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Captive Insurance:

Should You Get in the Game?

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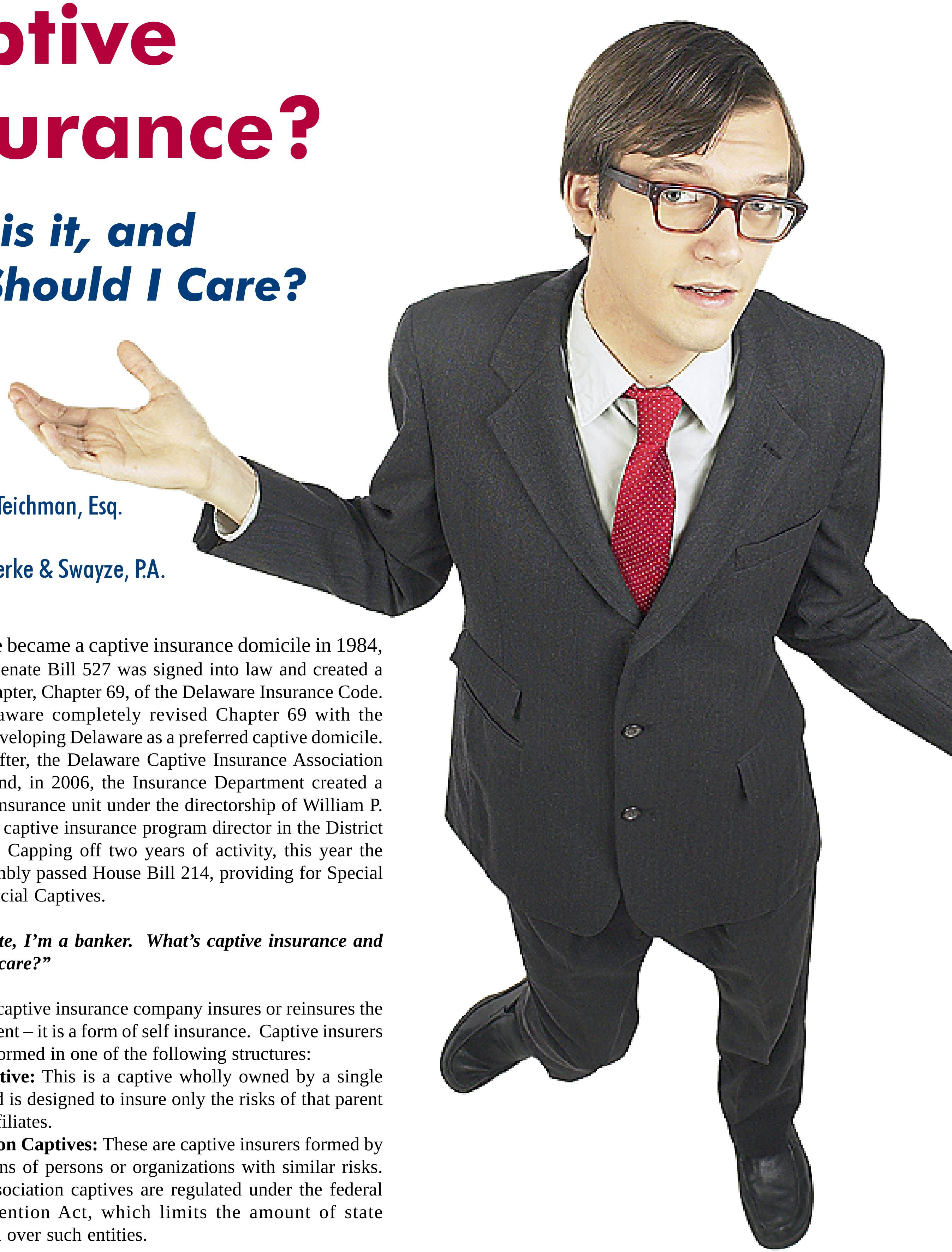
Captive Insurance?

What is it, and Why Should I Care?



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Delaware became a captive insurance domicile in 1984, when Senate Bill 527 was signed into law and created a new chapter, Chapter 69, of the Delaware Insurance Code. In 2005, Delaware completely revised Chapter 69 with the intention of developing Delaware as a preferred captive domicile. Shortly thereafter, the Delaware Captive Insurance Association was created and, in 2006, the Insurance Department created a new Captive Insurance unit under the directorship of William P. White, former captive insurance program director in the District of Columbia. Capping off two years of activity, this year the General Assembly passed House Bill 214, providing for Special Purpose Financial Captives.

"Wait a minute, I'm a banker. What's captive insurance and why should I care?"

Simply put, a captive insurance company insures or reinsures the risks of its parent – it is a form of self insurance. Captive insurers are typically formed in one of the following structures:

- **Pure captive:** This is a captive wholly owned by a single parent and is designed to insure only the risks of that parent and its affiliates.
- **Association Captives:** These are captive insurers formed by associations of persons or organizations with similar risks. Often, association captives are regulated under the federal Risk Retention Act, which limits the amount of state regulation over such entities.

- **Industrial Insured Captives:** Similar to Association Captives, these are captives held by large and sophisticated organizations all of which are in the same or similar business and share like risks.
- **Protected Cell Captives:** Often called "rent-a-captive," these entities are designed to allow organizations that do not wish to expend the resources necessary to create and license their own captive to nonetheless participate in a captive but yet segregate, in a so called "protected cell," their particular risks.
- **Special Purpose Financial Captives:** These entities are typically created by large life insurers and reinsurers and are designed to allow capital markets to participate in risk through securitizations.

The captive insurance industry got its start in the 1950s and 1960s, and for years it was exclusively the province of offshore domiciles, particularly Bermuda. At one time, tax considerations were an important driver in the decision to form a captive and tax is indeed still relevant. However, other considerations have eclipsed tax as a driving rationale for the formation of a captive insurer. Nowadays, the primary motivation is often to obtain insurance coverages that are either not available through the traditional markets or too expensive. Entities participating in captive insurers may also enjoy a profit from coverages that can, in certain circumstances, be sold to non-affiliated third parties which are not participants in the captive.

Overseas domiciles, including Bermuda, Guernsey, Cayman Islands, Luxembourg, Barbados, and Ireland, have long been preferred locations to organize captives, while U.S. jurisdictions, most notably Vermont, have experienced significant growth over the last 15 years or so, in part due to changes in the tax code that have reduced the tax benefits formerly resulting from an overseas domicile.

"Okay, you have explained what captive insurance is, but you haven't told me why I should care."

By amending the statute, creating a special captives unit in the Insurance Department, and creating an industry association, Delaware is looking to capitalize on its well established reputation as a center for corporate and financial services. Although the new statute retains a number of features from its earlier form, the captives statute is, in fact, entirely rewritten. The following are some of its more noteworthy features:

Flexibility as to corporate entity:

As revised, Chapter 69 of Delaware's insurance code allows a captive to opt from a range of business organizations, *i.e.*, corporation, limited liability company, partnership, limited partnership or statutory trust.[1]

Non-Captive Business:

The new statute preserves the unique ability of Delaware association and industrial insured captive insurers to write up to 50% of their business outside the association or industrial insured groups.[2] The only limitations are that such business be limited to entities in the same, related or similar business as the members of the industrial insured or association group and that the business be in the same or similar insurance lines as that written for group members.

Permitted lines of business:

Delaware captives are virtually unrestricted in the lines of business for which they can potentially obtain a certificate of authority, with the sole exception of workers compensation insurance.[3] As for workers compensation, Delaware captives are permitted to write so-called "excess workers compensation insurance" for parent and affiliated companies.[4]

Captive investments and accounting:

Delaware law previously extended great latitude to the ability of a pure or industrial insured captive to make investments of all types, and this has been retained.[5] However, under the new statute, Delaware captives of all types are expressly permitted to own the securities of, or interests in, another captive.[6] This allows a parent company or industrial insured group greater flexibility to segregate risks in multiple captives and to arrange those captives vertically in the corporate structure rather than horizontally.

Protected cells

This is one aspect of captive insurance where Delaware law clearly lagged behind that of other jurisdictions. Under the new statute, Delaware has adopted "sponsored captive" provisions much like those in place in other progressive domiciles.[7] Accordingly, Delaware captives may be organized to serve multiple members, each of which has the ability to segregate its risks in a protected cell that is insulated from the liabilities of other cells.

Special Purpose Financial Captives

This year's legislation[8] added cutting-edge provisions allowing for the formation of "special purpose financial captive insurance companies" that are designed to reinsure (*i.e.*, assume insurance risk from another insurer) blocks of insurance business from a parent company and securitize that risk in one or more capital markets transactions.

A thriving captive insurance industry will directly benefit the State, in terms of premium tax revenues, and will also indirectly benefit the State by fostering a service sector devoted to the needs of captives licensed in Delaware. The banking community can play a significant part in servicing the needs of captives.

Delaware's captive insurance law provides a number of "bricks and mortar" requirements that provide opportunities for Delaware's banking community:

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- Captive insurers licensed in Delaware must keep their books and records in this state.[9]
- Captive insurers licensed in Delaware must maintain a principal place of business in Delaware.[10]
- Captive insurers licensed in Delaware must hold at least one board meeting each year in Delaware.[11]
- Captive insurers licensed in Delaware must maintain "minimum capital and surplus" (between $250,000 and $1,000,000 depending upon the type of captive) on deposit with a financial institution in Delaware, either in the form of cash, irrevocable letter of credit or securities approved by the Commissioner.[12]
- One member of the captive's governing body (board of directors, managing partner, statutory trust trustee, etc.), must have principal place of business in Delaware.[13]

As is evident, most of these requirements lend themselves to banks that have the capability of providing services and facilities for captives, in much the same way that many Delaware banks have serviced the Delaware holding company industry here.

Many captives will be formed by entities, associations or industries with no experience in the insurance field, and this provides an additional opportunity for Delaware banks that service captives to become captive insurance managers. A captive manager acts as a clearinghouse to obtain and coordinate services that a captive will need in order to conduct its business, including actuarial, accounting, investment management, and underwriting. One Delaware bank that is already heavily invested in this activity is Wilmington Trust. Brian Flinchum, Assistant Vice President – Captive Management, describes Wilmington Trust's captive management business: "Captive insurance is a natural extension of the bank's current entity management services. The main difference is that you must add staffing with insurance accounting knowledge as well as individuals with an understanding of the complex alternative/captive insurance market." Flinchum states that Wilmington Trust was attracted to this business because "the captive insurance market is experiencing high growth, and our entrance into the market offers the bank a unique position as an institutional independent manager in the captive market. Currently, only 50% of Fortune 500 companies have captives, and as you move down to the Fortune 2000 companies, the number of firms with captives shrinks to 20%, so the market is still young enough to sustain many new entrants." When asked about the opportunities for Delaware banks in the captive management arena, Flinchum stated that "in order to justify forming a single parent captive, the prospect will need at least a $1 million in premium. Regional and national banks are therefore best suited to offer captive management services since their client bases consist of many companies with gross revenues in excess of $250 million."

In addition to servicing captives, local and regional banks may find a number of advantages in forming a captive insurer to insure their own risks. Insuring a bank's risks in a captive, as opposed to the conventional market, will allow a bank to structure its insurance programs to cover its unique exposures, rather than rely solely on the one-size-fits-all coverages available through traditional insurers. In this regard Flinchum points out that "regional and community banks between $250 million to $10 billion in assets are good candidates to form a small property and casualty company because banks of this size may be able to take advantage of beneficial treatment under section 831(b) of the Internal Revenue Code."

With the recent enhancements in Delaware's captive insurance laws, the creation of a dedicated captives unit in the Insurance Department, and the formation of the Delaware Captive Insurance Association, Delaware is poised to become a major player in this industry. Thus, while captive insurance might not seem an area of natural interest to bankers, if this growth occurs as is anticipated, Delaware banks will enjoy a significant opportunity to provide services to new Delaware captives. A Delaware captive may also prove to be an excellent vehicle for Delaware banks to improve and tailor their insurance and risk management programs to their unique risk management needs.

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Footnotes

[1] 18 *Del. C.* § 6906
[2] 18 *Del. C.* § 6903(a)(2) (for association captives); 18 Del. C. § 6903(a)(3) (for industrial insured captives).
[3] 18 *Del. C.* § 6903(a).
[4] 18 *Del. C.* § 6903(a)(8).
[5] 18 *Del. C.* § 6910(b). Association captives, risk retention groups and special purpose captives are still required to comply with investment requirements applicable to conventional insurers under Chapter 13 of the Delaware Insurance Code.
[6] 18 *Del. C.* § 6910(d).
[7] 18 *Del. C.* §§ 6931 – 6938.
[8] House Bill 214, signed into law on July 18, 2007
[9] 18 *Del. C.* § 6923.
[10] 18 *Del. C.* § 6903(b)(3).
[11] 18 *Del. C.* § 6903(b)(2)
[12] 18 *Del. C.* § 6905(c).
[13] 18 *Del. C.* § 6906(f).