WRCIC

WESTERN REGION CAPTIVE INSURANCE CONFERENCE, LLC

CELL CAPTIVES:
WHAT ARE THEY AND WHEN ARE THEY APPROPRIATE?

AKA – Drive For Show and Putt For Dough

Captive Cells:
Abbreviated History of Captives

1920s:

- **European Single-Owner - Captives** were formed to respond to the absence or unwillingness of commercial insurers to cover important risks. Some examples are British Petroleum's captive called "Tanker" which was used to insure for shipping risks.

1953:

- **First "Captive" - Frederic M. Reiss (1924–1993),** often called the father of the captive movement, founded Steel Insurance Company of America, a captive developed for an Ohio steel company, from which the term "captive" was borrowed from "captive" mines sending ore to company's mills.

1958:

- **First Bermuda Captive** - Fred Reiss set up American Risk Management in Bermuda, where the first captives were domiciled.

1976:

- **Cayman as a healthcare captive center** - the Harvard medical centers' captive met with "resistance" to licensing in Bermuda because of its need to cover individual physicians, so they switched to Cayman.

Captive Cells:

History of Cell Structures

1997:

- **Guernsey developed the concept of Protected Cell Company** in response to the demand from companies who wished to take advantage of the captive approach to risk management but did not wish to establish a captive of their own.

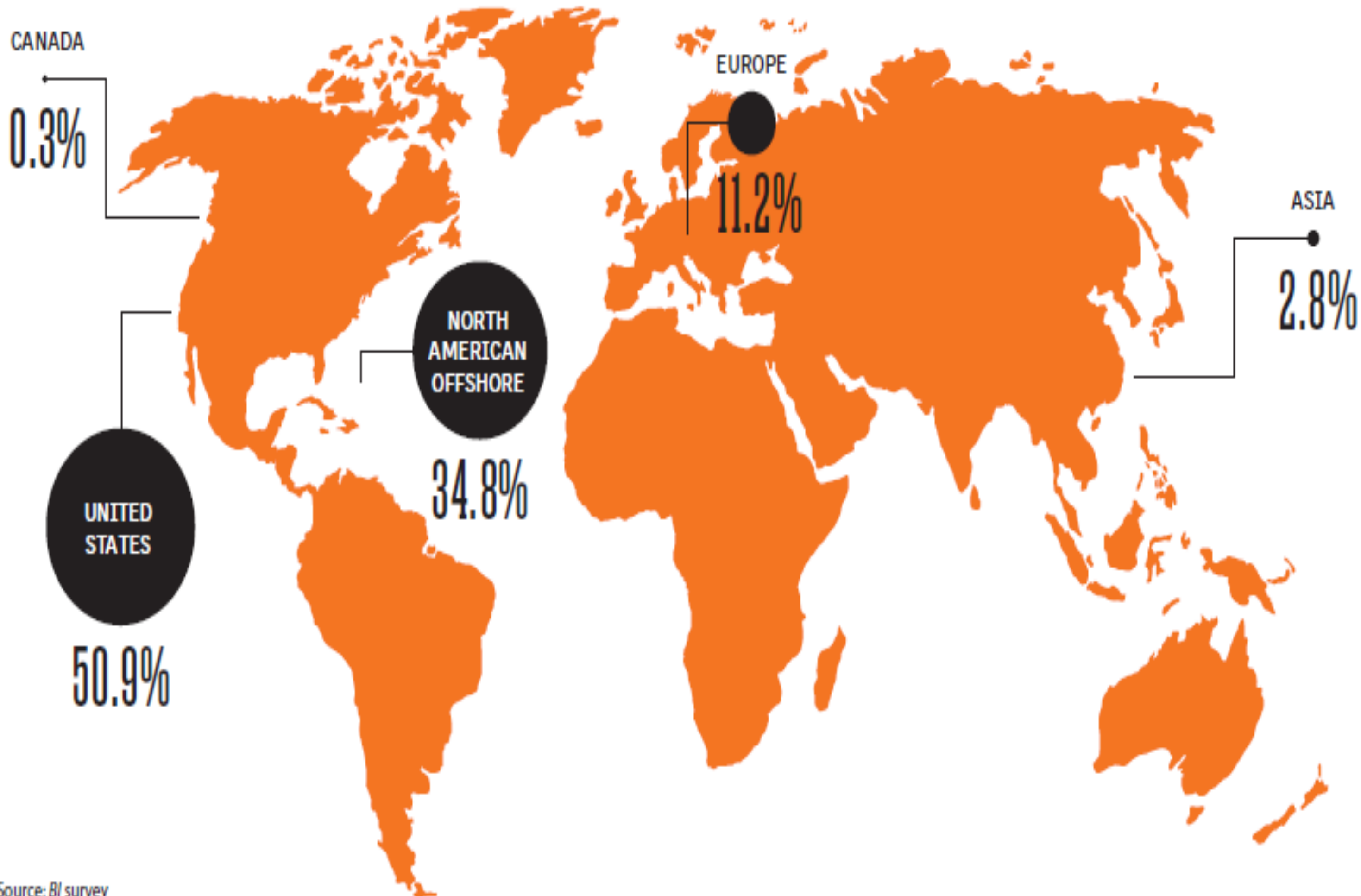
2006:

- **Guernsey adopted the innovative Incorporated Cell Company structure** in 2006 and by the end of that year, the first insurance ICC had been formed.

Captive Cells:

Current Captive Environment

There were 6,337 captives in 2018, not including microcaptives, series captives or individual cells or cell members in protected cell companies.



COUNTING CAPTIVES

Ranked by number of captive licenses at year-end 2018

Rank	Domicile	2018	2017
1	Bermuda	711	739
2	Cayman Islands	674	669
3	Vermont	580	578[1]
4	Utah	443	481[1]
5	Delaware	421	391
6	Barbados	276	266
7	North Carolina	240[2]	220
8	Hawaii	231	230
9	Guernsey	206	217[1]
10	Luxembourg	198	204[1]
11	South Carolina	171	172
12	Tennessee	169	155
13	Anguilla	165	188[1]
14	Nevada	156	172[1]
15	Nevis	155	151
16	Montana	129	141[1]
17	Arizona	124	121
18	District of Columbia	105	102
19	Isle of Man	103	109
20	Dublin	78	83
21	British Virgin Islands	73	111
22	Singapore	72	69[1]
23	Oklahoma	66	75
23	Turks and Caicos Islands	66	71[1]
25	Kentucky	64	65[1]

Source: Business Insurance, 2019 Captive Managers & Domiciles, Rankings + Directory: 2, 6. Used with permission

Captive Cells:
Broad Captive Categories

Captives typically fall into a few major categories:

Category	Description
Pure Captive / Single Parent (largest sector)	• Wholly owned by one parent company. • Insures or reinsures the risks of its parent, affiliated entities, or chosen unrelated parties.
Group / Association	• Owned by multiple companies or an association, and insures or reinsures the risks of the group.
US Branch	• A division of a single parent captive that is usually formed in the US (as a branch of a Bermuda or Cayman captive). • Allows a company access to TRIA and US employee benefit coverages that are required to be in a US domicile.
Risk Retention Group (US only)	• Regulated under US federal legislation, licensed in one state, and able to operate in all 50 states on a registered basis. • Can only write liability lines of risk, not workers' compensation (WC). • Pending legislation may permit for RRGs to directly insure property coverage.

Captive Cells:

Different Cell Captive Structures

Sponsored Captives or Rent-A-Cell

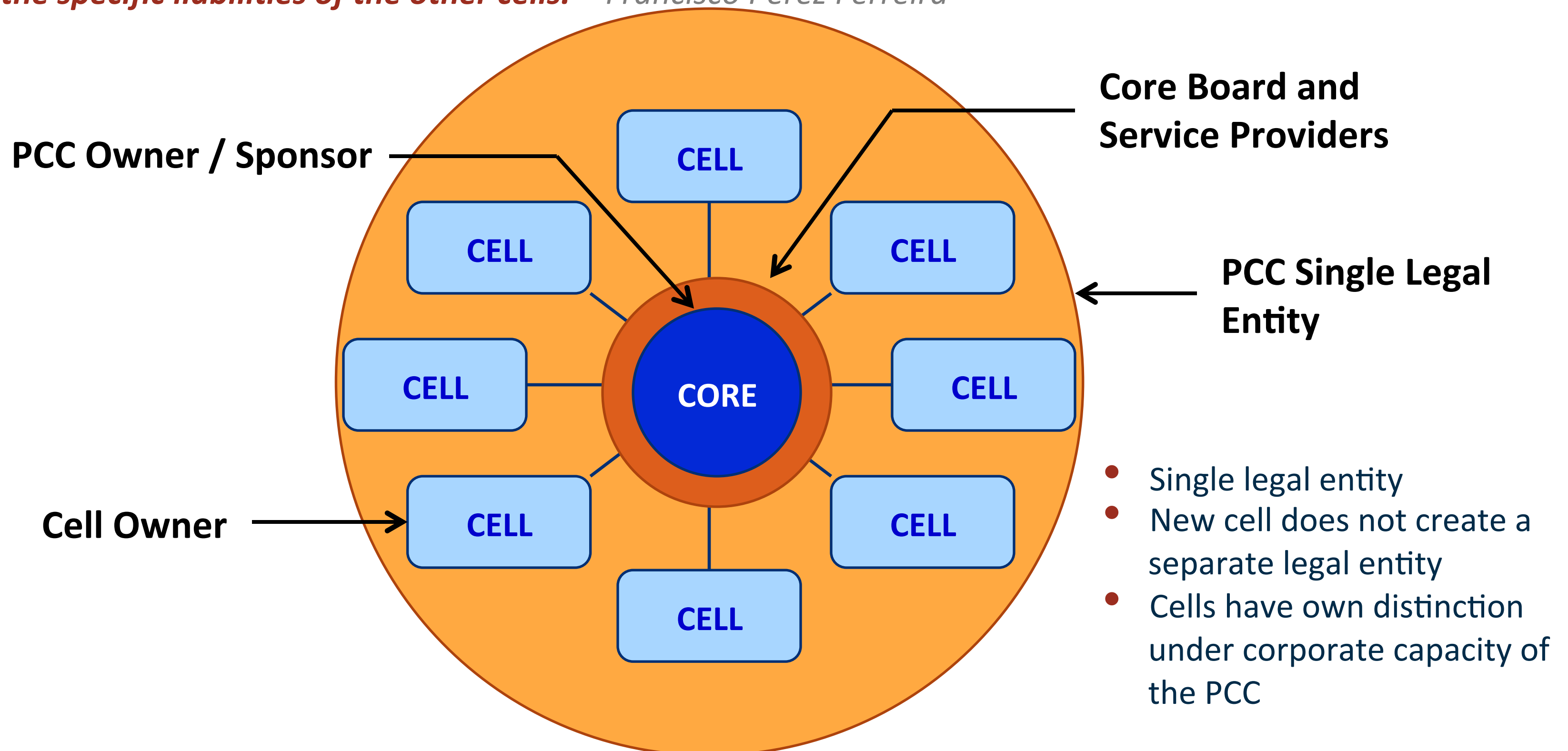
- Formed by a third party sponsor who “rents” cells to outside companies.
- Liabilities and assets of each cell are separate from other cells.
- Each cell owner is usually required to capitalize that particular cell.
- There are three forms of Rent-A-Cell captives, listed below.
    - **Protected Cell Company (PCC)**
    - **Incorporated Cell Company (ICC)**
    - Segregated Cell Captives

Captive Cells:

What is a Protected Cell Company (PCC):

Definition:

A corporation whose patrimony is composed of assets contained in structurally separate parts named "cells" [cellular assets], which are legally and functionally separate, distinct and independent among each other, and of assets not constituting "cells" [non-cellular assets], also structurally and legally independent, that has as main legal characteristic the fact that the portion of capital designated to a specific cell is neither liable for the general obligations, commitments or liabilities of the corporation nor for the specific liabilities of the other cells. - *Francisco Pérez Ferreira*



- Single legal entity
- New cell does not create a separate legal entity
- Cells have own distinction under corporate capacity of the PCC

Captive Cells:

PCC vs Pure Captive:

Elements that are similar:

- Capitalized and premium funding
  - Certain Cell Captives do not require full collateralization of limit like some other PCC facilities. (subject to regulatory and Core approval)
- Both require domicile regulator's approval of initial business plan and any changes.
- To obtain federal tax benefit, a PCC cell must meet the same IRS qualifications :
  - brother-sister structure, or
  - sufficient unrelated premium.

Elements that are different

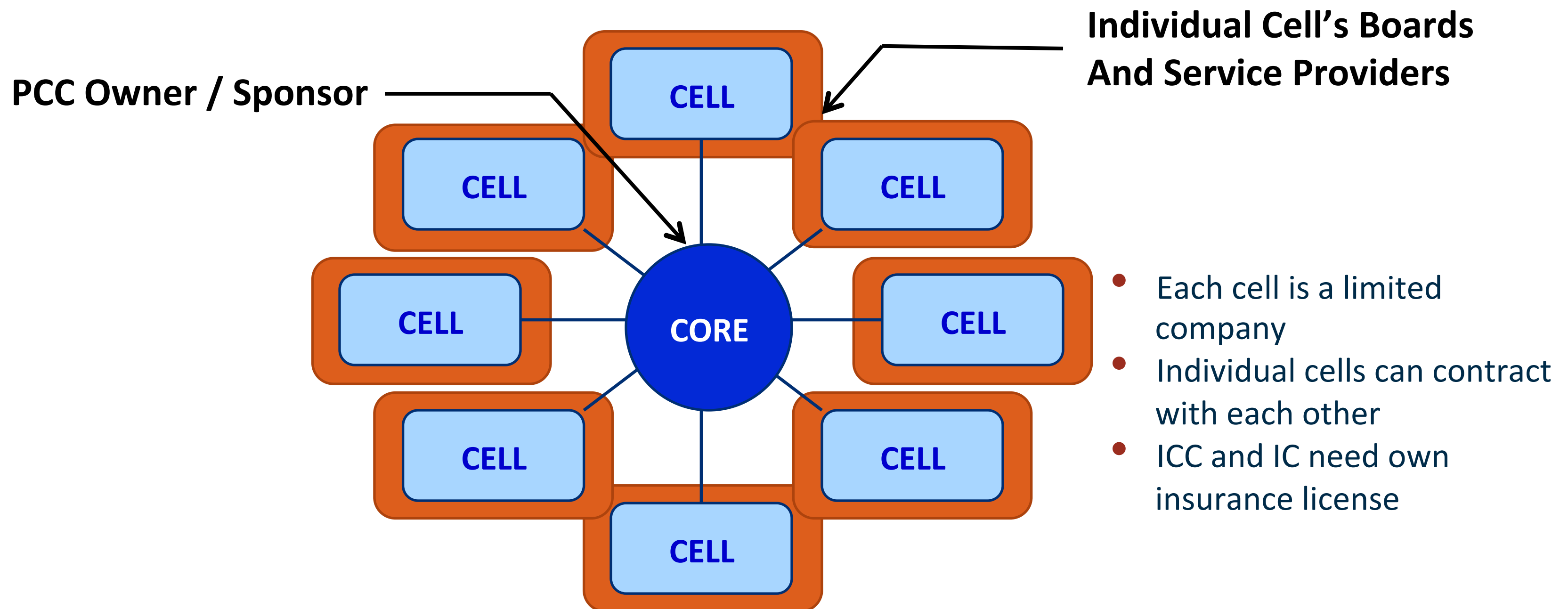
- Faster to set-up or dissolve
- Less expensive to set-up and operate
- Less management time commitment given that the PCC Core has its own board of directors.
- Not a separate entity so does not appear as a subsidiary of cell shareholder - however, assets and liabilities of cell would be recorded by cell shareholder.
- Less operational control:
  - Service providers (manager, auditor, actuary) chosen by PCC.
  - Core must approve business plan and any dividend distribution.

Captive Cells:

What is a Incorporated Cell Company (ICC):

Definition:

An ICC is a company which has the power to establish incorporated cells as part of its corporate structure. Like a protected cell company ("PCC"), an ICC may comprise any number of incorporated cells ("Cells"). However, unlike a protected cell of a PCC an incorporated cell has many of the attributes of a non-cellular company. Each incorporated cell has its own board of directors, its own memorandum and articles of incorporation and each is a separate legal entity which must be registered at the Guernsey registry and can sue and be sued in its own name. *- Wikipedia*



- Each cell is a limited company
- Individual cells can contract with each other
- ICC and IC need own insurance license

Captive Cells:

Unincorporated vs. Incorporated Cells

Kevin M. Doherty of Dickinson Wright PLC explained that protected cells might be incorporated or unincorporated. The basic characteristics of unincorporated and incorporated cells are reproduced from his article.

Unincorporated Cells

- Cells have no share or ownership.
- Cells have no ability to contract.
- The core must enter into all agreements (including insurance policies) on behalf of cells.
- Cells can obtain a separate Federal Employer Identification Number (FEIN).
- Cell's insureds sign a participation agreement.

Incorporated Cells

- Cells can be formed as corporations, limited liability companies (LLCs), series LLCs, etc.
- If a series LLC, only the core must be registered with the secretary of state.
- Series are formed by contract.
- If an LLC or corporation, each cell will be registered with the secretary of state.
- Good standing certificates can be obtained.
- Cells have ownership shares.
- Cells have the capacity to contract (e.g., reinsurance agreements among cells).
- Cells can obtain separate FEIN.
- Cell's insureds may sign a shareholder's agreement in addition to a participation agreement.

Captive Cells:

Different Cell Captive Structures

Protected Cell Company (PCC)	• A single legal entity comprised of a Core, and a number of segregated parts, or "cells, " which are completely independent and separate from the other cells, as well as from the core of the company. • A PCC is formed by a Sponsoring entity who manages the PCC through a board of directors and provides minimum regulatory and operating capital (the "core").
Incorporated Cell Company (ICC)	• An ICC is very similar to a PCC except that each ICC cell is individually incorporated which means that each ICC cell is in fact its own legal entity. • the legal structure of an ICC enables contracts, such as reinsurance, to be arranged between different cells within the same ICC • Many domiciles currently only offer PCC legislation.
Segregated Cell Captives	• Segregated Captives are an offshoot of rent-a-captives or Protected Cell Captive (PCC) – they are a typically a single entity, but the assets and liabilities of its individual cells are protected from each other. • They offer the benefits of a group captive but with lower startup costs. • Often formed by organizations too small to access normal reinsurance markets directly.

Captive Cells:

Different Cell Captive Structures:

Other Cell Structures:

- Special Purpose Vehicles (SPVs)
- Unincorporated Cell Companies (UCC's)
- Segregated Accounts Companies (SACs),
- Segregated Portfolio Companies (SPCs)

Captive Cells:

Who Are Using Protected Cells:

Ideal solution for companies:

- With high levels of predictable losses.
- Who wish to access the reinsurance market.
- Who retain worldwide risks on a reinsurance basis.
- With the desire for confidentiality of cell ownership.
- Who are unable or unwilling to join forces with others in the same industry in a group captive.
- That seek to direct write/front in the EU or non-EU/European Economic Area (EEA) captives.
- Who wish to access Insurance Linked Securities (ILS) or Reinsurance Special Purpose Vehicles (RSPVs).
- **That want a low-cost alternative with low-touch administrative effort instead of a wholly owned captive insurance company.**
- **With significant Federal Excise Tax (FET) and/or Surplus Lines Tax associated with their insurance placements. Proper use of the PCC as a front may reduce the tax liability.**
- **With a need to segregate risks associated with specific project, division, joint-venture, or strategic alliance.**

Captive Cells:

Who Are Using Protected Cells:

PCC legislation has been of interest to:

- Promoters of Association Captives,
- International group companies with numerous autonomous subsidiaries,
- Franchisors that want to segregate franchisee risks,
- Insurers writing long term business (life insurance) who wish to separate the funds relating to different policyholders into separate cells within a PCC

Captive Cells:

GAAP Tax Considerations:

Variable Interest Entities (VIE) Model:

- Determine if the cell is controlled by circumstances other than direct voting interest
- 2 Key Concepts, does the controlling entity or primary beneficiary
  - Have the ability to direct operational decisions?
  - Have an obligation to absorb losses or receive benefits

PCC's and ICC's use participation agreements that may be structured to give controlling interest to either:

- Core
- Sponsor of the Core, or
- Company participating in the cell

Although ICC's are owned by the participants, the participation agreement or reinsurance agreement may be too restrictive causing the cell to be controlled by the core or sponsor rather than the participant

Captive Cells:

GAAP Tax Considerations:

Controlling interest looks at these factors:

Equity at Risk – Does the cell have sufficient equity at risk for its insurance policies?

- Is equity risk shared or exclusive inside the cell?
- Does the core have an ownership interest in the cell through:
  - Preferred Shares?
  - Surplus Note?
  - Guarantees?
  - Letters of Credit?
  - Other financial instruments?

Take Away – Make sure any Equity Ownership of the cell by the Core or Sponsor doesn't transfer the right to cell operating profits or cell obligations to the Core or Sponsor

Captive Cells:

GAAP Tax Considerations:

Controlling interest looks at these factors:

Participation Agreements – does this agreement along with other agreements (reinsurance, management, capital) give the Core the ability to mandate significant operational decisions?

- Agreements often restrict operations to protect the Sponsor or provide operational efficiency
- Mandating use of common services:
  - Auditor
  - Tax and/or Investment advisor
  - Actuary
  - Is cell Sponsor also the general agent or management company
- How much latitude to make independent decisions:
  - Underwriting specific lines of business
  - Selecting reinsurance providers
  - Input on claims settlements
  - Investment policy
  - Loan back approvals

Captive Cells:

GAAP Tax Considerations:

Controlling interest looks at these factors:

Fees - are fees for Services appropriate?

- Core or Sponsor fees
- Reinsurance fees
- MGA fees
- Other service fees

- Excess or not "Arms-length" may cloud determination of who receives benefit created by the cell
- VIE determination needs to be completed for each cell
- Core Sponsors need to ensure consistency
    - All Participation Agreements
    - All program structures
- Changing internal agreements to meet specific cell needs can led to:
    - Increased financial reporting,
    - Legal costs
    - Management complexity

Captive Cells:

Who Are Using Protected Cells:

Can a cell be "converted" to a Pure Captive

- Flexibility for an incorporated cell to disassociate from the ICC
- Meet all requirements of a captive insurer
  - Organizational
  - Financial
- Unless otherwise prohibited by the PCC/ICC's participation agreement, cell has three options:
  1. continue in a participation agreement with its current PCC.
  2. migrate to and participate with a different PCC.
  3. spin off into its own captive insurance company.

Captive Cells:

Who Are Using Protected Cells:

Other uses of a PCC:

- Property & Casualty and Life Insurance business can be written in different cells of the same PCC provided these cells are not both reliant upon the core assets for solvency purposes.
- PCCs as Special Purpose Vehicles (SPVs) to facilitate:
    - translation of capital market transactions into insurance transactions or
    - risk transfer conduits to enable securitization of future income streams.

Captive Cells:

Who Are Using Protected Cells:

Where do we see the future of cells going?

- USA PCC legislation restricts their use to securitizing insurance risks

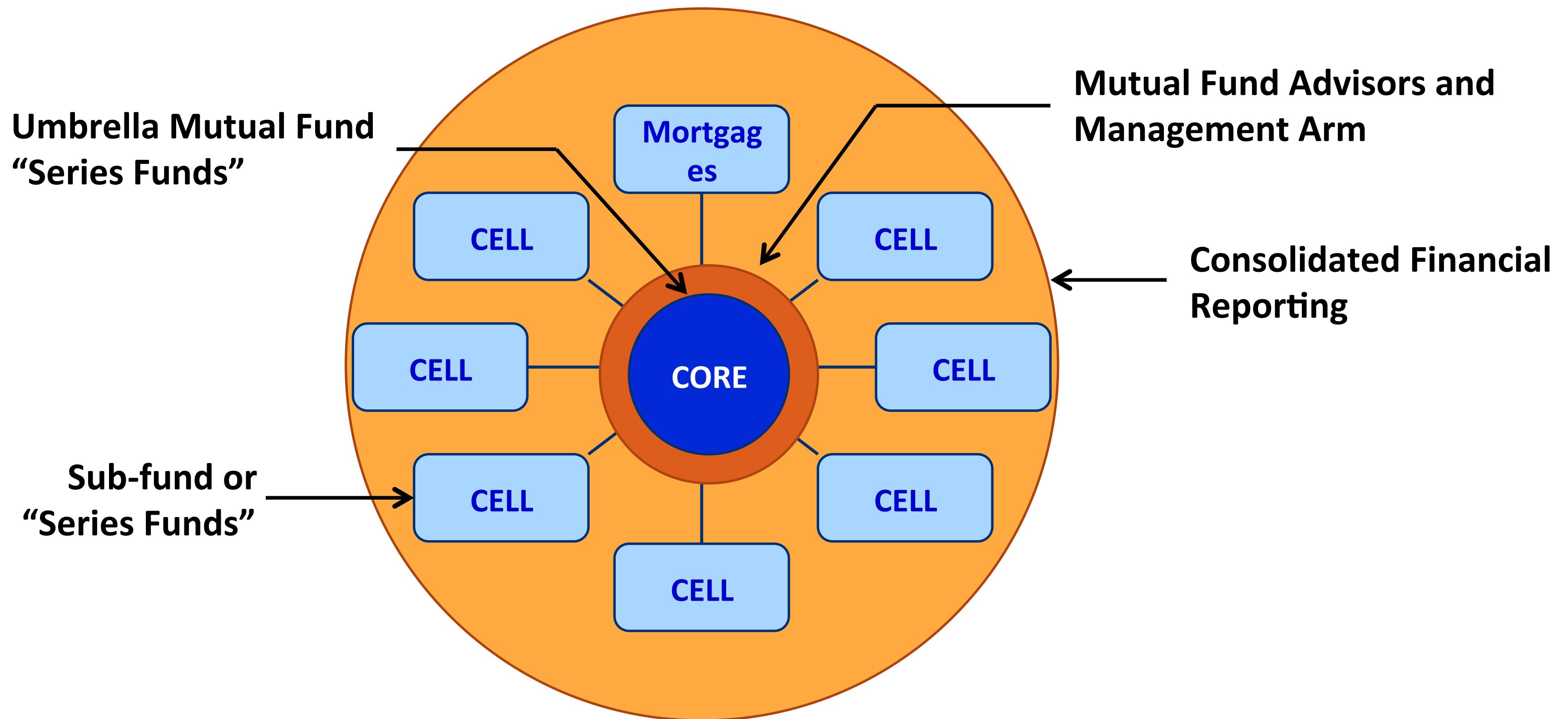
- Latin American country's such as:
  - Chile
  - Brazil
  - Paraguay
  - Peru, and
  - Ecuador

- laws allow for the securitization of various underlying financial assets:
  - Mortgage Notes
  - Assets and Leasing Contracts
  - Credits and Rights over cash flow

Captive Cells:

Example Uses of A PCC:

Investment Fund



Captive Cells:

PROs & CONs

Advantages of PCCs

- No or low commitment of funds for capitalization
- Reduced administrative costs as compared to owned captives
- Limited legal involvement
- Flexibility
- Underwriting profit and investment income
- Less restrictive exit provisions
- Do not need to create a separate legal entity

Disadvantages of PCCs

- Tax deductibility of premiums not certain
- Expenses can be higher than competing risk funding programs
- Control over governance, coverages and limits
- Limited flexibility of premium payments and collateral (letter of credit)
- Profit contingency for owners subject to fee deductions by the Sponsors
- Restricted domiciles

Questions or Comments?