

PRACTICAL ASPECTS IN THE FORMATION AND OPERATION OF CAPTIVES AND WORLDWIDE ANTI-MONEY LAUNDERING PROVISIONS

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Over thirty countries and territories worldwide have adopted legislation aimed at the identification, prevention, and reporting of suspicious money laundering transactions.² The implications for the operation of captive insurance companies doing business internationally are far-reaching and may subject captive insurance company owners, captive managers, TPA's, attorneys, accountants, and other professional service providers to criminal and civil liability. At the very least, participants in the alternative risk transfer industry should adopt responsible guidelines, procedures, and methods of operation designed to meet "know your customer" requirements. This should include training of staff and employees involved in the formation and operation of captive insurance companies to monitor on-going business relationships and transactions. Further, all types of service providers and captive operators should maintain records that demonstrate a level of due diligence when creating new business relationships, establish compliance with regulatory requirements, and lend assistance to investigations. Finally, the alternative risk transfer industry and each of its participants must promote a culture of responsible reporting and compliance.³

Money laundering, in its most basic form, is the process through which criminal and terrorist organizations attempt to conceal the actual origin and ownership of monies derived from criminal activities or obtained legally but destined to fund illegal organizations or activities.⁴ As described by the Cayman Islands Monetary Authority,⁵ the money laundering process is generally accomplished in a series of stages that may include numerous transactions:

Placement – the physical disposal of proceeds derived from criminal activity.

Layering – separating the illicit proceeds from their source by creating complex layers of financial transactions designed to disguise the audit trail and provide anonymity.

Integration – the provision of apparent legitimacy to wealth derived from crime. If the layering process has succeeded, integration schemes place the laundered proceeds back into the economy in such a way that they re-enter the financial system appearing as normal business funds.⁶

The alternative risk transfer marketplace is among the industries earmarked for increased regulatory scrutiny and monitoring to eliminate captives and captive transactions as a method for placement, layering, and integration activities as part of an illegal money laundering operation.

There are multiple basic forms of operational structure that exist under domestic captive enabling laws and in myriad off-shore jurisdictions that could be used in a money laundering scheme, including:

- Pure or single -parent captives of publicly traded companies;
- Pure or single -parent captives of privately held companies;
- Group or association captives of trade or professional organizations;
- Privately owned group or association captives;
- Privately owned investor captives offering insurance coverage to third parties;
- Producer owned captives underwriting the risks of the producer's clients; and
- Segregated portfolio captives with individual accounting portfolio cells ("rent-a-captive").

Each of these structures of captive operation gives rise to a differing series of inquiries that must be made, verified, and documented in the course of the prudent formation and operation of an alternative risk transfer entity in any captive domicile. For each type of captive operational structure it is incumbent upon counsel assisting in formation and organization to make appropriate inquiries, including: (i) what type of information should be obtained to verify the identity of beneficial owners and operators; (ii) when should the identity of beneficial owners and operators be confirmed and periodically reconfirmed; (iii) what additional information should be uniformly collected and maintained; (iv) what type of transactions fall outside the normal course and scope of typical captive transactions; and (v) how should an effective, commercially reasonable, and responsible anti-money laundering program be put in

place?

Responsible Guidelines, Procedures and Methods of Operation

As a part of the on-going business plan of the entity and as integral part of its material agreements with outside service providers, captive insurance company operations should adopt and maintain anti-money laundering guidelines, procedures, and methods of operation. At a minimum, these operational guidelines should establish a methodology to establish the identity of participants in captive operations, create on-going verification and record-keeping procedures, adopt internal controls and communication protocols, train current and future employees, provide for prospective training refresher courses, and establish, the position of a sufficiently high-ranking officer, oversight and responsibility over the entity's anti-money laundering activities.

In the context of the formation of a captive insurer, the owners, beneficiaries, and participants may take the form of a corporation or a similar structure giving rise to at least two levels of inquiry; first, documentation verifying the nature of the corporate entity; and second, documentation verifying and confirming the clear identity of beneficial owners, officers, and directors. Among the types of information that can be collected from corporate entities participating in the formation and operation of a captive insurance company are:

- Public Companies' Annual Reports, 10Ks, Board resolutions authorizing captive operations;
- Private Companies' financial statements, tax returns, organizational documents, Board resolutions authorizing captive operations; and
- Identification of all officers, directors, and owners of at least 10% of outstanding ownership interests including biographical information such as social security numbers and passport photograph information.

For groups or trade associations available information to be reviewed may additionally include:

- Organizational documentation (e.g. Articles of Association), background information on the entity's business purpose (including captive operation authorization), membership requirements; and
- Identification of all officers and directors, including biographical information such as social security numbers and passport photograph information.

For producer controlled and operated captive operations, producer licensing information and biographical information for the agency's owners should be verified and obtained, in addition to the type and nature of information noted above.

In addition to collecting and verifying information at the outset of a business relationship, as new officers, directors, or beneficial owners holding an ownership interest in excess of 10% come on board, verification of identity should be obtained. Likewise, all significant transfers of ownership to trusts or third parties should be reviewed to ensure complete knowledge and understanding of the ultimate beneficial ownership of the captive insurance company.

Warning Signs in Insurance Transactions

While the operation of a captive insurance company may include complex relationships among fronting insurers, reinsurers, and service providers, as well as the payment of significant or unusual claims, it is possible to monitor the on-going activities a captive operation for material operational inconsistencies with past patterns and practices. Among the general categories that can be monitored according to the Cayman Islands Monetary Authority are transaction type, transaction frequency, threshold dollar amounts associated with any one or a series of related transactions, geographical origin of a transactions, ultimate destination of funds transmitted by a captive, and account signatories.⁷ In addition, any type of transaction that places monies in an unusual party's control should be reviewed, such as a transaction in which return premium is remitted to a person other than the named policyholder; dividends ear-marked to be paid to persons other than shareholders or policyholders; and situations involving complex holding company or trust ownership structures.⁸ It is probably unwise to do business with a corporate agent for the benefit of an undisclosed or hidden principal.

Conclusions

The current hard market will fuel the creation of new alternative risk transfer vehicles in numbers not seen for over a decade in an international business environment increasingly focused on eliminating the funding sources of terrorists and criminals. The captive insurance company industry is especially susceptible to potential abuse given its international nature and the manner in which funds are transferred across borders. It is incumbent upon counsel in the prudent formation and operation of captives to ensure a culture of continued professionalism and compliance consistent with international efforts to prevent money laundering.

Endnotes

1. Alan J. Schmitz is a shareholder with the law firm of Shughart, Thomson & Kilroy, PC in Denver. He is also the current president of the Colorado Association of Captive Entities and assisted in re-drafting the current version of Colorado's Captive Insurance Company Act and associated Regulation promulgated by the Colorado Division of Insurance.
2. Argentina, Australia, Belgium, Brazil, Canada, Cayman Islands, Denmark, Finland, France, Germany, Gibraltar, Greece, Hong Kong, Iceland, Ireland, Italy, Japan, Luxembourg, Malta, Mexico, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Turkey, United Kingdom, and United States of America. *See generally*, "Guidance Notes on the Prevention and Detection of Money Laundering in the Cayman Islands," (June 2002).
3. *See generally*, Kevin G. Fitzgerald, Esq. and Brian S. Kass, Esq., "Anti-Money Laundering and the USA Patriot Act of 2001 – America's War Against Terrorism Spreads to the Insurance Industry," FORC Quarterly Journal of Insurance Law and Regulation, Vol. IX, Edition II, June 8, 2002, pp. 1 & 14.
4. "Guidance Notes on the Prevention and Detection of Money Laundering in the Cayman Islands," (June 2002), Section 9, Appendix A, p. 72.
5. The *Cayman Islands Monetary Authority* or *CIMA* was established in January of 1997 combining the former responsibilities, duties, and activities of the *Financial Services Supervision Department* and the *Cayman Islands Currency Board*. Among the operational divisions within *CIMA* is a division with responsibility over the affairs of captive insurers operating out of the Cayman Islands (British West Indies).
6. "Guidance Notes on the Prevention and Detection of Money Laundering in the Cayman Islands," (June 2002), Section 9, Appendix A, p. 73.
7. *Id.*, Section 4, p. 33.
8. *Id.*, Section 8, p. 70.