

ARIZONA BECOMES A CAPTIVE JURISDICTION

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After a number of stalled efforts, the Arizona Legislature enacted a captive insurer law in the State of Arizona in the 2001 Legislative Session. Historically, the majority of captive insurer jurisdictions were outside of the United States. However, as of the date of this article, the majority of United States jurisdictions have adopted captive insurer legislation in some form.

The recently enacted Arizona captive insurer laws are found within the Chapter 4 of the Arizona Insurance Code which identifies particular types of insurers. It has been added as Article 14 to Chapter 4 and is titled, "Captive Insurers." The Arizona Captive Insurer Legislation has an effective date of July 1, 2002. The Arizona Captive Insurer Legislation also includes an appropriation from the Arizona State General Fund to the Arizona Department of Insurance. This appropriation will be used to establish the captive insurer program and staff it with several full-time employees. A full-time Director of the Captive Insurance Division of the Arizona Department of Insurance has already been hired.

Captive insurance is similar in concept to self-insurance. That is, corporations have historically established and maintained captive insurance companies to guard against a risk that exists within the corporation or corporate holding company structure. The risks insured by captives vary greatly; however, most states prohibit insuring mandatory insurance through a captive insurer mechanism, e.g. workers' compensation, private passenger automobile insurance. Captive insurance typically includes a primary policy issued by the captive insurer, with excess risks ceded to insurers operating in the traditional insurance marketplace. Depending upon the size and volatility of the risk, there may be several levels of excess and stop-loss insurance coverages put in place.

The Arizona Captive Insurer Law requires that all captive insurers conducting business in this state to be licensed in Arizona, maintain their principal place of business in Arizona and hold at least one board of directors meeting in Arizona each year.¹ Captive insurers will be required to pay certificate of authority issuance fees as well as renewal fees as prescribed by the Director of the Arizona Department of Insurance.²

Types of Captives Authorized

Arizona law allows for two (2) types of captive insurers. Those types are "pure captive insurers" and "association captive insurers."³ Under Arizona law, a pure captive insurer is prohibited from insuring risks other than that of its affiliates' or controlled unaffiliated business, which are defined within the statutes. Alternatively, an association captive insurer is a captive insurer that insures risks of member organizations of the association or the member organizations' affiliates. A pure captive insurer must be incorporated as a stock insurer. An association captive may be incorporated as either a stock insurer or a mutual insurer. Additionally, Arizona captive insurers must be incorporated by at least three incorporators, at least one of whom is a resident of Arizona.

Authorization

Arizona law prohibits both pure captive insurers and association captive insurers from engaging in certain categories of insurance. Specifically, Arizona law prohibits such captives from engaging in the following types of insurance business: hospital and medical service corporations, health care services organizations (commonly referred to as HMOs), prepaid legal insurance contracts, title insurance, mortgage guarantee insurance, workers' compensation and personal motor vehicle or homeowner's insurance.⁴

In order to obtain an initial certificate of authority, a captive insurer must submit its articles of incorporation, bylaws and a statement under oath of its president and secretary showing its financial condition. Additionally, each Arizona captive insurer applicant shall also file with the Arizona Department of Insurance, evidence of the following:

- The amount and liquidity of assets relative to risks to be assumed.
- The adequacy of the expertise, experience and character of the person or persons who will manage the captive insurer.

- The overall soundness of its plan of operation.
- The adequacy of the loss prevention programs of its parent or member organizations.
- The engagement of a competent manager that resides in Arizona.
- The establishment of business relationships with any necessary accountants, banks, attorneys and other professionals that do business at a location in Arizona.
- The ability of the captive insurer's affiliates or association members to pay claims to third parties if the captive insurer is unable to pay those claims.
- Other factors deemed relevant by the Director in ascertaining whether the proposed captive insurer will be able to meet its policy obligations.

The Director of the Arizona Department of Insurance is required to approve or deny an application for a license to transact captive insurance business within thirty (30) days after the Director deems the application complete.⁵

Captive insurers are required to notify the Director within thirty (30) days of any material change in the information filed in connection with the original application for certificate of authority. Further, Arizona law provides that the information submitted in connection with an application for certificate of authority shall be deemed confidential and shall not be provided to any other person without the written consent of the captive insurer. Exceptions to this confidentiality provision relate to use of the information for enumerated regulatory purposes, as well as in response to a valid subpoena.

Capital and Surplus Requirements

As in most other jurisdictions, Arizona captives are required to possess and maintain specific levels of capital and surplus. A pure captive insurer must maintain minimum unimpaired paid-in capital and surplus of at least two hundred fifty thousand dollars (\$250,000). An association captive insurer must maintain minimum unimpaired paid-in capital and surplus of at least five hundred thousand dollars (\$500,000).⁶ In the event that the captive insurer (either pure captive or association captive) transacts only reinsurance in Arizona, one-half of the preceding minimum unimpaired paid-in capital and surplus is required, e.g. \$125,000 and \$250,000 respectively. All minimum capital and surplus shall be in the form of an irrevocable letter of credit that contains an evergreen clause. The letter of credit must be payable to and held by the Director for the protection of policyholders, ceding insurers and for related expenses. Additionally, the letter of credit must be issued by a qualified United States financial institution as that term is defined in A.R.S. § 20-261.03. A captive insurer may not be contingently liable for the letter of credit comprising its capital and surplus and no assets may be pledged as security for the letter of credit.

Annual Report Requirements

Once licensed, all captive insurers must submit an annual report. Such annual reports must be submitted to the Arizona Department of Insurance no later than ninety (90) days after the end of the captive insurer's fiscal year. The annual report must be verified by two of its executive officers.⁷ Annual reports may be submitted using GAAP principles unless the Director requires the captive insurer to utilize statutory accounting principles. Further, a captive insurer's financial statements must be audited unless the Director determines that an audit is not necessary.

Examinations

Arizona law allows the Director to examine the affairs of a captive insurer "whenever prudent." However, the confidentiality protections embodied within A.R.S. § 20-1098.01 apply to examination reports issued by the Director. All examination and examination related expenses are borne by the captive insurer being examined and such expenses are processed through the Arizona Insurance Examiners Revolving Fund.⁸

Suspension or Revocation of Authority

The Director may suspend, revoke or refuse to renew the license of any captive insurer for the following reasons: insolvency, refusal or failure to submit an annual report, failure to comply with organizational documents, failure to submit to examination or obligation related thereto, refusal or failure to pay the cost of examination, use of methods that render its condition unsound, and failure to otherwise comply with the captive insurer article.⁹

Permitted Investments

In some respects, captive insurers have been provided more latitude for eligible investments. For instance, a pure captive insurer is not subject to the restrictions on allowable investments found in Chapter 3, Article 2 of the Arizona Insurance Code. However, association captive insurers must comply with the investment requirements contained in Chapter 3, Article 2 of the Arizona Insurance Code. Arizona law restricts the ability of an association captive to make loans to affiliates. A pure captive insurer may make loans to its affiliates so long as the loan is evidenced by a note and it receives advance approval from the Director of the Arizona Department of Insurance.¹⁰

Reinsurance

Arizona law also allows captive insurers to provide reinsurance on risks ceded by any other insurer as allowed in the captive insurer article.¹¹ Additionally, captive insurers may take credit for reserves on risks or portions of risks ceded to reinsurers that are in compliance with A.R.S. § 20-261.01-20-261.04. Otherwise, a captive insurer may not take credit for such reserves.

Guaranty Fund Coverage

Captive insurers are prohibited from contributing to Arizona guaranty funds. Likewise, risks written through captive insurers are not eligible to receive benefits from such funds.¹² In other words, the risk of loss rests entirely with the captive insurer and its parent, affiliates, members or claimants. In the event of insolvency, there will be no Arizona guaranty fund coverage for claimants with unpaid claims.

Trade Practices

Arizona Insurance Code provisions relating to unfair trade practices are applicable to captive insurers, except to the extent the Director deems the application of such provisions inappropriate based upon the nature of the captive insurer. Likewise, all other provisions of the Arizona Insurance Code apply to captive insurers except to the extent the Director deems the application of such provisions inappropriate based upon the nature of the captive insurer.¹³

Rulemaking

The captive insurer article also provides for rulemaking by the Director in order carry out the provisions of the law. As stated above, the captive insurer article is effective July 1, 2002.¹⁴ The Arizona Department of Insurance has issued detailed captive insurer rules as an adjunct to the captive insurer statutes. Those regulations come before the Arizona Governor's Regulatory Review Council on May 7, 2002.

Engagement of an Arizona Captive Manager

Lastly, a captive insurer must engage an Arizona resident manager to maintain the books and records of the captive insurers business. Such books and records must be maintained within Arizona. The captive manager is required to notify the Director of the Arizona Department of Insurance of any failure of the captive insurer to comply with the captive insurer article.¹⁵ Given the fairly obvious conflict with the attorney/client privilege, attorneys licensed to practice law in Arizona must closely scrutinize the ethical propriety of serving as a captive manager to any of their clients. Additionally, the Director of the Arizona Department of Insurance may require a captive insurer to discharge a captive manager for failure to substantively fulfill the captive manager's duties under the captive insurer article.

Once the certificate of authority is obtained, there are various other functional considerations for the captive insurer. For example, the captive insurer will need to retain actuaries to set premium rates, establish banking and custodial accounts, retain accountants for financial statement and annual statement preparation, retain a broker for the placement of any necessary excess loss coverage, and retain an entity for claim adjudication. While many of these involve solely business decisions, counsel should be prepared to identify these issues in the initial stages of captive formation.

As is apparent from the foregoing, Arizona has adopted an efficient and sound method for establishing domestic

captive insurance companies. Such captive insurers can be formed relatively swiftly and efficiently. The minimal capital and surplus requirements and risk transfer possibilities offer creative risk assumption vehicles for corporations. Once formed, it is anticipated that Arizona captive insurers will provide viable alternative risk mechanisms for national and international corporations.

Endnotes

1. A.R.S. § 20-1098.01.
2. *Id.*
3. A.R.S. § 20-1098.04.
4. A.R.S. § 20-1098.01.
5. *Id.*
6. A.R.S. § 20-1098.03.
7. A.R.S. § 20-1098.05.
8. A.R.S. § 20-1098.06.
9. A.R.S. § 20-1098.07.
10. A.R.S. § 20-1098.08.
11. A.R.S. § 20-1098.09.
12. A.R.S. § 20-1098.11.
13. A.R.S. § 20-1098.13.
14. A.R.S. § 20-1098.12.
15. A.R.S. § 20-1098.14.