

THE D.C. CAPTIVE ACT: CAPITALIZING UPON INSURANCE MARKET OPPORTUNITIES

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On August 4, 2000, the District of Columbia (“District”) joined the trend of almost twenty U.S. jurisdictions by passing the Captive Insurance Company Act of 2000 (“Act”),¹ thereby becoming a captive insurance company domicile, effective October 31, 2000. Captives have existed since the 1960s, and today are considered to be significant, ongoing business opportunities.² A captive is an insurance company formed by its owners for the primary purpose of insuring the risks of its parent, affiliates or members of an association. Captive benefits include lower insurance costs, customization, better risk control, possible tax advantages, and tighter control over financial resources.³

The stated purposes of the Act are to permit the chartering and operations of captive insurance companies; provide for captive insurance regulation; establish minimum capital and surplus requirements; authorize the Commissioner to promulgate rules and regulations; and exempt licensed captive insurers from certain taxes.⁴ However, the District realized that merely enacting legislation would not ensure that captives will choose it as a domicile. Thus, the executive branch itself serves as an incentive to potential captives. The District’s mayor, City Council, and Department of Insurance and Securities Regulation (“DISR”) are progressive entities committed to the city’s insurance growth.⁵ The Act and other related legislation were supported by Mayor Anthony Williams and enacted by the City Council in the hope of establishing the District as a national and international site for financial services industries.⁶ Consistent with this pro-business approach, Lawrence Mirel, the DISR Commissioner, stated that “captives [are] an opportunity for the District of Columbia to diversify its economic base.”⁷ Currently, there are several active captives in the District, with a number of prospectives.

Association Captive Emphasis

Although the Act permits six different types of captives including agency, association, branch, pure, rental, and sponsored,⁸ it is in the association captive area where the District hopes to establish a unique niche. Associations, organizations comprised of companies or individuals to further shared interests, are commonly established in the District for federal lobbying efforts. Association captives insure their members, who are usually businesses or individuals from a particular industry or interest sharing similar exposures and common insurance needs. Economic strategists in the District hope the Act will serve to capitalize upon the many trade associations based out of the District.⁹ According to Kathryn Westover, captive advisor to the District’s Captive Insurance Division, its representatives actively meet with associations to “see how [the Division] can help them use captive insurance to better serve their membership.”¹⁰

The provisions of the Act are similar, in many respects, to the captive domicile legislation passed by other jurisdictions. The early domestic development of captive domiciles began with Colorado legislation in 1972, Tennessee in 1978, Virginia in 1980, and Vermont in 1981.¹¹ The Act is unique in that it has no prior existence seasoning requirement for associations to form a captive. Another important provision of the District’s Act allows for an association captive to be structured as a reciprocal, as well as a mutual or stock insurer,¹² which is not true of all captive domiciles.¹³ Reciprocal formation may provide significant tax benefits for not-for-profit organizations. A reciprocal captive insurance company transacts business through the exchange of reciprocal indemnity agreements among subscribers who agree to become liable for their share of losses and expenses incurred among all subscribers. Through an authorized attorney-in-fact, subscribers can exchange insurance, pay losses, invest premiums, recruit new members, effect contracts of reinsurance, and receive premiums.

Additionally, the Act includes risk retention groups (“RRGs”) under association captive insurers, allowing RRGs to organize in reciprocal form.¹⁴ An RRG is a captive formed in compliance with the Product Liability Risk Retention Act of 1981 or the Liability Risk Retention Act of 1986.¹⁵

Other Captive Types

In addition to the association captive, there are five other types of captives permitted by the Act.¹⁶ A pure captive insures only its parent company and affiliates. An agency captive is a captive owned by a brokerage or agency that insures only those policies placed by or through the agency or brokerage. This allows the captive to reinsure its various policy-writing companies, permitting an agent or broker to share in the profits of books of business with above-average loss experience. A rental captive is formed to contract with policyholders or associations providing some or all of the benefits of a program of captive insurance and only insures the risks of such policyholders and associations. In other words, a rental captive allows others to use its capital and surplus for a fee. A branch captive is an alien captive insurer licensed by the District to transact business through a unit with a principal place of business in the District. Branch captives are intended to permit branch offices of large U.S. companies having offshore captives to take advantage of the current ability to underwrite and administer parent and affiliate employee benefits in U.S.-domiciled captives. Finally, in a sponsored captive, also commonly called a protected cell captive, minimum capital and surplus is provided by one or more sponsors and insures risks of separate participants where each participant's liability is segregated through protected cells. Sponsored company shareholders are limited to its participants and sponsors. Participating cell insureds are often too small to operate their own captive companies. A sponsored captive allows these small companies to avail themselves of captive benefits at a much lower cost. District law requires that the pure, agency, rental, and sponsored captives be organized in stock form.

Captive Powers

A captive may offer any form of insurance except it cannot directly provide personal motor vehicle or homeowners' coverage.¹⁷ It may provide excess workers' compensation to its parent and affiliates unless prohibited by the state of contract. A captive may reinsure workers' compensation under a program of self-funded insurance of its parent or affiliates if the parent is certified as a self-insured employer by the Commissioner or qualified in the contract jurisdiction.¹⁸ Additionally, a captive can take credit for reserves on risks ceded to a reinsurer in compliance with the District's Law of Credit for Reinsurance Act of 1993,¹⁹ which has the effect of lowering capital requirements. A captive can write insurance or reinsurance for employee benefits subject to the Employee Retirement Income Security Act of 1974 ("ERISA") for its parents or affiliates.²⁰ It can pay dividends under an ongoing plan approved by the Commissioner if, at the time of payment, capital retained is in excess of the amount required. Only a pure captive type can make loans to its parent or affiliates.²¹

Forming a Captive in the District

In order to incorporate and obtain a license from the DISR, an applicant should first meet with the Commissioner to discuss the applicant's business plans.²² The District's application process requires that the license application and incorporation documents be submitted to the Commissioner, who contemporaneously reviews both. The Commissioner has committed to completing the review process within thirty days of receiving a complete application. The necessary documentation for the Certificate of Authority application includes: a certified copy of the charter and bylaws; a pro-forma financial statement prepared by a certified public accountant; evidence of the amount of liquid assets relative to the assumed risks; evidence of the expertise, experience, and character of the persons who will manage the captive insurer; a business plan with five-year projections demonstrating the plan's overall soundness; evidence of maintenance of minimum capital and surplus requirements; and any other information considered relevant by the Commissioner.²³

Two copies of the application and supporting documents must be filed with the DISR for review, as well as a \$500 non-refundable fee. The Commissioner will review the application or submit it to a qualified independent reviewer. The applicant selects a reviewer from a panel approved by the Commissioner and is required to pay the expert's costs. Such expert expenses are limited to \$5,000 for a pure captive and \$7,500 for all others. If the application is approved, the Commissioner will then concurrently incorporate the applicant and grant its Certificate of Authority, streamlining what is otherwise a two-agency process. The District's single-agency approach to incorporation and acquiring a Certificate of Authority is more expedited than similar processes in other jurisdictions and is just one more incentive the District provides to facilitate captives. Finally, the applicant pays the appropriate incorporation

fee and a \$300 fee for the issuance of the Certificate of Authority. Further information about captive formation, regulations and relevant application forms are available at www.disr.washingtondc.gov.

Required Capital and Surplus

Captive insurers are required to maintain minimum amounts of capital and surplus, depending upon the type of captive formed.²⁴ Pure and branch captives must maintain not less than \$100,000 in capital and maintain an unencumbered surplus of \$150,000. An association captive incorporated as a stock insurer must maintain \$200,000 in capital and \$300,000 in surplus. An association captive incorporated as a mutual insurer or reciprocal insurer must maintain a surplus of \$500,000. An agency, rental, or sponsored captive must maintain both \$300,000 in capital and \$300,000 in surplus. It should be noted that the Commissioner may require additional unimpaired paid-in capital or surplus based on the type, volume, and nature of the captive's insurance business.²⁵

Both the capital and surplus minimums must be in the form of either cash or an irrevocable letter of credit.²⁶ A letter of credit can be utilized by a captive insurer if it is automatically renewed each year; on an approved form; and issued by a District-chartered bank, Federal Reserve member, or FDIC-insured bank.²⁷

Investments

Currently, association, agency, and rental captives must comply with Section 18, Chapter 2 of the District Fire and Casualty Act.²⁸ A bill has been introduced, however, to completely recodify the District's investment law to be consistent with the current NAIC model. Passage of the bill is anticipated during the next legislative session. Upon request, the Commissioner may approve a reliable alternative to valuation and rating of investments. Pure, branch, and sponsored captives must file investments with the Commissioner for approval. Additionally, in a branch captive, all branch assets must be in an onshore trust.

Requirements for Transacting Business

A captive must maintain its principal place of business in the District, its board of directors must meet there at least once a year, and the captive must appoint a registered agent in the District to receive service of process.²⁹ Additionally, a captive insurer must make adequate arrangements with a District bank, contract with a nationally-recognized certified public accounting firm or qualified accountant, contract with an attorney licensed to practice in the District who meets the Commissioner's competency and experience standards, and contract with qualified, experienced actuaries to perform reviews and operation evaluations.³⁰ Any captive manager selected by the company must be authorized by the Commissioner, satisfying the DISR competence and experience standards.³¹

Also in order to transact business, the captive insurer must pay annual taxes³² by February 2 of each year, with an annual minimum tax of \$5,000.³³ For tax purposes, two or more captive insurers under common ownership are taxed as a single captive and for branch captive insurers, the tax applies only to the captive's branch business.

Other than as regulated by the Act, District captives are not subject to any other insurance laws.³⁴ Additionally, unlike other insurance companies, captives are not required to join a risk-sharing plan and therefore do not have to contribute financially to such a group. Captive insureds are not covered by any guaranty funds.³⁵ Similarly, captives are not required to join a rating organization.³⁶

Annual Reports

A captive insurer must submit, by March 2 of each year, a report of its financial condition, as prepared by a certified public accountant.³⁷ The report is to be prepared in accordance with generally accepted accounting principles ("GAAP"), with any modifications accepted or approved by the Commissioner. For branch and pure captives, the Commissioner may approve a fiscal year filing that allows the captive to file its annual report based on a fiscal year consistent with the fiscal year of the parent company.³⁸

All captives must file an annual audit report with an actuarial opinion by June 30 except for branch and pure captives filing on a fiscal year basis, which must file within sixty days of the end of the fiscal year. All captives must file calendar-year premium tax reports by March 2. Agency, association and rental captives must file a National Association of Insurance Commissioners (“NAIC”) Statutory Statement blank by March 1. Branch and pure captives must file per a DISR-approved format on a calendar-year basis or within sixty days of the end of its fiscal year.

Financial Examinations

The Act provides that a captive shall submit to a financial examination at least once every three years, to be conducted by the Commissioner or his designee, unless the captive conducts annual audits.³⁹ If the captive conducts annual audits, then such examinations are every five years.⁴⁰ The financial review conducted by the Commissioner’s office includes: an examination of the captive’s financial condition; the ability of the captive to fulfill its obligations; and a determination of whether the captive has complied with applicable laws, including the Act and its regulations.⁴¹ The Commissioner also has the option to require that a captive’s audits be conducted independently and subsequent recommendations made to the Commissioner, with the captive to pay incurred costs.⁴²

Conclusion

The District of Columbia has recognized the opportunity to broaden its business base within the recently expanding captive insurance market. In hopes of capturing a piece of the captive pie, the District not only passed the Act, but included such provisions as allowing a reciprocal structure for association captives, no prior existence requirements and expediting the licensure and incorporation processes by making them a simplified, single-agency approach. Furthermore, the District’s progressive executive branch and its committed Insurance Department beckon to those entities contemplating a captive insurer.

Endnotes

1. D.C. Code Ann. § 31-3901-31-3918 (2001).
2. Elizabeth R. Costle & Kathleen A. Schauer, “The Captive Alternative: A Regulatory Perspective,” 19 J. Ins. Reg., No. 2, Winter 2000.
3. Jon Harkavy & Arthur Perschetz, “Buyers and Brokers Look to Advantages of Captive Insurers,” 4 Insurance Advisor Monthly, Issue 11, Jan. 2002, at 22.
4. 1999 D.C. Stat. 192.
5. Government of the District of Columbia & the Department of Insurance and Securities Regulation, Washington, D.C.: a Global Financial Services Gateway (2000).
6. “Washington D.C. May Become Hospitable to Captives,” BestWire (June 5, 2000).
7. Caroline McDonald, “Washington, D.C. Grants Second Captive License; to Columbia Group Insurance Inc.,” Nat’l Underwriter Prop. & Casualty-Risk & Benefits Mgmt., Feb. 18, 2002, p. 21.
8. D.C. Code Ann. § 31-3901(9).
9. The Greater Washington Society of Association Executives (“GWSAE”) cites the region as having over 3,500 trade, professional & philanthropic associations, although this number is not nearly exhaustive, including only those that are GWSAE members; *see also* “Captive Legislation Pending in District of Columbia and Arizona,” 13 The Risk Retention Rep., No. 11, Nov. 1999 (stating that the District is home to over 6,000 trade associations).
10. McDonald, *supra* note 7.

11. Costle & Schauer, *supra* note 2.
12. D.C. Code Ann. § 31-3906(b).
13. *See* Ariz. Rev. Stat. § 20-1098.04(B) (2001) (stating that Arizona only provides for stock or mutual captive association structures); Mont. Code Ann. § 33-28-105(2) (2001) (stating that Montana only provides for stock or mutual captive association structures).
14. D.C. Code Ann. § 31-3901(5).
15. Donn P. McVeigh & Ted O. Hall, 1 The Captive Insurance Manual: A Guide to Captive Insurance Companies and Risk Retention Groups § II-1-4 (2001).
16. D.C. Code Ann. § 31-3901(9).
17. *Id.* § 31-3902(b)(1).
18. *Id.* § 31-3902(b)(3).
19. *Id.* § 31-3912.
20. *Id.* § 31-3902(b)(9).
21. *Id.* § 31-3911(c).22.
22. *See* captives.disr@dc.gov for a list of approved firms.
23. *Id.* § 31-3908(i).
24. *Id.* § 31-3908.
25. *Id.* § 31-3908(c) & (h).
26. *Id.* § 31-3908(i).
27. *Id.* § 31-3908(i).
28. *Id.* § 31-3911(a).
29. *Id.* § 31-3907(a).
30. *Id.* § 31-3907(b).
31. *Id.* § 31-3907(a).
32. *Id.* § 31-3915.

Annual District Tax Rates	Direct Bsns., Paid to the District	Assumed Reinsurance, Paid to the Mayor
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First \$20 Million	0.4%	0.000225%
Next \$20 Million	0.2%	0.000150%
Over \$40 Million	0.00075%	0.00025%

33. *Id.*

34. D.C. Code Ann. § 31-3918.

35. *Id.* § 31-3914.

36. *Id.* § 31-3913.

37. *Id.* § 31-3909(a).

38. *Id.* § 31-3909(b).

39. *Id.* § 31-3910(a).

40. *Id.* § 31-3910(b).

41. *Id.* § 31-3910(a).

42. *Id.* § 31-3910(c).

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