Chapter 1
Captive Company Formation

This chapter provides an overview of how to incorporate and start up a new captive insurance program and is a great place to get acquainted with basic terminology and see how different professionals work together to run captive programs. Chapters 2 and 3 provide insight concerning the legal theories underpinning captives but are not the best place to start for practitioners unfamiliar with the insurance industry. Treat the formation of a captive like any other investment in a new business line. It is imperative to perform a feasibility study and identify the following: the business operational plan; regulatory framework; and financial projections of this new business. Once established, a captive will need monitoring and management to continually meet the needs of its clients.

Feasibility Study

"The Road Note Taken," a poem by Robert Frost, gives this sage adivce:

> Two roads diverged in a yellow wood, and I—
> I took the one less traveled by,
> And that has made all the difference.

Any decision maker in a company must choose a road, as Frost did, every day, identifying and deciding on the best path to lead the business in the right direction. In business, there are countless data points decision makers use to identify the right path. Any decision must be made after careful consideration of the market, the business model, the return on investment, and opportunity cost. The decision to invest in a captive should meet these standards as well. Accordingly,

a feasibility study on the viability of the captive is the first step in the decision-making process.[1]

The first item to identify in the feasibility study is the right captive structure to be used. There are different types of captive insurance companies and captive arrangements that can meet the needs of the business. The following sections provide a baseline understanding of these different structures for the decision-making process.

Single Parent Captives

The single parent captive is an insurance company, normally a subsidiary of a business, formed to insure the risks of that parent and its affiliated companies. These captives can act as insurers or reinsurers. Further, these companies can underwrite unaffiliated risks to derive income for the consolidated group of companies.

Group Captives

A group captive is an insurance company that insures the risks of a heterogeneous or homogeneous group of unrelated insureds. Shares of the captive could be owned by all insureds or by unaffiliated businesses. These arrangements can be found in industries such as medical groups or construction and can sometimes be sponsored by industry associations.

Protected Cell Companies

A cell captive or segregated/protected cell captive is a special purpose insurer that is set up with a capitalized core company and many individual "cells" that use the core company's insurance license to issue insurance. The cells are kept separate through maintaining cell-specific books and identifying dedicated assets and liabilities ascribed to the cell, as well as individual underwriting accounts for each cell participant. Most notably, only the core company (not any of the other cells) can be used to meet the liabilities of any one cell. A segregated cell has the cells set up as individual, legally separate companies for further protection. In some domiciles, these cells operate as their own separate legal entities, and in other domiciles the cells reinsure the core company and the core company issues the insurance policies.

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[1] It should be noted that many times the domicile requires a feasibility study performed on the captive by a specific professional and submitted as part of the application for insurance business. However, the authors argue that best practices dictate a thorough feasibility study for all captives as a feature of good business.

Risk Retention Groups

A risk retention group (RRG) is an insurance company formed pursuant to the federal Liability Risk Retention Act of 1986. An RRG is usually formed by a group of businesses engaged in similar activities or a similar business to provide insurance coverage for those businesses. The RRG must be owned by its insureds, can insure a multitude of risks, and must be domiciled onshore in the United States.

Fronting

A fronting arrangement is found when a traditional admitted commercial insurer issues a policy to an insured, then reinsures all or a substantial portion of the risk from that policy to a reinsurance company. This reinsurance company is normally owned by the original insured. Fronting is used by businesses that have insurance and risk management needs in multiple jurisdictions and seek to use the already registered admitted carrier to that jurisdiction to penetrate those markets. There are contractual responsibilities regarding claim management and underwriting to be handled by the reinsurer or admitted carrier that are unique to each fronting arrangement. Fronting arrangements are expensive. Most carriers require collateral from the captive for the privilege of using the front's paper. The front has leverage because many insurance arrangements require a minimum financial rating (e.g., leases and malpractice insurance requirement). In addition, fronts often charge a percentage of gross written premium as an ongoing fee. Fronting is almost always used in workers' compensation captive programs.

Reciprocals

Reciprocals are an unincorporated group of individuals or businesses (called subscribers) that agree to pool risks and exchange insurance contracts indemnity with each other. This in turn spreads the risk among them to pay the cost of retained losses and purchasing reinsurance. Also known as interinsurance exchanges, they are normally managed by an attorney-in-fact, as there is no incorporated management.

While not specifically a type of captive, an important delineation for capitalization and control is the difference between a stock captive and mutual captive. A stock captive is an insurer that raises capital by selling shares to shareholders and is controlled by those shareholders. This differs from a mutual captive, in which a mutual

is not owned by shareholders but instead by the policyholders. Many of the aforementioned arrangements could be considered either a stock or mutual insurance company according to its ownership structure.

Knowing the specifics of these different types of captive arrangements provides a better picture for a business owner concerning the options for the best arrangement for their business and its risks. Certain types of captives previously described have less stringent barriers to entry than do other versions. The specific needs of each captive for setup and management are dictated by the domicile in which that company is found, with rules and regulations differing between type of captive on a domicile-by-domicile basis. After understanding the possible types of captives available, the feasibility study truly starts with domicile selection.

Domicile Selection and Regulatory Framework

Domicile is defined by the state or country that licenses an insurance company and has the primary regulatory oversight over that business. As discussed previously, insurance is inherently a state- (or locally) regulated business. This local jurisdiction emphasis provides a patchwork of rules and regulations that allows the consumer to choose a regulatory framework. Further adding complexity in choice are those domiciles located outside of the United States.

There are many elements to consider when comparing captive domiciles; however, picking a domicile is much like picking a long-term business partner. The regulator sets the rules according to which the captive insurer must conform. As with any successful long-term business partner, open and clear communication between the two parties is a must.

The domicile selection process is a unique decision that weighs which items are most important to the individual and to the business when making these companions. Some individuals focus on the ability to travel to exotic islands for board meetings. Others worry about the regulatory requirements for capitalization, investment restrictions, or time. Still others are guided by the type of insurance policy to be written, as many unique exposures might be available to be written only in very specific domiciles.

The following table identifies the top regulatory and business considerations for captive incorporation:

TABLE 1.1 Captive Insurance Company Domicile Considerations

Jurisdiction	Domicile 1	Domicile 2
Mature Captive Market		
Capitalization Requirements		
Incorporation Expenses		
Incorporation Timeframe		
Type of Insurance Allowed		
Investment Restrictions		
Taxes		
Reserve and Underwriting Requirements		
Reporting Requirements		
Local Office Requirements		
Reinsurance Requirements		

The Mature Captive Marketplace

The first consideration in the table is the maturity of the captive market. This takes into consideration:

1. whether there is a codified insurance act with specific captive insurance regulation and regulatory agency;
2. the length of time the captive domicile has been in operation; and
3. the sophistication of the insurance regulation and regulating agency in that domicile.

It is important to have a regulator that works with the business owners to achieve the right goals. Responsiveness, communication, and service should always be at the top of the consideration list.

Local captive insurance service providers are also critical. Attorneys, accountants, actuaries, investment advisors, bankers, and managers carry their weight. It is imperative that not only a strong regulatory framework exist to provide the foundation for the captive management, but these supporting players ensure continued profitability and compliance with the domicile. Most mature marketplaces will have many branches of well-known worldwide banks, accounting firms, and investment managers. Local attorneys and actuarial firms should be registered with the insurance regulator and should

be scrutinized when comparing domiciles, which brings us to a discussion about captive management groups.

A captive management company is a third-party company that manages all day-to-day operations of the captive. This includes accounting management, reserve management, claim management, filing, and regulatory compliance. Good captive management companies will be an ambassador to the insurance regulator for the captives they represent and can facilitate the feasibility study and introductions to other service providers.[2]

The domicile comparison should be completed to identify those items that are most important to you and your company. To illustrate this process, the following table is completed comparing two popular domicile locations.

TABLE 1.2 Domicile Comparison Chart: Cayman Islands and Vermont

Jurisdiction	**Cayman Islands**	**Vermont**
Mature Captive Market	Yes, passed first captive insurance law in 1979. There are 816 current captives.[3]	Yes, passed first captive insurance law in 1981. There are 566 current captives.[4]
Capitalization Requirements	Depends on class of insurance license: Class B(i) – General: US$100,000 – Long-term: US$200,000 – Composite: US$300,000 Class B(ii) – General: US$150,000 – Long-term: US$300,000 – Composite: US$450,000 Class C – General: US$500 – Long-term: US$500 – Composite: US$500	Statutory minimums on type of insurance company: – Pure: $250,000 – Association: $500,000 – Industrial insured: $500,000 – RRGs: $1,000,000 – Sponsored captive: $500,000

[2] While captive managers are not necessary except in select domiciles that require them, these professionals are necessary for all practical purposes. Only a select few of the largest companies in the world have self-managed captive insurance subsidiary businesses.

[3] Cayman Islands Monetary Authority Insurance Supervision Division statistic report as of March 31, 2018.

[4] Vermont Department of Financial Regulation active captives by type report as of December 31, 2017.

Jurisdiction	Cayman Islands	Vermont
Incorporation Expenses	Incorporation fees from Varies–$750 minimum. Annual license fees varying by to class: Class B(i) $8,500 Class B(iii) $10,500 Class C $5,000	$500 combined application/licensure fee. Annual license renewal fee of $500 and $5,000 actuarial review. Incorporation of business fees vary.
Incorporation Timeframe	4–6 weeks	30 days
Type of Insurance Written	All subject to approval by the head of Insurance Supervision.	All
Investment Restrictions	None for restricted Class B companies.	None for pure and industrial insured. Association and RRGs are subject to other admitted carriers in the state.
Taxes	No income tax. No premium tax. No capital gains tax.	Minimum tax of $7,500, maximum of $200,000. Tax levied on gross written premiums: $1–$20M GWP – Direct 0.38%, – Reinsurance 0.143% $40M–$60M GWP – Direct 0.19%, – Reinsurance 0.048% Over $60M GWP – Direct 0.19%, – Reinsurance 0.048%
Reserve and Underwriting Requirements	Premiums must be actuarially assessed or based on commercial market terms. No policy form or rate approval needed.	Actuarial opinion on reserves required annually. Requirements may be waived on short-tail risks.

(continued)

TABLE 1.2 Domicile Comparison Chart: Cayman Islands and Vermont (*continued*)

Jurisdiction	Cayman Islands	Vermont
Reporting Requirements	Class B: written confirmation of auditor on annual accounts; annual certificate compliance; changes to directors and shareholders must be reported.	Annual GAAP or SAP if desired, financial statement 75 days after fiscal year-end; NAIC statement for RRGs and Association Captives only.
Local Office Requirements	Registered office and locally licensed insurance manager required. Class B companies must have at least two directors.	Office in Vermont; one directors' meeting in Vermont annually; use of resident director and agent required; financial records must be kept in Vermont.
Reinsurance Requirements	NO specific regulatory requirements by the reinsurance plan is subject to review by the head of Insurance Supervision.	Reinsurers must be admitted or on the authorized captive reinsurers. List that involves the filing of financial statements and a $300 fee.

GAAP, generally accepted accounting principles; GWP, gross written premium; NAIC, National Association of Insurance Commissioners; RRG, risk retention group; SAP, statutory accounting principles

Retention Level Analysis

The deductible means the insurance company will pay every loss (up to a maximum liability) to which the insured will reimburse the insurer. This arrangement is well known in admitted carrier insurance coverage. However, the idea of the deductible is separate and distinct from a company's self-insured retention. In the captive or self-insurance realm, the self-insured retention is the primary layer of risk of loss the self-insured retains. All claims in this layer will be paid by the company. The excess insurer will generally not pay any claim until the self-retained limit is exceeded. A similar concept is the risk retention, which is the amount of risk the insured is willing to assume. In the reinsurance market, retention is the net amount of risk the ceding company keeps for its own account. As part of the feasibility analysis, the insured and their actuarial team should complete

a retention analysis. This analysis views the range of risks faced by the insured and assesses whether higher retention levels with lower premiums is right for that company. This discussion does not occur in a vacuum and should have input from the underwriting team. Retention analysis is discussed in Chapter 6 in tandem with a discussion of underwriting.

Capital and Solvency Requirements

What is capital? Capital is the initial value of the shares of stock issued to the owner of the captive. Capital contributions are not the same as premiums and are not deductible as a business expense. This initial capital is needed up front to start the insurance business and works as the baseline for the reserve of the captive business. In other words, it is the minimum amount of money the insurance business is expected to hold based on the types of risks to which the company is exposed.

Some companies will have the requisite capital to fund the captive. However, for strategic reasons the business might seek to capitalize the structure through several different ways: common or preferred stock offerings, traditional lines of credit, or surplus note issuance.

Paid in capital is the amount of capital "paid in" by investors during common or preferred stock issuances, including the par value of the shares themselves. For a captive, paid in capital refers to capital acquired by the insurance company from sources other than the captive business operations.[5] Upon the organization of the insurance company, it would sell common or preferred stock, which it would carry in the stockholder's equity shown on the company's balance sheet. Commercial lenders may lend the capital necessary to incorporate a captive. Depending on the size of the business starting the captive, this might be easy to acquire.

Surplus notes provide an attractive debt financing option for stakeholders. A surplus note is a bond-like instrument issued by the insurance company that pays a regular coupon with a finite maturity. They are contingent in that they are subordinated to the interest of the policyholders. Claims on policies are paid before the surplus note holders are paid. Despite their debt-like features, surplus notes are

[5] As of January 1, 2017, all European Union–domiciled captives will be subject to Solvency II regulations, which subject captives to a risk-based capital requirement. Risk-based capital is defined as a method developed by the National Association of Insurance Commissioners (NAIC) to determine the minimum amount of capital required of an insurer to support its operations and write coverage.

reported as part of the policyholder's surplus due to subordination. Surplus notes can be used to leverage third-party capital in order to capitalize a group or association captive, in which the initial policyholders lack the funds to capitalize the captive internally.

What is surplus? A policyholder surplus is the assets of the insurance company less its liabilities. This is the amount of equity over the statutory capital either earned or paid in by shareholders. It also includes the retained earnings of the business and is a reliable indicator of an insurance company's financial health. Surplus, along with reserves and reinsurance, is used should the need for additional capital arise owing to larger-than-expected claims and losses. Surplus is the real value of an insurance company. When the surplus sits in the insurance company, the capital is invested in the capital markets, generally in safe investments. Reserves are an additional source of revenue to the stakeholders. Restrictions surrounding surplus investments vary from domicile to domicile.

The solvency of the insurance company is the most important measurement of the business. Solvency is the ability for the captive to make payments on its outstanding liabilities. Solvency is viewed through the lenses of ratios and margins. The purpose of solvency is to give the regulator assurance that an insurance company maintains sufficient liquidity to satisfy the number of expected claims made on the risk the insurance company underwrites. The margin of solvency requirement for insurance companies is the insurer's unimpaired surplus as a percentage of its outstanding loss reserve. Solvency is not the same as capitalizing the company. However, the assets used to capitalize the company are included when determining solvency. Solvency is statutorily mandated and will vary from domicile to domicile. The solvency requirements for the Cayman Islands are such that Class B, C, and D insurers are required to keep solvency equal to or in excess of the total prescribed capital requirements as identified by the actuarial analysis.[6]

Cost Benefit Analysis

The final step in the feasibility study is the cost benefit analysis of a captive operation. This seeks to weigh the pros and cons of the

[6] Supplement No. 3 to the Insurance Law 2010 (Law 23 of 2010), *The Insurance (Capital and Solvency) (Classes B, C, D Insurers) Regulations 2012*, published with 129 Extraordinary Gazette (Dec. 20, 2012).

captive project. Because of the capitalization requirements, the prudent businessperson should ask, Could this money be used in a more efficient manner? Would it benefit the business more as reinvestment into operations or technology? What do I really know about the business of insurance? Can I find a team of professionals that support the captive so that it is not a burden but instead a profit-driven asset in my corporate group? This cost benefit analysis should be a high-level examination of adding a captive insurance business to your specific corporate ecosystem.

Benefits range from better control of insurance spending to the direct management of the claims process. The creativity and flexibility available to craft policies for the specific needs for each risk encountered by the business can outweigh many of the negatives. Tax planning and financial health improvement of the corporate group are also benefits. Further, finding the right support group in captive management and other professionals in the industry can negate most of the headaches associated with entering this business.

The cost benefit analysis is a unique final step in the feasibility study process. Having a myriad of professionals weigh in and identify the pros and cons throughout this process should provide the data points needed to perform the cost benefit analysis. Hopefully, the feasibility study process provides the needed information for corporate management to make an informed decision.

Implementation

Assuming after the feasibility study and cost benefit analysis the corporate group has decided to pursue a captive in a specific domicile, the next step in this process is implementation. The implementation process starts with drafting the incorporation documentation and gathering necessary documentation for the insurance application for the domicile selected.

The insurance company is a separate corporate entity than the parent and as such must be incorporated. Depending on the domicile of the captive, these start-up documents have different names. Domestically, the start-up documentation needed includes the articles of incorporation and the bylaws. Internationally, these are commonly known as the memorandum and articles of association. These documents are specific to the domicile but normally include the number of shares issued; the rights, powers, and restrictions of those shares; and the duties of the directors of the company. The bylaws will have

more information regarding the operations of the company. These should be filed with the appropriate authority so that the business is operational before completing the application.

The next step is more codification and documentation for submission of the application. The documentation that needs to be prepared for submission to the regulator with the completed application will vary from domicile to domicile. The following documents are standard:

1. a codified business plan (including reinsurance if necessary);[7]
2. at least a 3-year projection of financials (in some domiciles a 5-year projection is necessary);
3. detailed biographical information of directors;
4. selection of local professionals in the domicile;
5. appointment of auditors, managers, attorneys, accountants, actuaries, and investment manager;
6. a bank selected and account opened; and
7. finalized coverage and policy documents drafted.

As with many decisions in this arena, the captive implementation timeline will be dictated by the domicile. As previously noted in Table 1.2, timelines generally run from 4 to 8 weeks. The process is as follows:

1. Feasibility study of captive in corporate group
2. Decision to pursue captive insurance
3. Decision of domicile
4. Approval of implementation process
5. Application completed and submitted with domicile-specific backup
6. Shareholder letter regarding capital undertaking
7. License approval
8. Bank account opened and funded

[7] Reinsurance is covered in detail in Chapter 11. For this discussion, it is important to note that the reinsurance process can take longer because of the need to submit the proposal to the market to receive quotes. This is where the right domicile regulators and management team can help shepherd this process by providing introductions and relationships to reinsurers.

Ongoing Management

Once incorporated and approved, the business must function in accordance with the laws of the domicile as well as commonly accepted procedures in the insurance industry. Accordingly, underwriting guidelines must be governed by the captive's business plan, because the actuarial study's proposed reserves and rates are predicated on specific risks and expected loss ratios.

The next commonly accepted insurance practice is the need for claim submission and processing. The captive insurance company should have policies and procedures set up to handle incoming claims made on the policies. There should be oversight and record keeping of the process from the date claim was filed, and documentation of all contact and steps taken by captive and claimant in resolution of the claim must be kept. This is important to prove the validity of the insurance arrangement as well as add information to the actuarial analysis in the future of this insurance program.

Of utmost importance for the ongoing management of the captive insurance company is the accounting documentation. There are two different levels of accounting that run in parallel in the management of the captive. The first is the day-to-day operational accounting. This is accounting and recording of (1) premiums paid and received; (2) claims filed and recoveries related to those claims made by the business; and (3) administration of operating accounts (cash management, payroll, etc.). The second level of accounting management tracks the movement of capital in accordance with the captive's investment policy. This investment-level accounting must be accurate, as it directly affects the surplus. Strong communication is necessary between the investment advisor and the accounting team to ensure no fines are levied by the regulator or, worse, there is a revocation of the license.

Outside of the underwriting, claims processing, and accounting, the secretarial administration of the captive's vision is a constant for continued legitimacy and growth of the captive. A strong working relationship with the parent company must be maintained, as proper captive management functions in partnership with the business stakeholders. Changes in the parent company should be met with reviews of the stakeholder's risk profile to assess whether the captive is still providing appropriate coverage. This ensures the collective corporate ecosystem is striving for more profitability.

Concordant with meeting the needs of the customers of the captive, compliance with the regulator is of utmost importance. Again, maintenance of all records is key and should be a top priority for compliance. The domicile will have specific reporting deadlines and information needed at those times for prompt submission of and accurate information concerning financials. Finally, open communication about domicile law changes must be met with swift action by the management team for either implementation or a movement of operations to a more favorable jurisdiction.