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September 10, 2021

via email to RulesCoordinator@OIC.WA.GOV

Commissioner Kreidler
Washington State Office of the Insurance Commissioner
P.O. Box 40255
Olympia, WA 98504-0255

Re: R 2020-12 Captive Insurance Stakeholder Draft, released August 20, 2020 (2021)

Dear Commissioner Kreidler:

Alston & Bird LLP appreciates the opportunity to submit these comments within the period for comments for the stakeholder draft open until Sept. 10, 2021, with respect to the Captive Insurance Stakeholder Draft released August 20, 2021 (dated 2020) (the "Draft"). We are writing in connection with the scenario where a captive insurance owner and captive insurance company, both with their principal places of business ("PPB") outside of Washington, provide coverage to insureds that also have their principal place of business outside Washington. We believe this category is inappropriately and unconstitutionally disadvantaged by the Draft.

We have four concerns with the Draft:

1. It assumes that insuring risk in the state allows a state to assert taxing and regulatory jurisdiction over a foreign captive, without regard to the lack of constitutional power;
2. It subjects ineligible captives to criminal and other penalties and precludes an ineligible captive from insuring risk in the state despite the constitutional inability of the state to tax on the basis of risk in the state alone and in contravention of the Washington statute;
3. It apparently assumes that the constitutional limitation is overcome if the PPB of the insured is also in the state, which does not prove that the insurer transacted business in the state;
4. It imposes a tax retroactive to 2011, evidently in reliance on the Nonadmitted and Reinsurance Reform Act of 2010, 15 USCS § 8202 (the "NRRA"), on captives that are constitutionally protected from taxation by Washington; although the Commissioner's Captive Insurance Study dated Jan. 18, 2021 (the "Captive Study") stated that the NRRA did not clearly apply to captives.

Constitutional Nexus. The Draft wholly disregards the fact that the state has no constitutional power to tax and regulate captives solely on the basis of insuring risks in the state. *State Board of*

Insurance v. Todd Shipyards, Inc., 370 U.S. 451 (1962) ruled that the Constitution prevents a state from taxing a foreign insurer based on the mere presence of risk in the state, a proposition agreed to in Appendix B6 of the Captive Study.

Denial of Constitutional Protection to Insure Risks. The Draft states that "a captive insurer that is not eligible to register under this chapter … may not cover Washington risk" and adds criminal and other penalties for noncompliance.[1] This flagrantly disregards the constitutional protection of an ineligible captive to insure risks in the state as reflected by *Todd Shipyards*. Furthermore, Chapter 281 of the 2021 Washington Session Laws creating the Captive Insurance regime does not state that an ineligible captive is in violation of the state law by merely insuring risks in the state. WA Code 48.15.020 states that "An insurer that is not authorized by the commissioner may not solicit insurance business in this state or transact insurance business in this state, except as provided in this chapter." An ineligible foreign captive does not solicit business or transact business in the state simply by insuring risks in the state. In explaining why the mere presence of the insurance risk in the state did not provide a state a constitutional power to tax the out of state insurer, the *Todd Shipyards* opinion stated: "The tax cannot be sustained either as laid on property, business done, or transactions carried on within the state, or as a tax on a privilege granted by the state." 370 U.S. at 454. Consequently, the Draft goes well beyond the authority provided in the statute that is limited to soliciting business and transacting business – proxies for nexus – and disregards the state's constitutional inability to tax on the basis of risk in the state alone.

The Captive Study cites some cases in a footnote that are said to reflect that minimal additional facts can be used for the state to avoid *Todd Shipyards*, but they are not persuasive authorities. The Captive Study apparently reads *Todd Shipyards* to prevent the state from taxing the foreign insurer when, and only when, the insured is not headquartered in the state.[2] Evidently that led the drafters to write the 2021 Captive Insurance statute to base taxing power on one insured having a PPB in the state. But using that fact as a ground for taxing jurisdiction over the insurer is faulty. That view apparently was based on the views of the Texas courts as stated in *Combs v. STP Nuclear Operating Co.*, 239 S.W.3d 264 (Tex. App. 2007).[3] That opinion relied on an earlier opinion distinguishing *Todd Shipyards* where not only was the insured based in Texas, but the insurance contract was negotiated in Texas and the insurer received the premiums in Texas. In other words, the facts involved a local insured but the reasoning did not rely on that fact to create taxing power. The *Combs* opinion purported to rely on the earlier opinion to find due process nexus for the insurer where the insured was based in Texas, an insured employee in Texas "procured" and "negotiated" the contract in Texas, communications and premium payments originating in Texas went to the insurer. The opinion cites no case law supporting nexus on such facts. No court outside of Texas has agreed with the analysis in the earlier opinion or in *Combs*. None of the authorities cited by the Study support due process nexus over a foreign captive insurer based solely on risks in the state and the principal place of business of the insured in the state.[4]

[1] WAC 284-2XX-250.

[2] Study, at p. 100.

[3] Study, at fn. 71.

[4] For example, the Study cited *Howell v. Rosecliff Realty Co.*, 245 A.2d 318 (N.J. 1968). It found an insured liable to pay tax on premiums paid because the foreign insurer would necessarily perform the contract in

The Principal Place of Business Assumption. The Draft enforces the statute, 2021 Session Law Ch. 281, which defines an eligible captive in part as "One or more of its insureds have their principal place of business in Washington." That fact does not establish constitutional nexus to tax the foreign captive. It adds a fact to the fact of risk in the state, but the added fact is not constitutionally relevant to nexus. If the PPB concept was derived from the NRRA, the NRRA does not and could not alter the due process clause to make the home state of any one of the insureds an automatic nexus creator for the insurer. It may be that in cases of out of state marketing to individuals in a state, who sign contracts in the state, that a different constitutional result would apply. However, the proposed regulation addresses affiliated business corporations, not individuals, and implies that the inclusion of any one insured with a PPB in Washington is grounds for taxing the foreign insurer, without regard to where the policy was negotiated or created. We do not believe that the mere existence of a principal office of one insured in the state creates constitutional power to tax, particularly when the office may be of one of dozens of affiliates of a foreign parent that have nothing to do with Washington State.

The 2011 Effective Date. The 2011 effective date for captive insurers' tax liability for insuring risks in the state has no logical connection to any law unless it possibly is the NRRA, which has that effective date. The NRRA did not create constitutional nexus for state taxation of surplus lines insurers that have an insured with a principal place of business in a state, and the Captive Study, p. 41, states that it is an open question whether the NRRA applies to captive insurance.

Conclusion. We request that the regulation acknowledge that it and the statute are subject to constitutional due process requirements and they do not purport to assume that the eligibility of a captive necessarily satisfies the due process clause; and that a captive must be soliciting and transacting business in the state to be subject to registration.

Please let me know if you have any questions or if I can be of any further assistance.

Sincerely,
/s/

Jasper L. Cummings, Jr.

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the state. The contract was not a reimbursement policy in which the insurer simply refunds a loss to the insured. See Captive Study p. 100, which states that in reimbursement policies the insurer need not have any contacts with the state. The Captive Study also cited *In re Markel Ins. Companies*, 724 A.2d 848 (N.J. App. 1999), which involved a later enacted New Jersey tax on surplus lines insurance placed in the state through agents, resident brokers, similar to the WA law. It found nexus through the agents. Lastly, the Captive Study cited *People v. United Nat'l Life Ins*. Co., 427 P.2d 199 (CA 1967), which ruled California could regulate an out of state insurance company that mailed solicitations into the state to individuals who could cause the contract of insurance to be effective by signing and mailing the application from California. The combination of solicitation and contracting in the state satisfied due process. Again, all these cases are distinguishable where the only contact in the state is the presence of risk being insured.