paul v. Virginia, 75 U.S. 168, 183 (1868) (holding that insurance is not commerce).

commerce and held that the Sherman Antitrust Act applies to insurance companies.[33] As a consequence of this decision, Congress now had the power to regulate the insurance industry. State regulation of the insurance industry was invalidated overnight.[34] Almost immediately, Congress recognized the scope of the problem created by the Court's decision—there was no federal framework to regulate insurance. It quickly enacted the McCarran-Ferguson Act to resolve the legal and business crisis that ensued.[35] The regulation and taxation of insurance would remain with the states.

By enacting the McCarran-Ferguson Act, Congress recognized that, although insurance is interstate commerce, it is appropriately a responsibility of the states to regulate *unless* Congress *expressly* preempts state regulations.[36] Notwithstanding the express intent of the McCarran-Ferguson Act to maintain state regulation, Congress emphasized that state regulation and taxation of insurance is

> subject always . . . to the limitations set out in the controlling decisions of the United States Supreme Court, as . . . in *Allgeyer v. Louisiana*, *St. Louis Cotton Compress Co. v. Arkansas*, and *Connecticut General Life Insurance Co. v. Johnson*, which hold, inter alia, that a State does not have power to tax contracts of insurance or reinsurance entered into outside its jurisdiction by individuals or corporations resident or domiciled therein covering risks within the State or to regulate such transactions in any way.[37]

Since the McCarran-Ferguson Act, insurance regulation has been generally left in the hands of state regulators.[38]

The Supreme Court has repeatedly held that the Constitution limits the authority of states to regulate insurance.[39] The power of a state to regulate and tax insurance transactions *within* its borders has always been

33. *See* United States v. Se. Underwriters Ass'n, 322 U.S. 533, 552–53 (1944) (holding that insurance is commerce and can be regulated by Congress).

34. *Id.*

35. LENCSIS *supra* note 11, at 3.

36. McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015 (1945) (citation omitted).

37. H.R. REP. NO. 79-143, at 3 (1945).

38. *See id.* (explaining that even though the McCarran-Ferguson Act leaves insurance to state regulation, state regulation is still subject to the Supreme Court's controlling decisions).

39. *See* Julie Mix McPeak, *History and Purpose of Licensing of Insurers*, *in* 2 APPLEMAN ON INSURANCE LAW AND PRACTICE § 9.02 (2013), *available at* Lexis Advance (reviewing the Supreme Court's treatment of state insurance regulations); *see also* discussion *infra* Part II.A.2.

understood.[40] Whether a state may regulate and tax an insurance transaction that crosses state boundaries is a complicated consideration. In *Allgeyer v. Louisiana*, the Supreme Court recognized that the Fourteenth Amendment gives citizens the right to purchase insurance *outside* of their home state even if the insurance policy in question covers property located *within* that state.[41] Similarly, the Court in *St. Louis Cotton Compress Co. v. Arkansas* held that "the State may regulate the activities of foreign corporations within the State but it cannot regulate or interfere with what they do outside."[42] Consequently, the ability of a state to tax insurance premiums paid to an out-of-state insurer is, in each instance, a fact-based analysis.[43] Before a state may impose a tax on premiums paid to an out-of-state insurer or on the act of procuring insurance, it must demonstrate the insurance transaction occurred within its borders.[44]

In 1938, the Supreme Court in *Connecticut General Life Insurance Co. v. Johnson* provided guidance as to when a state may tax premiums paid to an out-of-state insurance company.[45] There, the Court held that to determine if a state may constitutionally tax an object, "we look to the state power to control the objects of the tax as marking the boundaries of the power to lay it."[46] Accordingly, a state may only tax insurance transactions when an insurer carries out transactions *within* that state.[47] The Court further stated: "[T]he due process clause denies to the state power to tax or regulate the corporation's property and activities elsewhere."[48] The question of when a state may properly impose taxes on insurance depends on the location of the business entities and transactions involved.[49]

Crucial to understanding the constitutional limitations on the NRRA is the seminal Supreme Court decision of *State Board of Insurance v. Todd Shipyards*.[50] The Court held that a Texas tax on premiums paid by an insured to an out-of-state insurer without a place of business in Texas was

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40. *See id.* (noting that every state has laws regulating and taxing insurance transactions within its borders).

41. Allgeyer v. Louisiana, 165 U.S. 578, 588–89 (1897).

42. St. Louis Cotton Compress Co. v. Arkansas, 260 U.S. 346, 349 (1922).

43. *See* JAMES T. MCINTYRE & ADAM D. MAAREC, THE NONADMITTED AND REINSURANCE REFORM ACT OF 2010 AND ITS POTENTIAL APPLICATION TO CAPTIVE INSURANCE 2 (2011), *available at* http://www.vermontcaptive.com/assets/files/Dodd%20Frank%20White%20Paper.pdf (noting that the inquiry depends on the object of the tax).

44. *See infra* Part II.A.2 (explaining when states may constitutionally tax insurance transactions).

45. Conn. Gen. Life Ins. Co. v. Johnson, 303 U.S. 77, 80 (1938).

46. *Id.*

47. *Id.*; MCINTYRE & MAAREC, *supra* note 43, at 2.

48. *Johnson*, 303 U.S. at 80–81.

49. *Id.*

50. State Bd. of Ins. v. Todd Shipyards Corp., 370 U.S. 451 (1962).

invalid under the Due Process Clause.[51] That is because the only substantive connection between Texas and the insurance transaction was that property covered by the policy was located in Texas.[52] The Court again confirmed its interpretation of the McCarran-Ferguson Act, stating it is "loath to change" its prior decisions limiting state taxation of insurance transactions.[53] The holding of *Todd Shipyards* is absolutely clear: a state may not tax premiums paid by an insured to an insurance company located outside of that state when the only connection between the state and the out-of-state insurance company is the location of the insured or the property covered.[54] The Supreme Court confirmed the validity of *Allgeyer*, *St. Louis Cotton*, and *Johnson*, all of which set the limits on when states may tax insurance transactions.[55]

These cases remain binding precedent for the proposition that a state may not tax an insurance transaction unless it is conducted within such state's jurisdiction. The NRRA cannot then be construed to authorize state taxation of an insurance transaction conducted elsewhere. Such a construction would be a clear violation of the Due Process Clause as interpreted on numerous occasions by the Supreme Court.[56]

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51. *Id.* at 453–54, 457–58.

52. *Id.* at 455; *see also* Dow Chem. Co. v. Rylander, 38 S.W.3d 741, 744 (Tex. App. 2001) (holding that a Texas independently procured insurance statute that imposes a tax on insurance covering risks in Texas but purchased from out-of-state insurance companies violates the McCarran-Ferguson Act). *But see* Combs v. STP Nuclear Operating Co., 239 S.W.3d 264, 274 (Tex. App. 2007) (holding that independently procured insurance tax imposed on an insurance transaction between a taxpayer and an insurer not licensed in Texas did not violate the Due Process Clause or the McCarran-Ferguson Act where the taxpayer was a Texas corporation headquartered in Texas and insurance contracts were negotiated and approved by the taxpayer's employees in Texas).

53. *Todd Shipyards*, 370 U.S. at 457.

> [T]he policy announced by Congress in the McCarran-Ferguson Act was one on which the [insurance] industry had reason to rely since 1897, when the *Allgeyer* decision was announced; . . . [and] [w]hen . . . Congress has posited a regime of state regulation on the continuing validity of specific prior decisions, we should be loath to change them.

Id. (citations omitted); *see also* MCINTYRE & MAAREC, *supra* note 43, at 3.

54. *Todd Shipyards*, 370 U.S. at 454, 456, 458.

55. *See id.* at 456.

> [W]hile Congress provided in [the McCarran-Ferguson Act] that the insurance business 'shall be subject to the laws of the several States which relate to the regulation or taxation of such business,' it indicated without ambiguity that such state 'regulation or taxation' should be kept within the limits set by the *Allgeyer*, *St. Louis Cotton Compress*, and *Connecticut General Life Insurance* decisions.

Id. (quoting 15 U.S.C. § 1012(a) (2006)) (internal quotation marks omitted).

56. *See infra* Part II.A.

B. The Distinction Between Admitted Insurance, Surplus Lines Insurance, and Captive Insurance

Generally, three types of insurance are sold in the United States: admitted, surplus lines, and captive. To protect consumers, states typically require insurers selling insurance within their borders to become licensed.[57] When a license to do business is issued, an insurer is deemed to have been admitted.[58] A license is only issued after a state's regulatory review of an insurance company's financial structure, rates, and policy forms.[59] An admitted insurer is subject to state taxation and regulation.[60] Surplus lines insurance is insurance business transacted in a state by an insurer that has not been formally licensed to do business in that state.[61] Nevertheless, a surplus lines insurer may sell insurance in a state where it has not been formally licensed, subject to certain restrictions.[62]

A surplus lines insurer must be "approved" by each state in which it does business.[63] In addition, a consumer is unable to purchase a policy of insurance from a surplus lines insurer unless a number of admitted insurers have declined to provide insurance coverage to the consumer.[64] Surplus lines insurance is often referred to as a residual market: it is only available to consumers when licensed carriers are unwilling to provide insurance coverage.[65] States allow consumers to purchase surplus lines insurance through a surplus lines broker if such insurance meets state eligibility requirements.[66] Typically, state regulators publish a "white list" identifying surplus lines insurers that have satisfied the state criteria to sell insurance

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57. McPeak, *supra* note 39, § 9.02.

58. *Id.*; *see also* ELIZABETH K. AINSLIE ET AL., BUSINESS AND INSURANCE LAW PRACTICE GUIDE § 1.02(3)(d) (2013), *available at* Lexis Advance (explaining the advantages and disadvantages to becoming a licensed insurance company).

59. McPeak, *supra* note 39, § 9.02; *see also* Steven Plitt et al., *The Insurance Industry and Insurance Relationships*, *in* COUCH ON INSURANCE §§ 2:22, 2:8 (3d ed. 2013), *available at* Westlaw COUCH (discussing the licensing process and the responsibilities of state insurance departments respecting licensing companies to conduct the business of insurance).

60. McPeak, *supra* note 39, § 9.02; *see also* AINSLIE ET AL., *supra* note 58, § 1.02(3)(d) ("[I]nsurance companies accept regulation as a part of doing the business of insurance. . . . [They] must pay a premium tax based on premiums written. . . .").

61. LENCSIS, *supra* note 11, at 87.

62. WESTOVER, *supra* note 19, at 215; Gary M. Cohen, *Regulation of Domestic Insurers Compared to Foreign Insurers*, *in* 2 APPLEMAN ON INSURANCE LAW AND PRACTICE, *supra* note 39, § 8.04(3).

63. LENCSIS, *supra* note 11, at 89.

64. *Cf.* Cohen, *supra* note 62, § 8.04(3) (explaining that surplus lines insurance covers "certain types of insurance that are not offered in the admitted market").

65. *Cf. id.* (indicating that surplus lines insurers offer coverage for risk not covered by admitted insurers).

66. WESTOVER, *supra* note 19, at 215; Cohen, *supra* note 62, § 8.04(3).

within the state.[67] Once a surplus lines insurer meets state eligibility requirements, the insurer may place business through an approved surplus lines broker.[68] Surplus lines brokers selling the insurance are legally responsible for collecting and remitting premium taxes paid by the insured to the state of the insured.[69]

Captive insurance represents a third type of insurance. Captive insurance companies are "owned and controlled by [their] insureds."[70] Corporations and associations, typically referred to as *parent companies*, create captives to insure their own risks.[71] Captive insurance is distinct from admitted and surplus lines insurance. A captive insurance company does not receive approval to do business in any state other than the one in which it is licensed to transact business.[72] The material elements of the transaction to obtain insurance occur in the state where the captive is domiciled.[73] Captive insurance companies cover risk in many states other than their domiciliary states.[74] However, when a captive insures risk located in another state, such state has no jurisdiction to tax or regulate the insurance transaction, unless facts demonstrate that a material portion of the insurance transaction occurred within its borders.[75] A captive insurance company may issue the type of policy form and charge premiums it deems appropriate, provided such coverage is consistent with the permission received from the regulator in its domiciliary state.[76] That result—single state regulation of a transaction involving a risk located in another state—is possible when the insurance transaction occurs in the captive's domicile.

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67. LENCSIS, *supra* note 11, at 89.

68. *Id.*

69. WESTOVER, *supra* note 19, at 215. This is the critical distinction between the functions of surplus lines and captive insurers for understanding the NRRA's intended application. Because captives traditionally restrict insurance transactions to their domiciliary states and thus only pay a premium tax to one state, allowing only the home state of a captive's parent to collect a premium tax would be pointless. In comparison, because surplus lines operate in multiple jurisdictions and remit premium taxes in all such jurisdictions, a federal law requiring only the home state of a surplus lines insurer to collect premium taxes makes sense in order to streamline the collection and allocation of premium taxes.

70. *Id.* at 4.

71. *See id.* (defining captive insurance).

72. *Id.* at 4–5 (explaining that captives are admitted in at least one jurisdiction but "operate on a multistate basis").

73. *Cf.* Julie Mix McPeak, *Variations in Licensing by Type of Insurer*, *in* APPLEMAN ON INSURANCE LAW AND PRACTICE, *supra* note 39, § 9.04(2)(b) (explaining that a captive insurer "must be approved for operation in its domicile state and is regulated similarly to a commercial insurer").

74. WESTOVER, *supra* note 19, at 4–5.

75. *See* WESTOVER, *supra* note 19, at 156 (stating that taxing authorities may only tax an insurer where there is a "nexus" between the insurer and the jurisdiction seeking to impose the tax); *see also* discussion *infra* Part II.A.2.

76. *See, e.g.*, VT. STAT. ANN. tit. 8, § 6002 (2013) (discussing the licensing requirements for captives to engage in insurance business in Vermont).

Captive insurance has become an increasingly popular form of insurance, especially for businesses.[77] Instead of paying premiums to a third-party admitted insurer, a corporation pays premiums to its wholly-owned captive insurance company.[78] When, for example, a company pays an annual premium of $1 million to a third-party admitted insurance company and has only $600,000 in claims and other expenses, the company has, in most instances, paid more than it would have paid to its affiliated captive.[79] Non-profit organizations, hospitals and medical schools for example, have used captives for decades to self-insure against inherent risks, such as workers' compensation or malpractice.[80]

Not every state has captive legislation, and in those states where captive laws are in place, they differ from one state to the next.[81] Some states tax captive insurance premiums while others do not.[82] A corporation in one state looking to create its own captive insurance company can choose the captive's domiciliary state.[83] Consequently, a captive insurance company is frequently domiciled in a different state from its parent company. Under these circumstances, the parent company procures its insurance from outside of its home state's borders by purchasing insurance from its affiliated captive insurance company.[84]

A majority of states impose a procurement tax on the entities procuring insurance in another jurisdiction.[85] These states are unable to impose a premium tax on the captive.[86] Such a state would lack jurisdiction over a captive domiciled in another state, even though the covered risk is within its

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77. Captive Ins. Co. Design, Formation and Mgmt. Experts, *History of Captives*, CAPTIVEEXPERTS.COM, http://captiveexperts.com/History_of_Captives.html (last visited Apr. 8, 2014).

78. *See* Paul Sullivan, *An Insurer of One's Own? It's Possible, With Caveats*, N.Y. TIMES, July 13, 2012, http://www.nytimes.com/2012/07/14/your-money/a-captive-insurance-company-offers-financial-benefits-if-not-abused-wealth-matters.html?pagewanted=all (discussing incentives to forming a captive).

79. *Id.*

80. *Id.*

81. Mary Williams Walsh & Louise Story, *Seeking Business, States Loosen Insurance Rules*, N.Y. TIMES, May 8, 2011, http://www.nytimes.com/2011/05/09/business/economy/09insure.html?pagewanted=all. Roughly thirty states have captive laws. *Id.*

82. Cara Griffith, *The State Tax Implications of Captive Insurance Companies*, TAX ANALYSTS: STATE TAX NOTES, May 21, 2012, at 557, 561 (explaining premium tax benefits for captives and how some states, like Arizona, do not impose a premium tax on captives).

83. WESTOVER, *supra* note 19, at 146.

84. *See, e.g.*, DEL. DEP'T OF INS., PREMIUM TAXES AND FEES: INDEPENDENTLY PROCURED INSURANCE (ALSO KNOWN AS SELF-PROCURED) 1 (2012), *available at* http://www.delawareinsurance.gov/departments/documents/PremiumTax/IndependProcuredIns.pdf (defining independently procured insurance).

85. Griffith, *supra* note 82, at 559. "Roughly 39 states impose similar independently procured insurance premium taxes on insureds in their states." MCINTYRE & MAAREC, *supra* note 43, at 5 n.14.

86. *See infra* Part II.A.2.

geographic borders.[87] Captives do pay a premium tax to their domiciliary state.[88] Nevertheless, a captive's parent company remains exposed to a procurement tax in its home state should the facts demonstrate key aspects of the insurance purchase transaction occurred in the home state.[89] But where, as previously noted, the *only* connection between a captive insurer and the state in which its parent company operates is that the captive insures risks located in that state, the state where the parent operates may not constitutionally impose a procurement tax on premiums paid to a captive.[90] A premium tax and procurement tax are similar in that both are taxes based on premiums paid for insurance.[91] The distinction lies in the focus of the tax: a premium tax is imposed on the insurer for premium payments received for a given insurance policy, whereas a procurement tax is imposed on the insured or entity procuring insurance from an out-of-state, unauthorized insurance company.[92]

C. The Nonadmitted and Reinsurance Reform Act of 2010 (NRRA)

In July 2010, Congress enacted the Nonadmitted and Reinsurance Reform Act (NRRA) as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[93] The NRRA was designed to "streamline the taxation and regulation of non-admitted insurance" in the United States.[94] The NRRA applies to the payment of premium taxes for nonadmitted insurance.[95] The NRRA provides that "[n]o State other than the home State of an insured may require any premium tax payment for nonadmitted insurance."[96] Moreover, "[t]he States *may* enter into a compact or otherwise

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87. *See* discussion *infra* Part II.A.2.

88. *See, e.g.*, VT. STAT. ANN. tit. 8, § 6014 (2013) (requiring each captive insurance company to pay a tax to the Commissioner of Taxes each year); *cf.* Griffith, *supra* note 82, at 561 (explaining that some states do not impose a premium tax on captive insurers).

89. *See* discussion *infra* Part II.A.2.

90. *See* LENCSIS, *supra* note 11, at 92 (discussing the "basic constitutional principle behind the formation of a captive").

91. Brian T. Casey & R. Dean Conlin, *State Direct Independent or Self-Procurement of Insurance Tax*, *in* 2 APPLEMAN ON INSURANCE LAW AND PRACTICE, *supra* note 39, § 12.11(1).

92. *Id.* A procurement tax is a residual tax that is often higher than a premium tax. *See infra* Part II.B. That likely reflects the fact that states seek to discourage their residents from purchasing insurance from nonadmitted or captive insurance companies.

93. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 511–542, 124 Stat. 1376, 1589–96 (2010) (codified at 15 U.S.C. §§ 8201-8232 (2012)).

94. Griffith, *supra* note 82, at 560.

95. *Id.*; 15 U.S.C. § 8201.

96. 15 U.S.C. § 8201(a).

establish procedures to allocate among the States the premium taxes paid to an insured's home State."[97] In addition, the NRRA states:

> To facilitate the payment of premium taxes among the States, an insured's home State may require surplus lines brokers and insureds who have independently procured insurance to annually file tax allocation reports with the insured's home State detailing the portion of the nonadmitted insurance policy premium or premiums attributable to properties, risks, or exposures located in each State.[98]

If states entered into an interstate compact pursuant to the NRRA, allocation of premium taxes paid to an insured's home state to other states would be based on such annual tax allocation reports. Therefore, states in an interstate compact would receive premium tax payments based on the property, risk, or exposures located in each state.[99]

According to the NRRA, "[t]he term 'nonadmitted insurance' means any property and casualty insurance permitted to be placed directly or through a surplus lines broker with a nonadmitted insurer eligible to accept such insurance."[100] Further, "[t]he term 'nonadmitted insurer' . . . means with respect to a State, an insurer not licensed to engage in the business of insurance in such State."[101] "Independently procured insurance" is defined as "insurance procured directly by an insured from a nonadmitted insurer."[102] Last, "home state" is defined as:

> [W]ith respect to an insured . . . the State in which an insured maintains its principal place of business or, in the case of an individual, the individual's principal residence; or . . . if 100 percent of the insured risk is located out of the State . . . , the State to which the greatest percentage of the insured's taxable premium for that insurance contract is allocated.[103]

The NRRA also defines a "premium tax" as:

> [W]ith respect to surplus lines or independently procured insurance coverage, any tax, fee, assessment, or other charge

97. *Id.* § 8201(b)(1) (emphasis added).
98. *Id.* § 8201(c).
99. *Id.*; MCINTYRE & MAAREC, *supra* note 43, at 1.
100. 15 U.S.C. § 8206(9) (2012).
101. *Id.* § 8206(11)(A).
102. *Id.* § 8206(7).
103. *Id.* § 8206(6)(A)(i)–(ii).

> imposed by a government entity directly or indirectly based on any payment made as consideration for an insurance contract for such insurance, including premium deposits, assessments, registration fees, and any other compensation given in consideration for a contract of insurance.[104]

In addition, the insured's home state[105] has exclusive authority over the regulation of nonadmitted insurance.[106] "Except as otherwise provided in [§ 8202], the placement of nonadmitted insurance shall be subject to the statutory and regulatory requirements solely of the insured's home State."[107] Consequently, the NRRA preempts the placement rules of non-home states.[108]

In summary, the NRRA's express purpose is to create a more efficient and effective way to tax and regulate premium tax payments on nonadmitted insurance. To do so, the NRRA provides that *only* the insured's home state may require premium tax payment for nonadmitted insurance rather than various states with covered risks requiring premium taxes as well. Moreover, the NRRA encourages home states collecting premium tax payments to enter into compacts with other states to allocate premium tax payments based on risks covered in those states.

II. ANALYSIS

A. The NRRA's Definition of Nonadmitted Insurance Does Not Cover Captive Insurance

The definition of nonadmitted insurance in the NRRA raises a serious question regarding its applicability to captive insurance companies.[109] There is absolutely no doubt that the NRRA applies to surplus lines insurance.[110] Its potential applicability to captive insurance is far less clear. When legislative intent is considered in connection with a reasonable construction of the NRRA, it becomes clearer that the NRRA does not apply to captive

104. *Id.* § 8206(12).

105. The NRRA provides the standard for determining an insured's "home State," whether it is by principal place of business or majority of risk, theoretically making it easier to collect and remit premium taxes. *Id.* § 8206(6).

106. 15 U.S.C. § 8202(a) (2012).

107. *Id.*

108. MCINTYRE & MAAREC, *supra* note 43, at 1.

109. Phillip England et al., *The Nonadmitted and Reinsurance Reform Act's Questionable Applicability to Captive Insurance Companies*, DAILY TAX REP., Dec. 7, 2012, at 4, *available at* http://www.andersonkill.com/webpdfext/NRRAs_Captive_Ins_Co.pdf.

110. *Id.* at 2 n.2; 15 U.S.C. § 8206.

insurance. Should the NRRA be applied to captives, such application would in many instances violate established United States Supreme Court precedent construing due process limitations on states' powers to tax.[111] A state may not impose a tax on a transaction accomplished in another state.[112] Given that constitutional limitation, the NRRA cannot be construed to authorize an otherwise unconstitutional assessment either of a premium tax on a captive insurer or a procurement tax on the entity purchasing insurance from a captive insurer. The NRRA must be read in a manner consistent with the applicable constitutional standards.[113]

In support of the conclusion that the NRRA does not apply to captive insurance, this Note explores the following aspects of the NRRA: the legislative history leading up to the NRRA's enactment and the constitutional limitations on states' ability to impose taxes on insurance transactions occurring in other states.[114] Last, this Note discusses the potential impacts of a misreading of the NRRA on Vermont's captive industry.

1. The NRRA's Legislative History and Intent

The NRRA's legislative history indicates that Congress intended the NRRA to apply only to surplus lines insurance.[115] In their comments on the House floor, three sponsors of the 2009 version of the NRRA "described the bill as a resolution to improve *surplus lines insurance* laws."[116] The sponsors' comments on the floor provide strong evidence that the NRRA's definition of nonadmitted insurance applies only to surplus lines insurance.[117]

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111. *See* discussion *infra* Part II.A.2.

112. *See* discussion *supra* Part I.A.

113. *See* Clark v. Martinez, 543 U.S. 371, 380–81 (2005) (discussing the canon of constitutional avoidance, and, in particular, that "[i]f one of [two plausible statutory constructions] would raise a multitude of constitutional problems, the other should prevail").

114. This Note does not analyze the plain language of the NRRA itself. Such an analysis is too industry specific and beyond the purpose of this Note. However, some practitioners argue that the express language of the NRRA does not cover captive insurers, primarily because captive insurance, unlike surplus lines, is not "permitted to be placed" directly with an "eligible" insurer. 15 U.S.C. § 8206(9) (2012). Rather, captive insurance is procured directly from a nonadmitted, out-of-state captive insurer. For a further discussion and analysis of the express language of the NRRA, see MCINTYRE & MAAREC, *supra* note 43, at 6.

115. *See* 155 CONG. REC. 21235–39 (2009) (explaining that the NRRA was intended to apply to surplus lines insurance).

116. MCINTYRE & MAAREC, *supra* note 43, at 7 (emphasis added).

117. *See* 155 CONG. REC. 21237–39; MCINTYRE & MAAREC, *supra* note 43, at 7 (discussing floor comments of Representative Moore of Kansas, Representative Garrett of New Jersey, and Representative Bachus of Alabama).

In 2009, Representative Dennis Moore of Kansas, Representative Scott Garrett of New Jersey, and Representative Spencer Bachus of Alabama all addressed the House and made comments on the floor clarifying the intent of the NRRA.[118] Representative Moore explained:

> Under today's laws, the regulation of the surplus lines market is . . . fragmented and cumbersome . . . .
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> * * *
>
> Accordingly, H.R. 2571 specifies that only the tax policies, licensing and other regulatory requirements of the home State of the policyholder govern a surplus lines transaction [and] it allows sophisticated commercial entities direct access to the surplus lines market . . . .[119]

In addition, Representative Garrett added:

> [T]he Nonadmitted and Reinsurance Reform Act of 2009 . . . will reform and will streamline the regulation of the nonadmitted—that's surplus lines—insurance market . . . .
>
> Title I, which addresses the surplus lines market, will reduce regulatory overlap, and will clarify where the appropriate taxing authority really should lie with each market transaction.[120]

Last, Representative Bachus contributed:

> [T]oday we are seeking to advance a modest but long-overdue measure to streamline the current system for surplus lines insurance . . . .
>
> Surplus lines insurance, also known as "nonadmitted" insurance, is highly specialized property and casualty insurance for exceptional risks, such as hazardous materials or amusement parks.
>
> H.R. 2571 would adopt a "home state" approach to address inconsistencies in state regulation of the surplus lines insurance

118. *See* 155 CONG. REC. 21237–39 (explaining the intent of the NRRA).
119. *Id.* at 21237.
120. *Id.* at 21238.

> market, and the bill generally follows the model law on nonadmitted insurance adopted by the National Association of Insurance Commissioners.[121]

The comments of these three sponsors indicate the NRRA was intended to apply to streamline the regulation of the "fragmented and cumbersome" surplus lines market.[122] Representative Moore addressed the House floor again after the Dodd-Frank Act was signed into law.[123] Representative Moore explained, "Section 521(a) of the Dodd-Frank Act is intended to require the broker to pay or remit all tax in a *surplus lines transaction* to the 'Home State' of the insured as defined in the Act . . . ."[124] Any lingering uncertainty about the NRRA's intent and purpose was addressed in Representative Moore's December comments:

> Non-admitted insurance, or surplus lines, is specialty insurance you cannot purchase in the traditional, admitted market. Often called the "safety net" of the insurance market, surplus lines provides for coverage when the traditional market is not available. This is insurance for satellites, toxic chemicals, new inventions, or insurance on homes and businesses in a scarce market.
>
> * * *
>
> The goal of the NRRA was not to eliminate regulatory protections, but to streamline the regulatory regime to enable insurers and brokers to more easily and efficiently comply with state rules and provide much-needed insurance protections to consumers. The law accomplishes this by giving sole regulatory authority over a surplus lines transaction—including the authority to collect premium taxes—to the home state of the insured.[125]

Around the time that Representative Moore made his December comments on the House floor, the NAIC was in the midst of preparing an interstate compact to facilitate the implementation of the NRRA.[126]

121. *Id.*
122. *See id.* at 21237 (stating the purpose of the NRRA).
123. 156 CONG. REC. E1407 (daily ed. July 22, 2010); MCINTYRE & MAAREC, *supra* note 43, at 7.
124. 156 CONG. REC. E1407 (emphasis added).
125. 156 CONG. REC. E2144 (daily ed. Dec. 15, 2010).
126. *See id.* (discussing the NAIC's model agreement and statutory language).

Accordingly, Representative Moore stated: "[The NAIC] is moving swiftly to draft a model agreement and statutory language to enable the states to collect and share surplus lines premium taxes."[127] Representative Moore further explained that "[t]he broader intent of the law is to provide a comprehensive, uniform solution to the current regulatory mess by addressing the full spectrum of *surplus lines regulation*" and that "the states need to take this opportunity to adopt a single set of uniform *surplus lines* regulatory requirements."[128]

Based on the statements of Representative Moore, Representative Garrett, and Representative Bachus, it is evident that the NRRA was designed to reform and streamline surplus lines insurance regulation. Nowhere in these three House Reports is captive insurance mentioned. The three sponsors explain that surplus lines insurance is nonadmitted insurance and provides non-traditional coverage. Captives, although they may be considered "non-traditional" insurance companies, provide traditional coverage such as medical and employee benefit insurance. To this end, the NRRA does not reach captive insurance.

2. The NRRA Would Violate the Constitution if Applied to Captives

Should the NRRA be construed to apply to captive insurance, its application would often result in violations of longstanding Supreme Court precedent as it would require a premium tax payment to the home state of an insured even in those situations where the home state lacks the requisite jurisdictional nexus to impose such a tax.[129] Under the NRRA, only the "home State of an insured may require any premium tax payment for nonadmitted insurance."[130] The NRRA defines home state as the insured's principal place of business or, in the case of an individual, the individual's principal residence.[131] If none of the risk is located within such a state, the home state is the state in which the "greatest percentage of the insured's taxable premium for that insurance contract is allocated."[132] This definition creates a potential constitutional issue because the home state could be a state in which no insurance transactions between the insurance company

127. *Id.*

128. *Id.* at E2144–45 (emphasis added).

129. MCINTYRE & MAAREC, *supra* note 43, at 12. The NRRA does make sense and is constitutional as long as it *only* applies to surplus lines transactions. *See supra* Part I.B (distinguishing the functions of surplus lines insurers and captive insurers); *cf.* 15 U.S.C. § 8206(6) (2012) (defining home state).

130. 15 U.S.C. § 8201(a) (2012).

131. *Id.* § 8206(6)(A)(i).

132. *Id.* § 8206(6)(A)(ii).

and the insured have occurred.[133] Moreover, if the home state adopts an interstate compact pursuant to the NRRA to allocate premiums to other states based on risk covered in each state, the NRRA could, in the context of captive insurance, be promoting the distribution of tax proceeds to states that do not have the authority to collect such proceeds. Such payment of a premium tax would directly conflict with the Supreme Court's holdings in *Allgeyer*, *St. Louis Cotton*, and *Johnson*.[134]

This trilogy of cases, reaffirmed by the Supreme Court in *Todd Shipyards*, laid the foundation for the minimum contacts necessary for a state to constitutionally tax insurance transactions. These cases hold that the critical factual question for determining when a state may tax an insurance transaction is whether the "transaction occurred entirely outside the taxing state."[135] When a court determines a transaction occurs "entirely outside the taxing state," that state may not impose a tax on such a transaction.[136]

The first in this line of cases, *Allgeyer*, established that a resident in one state may legally contract with an out-of-state insurance company that is not licensed to do business in the insured's state in order to insure risk covered in that state without offending the Due Process Clause of the Fourteenth Amendment.[137] Following *Allgeyer*, the Court in *St. Louis Cotton* held an Arkansas tax on premiums paid for a policy covering risk in Arkansas invalid under the Due Process Clause.[138] In that matter, the policy was made with an out-of-state insurance company that had no office or agents in Arkansas.[139] Last, in *Johnson*, the Court concluded that a California tax on premiums paid in Connecticut by one insurance company to another insurance company reinsuring policies written in California covering California residents violated the Due Process Clause, notwithstanding that both companies were authorized to do business in California.[140]

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133. MCINTYRE & MAAREC, *supra* note 43, at 12.

134. *See* discussion *supra* Part I.A (discussing how a state may not impose a premium tax unless there is the proper jurisdictional nexus to impose the tax); *supra* Part II.A.

135. Combs v. STP Nuclear Operating Co., 239 S.W.3d 264, 272 (Tex. App. 2007); *see also* State Bd. of Ins. v. Todd Shipyards Corp., 370 U.S. 451, 454–55, 457–58 (1962) (holding that the Due Process Clause of the Fourteenth Amendment prohibited Texas tax on insurance premiums where "transactions involved in the present litigation [took] place entirely outside Texas").

136. *Combs*, 239 S.W.3d at 272.

137. *See* Allgeyer v. Louisiana, 165 U.S. 578, 591 (1897) (holding unconstitutional a Louisiana statute that prohibited residents from contracting, through the use of mails, for insurance on risk located within Louisiana with an out-of-state insurance company not licensed to do business in Louisiana).

138. St. Louis Cotton Compress Co. v. Arkansas, 260 U.S. 346, 348–49 (1922).

139. *Id.*

140. Conn. Gen. Life Ins. Co. v. Johnson, 303 U.S. 77, 81–82 (1938).

St. Louis Cotton is particularly interesting as it dealt with a situation much like that which could occur if the NRRA is erroneously construed to apply to captives.[141] There, Arkansas sued a Missouri corporation that was authorized to conduct business in Arkansas.[142] The State sought to recover a 5% tax on the company's gross premiums paid for insurance covering property in Arkansas.[143] But, and similar to how captive insurers function, the policies at issue "were contracted for, delivered and paid for in St. Louis, Missouri, the domicil [sic] of the corporation, because the rates were less than those charged by companies authorized to do business in Arkansas."[144] On these facts, the Court explained that this case is even "stronger than that of *Allgeyer* in that here no act was done within the State, whereas [in *Allgeyer*] a letter constituting a step in the contract was posted within the jurisdiction."[145] The Court concluded that a "State may regulate the activities of foreign corporations within the State but it cannot regulate or interfere with what they do outside."[146] This statement well covers captives' typical operation, as they insure risk in jurisdictions in which they conduct no insurance transactions.[147] Furthermore, if the NRRA were construed to cover captives, situations would likely arise where multiple states assert a right to collect premium taxes arising from a single transaction by a captive insurer. This was exactly what happened when Arkansas attempted to collect premium taxes from *St. Louis Cotton*.[148]

Johnson articulates the Court's rationale for prohibiting a state from imposing a tax on an entity where the "transaction[s] occurred entirely outside the taxing state."[149] There, the Court reiterated a fundamental limitation imposed by the Due Process Clause upon the states: "[T]he due process clause denies to the state power to tax or regulate the corporation's

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141. *See infra* Part II.B (discussing how the application of the NRRA to captive insurers could result in multiple states claiming home state status and seeking premium tax payment from a captive).

142. *St. Louis Cotton*, 260 U.S. at 347.

143. *Id.*

144. *Id.*

145. *Id.* at 349.

146. *Id.*

147. *See supra* Part I.B (describing the functions of captive insurers).

148. *See infra* Part II.B (discussing how the application of the NRRA to captive insurers could result in multiple states claiming home state status and seeking premium tax payment from a captive).

149. Combs v. STP Nuclear Operating Co., 239 S.W.3d 264, 272 (Tex. App. 2007) (discussing *Connecticut General Life Insurance v. Johnson* and related cases). The Court in *Johnson* was presented with a unique situation. A Connecticut corporation, admitted to conducted business in California, entered into contracts to reinsure other California insurance companies on insurance policies written in California. Conn. Gen. Life Ins. Co. v. Johnson, 303 U.S. 77, 78 (1938). These reinsurance contracts, however, were entered into in Connecticut where the premiums were paid and where the losses, if any, were payable. *Id.*

property and activities elsewhere."[150] Moreover, the due process limitations on a state's authority to impose a tax "are to be ascertained by reference to the incidence of the tax upon its objects rather than the ultimate thrust of the economic benefits and burdens of transactions within the state."[151] In other words, "we look to the state power to control the *objects* of the tax as marking the boundaries of the power to lay it."[152] Because an insurer realized an economic benefit from transactions within a state does not necessarily subject that insurer to that state's jurisdiction to impose a tax on another, distinct transaction that took place elsewhere.[153] On that point, the Court wrote:

> [A] tax, otherwise unconstitutional, is not converted into a valid exaction merely because the corporation enjoys outside the state economic benefits from transactions within it, which the state might but does not tax, or because the state might tax the transactions which the corporation carries on outside the state if it were induced to carry them on within.[154]

Applying the Court's due process analysis and its holdings from these three landmark cases to captives, when a captive's insurance transactions do not take place whatsoever within the borders of its parent's home state, or any state in which it covers risk, the home state is prohibited from collecting a tax predicated on such transactions.[155] To do so would conflict with the Court's express holdings in *Allgeyer*, *St. Louis Cotton*, and *Johnson*. The holdings in these cases provide that where a constitutional outcome is possible, statutes should be construed consistent with that constitutional outcome. Consequently, the NRRA should not be construed to apply to captive insurers, which, by their very nature, insure risk in various jurisdictions without conducting transactions within those states.[156]

Roughly thirty years after the last of these three cases was decided, *Todd Shipyards* reaffirmed the holdings of these cases.[157] *Todd Shipyards*, a case arising from a dispute over insurance premium taxation, is particularly relevant to the issues presented by the NRRA. *Todd Shipyards* arose from a

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150. *Johnson*, 303 U.S. at 80–81.

151. *Id.* at 80.

152. *Id.* (emphasis added).

153. *Id.* at 81.

154. *Id.*

155. Under the NRRA, "home state" is the state where the individual resides or the entity's principal place of business. 15 U.S.C. § 8206(6)(A)(i) (2012).

156. *See supra* Part I.B (explaining the distinction between captive insurance and admitted and surplus lines insurance).

157. State Bd. of Ins. v. Todd Shipyards Corp., 370 U.S. 451, 455, 458 (1962).

Texas statute imposing a tax on insurance premiums paid for a policy covering risk located in Texas.[158] The policy in question was entered into out of state with an out-of-state insurance company.[159] Under such circumstances, the Supreme Court concluded that where the only connection between a state and an insurer is the property covered, the Texas premium tax imposed on the insurer was unconstitutional.[160] *Todd Shipyards* requires more extensive contacts between a state and out-of-state insurance company covering risk in a state prior to that state constitutionally taxing premiums paid by an insured to the out-of-state insurance company covering those risks.[161] Implicit in *Todd Shipyards*' holding is that where a state has jurisdiction over an insured procuring out-of-state insurance, such a state could constitutionally tax the *insured* on its premium payments.[162] In that case, the state would have jurisdiction over an entity operating and making payments from within its borders.[163]

The Court in *Todd Shipyards* based its decision on a number of factors. Specifically, it noted that "[t]he insurance transactions involved in the present litigation [took] place entirely outside Texas."[164] The Court further explained that the insurance policies were negotiated, paid, and issued outside of Texas.[165] Moreover, "[t]he insurers [were] not licensed to do business in Texas, [had] no . . . place of business in Texas, [did] not solicit business in Texas, [had] no agents in Texas, and [did] not investigate risks or claims in Texas."[166] Last, and perhaps most crucial when considering captives, the insured was "not a domiciliary of Texas but a New York corporation doing business in Texas."[167] This is how captive insurance companies typically function. The insurance transaction is not conducted in the jurisdiction where the insured operates.[168] Rather the transaction is completed in another state where the captive is domiciled.[169] When that transaction completely occurs elsewhere, the insured's domiciliary state has

158. *Id.* at 453.
159. *Id.*
160. *Id.* at 454.
161. *Id.*
162. *Cf.* Risk Managers Int'l, Inc. v. Texas, 858 S.W.2d 567, 570–71 (Tex. App. 1993) (concluding that Texas could tax and regulate insurance transactions where the insured was domiciled in Texas and the transactions occurred in whole or in part within Texas).
163. *Id.*
164. *Todd Shipyards*, 370 U.S. at 454.
165. *Id.*
166. *Id.* at 454–55.
167. *Id.* at 455.
168. *See supra* Part I.B (explaining the functions of captive insurance companies).
169. *See supra* Part I.B.

no jurisdiction under the U.S. Constitution to either tax or regulate the transaction.

In the years following *Todd Shipyards*, Texas has had occasion to decide similar cases and further validate the principles enunciated in *Allgeyer* and its progeny—these cases are instructive concerning the NRRA's application to captives. The Court of Appeals of Texas was presented with a similar situation to that of *Todd Shipyards* in *Risk Managers International, Inc. v. Texas*.[170] The Texas appellate court was faced with the issue of whether an *insured* could properly be assessed a procurement tax when procuring out-of-state insurance, rather than whether the *insurer* could be taxed on premiums.[171] The court found that, unlike *Todd Shipyards*, because the insured was incorporated in Texas, had offices in Dallas, negotiated its insurance policy in Texas, and, in some instances, the insurer received premium payments in Texas, Texas could properly tax this procurement of insurance.[172] Put simply, Texas could regulate and tax insurance transactions when the insured that is procuring out-of-state insurance is physically located in Texas.[173] The key here is that the transaction occurred in Texas; thus *Todd Shipyards* is distinguishable from *Risk Managers*. It is possible for a captive transaction to be taxed in states other than its domicile. That happens when the transaction is, "in whole or in part," completed where the insured resides.[174] This distinction is noted as the NRRA could be applied in *only* this limited circumstance.

The Texas Court of Appeals decided two more significant cases involving the same issue as *Risk Managers*, finding the Texas independently procured tax could not be imposed given the lack of jurisdiction in *Dow Chemical Co. v. Rylander* and upholding the tax in *Combs v. STP Nuclear Operating Co.*[175] The court reiterated its previous holdings. *Dow* involved strikingly similar facts to *Todd Shipyards*. The court found that "[b]ecause the law and the facts at issue today are essentially the same, we hold that the insurance at issue in *Todd Shipyards* is virtually identical to the insurance at issue in this case."[176] Thus the court determined the Texas independently procured tax could not be

170. Risk Managers Int'l, Inc. v. Texas, 858 S.W.2d 567, 570 (Tex. App. 1993).

171. *Id.* at 570.

172. *Id.* at 570–71.

173. *Id.* at 571.

174. *Cf. id.* (holding that "Texas may regulate insurance transactions where an insured domiciled in Texas obtains insurance by negotiations occurring in whole or in part inside the borders of Texas").

175. Combs v. STP Nuclear Operating Co., 239 S.W.3d 264, 274 (Tex. App. 2007); Dow Chem. Co. v. Rylander, 38 S.W.3d 741, 746–47 (Tex. App. 2001).

176. *Dow Chem.*, 38 S.W.3d at 746.

constitutionally applied where the entire transaction took place out of state and the insured had no place of business in Texas.[177]

The court concluded the opposite in *Combs*, a case that involved facts more analogous to *Risk Managers* than those found to be determinative in *Todd Shipyards*.[178] The court therefore held that the independently procured tax as applied did not violate either the Due Process Clause or the McCarran-Ferguson Act.[179] The court considered several factors consistent with its decision in *Risk Managers*.[180] The most significant fact was that STP was a Texas corporation headquartered in Texas that paid premiums originating in Texas to an out-of-state insurer.[181] Thus, Texas had jurisdiction over the insured and the insurance transaction providing the proper factual nexus to constitutionally tax premiums paid by STP.

These cases illustrate the fundamental principle pronounced in *Allgeyer* and confirmed by its successors: a state may not constitutionally tax an insurance transaction where the transaction did not take place within the taxing state. The mere connection of property or risk covered in a state does not create a nexus for a state to tax either the insured (procurement tax) or insurer (premium tax). The NRRA's definition of nonadmitted insurance cannot be constitutionally interpreted to include captive insurance when an insurance transaction occurs within the confines of the captive's state of domicile. In that circumstance, the home state of the insured has no authority under the U.S. Constitution to impose either a procurement tax on the party purchasing insurance or a premium tax on the captive providing insurance coverage.

B. Procurement Tax Issues

Applying the NRRA to captives has important implications for procurement taxes. At the outset, it is important to reiterate that the NRRA does not preempt state procurement laws.[182] There is, in fact, no mention of procurement laws in the NRRA.[183] Well before enactment of the NRRA, thirty-nine states imposed procurement taxes on individuals and entities

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177. *Id.*; *accord* State Bd. of Ins. v. Todd Shipyards Corp., 370 U.S. 451, 454, 458 (1962) (holding the tax on premiums unconstitutional).

178. *See Combs*, 239 S.W.3d at 274 (discussing *Risk Managers* and *Todd Shipyards*).

179. *Id.*

180. *Id.*

181. *Id.*

182. *See* MCINTYRE & MAAREC, *supra* note 43, at 14 (explaining that the NRRA does not preempt state procurement laws); Michael R. Mead, *Direct Procurement Revisited*, IRMI.COM (April 2010), http://www.irmi.com/expert/articles/2010/mead04-insurance-captive.aspx (discussing the uncertainty about whether procurement laws necessarily apply to captives).

183. *Cf.* 15 U.S.C. §§ 8201-8206 (2012) (yielding no mention of procurement laws).

obtaining insurance in other jurisdictions.[184] Such imposition of procurement taxes is constitutionally permissible.[185]

As noted, whether a procurement tax may be imposed depends on the facts.[186] One of the key considerations is the location of the insured risk subject to this taxation.[187] Relying on the NRRA, several states have erroneously concluded that 100% of the premium tax paid by a captive may be retained and not allocated among the states where the insured risks are actually located.[188] The argument put forth to support such action is that when a premium tax is appropriately paid under the NRRA (to the state where the captive's parent is domiciled), the parent company's procurement tax obligations to other states are eliminated.[189]

New York and California, for example, have found it more beneficial to tax and retain 100% of the premiums paid for nonadmitted insurance rather than "shar[e]" tax revenue with other states that should receive a proportion of the premiums.[190] This strained interpretation of the NRRA creates serious issues for captive insurance companies because captives typically cover risk allocable to multiple states and even countries.[191] Assuming for argument's sake that the NRRA applies to captives, if the home state of an insured taxes 100% of the premiums paid to a captive, the insured would be taxed on portions of the policy that would not have been taxed in states that do not impose a procurement tax.[192] New York and

184. Griffith, *supra* note 82, at 559. "Roughly 39 states impose similar independently procured insurance premium taxes on insureds in their states." MCINTYRE & MAAREC, *supra* note 43, at 5 n.14; *see also* Kevin Moriarty & Kathy Davis, *Good Intentions Gone Awry*, *in* CAPTIVE REV. VT. REP. 2012, *supra* note 2, at 14, 14 (explaining that prior to the enactment of the NRRA, some states imposed procurement taxes on premiums paid for nonadmitted and independently procured insurance).

185. MCINTYRE & MAAREC, *supra* note 43, at 6; *see supra* Part II.A.2.

186. *See supra* Part II.A.2.

187. *See supra* Part II.A.2.

188. *See* Moriarty & Davis, *supra* note 184, at 15 (explaining that some states are retaining and taxing 100% of premiums paid for nonadmitted insurance).

189. *See, e.g.*, McCarren-Ferguson Act, 15 U.S.C. §§ 1011-1015 (1945) (indicating that Congress will only preempt a state law involved with the taxation or regulation of insurance *when* it does so expressly); *see also supra* Part I.A (discussing the McCarran-Ferguson Act).

190. Moriarty & Davis, *supra* note 184, at 15. New York imposes a 3.6% tax on independently procured insurance (captive insurance) on premiums paid for coverage of risks that reside in New York—unless the captive is domiciled in New York. OFFICE OF GEN. COUNSEL, INS. DEP'T, USE OF CAPTIVE INSURERS–SELF PROCUREMENT TAX (2005), *available at* http://www.dfs.ny.gov/insurance/ogco2005/rg051006.htm. The captive parent must also have operations in New York. *Id.* In addition, Article 33-A of the New York Tax Law states that only the portion of risks allocable to New York are subject to the 3.6% procurement tax. *Id.* Still, there may be jurisdictional issues regarding New York's ability to tax premiums paid for insurance procured beyond New York's borders if no part of the transaction occurs within New York's borders. *Id.*

191. *See* Moriarty & Davis, *supra* note 184, at 15 (explaining the potential problems with the NRRA's application to captives).

192. *See id.* (highlighting the potential procurement issues under the NRRA).

California are collecting taxes on transactions conducted in other states, some of which do not tax the transactions at issue.

If a "non-home state" containing risk covered by a captive policy imposes a procurement tax, but at a lower rate than the home state, and the home state does not enter into an interstate compact, "the home state's higher rate will apply to 100% of the premium."[193] This point is illustrated in the following hypothetical. A corporation has 49% of its business in Illinois, which does not impose a tax on the procurement of insurance.[194] This corporation also operates and has 50% of its business operations in New York, where its principal place of business is located. This corporation initially has a captive insurer domiciled in Vermont and pays its premium tax to Vermont. Under its construction of the NRRA, New York now asserts that as the company's headquarters are in New York, it is entitled to collect and retain a procurement tax from the company on 100% of the premium paid in Vermont.[195]

If the facts establish the transaction occurred within the state of Vermont, only the Vermont tax would be owed.[196] New York asserts a right to collect taxes on the entire transaction even though 49% of the procurement activity is reasonably attributed to Illinois, a state that does not tax insurance procurement. In this instance, New York would be taxing, in part, an Illinois transaction. Under applicable constitutional standards, it has no right to collect and retain procurement taxes, except for that portion of the procurement fairly attributed to New York risks.[197]

As a result, there is a concern that certain captives may re-domicile to their parent company's home state if the parent's home state has captive legislation.[198] If a captive's parent company (the insured) was facing a high procurement tax imposed by its home state and that home state has captive legislation, a captive may re-domicile in its parent's home state so the parent can avoid the high procurement tax.[199] Most states' premium tax on admitted insurance is much lower than a procurement tax on nonadmitted or independently procured insurance.[200] However, even if a captive re-

193. *Id.*

194. *Cf. Direct Procurement Tax Laws by State*, EDWARDSWILDMAN.COM, http://surplusmanual.edwardswildman.com/esappendixb/#Illinois (last visited Apr. 8, 2014) (indicating that Illinois does not impose a procurement tax).

195. *See* 15 U.S.C. § 8201(a) (2012) ("No State other than the home State of an insured may require any premium tax payment for nonadmitted insurance.").

196. *See supra* Part II.A.2.

197. *See supra* Part II.A.2.

198. Moriarty & Davis, *supra* note 184, at 15.

199. *Id.*

200. *See id.* (stating that a premium tax on admitted insurance is significantly less than a procurement tax).

domiciles so its parent may avoid high procurement taxes from its home state, the parent company may still face home state issues if 100% of the risk covered is located outside of the parent's home state.[201] Therefore, the re-domiciled captive's parent may still face "potential excessive taxation" where a state with the greatest proportion of risks covered claims home state status and imposes a procurement tax.[202]

Similarly, this interpretation of the NRRA could open the door to unnecessary litigation should multiple states claim home state status. Because states are intensely seeking additional sources of revenue, multiple states may be tempted to claim home state status for a single nonadmitted policy.[203] This exposure to insurers is very problematic as multiple states may claim the right to tax captive insurance premiums.[204] Should captives be considered nonadmitted insurers under the NRRA, they may face the cost and risk of litigating claims from multiple states seeking to recover premium taxes.[205]

Under most circumstances, the home state of a captive parent would not be permitted to tax a captive on its premiums because, as previously discussed, the home state would not have jurisdiction over the captive. Similarly, a home state cannot impose a procurement tax on an insured while maintaining a premium tax on the insurer. Unlike surplus lines companies that operate in multiple states and are subject to premium taxes in those states, a captive operates in one state and insures risk located in others. Traditionally, captives only pay a premium tax to its domiciliary state. Surplus lines brokers remit premium taxes to each state in which they conduct business. As the NRRA was designed to streamline the collection and allocation of premium taxes, permitting only a home state to collect a captive's premium tax would be futile. These home states could impose a procurement tax on the parents of captives for procuring out-of-state insurance but would not be able to impose a premium tax on the captive at the same time.

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201. *Id.*; *see also* 15 U.S.C. § 8206(6) (2012) (defining home state).

202. *See* Moriarty & Davis, *supra* note 184, at 15 (discussing how even if a captive re-domiciles so its parent can avoid high procurement taxes from its home state, a captive parent may still face issues if other states claim home state status and impose procurement taxes).

203. *Id.*

204. *Id.*

205. *See id.* (stating that multiple states may claim home state status under the NRRA). For example, if the home state of a captive's parent company was New York, but the captive covered a majority of risk in California such that California believed it should enjoy home state status for the captive's premium tax, California may seek to collect a tax from that captive. That captive, whose parent's home state is New York, would likely respond that New York has already collected its premium tax, even though a portion of those premiums taxed were allocable to California. Thus litigation between California and the captive would be likely.

Whether the NRRA was intended to apply to captives or not, surely Congress did not intend for states to take advantage of the NRRA and impose higher taxes on nonadmitted insurance where the legislative history conveys a clear intent to improve the tax collection and regulation of nonadmitted insurance. Perhaps more telling, the potential for unnecessary litigation between multiple states seeking premium taxes from insurers indicates that Congress did not contemplate the NRRA applying to captives. It is highly unlikely that Congress would intend a federal law to be construed unconstitutionally.

C. The NRRA's Potential Effects on Vermont's Captive Insurance Industry

If the NRRA is applied to captive insurance companies, their parent companies may face high procurement tax rates imposed by the parent company's home state and—in cases where the home state retains and taxes 100% of premiums—may even face a home state's tax on premiums paid for risk covered in other states that impose a lower or no procurement tax at all. As a result, some in the captive industry are concerned that captives domiciled in Vermont may leave and re-domicile in their parent companies' home states.[206] For a small state like Vermont, which is the third largest captive domicile in the world behind Bermuda and the Cayman Islands, this is a legitimate fear.[207] It is ironic that despite the virtual certainty that the NRRA does not apply to captives, a misconstruction of the law provides an incentive to redomesticate captives.

Recently, the Coalition for Captive Insurance Clarity (CCIC) was formed "to push for legislative language" to clarify that the NRRA is not intended to apply to captive insurance.[208] The CCIC is seeking to work with Congress to amend the NRRA to provide "clear and definitive language" clarifying the NRRA's intent.[209] Peter Shumlin, Governor of Vermont,

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206. *See* Rodd Zolkos, *Captive Insurance Expands, Evolves: Owners Warned to Expect Scrutiny from Other Regulators*, BUS. INS. (Aug. 19, 2012, 6:00 AM), http://www.businessinsurance.com/article/20120819/NEWS06/308199977# (discussing Vermont regulators' fears that uncertainty about the application of the NRRA to captives may prompt captive companies to leave Vermont and re-domicile in their parents' home states).

207. *See* William P. Elliott, *A Guide to Captive Insurance Companies (Part 1)*, 16 J. INT'L TAX'N 22, 37 (2005) (listing the leading captive domiciles). VCIA president Richard Smith expressed concern over the confusion of the NRRA and what effect it may have on captives domiciled in Vermont. Zolkos, *supra* note 206. "From my perspective, the longer there's ambiguity about what the NRRA does or doesn't do, it's not good." *Id.* (quoting Richard Smith) (internal quotation marks omitted).

208. Press Release, Vt. Captive Ins. Ass'n, Coalition Launched to Address NRRA Confusion on Captive Insurers (Nov. 15, 2012), *available at* http://www.vermontcaptive.com/print.html&p_docid=537.

209. *Id.*

Richard Smith, VCIA President, and Dan Towle, Vermont's Director of Financial Services, all support the CCIC initiative to clarify the limited scope of the NRRA.[210]

The Vermont captive insurance industry has expressed concern with the NRRA and how it will affect Vermont captives. Some captives have even left Vermont in an effort to eliminate their parent company's procurement tax obligations. Further, the vast uncertainty surrounding the NRRA is impeding the highly regulated captive industry. The NRRA's ambiguities burden a booming industry crucial to Vermont's economy. Whatever the outcome, Vermont and the thirty-plus other U.S. captive domiciles need clarification of the NRRA's scope.

CONCLUSION

Insurance in the United States is regulated by the individual states. As a result, jurisdictional issues, primarily concerning regulation and taxation, impact insurance regulatory activities. To improve state regulation and taxation of surplus lines insurance, Congress enacted the NRRA. Unintentionally, however, some have read the NRRA to encompass captive insurance. The legislative history of the NRRA makes clear that the NRRA was intended to apply only to surplus lines insurance. Captives are admitted only in their state of domicile but may constitutionally insure risk in other states. Consequently, captives may only be taxed by their domiciliary state. A state may, however, impose a procurement tax on independently procured insurance where it has the proper nexus to impose such a tax. As such, a captive parent company may be subject to a procurement tax. If states continue to impose procurement taxes on captive insurance procured beyond their borders, captives' parents may attempt to avoid procurement taxes levied by their home states by maintaining all business transactions within their captives' domiciliary states.

The NRRA, if applied to captives, would violate longstanding Supreme Court precedent and due process where it permits only an insured's home state to collect premium taxes for nonadmitted insurance. Should premiums paid involve risk in states that do not have the proper nexus to impose such a tax, the NRRA would violate *Allgeyer* and its progeny and erode *Todd Shipyards*. Further, even where there is a proper nexus to impose a procurement tax, home states that choose to retain and tax 100% of premiums rather than allocate premiums through an interstate compact may be taxing captive parent companies based on risk allocable to other states.

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210. *Id.*

In some cases, parent companies may be taxed on portions of premiums paid for risk covered in states that either have a lower procurement tax than the home state or no tax at all. Additionally, more than one state may attempt to claim home state status, causing unnecessary litigation and potential excessive taxation for captives and their parents. These are surely unintended consequences of a federal law intended to improve the taxation and regulation of surplus lines insurance.

Vermont, the captive insurance industry's third largest domicile in the world, could see captives re-domicile to their parent companies' home states. Such action should not generally eliminate procurement tax obligations of parent companies operating in multiple states. The NRRA should be amended to clarify its intent; otherwise the Vermont captive industry may lose business, negatively affecting Vermont's economy. Because the captive industry is crucial to Vermont's small-state income, negative impacts from the erroneous interpretation of the NRRA would be substantially felt.[211] Unfortunately, because "the core provisions of Dodd-Frank are the subject of very hot debate in the banking industry . . . , it would be surprising if the captive insurance wrinkle became a priority for Congress."[212]

While congressional action in this area would be useful, it may not be absolutely necessary as the states better understand the ramifications of captive insurance being erroneously included within the definition of nonadmitted insurance. Specifically, some states will be impermissibly collecting and retaining taxes on transactions that take place in other states. How long will parent companies pay taxes to states that do not have a taxable nexus? How long will states permit the collection of taxes by other states that do not have the constitutional right to collect and retain such taxes? These questions will be resolved through either congressional action or, absent that, by the courts.

–Peter I. Dysart[*]

211. At the 2012 Vermont Captive Insurance Association's annual conference, U.S. Representative Peter Welch (D-Vt.) told attendees that he was working on a bill to clarify the NRRA. England et al., *supra* note 109, at 7.

212. *Id.*

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