# CAPTIVATING Options

*Variations in enterprise risk captive insurance help smaller or midsize firms cut costs and improve operational efficiency*

*By Bruce Shutan*

A growing number of smaller and midsize companies have used enterprise risk captives (ERC) for more diverse risk exposure. These alternative risk transfer arrangements, which generally address uninsured risks or gaps in commercial insurance programs, feature several variations that help reduce costs, administrative burdens or both.

Traditional "cells" are structured almost like a separate drawer in the filing cabinet of one corporate entity, explains Patrick Theriault, managing director of Strategic Risk Solutions. But unlike more recently developed incorporated cells, he says they do not require the employer to establish a separate corporation. The separation terms of both cell types are detailed in state insurance laws.

Another newer vehicle involves the "series" limited liability company (LLC), which was created under corporate law prior to being used in the captive insurance arena. This structure is "more separate in nature than the traditional cell, but it's not fully a separate corporation like an incorporated cell," Theriault notes.

He says insurance laws in Delaware and other states have started to address this concept. A key difference is that while a cell is a creation of and regulated under insurance laws, a series business unit on the other hand is a corporate law creation (state LLC statutes).

ERC cells arose from a desire to segregate some risks or lines of insurance from one another and run them as separate divisions or businesses, according to Jeff Simpson, an attorney with Gordon, Fournaris & Mammarella, P.A. By doing so, he says they escape the burden of having to establish a different entity or insurance company for legal or regulatory purposes.

Many business owners, particularly small or family held enterprises, are drawn to the cell structure because they require less capital than if they were dealing with a separate corporation.

A traditional cell is also known as a protected cell, segregated portfolio or separate account – all of which Simpson says are simply separate accounting buckets built inside of a single entity.

An incorporated cell company is essentially comprised of several separate entities, corporations, or LLCs that an insurance regulator is willing to treat as a single insurance company and amalgamate for regulation, he explains.

These separate buckets are "administratively more efficient and less expensive, but not as separate as some people would like," Simpson says. "On the other end, you have these bona fide separate entities, but there are some frictional costs and additional expenses. And in between, you have the series, which is sort of a function of coincidence.

"The series was already there," he continues. "It existed in a few limited liability company acts. It works very much like a cell, but it has more indicia of separateness than a cell does, however, not so much that it's an actual separate entity."

A captive is typically not defined by the type of entity that's used. "When we talk about enterprise risk captives, they can be formed as separate corporations or a variety of different kinds of cells or series," Simpson explains. That decision is often tied to cost and operational efficiencies associated with not having a separate corporation.

## CELL AND SERIES CAPTIVES

| | Cells at 12/31/2014 | Net Additions | Cells at 12/31/2015 | Captives + Cells at 12/31/2015 |
|---|---|---|---|---|
| Cayman | 606 | -3 | 603 | 1,310 |
| Delaware | 624 | 78 | 702 | 1,061 |
| Tennessee | 206 | 98 | 304 | 430 |
| North Carolina | 120 | 120 | 240 | 334 |
| Vermont | 78 | 12 | 90 | 678 |
| Utah | 71 | -3 | 69 | 516 |
| Total | 1,705 | 282 | 2,011 | 3,149 |

- The growth in number of cells and series in 2015 across these six domiciles alone exceeded captive growth. Cells and series are growing at much faster rate.

He makes a helpful analogy: *"Some people when they form their captives seek the American dream. They want the house; they want the yard. If you're going to do that, then you're going to need a separate corporation. Other people want the least expensive place to live and that militates toward a condo, which is a cell."*

### Renting vs. owning

Traditional cells were an improvement to the original "rent-a-captive" concept that were initially used as a group captive hybrid in offshore domiciles such as the Cayman Islands where the different programs or participants were tracked separately from an accounting perspective, according to Theriault.

But since there was no legal separation of assets and liabilities, even though there was a business intent, all participants in these "rent-a-captive" arrangements could have (and some were) ultimately exposed to large claims of other participants where funds were insufficient. He says such experience gave rise to the creation of the protected cell concept involving traditional, incorporated and series to shield each participant from the activities of others (i.e., it converted a handshake arrangement to more formal legal contractual or corporate law separation).

Cells will appeal to programs with a much smaller amount of premium that benefit from being able to bypass the statutory minimum level of capital otherwise required for a standalone captive, which Theriault says is already provided by the cell facility owner. Instead, the focus is on a need for risk-based capital only as determined by the domicile regulators. All these cells need is risk-based capital, he adds.

More midsize company owners are inquiring about these arrangements, which he notes have also drawn a growing involvement among attorneys, CPAs and new captive managers. Some have established their own facilities they can offer to their clients. In addition, he points to at least one or more sessions now devoted to ERCs at most captive industry conferences. ERCs are typically owned by small or privately held enterprises rather than big, publicly held companies.

Most of the ERCs Theriault's company manages involve so-called single-parent pure captives that underwrite only risks of related entities. He believes cost savings derived from using cells vs. wholly owned captives are generally immaterial for groups with $1 million up to $2.2 million in premiums, with such annual savings typically in the 10% to 20% range but coming with some requirements.

"The majority of our clients prefer owning vs. renting because they get to have full control, and they're not subject to any restrictions of the cell company owner," he reports. "And they're willing to pay a little bit more in operating costs to have that flexibility."

### How domiciles differ

Nearly every U.S. domicile has some kind of protected cell provisions in its statute, according to Simpson. In most of those cases, a protected cell company can be formed while some have series LLCs under their local statutes.

*"There is at least one state whose local law doesn't allow for series, but will license series from other states within its borders, and so it's broadening a little bit,"* he says. *"North Carolina has licensed some series LLCs from other states within North Carolina. It's not so much about receptivity as it is about understanding and interest."*

While some states haven't focused on attracting ERCs because they haven't needed it, Simpson reports that others have tried to bring in that business or became known as good domiciles for understanding the concept, and therefore, improving efficiency.

Theriault has noticed an increasing focus around specific types of risk use in cells across various domiciles. For example, he has noticed that in general medical stop-loss cells primarily have gone to Vermont, while ERCs have gravitated to Delaware, North Carolina, Tennessee, Utah and Montana.

He says one possible driver is that a substantial percentage of the ERC structures participate in some form of reinsurance often referred to as "risk pooling" and some states are more receptive than others to those structures. As it relates to the continued rising interest in ERC structures, another reason could be a better understanding of risk exposures among brokers, TPAs, attorneys and other service providers, according to Theriault.

## Need for meaningful regulatory guidance

The IRS has adopted a largely skeptical view of captive insurance, which recently landed ERCs for example on an infamous list of "dirty dozen" tax scams. The relative newness of these increasingly popular arrangements has made them prone to misconception or suspicion of ulterior motives, Simpson suggests.

As it relates to cell taxation, the IRS issued proposed guidance in 2010 and asked the industry for comments, but has yet to follow up with final regulations. It's anyone's guess when any meaningful guidance will come.

Theriault surmises that the agency is too busy focusing on other parts of the industry to produce regulations governing the taxation of cells. Regulatory action, along with the pending outcome of some court cases, could help reverse a slowdown in the number of ERC cells or series adopted last year, he observes.

IRS revenue rulings in the early 2000s increased the comfort level among regulators regarding how an ERC structure might work, while cells and series have made the arrangements more efficient, Simpson says. "We're at a point now where people who may have found this economically unfeasible now find it is feasible and that these are risks that, when it's feasible, they do want to cover," he says.

Simpson wonders when there will be meaningful guidance on ERCs, whose current state he describes as somewhat of a street fight between the industry and IRS.

"There should be some guidance coming out in the not-so-distant future on recent changes to the 831(b) provisions," he reports. "There are some pending cases, one of which should be decided in 2017, that should give us some instruction. And then, hopefully, those things together will add up to maybe an opportunity for the IRS to give you the more precise guidance that we can all rely on and work with."

The regulatory reins on small captives were loosened under changes to Section 831(b) of the Internal Revenue Code. Premiums allowed for property and casualty insurers under elections made to this part of the tax code increased to $2.2 million from $1.2 million and were adjusted to inflation for the first time since 1986. A subset of ERCs actually takes the 831(b) election, Simpson explains. The Protecting Americans from Tax Hikes Act of 2015 was signed into law by then-President Obama before Congress adjourned for 2015.

Whatever happens to the view of these arrangements inside the Washington, D.C., beltway, one thing is clear: ERC variations offer smaller and midsize employers more flexible options to meet their changing insurance needs. ■

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