

Summer 2010
Vol 6. No. 3



Delaware Banker

Captivating Summer Reading

*Delaware
Captive
Insurance*

The Quarterly Publication of the Delaware Bankers Association

A Captivating Tale

Delaware's Continued Commitment to Captive Insurance

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Delaware continues its commitment to establishing a reputation as a competitive domicile for licensing a captive insurance company. Recent amendments to the Delaware Revised Captive Insurance Company Act (the “Act”),¹ as well as the demonstrated openness of the Delaware Department of Insurance (the “Department”) to licensing financially sound but novel structures using series limited liability companies, will help advance this reputation. This is good news for those that have considered, or may be considering, providing captive management services and for those companies seeking a jurisdiction already widely known for responding responsibly to modern business concerns and changing needs.

According to the Department, as of March 31, 2010, the state had licensed fifty-three captive insurance companies of various types, mostly pure captive insurance companies and special purpose captive insurance companies.² While this number may seem small compared to other well-established jurisdictions, it represents a substantial increase since the overhaul of Delaware’s captive insurance statute in 2005. With the Department’s newly formed, professionally staffed Bureau of Captive and Financial Insurance Products, established by Commissioner Stewart, the Department expects continued growth.³ Notably, because of continuing economic concerns and current market conditions, many well-established jurisdictions have been experiencing slower growth.

House Bill 314

On May 3, 2010, Governor Markell signed into law House Bill 314 amending the Act.⁴ The bill had the overwhelming support of the State Legislature, having passed by all but one vote in the Senate and unanimously in the House. The amendment added “agency captive insurance companies” and “branch captive insurance companies” as additional forms of captive insurance companies explicitly permitted under the Act.⁵ Captive insurance companies licensed as such may present additional opportunities for captive management companies and banks providing services to these companies.

Branch Captive Insurance Companies

Branch captive insurance companies are typically on-shore branches of off-shore captives. Branch captives can be used to underwrite employee benefits under the Employee Retirement Income Security Act (“ERISA”),⁶ which must be provided by a United States domiciled insurer. The amendment, however, permits branch captive insurance companies to write any line of business for which captive insurance companies are authorized to write under the Act.⁷ Branch captive insurance companies must maintain minimum capital and surplus of \$250,000, or such other amount determined by the Insurance Commissioner.⁸ If the Insurance Commissioner is satisfied that the branch captive insurance company has provided adequate information concerning its financial condition in the reports and statements it is required to file with the jurisdiction in which the insurance company that formed the branch captive insurance company was formed, the Insurance Commissioner may waive the annual report otherwise required pursuant to Section 6907 of the Act.⁹ Premium taxes apply only to the branch business of the branch captive insurance company conducted in Delaware.¹⁰ A branch captive insurance company must maintain a principal place of business in Delaware.¹¹

As should be clear from the above, a branch captive insurance company is exactly that: a branch of a licensed insurance company that is licensed outside the jurisdiction in which the branch of such insurance company is licensed and regulated. Consequently, branch captive insurance companies do not necessarily have a separate legal form that other captive insurance companies licensed by the Department take; for example, a corporation, limited liability company, partnership or statutory trust.¹² This distinction, however, does not mean that the Department has any less regulatory oversight over a branch captive insurance company as compared to other types of captive insurance companies licensed by the Department. Indeed, the branch captive

insurance company would be regulated much like any other captive insurance company licensed by the Department, with the exception that the annual report may be waived by the Insurance Commissioner under the conditions described above.¹³

While branch captive insurance companies may be ideal for companies that would like to insure employee benefits through a branch captive insurance company, they do not come without certain costs and regulatory hurdles. Obtaining the U.S. Department of Labor (“DOL”) blessing and meeting other DOL requirements and exemptions, or both, in addition to Department licensing, will be necessary. For example, during its first year there must be a benefit to the participants in the form of lower premiums or increased benefits. Thus, the planning necessary to establish this type of captive insurance company requires the expertise of those well versed not only with captive insurance companies but with ERISA and its related regulatory framework, as well as tax and accounting experts--all of which is beyond the scope of this article. Despite the foregoing, the benefits of insuring employee benefits through a branch captive insurance company should be similar to those benefits obtained from establishing other types of captive insurance companies, and establishing such a captive may provide substantial savings.

Agency Captive Insurance Companies

Agency captive insurance companies are typically owned or controlled by an insurance agency or broker and insure the risks associated with insurance contracts placed by such agency or broker. The agency or broker shares in the profits and losses associated with such contracts and, as such, has better control of the risks as well as financial incentives for profitable underwriting. Agency captive insurance companies must maintain minimum capital and surplus of \$250,000.¹⁴ An agency captive insurance company can be incorporated as a stock corporation or as a nonstock corporation; may be formed as a limited liability company, partnership, limited partnership or statutory trust; or may be such other person, other than a natural person in that natural person’s individual capacity, approved by the Insurance Commissioner.¹⁵

Clearly, agency captive insurance companies provide an opportunity for agents or brokers to be directly involved in the underwriting of the policies they are writing. Done right, such intimacy should lead to greater profitability. The frequently used expression “skin in the game” applies to agency captives probably more than in other contexts in which the phrase has recently been applied: agents and brokers who establish an agency

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captive insurance company will be strongly motivated to ensure careful underwriting and investing and use of reinsurance to manage the assets and liabilities of the agency captive insurance company.

An agency captive insurance company may present opportunities for tax savings that lead to still greater profitability. Under Section 831(b) of the Internal Revenue Code,¹⁶ certain qualifying insurance companies can elect to be exempt from paying taxes on premium income.¹⁷ So long as the premium income does not exceed \$1.2 million in any given year, it may be possible for the agency captive insurance company to obtain this election; however, the agency captive insurance company will continue to pay taxes on its investment income.¹⁸ Clearly, Section 831(b) is mostly likely to be used by small and mid-size companies, as larger captives will quickly exceed the premium ceiling. Nonetheless, if structured and planned for properly, an agency captive insurance company may save considerably on its tax bill. As always, consultation with tax, legal and accounting experts with knowledge in the captive insurance area must be sought before establishing a captive insurance company designed to take advantage of the Section 831(b) election.

As with many other forms of captive insurance companies licensed under the Act, neither an agency captive insurance company nor a branch captive insurance company is subject to any restrictions on allowable investments whatsoever, including those limitations contained in the Delaware Insurance Code; provided, however, that the Insurance Commissioner may prohibit or limit any investment that threatens the solvency or liquidity of any such captive insurance company.¹⁹

Advantage Delaware: Series Limited Liability Companies

In January 2010, the Department licensed its first captive insurance company organized as a series limited liability company.²⁰ The Delaware limited liability company act (the "LLC Act") provides options to create series of a single limited liability company where each "such series may have separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations, and any such series may have a separate business purpose or investment objective."²¹ In addition, the LLC Act provides that,

if the records maintained for any such series account for the assets associated with such series separately from the other assets of the limited liability company, or any other series thereof, and if the limited liability company agreement so provides, and if notice of the limitation on liabilities of a series as referenced in this subsection is set forth in the certificate of formation of the limited liability company, then the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to a particular series shall be enforceable against the assets of such series only, and not against the assets of the limited liability company generally or any other series thereof, and, unless otherwise provided in the limited liability company agreement, none of the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to the limited liability company generally or any other series thereof shall be enforceable against the assets of such series.²²

Use of a series limited liability company where each series is a separate cell makes Delaware a more attractive jurisdiction for establishing a cell captive. More importantly, the licensing of a series limited liability company as a captive insurance company demonstrates the Department's willingness to work with those who are considering establishing a captive insurance company and are unsure which domicile would provide the best location, particularly where the anticipated structure may not quite fit the standard captive insurance molds.

Conclusion

While in many respects Delaware's captive insurance business remains in its infancy as compared to other long-established jurisdictions, there are solid signs of a growing interest in Delaware as an attractive jurisdiction for the formation and use of captives and results that substantiate that interest. In addition, the Delaware General Assembly and the Department (as well as many dedicated professionals in the private sector) remain committed to the continued development of the State's captive laws, amending those laws as necessary to ensure that Delaware remains competitive with other domiciles. The Department, with its qualified and highly regarded staff in the Bureau of Captive and Financial Insurance Products, has demonstrated and continued the commitment first established by the prior Insurance Commissioner.

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Richard J. Facciolo focuses on transactional matters involving Delaware entities, including those seeking licensure as a captive insurance company. Mr. Facciolo participated in the drafting of House Bill 314 as well as the Delaware Special Purpose Financial Captive Insurance Company legislation adopted in 2007. He represented Delaware's first newly formed company seeking licensure under the Delaware Revised Captive Insurance Company Act in a Regulation XXX transaction. Mr. Facciolo routinely represents Delaware banking organizations in their capacity as trustees, and has been special Delaware counsel in many public and private asset-backed securitizations, trust preferred transactions and project finance transactions.

Notes:

¹ 18 Del. C. § 6901, et seq.

² Statistics obtained from the Delaware Department of Insurance.

³ Delaware Department of Insurance Press Release, Insurance Commissioner Stewart Establishes Captive - Financial Revenue Generating Division, July 30, 2009.

⁴ H.B 314 145th Gen. Assem. (Del. 2010).

⁵ 18 Del. C. § 6902(9).

⁶ 29 U.S.C §§ 1001, et seq.

⁷ 18 Del. Code § 6971.

⁸ Id. § 6905(a)(8).

⁹ Id. § 6974.

¹⁰ Id. § 6976.

¹¹ Id. § 6972(3).

¹² Id. § 6906.

¹³ Id. § 6975.

¹⁴ Id. § 6905(a)(4).

¹⁵ Id. § 6906(c).

¹⁶ 26 U.S.C. § 831(b).

¹⁷ Id.

¹⁸ Id.

¹⁹ Id. § 6910(b).

²⁰ Delaware Department of Insurance Press Release, Delaware Insurance Commissioner Karen Weldin Stewart Licenses World's First Serial Captive Insurance Company, January 25, 2010.

²¹ 6 Del. C. § 18-215(a).

²² 6 Del. C. § 18-215(b).