ALTERNATIVE RISK TRANSFER: AN ANALYSIS OF CAPTIVES AND THEIR FORMATION

Kim Yelkin, Esq.[1]
(512) 413-7412

Since September 11th the insurance industry has been experiencing a hard market, characterized by premium increases and increased deductibles. The industry is going through a period of shaken confidence, resulting in revised underwriting, risk allocation, and pricing. Insureds are finding that certain types of coverage are not as readily available. The financial stability of insurers has come into question as a result of September 11th losses. The general slowdown in the economy has placed additional pressure on corporate budgets. The hard market has resulted in a renewed corporate interest in alternative risk transfer techniques. One such alternative risk transfer technique is the captive insurance company ("captive").

A captive can be formed by any insured as a subsidiary corporation to insure or reinsure the risk of the insured or occasionally third parties. Captives are created using various organizational structures and may be domiciled offshore or in one of several states that authorize captives.

Captive insurance companies offer several potential benefits. First, the tax savings should be examined. A company may be able to deduct insurance premiums as an expense in the current tax year (as opposed to self-insurance premiums, which are not deductible). The captive may deduct from current taxable income funds placed in loss reserves to pay future claims, even though several years may pass before a claim is settled. The timing of these deductions may result in considerable savings for a corporation. Second, a corporation may achieve cost savings by eliminating the profit built into premiums charged by commercial insurers. Premiums may also be priced to more accurately reflect the parent company's loss experience. Third, because reinsurance companies work on lower expense ratios than direct insurers, reinsurance may be obtained at a lower cost than conventional direct excess and umbrella insurance. Commissions may also be earned on reinsurance ceded to the captive, which can reduce the overall cost of insurance to the parent company. Fourth, in terms of coverage availability, a captive insurance company may be the only realistic alternative for lines of business that are not available with acceptably priced premiums and unrestrictive terms. Fifth, a captive provides cash flow management because premiums and reserves are invested for the benefit of the captive, and investment income may not be taxed. Premium payments may be restructured based upon a company's individual cash flow needs. Sixth, a captive provides greater control of risk management issues, such as loss control, loss reporting, and safety procedures, which may reduce the frequency and severity of claims. Seventh, the captive may earn profits from insuring the risks of unrelated third parties.

In today's market, the captive insurance industry is facing two potential difficulties: a smaller pool of fronting insurers, which are becoming increasingly selective, and a hardened reinsurance market. A captive writing workers' compensation insurance, for example, needs a "fronting" insurer to meet regulatory compliance requirements that this type of coverage be written by an admitted carrier. The fronting insurer writes the coverage directly and then the risk is transferred through reinsurance to the captive insurance company. Favorable fronting insurers are becoming increasingly difficult to find. Fronting insurers have recently begun asking for protection from captives in the form of letters of credit. In addition, finding reinsurance for the captive's coverage has become difficult due to market conditions.

Traditional lines of business written by captives are general liability, workers' compensation, malpractice, and products liability insurance. In October of 2000, the Department of Labor approved Columbia Energy's use of a captive insurance company for employee benefits, specifically to provide long-term disability benefits.[2] A second company, Archer Daniels Midland Company, has filed a similar application with the Department of Labor to provide its group life insurance benefits through a captive. If approved, other companies could submit similar filings to the Department of Labor using an expedited process, which could produce a wave of captives formed to insure or reinsurance employee benefits, particularly long-term disability and life insurance.

Several types of captive structures exist. The type of structure used depends upon the needs of the owner/insured and the laws of the captive's domicile. The most common type of captives are single parent or "pure" captives. A single parent captive is formed by a parent company to insure or reinsure the risks of the captive's non-insurance company parent or affiliates. An association captive is formed by a pre-existing association to provide coverage for its members. A group or industry captive is jointly owned by companies within the same industry to meet a common insurance need. An agency captive is established by an agency or brokerage company that sells insurance. The agency captive is used to reinsure a portion of the insurance sold by the brokerage company. A "rent-a-captive" may be used for programs that are too small to justify establishing their own captive. With a rental captive, the capital investment of a captive is not necessary, but the rental captive owner may require full security for the aggregate exposed liability. A segregated portfolio captive is set up so that the assets of one segregated portfolio are not subject to the liabilities of another segregated portfolio. In effect, each segregated portfolio operates like a separate limited liability corporation; however, it is actually a segregated section of one legal entity.

The choice of domicile is an important consideration in the formation of a captive. Several offshore and United States domiciles have specific legislation authorizing the formation of captives. In choosing a domicile, the laws and regulations governing captives should be reviewed, taking into account the objectives of the company. Location should also be taken into consideration. For example, Dublin may be a favorable choice for European companies, while Vermont may be most attractive to companies based in the United States. The top ten offshore domiciles are Bermuda, Cayman Islands, Guernsey, British Virgin Islands, Luxembourg, Barbados, Dublin, Isle of Man, Turks & Caicos Islands, and Singapore.[3]

In the year 2001, twenty percent of captives formed were domiciled in Bermuda. Bermuda has the third largest insurance market, behind New York and London. Forty percent of the offices on the island are companies with insurance companies. Located between Europe and North America, the island has proximity to and connections with the London reinsurance market. Bermuda attracts captive business with its favorable regulatory scheme and tax breaks. The minimum paid-in capital requirement for a single parent captive is $120,000.[4] For a group or association captive that derives less than 20 percent of net premiums from unrelated premium, minimum paid in capital of $250,000 is required.[5] If the captive derives more than 20 percent of its net premium from unrelated premium, a minimum paid in capital of one million dollars is required.[6] A premium to surplus ratio of 20 percent is required for premiums below six million dollars for single parent and group or association captives that derive 20 percent or less of net premiums from unrelated premium.[7] Total costs for incorporation in Bermuda including local management company fees are approximately $15,000 per year.

Behind Bermuda and the Cayman Islands, Vermont is the third largest captive domicile, and the number one captive domicile in the United States.[8] The top ten states with laws that allow the formation of captives are Vermont,[9] Hawaii,[10] Georgia,[11] South Carolina,[12] Colorado,[13] Tennessee,[14] Delaware,[15] Illinois,[16] Nevada,[17] and the District of Columbia.[18] [19] Other states with captive legislation are New York,[20] Rhode Island,[21] Maine,[22] Montana,[23] Arizona,[24] Arkansas,[25] South Dakota,[26] and Virginia.[27]

Vermont has a strong and growing captive insurance industry, with several applications for 2002 pending. The minimum capital requirements for single parent captives are $250,000 and $750,000 for association captives.[28] Approved letters of credit can be used to satisfy capital requirements.[29] Vermont does not have a minimum premium-to-surplus requirement. The licensing costs include an application fee of $200, an actuarial application review fee of $3,200, a $300 license issuance fee, and a $300 annual license fee.[30] The minimum annual premium tax is $5,000.[31] Tax rates on direct written premiums decrease incrementally as the volume of premium increases, beginning with a .4 percent tax on the first 20 million of direct written premium.[32]

A major factor in the decision to form a captive is the tax benefits potentially available. Tax accountants and attorneys should be consulted to determine whether a captive is the appropriate solution to a particular company's needs. Corporations may deduct premiums paid to insurance companies, including captives, as expenses for the current tax year. The captive may deduct from current taxable income funds placed in loss reserves to pay future claims, even though it may be several years before the claim is settled. Generally, these tax benefits are the reason why a captive is favored over self-insurance. Corporations that self-insure may not deduct self-insurance premiums or funds set aside to pay future losses.

The position of the IRS regarding the taxation of captives is uncertain, which further complicates the tax implications in forming a captive. In general, the IRS will want to see competitive, arms-length pricing, comparable to a third party transaction. A captive should be formed for reasons other than purely tax purposes. Tax experts advise that in order to better pass IRS scrutiny, no parental guarantees or hold harmless agreements should exist between the parent and captive.[33] All dealings between the parent and captive should meet the definition of an "insurance transaction", which requires risk shifting and risk distribution.

If a company thinks that a captive may be a viable option, it should first conduct a feasibility study to determine the appropriate business strategy. The feasibility study would cover issues such as the necessary level of capitalization and premium volume, risk management and loss control issues, fronting arrangements and reinsurance concerns, and parent management commitment to the venture. In addition, tax experts must be consulted to analyze the tax implications of owning a captive. At the same time, the appropriate domicile should be chosen.

The legal and regulatory framework of the domicile is an important consideration, along with the tax status of captives within the domicile. A local management service for the captive should be utilized to assist with incorporation and maintain regulatory compliance within the domicile. The domicile should have few exchange controls and allow the captive to transact business in principal international trading currencies. Travel and communication services are also items that should be considered. A minimum of ten weeks is generally required to complete the feasibility study and imp lement the captive program.

Overall, the captive insurance industry is currently in a growth cycle and tremendous interest is being generated over the prospects of captives as an alternative risk transfer technique.

Endnotes

1. Kim Yelkin is a partner with the law firm of Gardere Wynne Sewell, LLP. Special thanks go to co-author Melissa Irion, an associate in the insurance practice group in the Austin office of Akin, Gump, Strauss, Hauer & Feld, L.L.P. Ms. Irion's practice includes all aspects of insurance regulatory and legislative matters.

2. Grant of Individual Exemptions; Columbia Energy Group (Columbia), 65 Fed. Reg. 60452 (Oct. 11, 2000).

3. *Counting Captives*, Business Insurance, Feb. 4, 2002, at 10.

4. Insurance Act 1978 (as amended in 1995 and 1998).

5. *Id*.

6. *Id*.

7. *Id*.

8. *Counting Captives*, Business Insurance, Feb. 4, 2002, at 10.

9. *See* Vt. St. Ann. tit. 8 §§ 6001 to 6023.

10. *See* Haw. Rev. Stat. §§ 431:19-101 to 431:19-116.

11. *See* Ga. Code Ann. §§ 33-41-1 to 33-41-24.

12. *See* S.C. Code Ann. §§ 38-90-10 to 38-90-240.

13. *See* Colo. Rev. Stat. §§ 10-6-101 to 10-6-130.

14. *See* Tenn. Code Ann. §§ 56-13-101 to 56-13-133.

15. *See* Del. Code Ann. tit. 18, §§ 6901 to 6916.

16. *See* 215 Ill. Comp. Stat. 5/123C-1 to 5/123C-22.

17. *See* Nev. Rev. Stat. 694C.010 to 694C.460.

18. *See* D.C. Code Ann. §§ 31-3901 to 31-3918.

19. *Counting Captives*, Business Insurance, Feb. 4, 2002, at 10.

20. *See* N.Y. Ins. Law §§ 7001 to 7012.

21. *See* R.I. Gen. Laws §§ 27-43-1 to 27-43-13.

22. *See* Me. Rev. Stat. Ann. tit. 24-A §§ 6701 to 6720.

23. *See* Mont. Code Ann. §§ 38-28-101 to 38-28-207.

24. *See* Ariz. Rev. Stat. §§ 20-1098 to 20-1098.14.

25. *See* Ark. Reg. 73 §§ 1 to 19.

26. *See* S.D. Codified Laws §§ 58-46-1 to 58-46-26.

27. *See* Va. Code Ann. §§ 38.2-1100 to 38.2-1109.

28. Vt. Stat. Ann. tit. 8 § 6004(a)(1)-(2).

29. *Id*. § 6004(d).

30. *See Vermont Captive Fees & Taxes*, *available at* http://www.bishca.state.vt.us/captives/Fees&taxes.html (last visited Apr. 24, 2002).

31. Vt. Stat. Ann. tit. 8 § 6014(c).

32. *Id.* § 6014(a).

33. Michael Bradford, *Captives face problems with fronting, reinsurance,* Business Insurance, March 4, 2002, at 24.