VERMONT SPONSORED CAPTIVE INSURERS
THE ALTERNATIVE, ALTERNATIVE MARKET

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In 1981 Vermont first enacted a statute permitting the formation of captive insurance companies.[1] The legislation was endorsed by every voting representative and senator with only one dissent. A Vermont farmer serving in the Vermont House objected to the bill stating, "There is nothing all good." In the ensuing twenty-five (25) years, the Vermont Department of Banking, Insurance, Securities & Health Care Administration ("BISHCA") issued seven hundred and fifty-four (754) licenses to captive insurers, thereby validating the consensus wisdom of the Vermont Legislature.[2]

The use of the word "captive" was also controversial in 1981. Then Vermont Governor Richard Snelling expressed concern that the term might seem disrespectful to American embassy employees held hostage in Iran. The reference stuck as it had currency in off-shore domiciles and because it well expresses the relationship between a corporation formed specifically to insure the risks of its parent corporation and affiliates. In fact, 79% of all Vermont Captive Insurance licenses issued have been provided to "pure captive" entities owned by a corporation to insure its risks.[3]

Vermont also permits the formation of group captives. Associations, industrial insureds and risk retention groups are standard forms of such entities. While these types of captives have different characteristics, they are similar in that risk is shared among policyholders.[4] In 1999 Vermont significantly expanded the on-shore concept of a group captive insurance company by authorizing sponsored captive insurers.[5] In essence, the law permits a qualified sponsor to establish and operate an insurance program for third-party participants. The key distinction between standard group captives and sponsored captives is the obligation of the latter to establish a segregated, protected cell for the assets and liabilities of each participant.

The Vermont captive statute establishes the framework under which all manner of captive insurers are formed, operated and, on occasion, dissolved. The standard regulatory requirements applicable to traditional insurers are preempted unless expressly preserved within the captive law. The general regulatory control mechanism is a detailed, written business plan, including an actuarial feasibility study, which is subject to prior review and approval by regulators.

There are also detailed statutory provisions that control all aspects of a sponsored captive insurer's operation. The law prescribes strict limits on the type of entity that may act as a sponsor. When this legislation was under consideration, BISHCA testified in favor of requiring either significant financial expertise or a solid track record operating a Vermont captive as a basis for acting as a sponsor. Thus, under current law, only an insurer licensed under the laws of any state, a reinsurer authorized or approved under the laws of any state or an existing Vermont captive may act as a sponsor.[6]

The statute also defines who may qualify to participate in a sponsored captive. The list of eligible entities is broad, even permitting a sponsor to insure its risks as a participant. The provision confirms that a participant need not have an ownership interest in the sponsored captive. Significantly, the law specifies that a participant may only insure its risks through the segregated cell. In this respect, a sponsored captive operates in the same manner as other captives: there is mutuality of ownership (at the cell level) with the risks insured by each participant. It is this alignment of interests which has served well the objective of captive insurance company solvency.

The heart of the sponsored captive law lies in its provisions establishing "protected cells." Each participant's assets and liabilities are maintained in such a cell, protected by firewalls from the experience of other cells. In fact, the sponsored captive must separately account for the experience of each protected cell. At one level, this type of accounting is necessary to ensure that a participant receives the benefits of the bargain established pursuant to the participant contract. However, this type of approach is also necessary so that regulators may evaluate the financial condition of each protected cell. Sponsors must also notify and obtain BISHCA's approval each time a cell is created or dissolved. Vermont regulators retain some concern about the solvency of small, protected cells. As such, the law requires that all business insured through a protected cell must be fronted by an insurer licensed in any state, reinsured by a reinsurer authorized or approved by Vermont or have its liabilities secured by a trust for the benefit of policyholders and claimants, letter of credit or other mechanism acceptable to regulators.

The assets of two or more protected cells may be combined for the purpose of investment. This commingling is allowed so that investment of assets may be accomplished on a cost-effective basis. Each participant would nonetheless retain a specific interest in its contributed assets which remain exclusively dedicated to the cell's

obligations. All investments made by the sponsored captive are subject to standard investment law requirements, absent an express waiver of the standards by BISHCA.

Sponsored captives are viewed as a vehicle to permit smaller companies to enjoy the benefits of participation in a captive insurer. The assumption is that a sponsored captive will provide more efficient access to the captive marketplace by reducing frictional costs related to the operation of a stand-alone company. For example, the minimum capital requirement for a sponsored captive is $500,000. In comparison, an entity forming a pure captive must only provide minimum capital of $250,000. However, for each participant after the second, the cost of capital, at least at the minimum level, is lower than that required if each participant instead formed a separate pure captive. In addition, it is probable that a sponsored captive's per participant cost for captive management, actuarial, accounting and legal services will also be lower. Finally, participants are able to avoid certain requirements and costs such as holding an annual Vermont meeting.

One of the questions not yet completely addressed is what happens in the event a protected cell fails. The good news here is that the lack of clarity is a result of a lack of experience: no protected cell of a Vermont sponsored captive has failed. It is clear, however, that the assets of a protected cell are only available to satisfy its liabilities. Further, the captive statute indicates that the general solvency statute dealing with insurance company supervision, rehabilitation and liquidation would apply to any financial problems arising at either the sponsored captive or protected cell level.[7] The protected cell should be treated similarly to a stand-alone insurer and its financial issues resolved without consequence to the other protected cells. The statute also notes that the capital and the surplus of the sponsored captive must be available to pay claims and expenses arising from claims.

Since 1999 sixteen (16) sponsored captives have formed in Vermont. As of April 1, 2006, fourteen (14) sponsored captives with a total of one-hundred and seven (107) protected cells were operating.[8] Several major insurers including John Hancock Life Insurance Company, Liberty Mutual Insurance Company and National Union Fire Insurance Company have formed sponsored captives. In general, these facilities have permitted insurers to enter into risk sharing arrangements with clients. The surprising fact is that the typical participant and program are much larger than expected when the statute was first enacted. This is not a business dominated by mom and pop type operations too small to form a pure captive.

A second development has been the spread of the sponsored captive approach to other captive insurance domiciles. Both Arizona and South Carolina, for example, refer to their entities as "sponsored captive insurance companies" and "protected cell captive insurers", respectively.[9] It is clear that in Vermont and in other captive domiciles, sponsored and protected cell insurers will continue to develop, providing the cost-efficiencies and flexibility needed to establish creative, risk-sharing arrangements between insurers and their customers.

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[1] Title 8, Chapter 141, Vermont Statutes Annotated
[2] Based on data available on the BISHCA website http://www.bishca.state.us
[3] In addition to insuring risks of a parent corporation and affiliates, a pure captive may, with permission of regulators, insure controlled unaffiliated business. This is permitted when a contractual relationship exists between the pure captive's parent or affiliates and a third-party. In addition, the pure captive must be authorized to manage third-party risks.
[4] Vermont also permits the formation of risk retention groups under its captive statute. These entities are a form of group captive authorized by the federal Liability Risk Retention Act of 1986, 15 USC Sections 3901-3906.
[5] Title 8, Chapter 141, Subchapter 2, Vermont Statutes Annotated.
[6] Legislation has passed the Vermont House and Senate which would expand the category of eligible sponsors to include financial institutions (state and nationally chartered banks), financial holding companies and Vermont registered broker-dealers. House Bill No. 68.
[7] Title 8, Chapter 145, Supervision, Rehabilitation and Liquidation of Insurers.
[8] Information provided by Derick White, Director of Captives.
[9] Title 38, Chapter 90, South Carolina Code of Laws
Title 20, Chapter 4, Article 14, Arizona Revised Statutes