STATE OF THE SERIES LLC CAPTIVE

Jeffrey Simpson, Andrew Rennick and Daniel Fitzgerald of Gordon, Fournaris & Mammarella survey the series landscape and review the different approaches that domiciles and practitioners are taking

Since Delaware licensed the first series LLC captive insurance company in 2010, series have been among the fastest growing and most popular forms of captives, with hundreds formed across several domiciles. Sponsors and users of series LLC structures are increasingly attracted to the flexibility, cost savings and administrative efficiency. In response to the demand for series structures, states have taken action. Some states have interpreted their statutes to allow the licensing of series while others have amended their statutes to expressly permit the licensing of series. Delaware updated its captive insurance statute in 2015 to formalise the licensing, taxation, reporting and governance of what it now calls a "series captive insurance company" (SCIC). And this year, North Carolina, a state whose LLC act does not allow for series, amended its captive statute to expressly allow licensing of entities formed in other states so that a foreign series LLC could be licensed in North Carolina as a special purpose captive.

What is a series?

While very similar to protected cells, series differ in that they are typically more than mere accounting conventions. Several states' LLC acts permit LLCs to designate series of owners, managers, or assets and liabilities, which are segregated from each other and from the LLC generally (core). The authorising statutes usually recognise series as separate persons for purposes of contracting, suing and being sued.

Series formation

To form a series, the core enters into an operating agreement, often called a "Series Agreement", with the series' owners. While a few states require a public filing to form a series, most states where series LLC captives are popular do not.

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Licensing a series

States vary in their approaches to licensing a series to transact business as a captive. Some states license the core as a special purpose captive and grant individual series supplemental licences under the core's certificate of authority. Other states license the core as a protected cell captive and permit the core to form series that are licensed as protected cells. By complying with the segregation of assets, liabilities, profits and losses required for series under the respective LLC acts, the individual series satisfy the protected cell statutes' requirements regarding separation of assets and liabilities. The Series Agreement between the series' owner and the core satisfies the protected cell statutes' requirement for a participant contract. In this way, the protected cell regulatory regime is mapped onto a series LLC structure. Finally, Delaware adopted a new method last year and now recognises an SCIC as a type of captive insurer, allowing an SCIC to file its own application and obtain its own certificate of authority.

Operating a series

The typical series structure is established so that the core serves as an administrative centre and the insurance business is transacted by the series. Occasionally, however, the core serves as a direct writer and reinsures to its series.

Cash flow

When we first started forming series structures, the core usually served as a common paymaster for the structure, procuring service providers for the series and assessing the series by charging access fees and passing through costs. However, since the core is regulated as a captive insurer, many captive managers and sponsors have found it to be less burdensome to address series fees and expenses through captive management agreements. Treating the core more as the "hub in the wheel" and less as an active administrative and profit centre results in fewer transactions and simpler financial statements, and enables the sponsors to distribute fee income without needing regulatory approval.

Account opening challenges

While the ability to form a series without a state filing provides ease of formation, one drawback is the inability to obtain a good standing certificate (GSC) for the series. This may cause difficulties opening bank or brokerage accounts in the series' name. One solution is to form a subsidiary LLC which is 100% owned by the series and holds the series' assets. Accounts are opened in the subsidiary LLC's name on the strength of its GSC. However, this approach has the effect of separating the series from its assets. Care must be taken to ensure that the series can access the assets held in its subsidiary LLC to pay claims and expenses, and the arrangement should be disclosed to the regulators. Another common approach is to produce a secretary's certificate, signed by the secretary of the core, which delineates the authority and includes appropriate exhibits. In our experience, the secretary's certificate often satisfies a bank and will avoid the ancillary difficulties and costs that arise from forming subsidiary LLCs.

Administrative and regulatory efficiencies

Series were originally envisioned as a way of achieving administrative and regulatory efficiencies, and they have delivered streamlined management and regulatory reporting. Series benefit from versatility in governance models, which may include establishing a separate board of managers and officers for the series or delegating management authority for the series to the officers and managers of the core. The governance requirements under captive statutes are generally directed at the core and not the individual series, since only the core falls within statutory definitions of "captive insurance company". Accordingly, series management is delegated to the core, requirements for a resident manager, an annual meeting in the state, and a conflict of interest policy for managers and officers are satisfied at the core level. In Delaware, because the statutory definition of captive insurance company now includes SCICs, if the SCIC is managed by a board of managers, an annual meeting in Delaware is required, and each SCIC must adopt and comply with a conflict of interest policy.

With respect to reporting, series may participate in a consolidated audit of the series LLC provided that the financial condition of each series is accounted for separately within the consolidated audit. Most states also permit the filing of a consolidated annual report with schedules for each series, except Delaware now requires that each SCIC file a separate annual report. States are split over statements of actuarial opinion (SAO); some require each series to submit its own SAO while others permit a consolidated SAO.

Because a series can contract in its own name, licensing a series as a captive can help address the "intra-company contracting" challenge faced by unincorporated protected cells. Generally, because unincorporated cells do not have authority to contract in their own name, they cannot contract with one another. As such, reinsurance among related captives or captives operated by a single manager can only be accomplished through another vehicle outside of the cell company. However, in a series structure, series can contract with one another so that intra-company contracting, including intra-company reinsurance, is possible.

Capitalisation

Series have been able to provide capital relief, particularly at the formation stage. Most regulators have used their discretion to permit minimum capital and surplus as low as $25,000, with the caveat that, by the end of the first year, the series must achieve and maintain a healthy premium to surplus ratio.

Taxes

Another attractive feature of series is lower premium taxes. Almost all states assess the premium tax to the core, based on the series structure's aggregate premium. Typically, the core allocates the premium tax liability to the various series, as if each were directly subject to the premium tax. In those states, a minimum premium tax is not applied at the series level. In Delaware, however, since 2015, each SCIC is assessed its own premium tax, subject to a $3,500 minimum.

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Summary

The last six years have given practitioners and regulators comfort that series captive structures actually work as intended. Over that time, the use of series has increased while regulation has been refined. Accordingly, we not only expect continued growth, but also more creativity. However, a robust series market has increased the cost of regulating series, and the refinement process has led to the elimination of some regulatory efficiencies. While we expect that trend to continue in the form of requiring separate SAOs and increases in taxes and fees charged to series, we anticipate that the premium taxes will still be less than those charged to pure captives and that the administrative efficiencies, flexibility in governance, and capital relief will continue to make series an attractive form.