## Contents

About the Authors xi  
Acknowledgments xiii  
Introduction xvii  

### Chapter 1  
Captive Company Formation 1  
Feasibility Study 1  
  *Single Parent Captives* 2  
  *Group Captives* 2  
  *Protected Cell Companies* 2  
  *Risk Retention Groups* 3  
  *Fronting* 3  
  *Reciprocals* 3  
Domicile Selection and Regulatory Framework 4  
The Mature Captive Marketplace 5  
Retention Level Analysis 8  
Capital and Solvency Requirements 9  
Cost Benefit Analysis 10  
Implementation 11  
Ongoing Management 13

### Chapter 2  
Captives and Capitalists 15  
The Elements of Insurance 16  
Deductibility of Premiums and Federal Tax 17  
Winners and Losers, Applicable Case History 18  
Insurable Risk and Commonly Accepted  
  Notions of Insurance 28  
Risk Shifting and Risk Distribution 30
Chapter 3  
Risk Pools 43  
Risk Distribution Review 43  
Risk Distribution and Single Parent Captives 45  
Third-Party Risk and Risk Distribution 47  
Third-Party Risk and Group Captives 48  
Risk Pooling 49  
Avrahami v. Commissioner 54  
Reserve Mechanical 55  
The Future of Risk Pooling 57

Chapter 4  
Financial Statements, Investments, and Financial Ratings 59  
Insurance Financial Statements 59  
The Exciting World of Accounting 60  
The Balance Sheet 63  
   Bonds 63  
   Premium Balances 63  
   Liabilities 64  
   Reserves for Losses 64  
   Unearned Premiums 65  
The Income Statement 65  
Statement of Cash Flows 67  
Financial Ratings 68  
Investment Considerations 69  
   Asset Restrictions 69  
   Investment Restrictions 70  
   Financial Ratios 71  
The Premium to Surplus Ratio 71  
The Liquidity Ratio 72  
Profitability Ratios 72  
Ratings Agencies 73  
Of Captives and Loans 73

Chapter 5  
Policy Drafting and Coverage 75  
Captive Insurance Policy Drafting 75  
The Insurance Policy: Elements of a Contract 76  
What Insurance Policies Do 78  
The Commercial General Liability Policy 79  
   Declarations 80  
   Insuring Agreement 80  
   Exclusions 81
Chapter 6 Underwriting and Claims Reserving 95
Underwriting Fundamentals 95
The Underwriting Cycle 97
Captive Underwriting 97
   Data Gathering 98
   Data Analysis 99
   Monitor the Insured 99
Insurance Rates 100
   Frequency and Severity 101
Calculating Insurance Premiums 102
   Experience Rating 103
   Retrospective Rating 103
Deductibles and Self-Insured Retentions 106
   Collateral Requirements 106
   Defense Costs and Limits Erosion 106
   Certificates of Insurance 107
Reporting Requirements to Excess Carriers 107
   Excess Reporting Requirements: Notice
      Conditions 108
   Late Reporting and Claims Made Policies 109
Claims Reserving Introduction 110
Claims Reserving and You 111
   Case Reserves 112
   IBNR Reserves 112
Reserving Practice 112
   Assess the Background 113
   Consider the Appropriate Data 113
   Analyze the Data 113
   Report the Data in a Meaningful Way 114
Claims Development 114
Chapter 7  Federal Income Tax and Captives  117
Introduction  117
Starting a Captive Insurance Company  118
Start-Up Costs Deductions  119
Managing a Captive Insurance Company  120
Reserve Calculations  121
Investment Income  122
Dividends Received from Captive Insurer Subsidiary C Corporations  122
Proration of DRD for Insurance Company Corporate Subsidiaries  124
Subsidiary LLC Entities of Captive Insurers  125
Loans to Related Parties  126
Taxation of Protected Cell Companies  126
Foreign Captive Insurance Companies  127
Controlled Foreign Corporations and the Insurance CFC  129
Related Party Insurance Income  131
Passive Foreign Investment Company  132
Federal Insurance Excise Tax  134
Global Intangible Low-Taxed Income  135
Base Erosion and Anti-Abuse Tax  135
U.S. Information Reporting Requirements for U.S. Persons  136
Foreign Tax Credits  136
Alternative Taxation Regimes  137
Merging Captive Operations  140
Taxable Acquisitions  141
Tax-Free Statutory Reorganizations  142
Treatment of Reserves Transferred in Reorganization or Liquidation  143
Tax-Efficient Unwinding Strategies  144

Chapter 8  State and Local Captive Insurance Issues  149
Captive Insurance Taxes in General  149
The Power of States to Tax Captive Insurance Companies  151
Commerce Clause and Due Process Summary  156
The Power of States to Regulate Insurance Companies  156
An Introduction to Todd Shipyards  158
The Frozen Trilogy  159
The Exaggerated Death of Todd Shipyards  161
Further Rebellion Against Todd Shipyards  164
Breadth of Todd Shipyards  166
Todd Shipyards Affirmed  167
State “Doing Business” Laws  169
Summary of Independent Procurement Taxes | 170
Surplus Lines and the Nonadmitted and Reinsurance Reform Act | 171
Johnson & Johnson’s Unconstitutional Holding | 173

Chapter 9  Tax-Exempt Organizations and Captive Insurance | 177
IRC § 501(c)(3) Organizations and Captive Insurance | 177
Setting Up the Tax-Exempt Subsidiary Captive Insurer | 180
Offshore Health-Care Captives with “Non-Insurance” Status | 183
Captives in the Educational Space | 184
IRC § 501(c)(6) Organizations and Captives | 184
Unrelated Business Income Tax | 192
Charitable Risk Pools | 194

Chapter 10  Risk Retention Groups and How They Work | 197
RRGs and Federalism | 199
RRGs and Non-Domicile States | 201
Liability Insurance | 202
State Law Preemption Battlegrounds | 203
“Direct Action” State Statutes | 204
“Authorized and Minimum Insurance” State Statutes | 206
Financial Responsibility State Statutes | 208
Arbitration Clauses | 209
State Guarantee Funds | 210
Preemption Battlegrounds Summary | 211

Chapter 11  Reinsurance | 213
Basic Terms of Reinsurance | 213
Reinsurance Program Design and Placement | 217
Common Reinsurance Clauses | 219
Reinsurance Regulation | 221

Chapter 12  Workers’ Compensation and the Grand Bargain | 223
Federal Forms of Workers’ Compensation | 225
Workers’ Compensation Self-Insurance and Captives | 228
Large Deductibles and Retrospective Rating Plans | 230
Workers’ Compensation Structure and Rates | 232
Texas Non-Subscription | 233
Bankruptcy Considerations with Self-Insured Workers’ Compensation Plans | 234
Chapter 13 Employee Benefits 237

The Employee Retirement Income Security Act (ERISA) 239

Parties in Interest 242

Plan Assets 242

Fiduciaries 243

A Very Brief Summary of the Affordable Care Act 244

Health-Care Self-Insurance 246

Stop-Loss Insurance 247

Risk Retention Groups and Benefits 251

How Health Care Works 254

MEWAs and VEBAs 255

Conclusion 259

Table of Cases 261

Index 267