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Captives: The Alternative Markets Role for Midsize Accounts

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The Rough Notes Company, Inc.

Finding a home for smaller risks in rent-a-captives, cell captives & protected cells

Early projections for property/casualty insurance rates for 2014 are for a slow climb, barring any major catastrophe activity through the remainder of this year. As a result, insurance buyers continue to have a variety of risk-financing approaches available to them. However, some of the more sophisticated alternatives are mostly designed for larger accounts. The smaller to medium-sized accounts have fewer options available.

Such is the case with captives, where many of the buyers do not have sufficient premium to elect a self-retention method for their business risks. For example, a rule of thumb in determining the feasibility of a single-parent captive option is $1 million in premium. And since insurance premiums have generally been trending downward for the past 8 to 10 years, it now takes a pretty substantially sized organization to exceed $1 million in premium.

Group therapy

For those organizations that are not of sufficient size to establish their own solution, the insurance industry originally developed several alternative risk programs to assist the smaller accounts. One of the first options for combining groups of insureds has been association captives and, later, risk retention groups. But usually these approaches required the banding together of corporations within the same business or industry sector to develop homogeneous solutions.

While both association captives and risk retention groups proved to be viable risk-funding alternatives, some business owners shied away from them. One reason is that these business owners realized that they would have to divulge confidential information which they did not want to share with their competitors. As a result over the last few years, group captives such as association captives have become less and less popular with small to mid-sized accounts.

The insurance industry became aware of the situation and started to develop alternative solutions that would not require members from the same industry to share confidential information. One of the first options that began to get attention in the 1970s was an alternative known as a “rent-a-captive” (RAC) in which a contractual segregation of the participants in the captive was possible. A key selling point of the RAC approach was that smaller to mid-sized companies did not have to spend the money for the startup or maintain proper surpluses. The RAC also gave them flexibility to utilize the captive in response to sudden changes in conditions. Within the insurance industry, many thought that RACs would be used as a stepping stone to a full-blown single-parent captive, but that has rarely been the case.

From both a structural and operational standpoint the “cell captive” is quite simple and straightforward. Cell captives consist of an entity, typically established by an insurance company, agent, broker or other entrepreneurial enterprise, that takes the time and incurs the expense to establish a captive insurance company. The sponsoring entity provides the capital and surplus necessary to formally fund the captive. This initial capital infusion is frequently referred to as the “core capital.” The start-up captive then makes available to other businesses, for a fee, the use of its capital and domicile-issued license. The other businesses, in effect, rent a space within the captive, each participant having its own “rental” space, or cell.

Advantages typically associated with the cell captive structure include:

• Participants are not required to fully capitalize the captive but instead pay a rental fee to the captive owner who provides the captive facility.

• Operational costs of the captive insurance company are also usually lowered by sharing expenses with the additional members of the captive. These are typically spread across all cell participants thereby preserving purchasing power. However, the cells operate in much the same manner as a RAC and still require the same services.

• While the cell participant will need to comply with the provisions of the participation agreement, the captive owner will be responsible for complying with the domicile and other regulatory requirements. With increasing emphasis on corporate governance of captives, this has become a significant benefit of using a cell captive.

While the cell captive proved to be a more viable alternative than the RAC for many small to mid-sized corporations, some major issues remained. Participants soon learned that one of the largest impediments was that despite segregation of the cells, in many cases the participants of other cells found themselves financially responsible for the bad results in one of the other cells. Frequently, the sponsor found itself in a similar position.

As a result, the industry developed another product called a “protected cell captive.” Originally this concept was established in Guernsey via the protected cell companies’ ordinance. However, the concept quickly spread throughout many of the offshore domiciles, including the Cayman Islands with its segregated portfolio companies and Bermuda through its providence mutual limited private act. After seeing the value of the protected cell concept, onshore domiciles soon modified their regulatory requirements to also allow segregated cell captives.

A rose by any other name

The structural inefficiencies that were first noted in RACs and later in cell captives were significantly resolved via the “protected cell captive.” The biggest change in the protected cell arrangement revolved around potential liability from the financial problems of one of the cell owners impacting the remaining cell owners. In simple terms, the protected cell captive is a corporation whose structure is similar to the cell captive, except all cells are segregated into their own individual cell and are independent and separate from each other and from the core sponsoring entity. In addition to avoiding potential liability issues, the segregation also helps avoid combining sources of funds and assets from different sponsoring participants or cell owners. So the assets of the individual participants are preserved within their cell via a participation agreement.

The approach used to assist protected cell captives is frequently referred to as “ring fencing,” and its rules are applicable to any liquidator or receiver of one of the cells. Thus, the insolvency of a single cell should not affect the business of the entity as a whole or the performance of the other cell owners. Conceptually, the protected cell concept has become much more acceptable to the individual cell participants. However, it should be noted that at this point in time no court anywhere in the world has accepted these claims of limited liability or for that matter even considered such claims. Only time and court precedents will resolve this issue once and for all.

As protected cell captives began to be implemented in various domiciles in the United States as well as offshore, the domiciles, usually for competitive purposes, adopted slightly different names for their protected cell legislation. In addition, each domicile commonly made minor changes to the specific legislation, again for competitive reasons. As a result, the protected cell concept now goes by a number of different names, in each U.S. and most off-shore domiciles.

Of recent interest is a development in Delaware that introduced the “series captive” that was designed to allow a series of structures such as LLCs, statutory trusts or limited partnerships to be licensed as a captive. The captive exists as a single entity, but it can form one or more series of business units or cells, which are segregated under “series entity” law. The segregation process under the series entity law has been tested in courts and thus should provide comfort for cell owners. Additionally, alternative entities such as LLCs can also enjoy greater contractual and governance flexibility than under other protected cell captives. This approach may also have minimum premium tax advantages as well.

Despite the names involved, the structures of many of these cell captives are similar and they share a number of advantages. Among these are allowing smaller programs to enjoy the benefits involved with the captive ownership. By sharing and thus reducing the overhead and operating expenses associated with the captive, small to mid-sized corporations can gain most of the advantages typically reserved for single-parent captives.

Additionally, the time it takes for cell owners to get licensed is significantly shorter than for a single- parent captive. Cell captives can be set up and dismantled in a short time. So if a program is going to operate for only several years, a protected cell captive can provide significant advantages. Frequently these programs can be used for such things as construction projects or runoff business. Warehousing of existing accounts can also be accomplished through the segregated cell captive approach.

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