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CAPTIVE INSURANCE COMPANIES AND WORKERS' COMPENSATION GROUP FUNDS IN THE SOUTHEAST: A COMPARATIVE VIEW

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Alternative methods of delivering workers' compensation coverage were developed in the wake of the early 1980's trend toward high premiums, high residual market assessments and generally, higher loss ratios. Many states enacted laws which permitted individual businesses to pool resources with those of similar or like kind businesses and form workers' compensation group funds. Still others expanded the notion of captive insurance companies to include association captives formed by groups of employers engaged in like kind businesses, or industrial insured captives comprised of businesses having a minimum number of employees and premium size or a minimum insured aggregate insured risk.

Given the cyclical nature of most insurance products, including workers' compensation, it is likely that the need for these alternative systems for the delivery of workers' compensation benefits may again become popular. This article attempts to profile the law and regulation in each of the southeastern states pertaining to captive insurance companies and workers' compensation group funds.

Georgia

Georgia's law authorizing captives is found at O.C.G.A. 33-41-1 *et seq.* and allows for pure captives, association captives and industrial insurer captives. The association captives must consist of groups of individuals, corporations or partnerships engaged in a "similar or related profession, trade or business activity . . ." By contrast, a pure captive is limited to insuring or reinsuring only the risks of its parent or affiliates of the parent. Finally, an industrial insured captive insurer is one which is comprised of members who use a full-time agent broker or counselor; whose aggregate annual premium is at least $25,000; and which either (i) has at least 25 full-time employees; (ii) has gross assets in excess of $3 million; or (iii) has gross annual revenues in excess of $5 million.

Georgia captives can write casualty insurance except accident and sickness, marine and transportation insurance, property insurance and surety insurance. This includes the ability to write workers' compensation insurance, which is the most frequently offered product amongst the currently 15 Georgia licensed captives. Georgia captives may also reinsure any line of business which they are entitled to write on a direct basis. Pure captive insurers must be incorporated as stock insurers, but association or industrial insured captives can be either a stock insurer or a mutual insurer. There is no provision under Georgia law for a captive licensed in another state to do business in the state of Georgia. Georgia captives must maintain a minimum of $500,000 in capital (if a stock insurer) or $500,000 in surplus (if a mutual insurer).

Captive insurers are required to file the same financial statements, including an annual statement, an annual certified audit and an actuarial report, as required of traditional property casualty insurers, and are subject to examination by the Commissioner on the same three year cycle as applied to domestic Georgia insurers. A key distinction of Georgia captives, which is not applicable to other standard or nontraditional companies in the state, is that Georgia captives are not required to make any rate and form filings with the Department and, in theory, are free to charge any rate which does not adversely affect their financial condition. The captives are also not participants in the guaranty fund. However, captive insurance companies shall be charged premium tax in accordance with that which is applicable to domestic property and casualty insurers (the maximum rate is 4.75%, including both state and local premium taxes).

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Georgia allows group self-insurance funds under the authority of O.C.G.A. 34-9-150. These funds can be formed by a group of municipalities, group of counties, group of school boards, or by a professional trade association comprised of a "bona fide group of employers engaged in the same or substantially similar types of professions that have similar governing industry classifications." The Georgia law provides that there may be only one fund for municipalities and counties, but that trade associations, school boards or hospital authorities can form multiple funds in competition with one another. Funds prepare an intra-state agreement which creates joint and several liability among the members and, in most cases, appoints a third-party administrator to handle the day-to-day operations of the fund. Pursuant to a change made in 1995, the Department is only responsible for the review and approval of the initial members of a group fund; thereafter, the fund can petition the Commissioner to perform its own admission of new members provided that they submit underwriting criteria which outline the procedures for admission and termination of members. Funds are required to submit an annual statement and quarterly statements on a form prescribed by the Commissioner.

Funds must maintain their principal office within the state, must be comprised of at least 15 members and 1,500 employees, and maintain a minimum gross annual premium of $1 million. Only the initial members of a group fund need be submitted for approval to the Georgia Department; thereafter, the fund may admit and terminate members provided it has submitted and received approval for underwriting from the Department for this purpose. Funds are required to file an annual financial statement, quarterly statements and an actuarial report. Reserves are expected to be set at the lesser of 45% of earned premiums or the amount set by an actuary, whichever is greater. Funds are required to maintain a security deposit of $200,000 pledged to the Commissioner (or a surety bond for $250,000), and must further provide evidence of an excess loss funding arrangement consisting of either excess reinsurance policies or a self-funded reserve for catastrophic losses. Funds are required to maintain a minimum surplus of $200,000 and must invest their assets in accordance with the laws applicable to traditional insurance companies under O.C.G.A. 33-11-1 *et seq*.

All third-party administrators ("TPA") for group funds must be separately licensed pursuant to O.C.G.A. 33-23-100 *et seq*., and the TPA is also required to have and maintain a fidelity bond of at least $100,000 for the protection of funds held in trust. Funds are to be examined at least once every five years. The funds are not members of the Georgia insurance insolvency pool or any other guaranty association, and the funds are also not required to pay either state or local premium taxes. Georgia group self insurers are required to file rates and forms for prior approval with the Georgia Department, as is also done with traditional workers' compensation insurers.

There are currently 32 authorized group self-insurance funds in Georgia consisting of one for the municipalities, one for the counties, one for the hospital authorities, two for the school boards with the balance being comprised of private industry trade and professional organizations. Of these, only 20 are actively writing business and the others are in a dormant status. The number of group funds in Georgia has declined significantly from a high of 42 operating funds in the mid-1990's. The Department believes the decline is largely attributable to a depopulation of the state's residual market and an overall trend toward lower rates and greater availability of coverage in the voluntary market.

Alabama

Alabama law permits workers' compensation groups to be formed by a county or a group of counties allowing these governmental entities to pool the workers' compensation liability of their employees. Also, private employer groups can form a fund, either homogenous or heterogeneous in nature. (*See* Ala. Code 25-5-9.) Once formed, these workers' compensation funds are viewed as a form of self-insurance and must comply with all of the workers' compensation laws of Title 25 of the Alabama Insurance Code. (*See* Ala. Code 11-26-1.) The fund must deposit $200,000 with the Department of Industrial Relations and its members must demonstrate an aggregate net worth of $1 million or more. Funds are exempt from Alabama's premium tax and *may* join a guaranty association for Alabama self-insurers. Funds do not participate in the Alabama Property and Casualty Guaranty Association. (*See* Ala. Admin. Code 480-5-3.01 et. seq.) At the present time, there are 20 separate funds operating in Alabama.

Alabama law does not contain any provisions for Captive insurers and would not recognize a captive authorized in another state.

Arkansas

Arkansas law allows for two or more employers engaged in the same type of business activity and pursuit to enter into an agreement to pool their workers' compensation liabilities and qualify as a "homogenous self-insurer." (Ark. Stat. Ann. 11-9-404.) In addition, two or more employers who are members of the same trade or professional association may pool their liabilities as a "common self-insurer." However, the common self-insurer category requires the sponsoring association to have been in existence for more than three years and to have been formed for purposes other than creating a common self-insurance pool. Arkansas law also prohibits two separate trade or professional associations from combining into one common workers' compensation pool.

In order to be licensed, common insurer groups submit an application, prepare an Indemnity Agreement which jointly and severally binds each participating member, prepare a current audited financial statement for each member demonstrating the members' aggregate net worth exceeds $1 million, and deposit or maintain securities with the Arkansas Workers' Compensation Commission of at least $200,000 (except government sponsored funds, which do not have to meet the security deposit requirement). There is a mandatory guaranty association for the self-insured groups, and all members except the three government sponsored funds must become members. The funds are subject to the same premium tax as standard workers' compensation insurers. There are currently 18 self-insurance groups operating in Arkansas.

Florida

Florida allows for group self-insurance funds where two or more employers enter into an agreement to pool their workers' compensation liabilities. (*See* FSA 624.4621.) Florida law allows the group fund to structure liabilities so that the pool is only responsible for 80% of workers' compensation liabilities, and the employer member retains 20% of liabilities for medical benefit claims up to $5,000 for one employee. Above $5,000, 100% of the medical expenses are paid by the pool. This is the only state we surveyed having a statutory authorization for a significant self-insured retention in connection with the workers' compensation group fund. The Florida law relating to group funds also prohibits the fund from making dividends contingent upon continued membership in the fund. All funds must submit annual audited financial statements, an annual report, and an annual actuarial reserve study within seven months of the close out of their fund year. Dividends must be reviewed and approved by the Department, but are automatically deemed approved if the Department does not disapprove them within 60 days. The Florida group funds are subject to premium tax, except that the tax rate is 1.6% of gross premiums, whereas the general Florida premium tax rate is 1.75% of gross premiums. Florida has a mandatory Florida Self Insurance Fund Guaranty Association, which all group funds must participate in.

The Florida regulations relating to group funds contain the following requirements:

A. Funds are expected to use GAAP accounting rather than statutory accounting.

B. Fund members must have a common interest, which is defined as ". . . belonging to a bona fide trade association or being engaged in the 'same or similar' type of business."

C. Funds which have voluntarily gone out of business or those which have had their privilege to operate terminated or revoked must provide an independent actuarial report every six months indicating the present value of known future claims.

D. Funds are required to file the separately prepared Florida financial statement for group funds or may file the NAIC annual and quarterly financial statement required of fire and casualty companies.

E. Funds must also perform an annual payroll audit of all employers who represent at least 90% of the fund's normal collected premium.

F. Funds are also required to make copies of their financial statements available to their membership upon request.

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Florida group funds are entitled to refund excess surplus to their membership, but a fund's declaration of a return of surplus creates an immediate liability for the fund. Florida's regulations do not set forth the dividend distribution criteria, but instead leave the criteria to be developed by the fund's trustees; however, the regulation indicates that the dividend distribution criteria must be "objective and measurable and must be pro rated according to the length of a fund member's participation in the fund." Funds must ask for division acceptance/approval of the dividend request, and the amounts refunded to members "must not impair the financial solvency of the fund." Any time dividends are paid out, they must also be distributed to eligible former members of the fund and the fund must make a reasonable effort to locate such former members who are eligible for participation. The number of active group funds has declined significantly in Florida in recent years, from a high of approximately 35 funds to only six in operation presently. State regulators contacted in Florida believed the declining number of funds is a function of the wider availability of coverage in the voluntary market and due to publicity related to the financial difficulties of some of the funds.

Florida's captive laws are defined at Fla. Stat. Ann. 624.402 *et seq.* and 628.901 *et seq.* Florida will recognize a captive licensed in another state provided that the captive's writings are limited to hospital professional, hospital liability or hospital general liability insurance under certain circumstances. Florida based captives can be either pure captives or industrial insured captives, but the law does not recognize association captives. An industrial insured captive is defined as "a captive comprised of insureds which has gross assets in excess of $50 million, has at least 100 full-time employees covered, pays annual premiums of at least $200,000 from each line of insurance written by the industrial captive or alternatively, premiums of at least $75,000 for each line with a total of $25 million written premium in the aggregate." An industrial insured captive is entitled to direct, write or reinsure business of its participating stockholders or members. (*See* 628.903.) Association captive insurers in Florida are entitled to write commercial property, casualty or marine, but are prohibited from writing workers' compensation and employer's liability. However, industrial insured captive insurers may write workers' compensation and employer's liability, provided that they meet the premium threshold of amounts described above. An industrial insured captive insurer need not be incorporated in Florida if it has been validly incorporated under the laws of another jurisdiction which permits such form of captive. Finally, Florida's captives are not permitted to join or participate in a joint underwriting association or a guaranty fund. This requirement applies equally to pure captives and industrial insured captive insurers. (*See* 628.915.) There are currently two captives operating in Florida, and the Florida Department of Insurance reports that they have not licensed a new captive in approximately 10 years.

Louisiana

In Louisiana, employers are entitled to enter into agreements to pool their workers' compensation liabilities with other similar employers. (La. Rev. Stat.Ann. 23:1191-1193.) Louisiana self-insured groups are required to file and report their rates to the Insurance Commissioner, but they are exempt from premium taxes. As in other states, members of group funds are held jointly and severally liable for the claims of the group. Even if such member elects to cancel or terminate their membership in the fund, that member is still held responsible for claims arising out of their membership period. There are no minimum capital or surplus requirements required of funds; however, the aggregate net worth of the membership must be at least $1 million. There are currently 16 group funds operating in Louisiana

Third-party administrators for workers' compensation group funds in Louisiana are required to be licensed separately by the Commissioner. Under Louisiana law, third-party administrators are typically required to post a $100,000 bond or cash deposit with the Commissioner for the protection of all policyholders.

The Louisiana Department is authorized to review any proposed dividend distribution by a fund and requires the fund to demonstrate that any fund year from which a dividend is declared resulted in accumulated surplus. Louisiana directive indicates that a fund may not limit distribution of a dividend and shall not condition the right to participate in the distribution of the dividend on continued membership in the fund. All such dividend distributions must be submitted to the Commissioner at least 30 days in advance of the proposed distribution date.

Louisiana has no specific statute for captive insurers and instead regulates captive insurers the same as traditional companies. Captive insurers are subject to rate and form regulation and pay premium taxes. They must meet similar capital and surplus requirements as those of traditional insurers. For workers' compensation writers, this would be a minimum of $5 million. The Louisiana Department indicated that they would recognize a captive insurer licensed in another state, but only if the captive could meet Louisiana's admission standards for a traditional insurer in that same line or lines of business.

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Mississippi

Group Funds in Mississippi are governed by the Workers' Compensation Commission and there are currently 16 funds in operation. Although the state requires no minimum capital or surplus requirements, the aggregate net worth of the funds' members must be at least $1 million.

Mississippi law permits captive insurers to operate; however, the law does not distinguish between a captive insurer and a traditional carrier. Accordingly, Mississippi's standard capital and surplus requirements would apply to any captive insurer. (Miss. Code Ann. 83-19-31.) For workers' compensation coverage, Mississippi requires $1 million in capital and surplus, consisting of $400,000 capital and $600,000 surplus. Captives also are subject to Mississippi's premium tax of 3%. The Department reports that there are currently five captives in operation in the State of Mississippi.

North Carolina

North Carolina permits workers' compensation in groups under 58-36-15 in the North Carolina general statutes. Such groups must file their rates, loss costs, classification plans and rating systems with the separate North Carolina Workers' Compensation Bureau in addition to being licensed and maintaining compliance with all laws and regulations promulgated by the North Carolina Insurance Commissioner. A "group" in North Carolina means any two or more employers who agree to pool their workers' compensation risks and are properly licensed by the Insurance Commissioner. In cases where a third-party administrator (the "TPA") is utilized, the TPA is required to provide a written notice approved by the self-insurer to advise all covered members of its identity and the relationship between the TPA and the self insurer. The TPA is also required to disclose the nature of any other business in which it is involved other than administering for the self insurer.

North Carolina group funds need an "Indemnity Agreement" which creates joint and several liability and all applications to form a fund must be filed at least 90 days in advance of beginning to provide insurance. There is a mandatory guaranty association, comprised of individual, self-insured businesses and pooled groups of employers. The assessment for participation in the Guaranty Association is initially 1/4 of 1% (.25%) of the individual member's annual premium which can be offset against premium tax. Once the self-insurance guaranty fund has an aggregate net equity of $5 million, no further assessments are necessary except to maintain the $5 million balance.

The premium tax for self insurers is consistent with the premium tax for other writers of the same line of insurance. The premium tax applies to the group funds, and North Carolina's rate for workers' compensation writers is 2.5% times all gross premiums, whereas the tax on most other lines is a standard rate of 1.9% times gross premiums. All premium taxes are collected and monitored by the North Carolina Revenue Department.

Group funds are also required to file annual financial statements, an annual actuarial report and summary loss reports. The failure to file any annual or other required report is grounds for suspension, revocation or non-renewal of the license. (*See* N.C.Admin. Code, tit. 11 11b.0612.) Funds must also obtain the written permission of the Insurance Commissioner before returning any dividend to members (*See* .0615) and must maintain a positive group fund surplus. Funds with a negative group funds surplus are deemed insolvent and subject to insolvency proceedings by the Insurance Commissioner. (*See* .0616.) Groups must also prepare a plan filed with the Commissioner outlining their proposed method for assessment of the members, should any such assessment become necessary. (*See* .0617.) There are currently 19 group funds in North Carolina and although there are no capital requirements, new surplus requirements went into effect last December. The minimum surplus for a fund must be the amount set by Risk Based capital requirements applicable to Property Casualty insurers, or 10% of the group's undiscounted aggregate claims liability, but in no case can total surplus fall below a minimum of $300,000.

South Carolina

South Carolina law permits two or more employers to enter into an agreement to pool liabilities for purposes of qualification under the Workers' Compensation Law. Such multi-employer trusts are regulated by the South Carolina Industrial Commission, not the Insurance Department, because such trusts are specifically not deemed to be insurance companies under the statute. (*See* S.C. Code Ann. 45-5-20.) The capital and surplus requirements are the same as for traditional insurance

the statute. (*See* S.C. Code Ann. 45-5-20.) The capital and surplus requirements are the same as for traditional insurance companies, and the trusts are not exempt from paying premium taxes. An interesting quirk of South Carolina law is that any reinsurance program of a self-insured fund must provide that the underlying member or claimant have *direct recovery* against the reinsurer, rather than the traditional requirement that the claimant pursue a claim against the group fund, which in turn seeks indemnity from its reinsurer. There are currently two licensed group funds operating in South Carolina.

There is no authorization for captive insurance companies under the South Carolina law, and no captive insurers operate in South Carolina.

Tennessee

Tenn. Code Ann. 50-6-405 relating to methods for employers to qualify under the Workers' Compensation Law permits ten or more employers of the "same trade or professional association" to pool their liabilities and qualify as a self-insurance group, provided that the trade or professional association has been in existence in Tennessee for five years, has a constitution or by-laws, dues paying members, and was formed for purposes "other than the creation of a group self-insurance pool." There is no minimum surplus requirement; however, funds must have a projected first year premium of $150,000 ($250,000 in subsequent years). Funds are subject to Tennessee's workers' compensation premium tax of 4.4%, but there is no applicable guaranty association coverage. Tennessee law requires group insurance pools to set up an investment policy for the investment of the pools' funds. The Department reports there are currently 12 insurance groups operating in the state.

Tennessee law also allows for association captive insurance companies (Tenn. Code Ann. 56-13-102) to write direct insurance and reinsurance for members of any association which has been in existence for one year. The one year existence requirement may be waived if the association owns a captive insurer license under another jurisdiction or has participating members having total aggregate insurance premiums of at least $100,000 per member per year. Tennessee law also allows for industrial captive insurers which are defined as "businesses which [rely upon] a full-time employee who acts as insurance manager or broker, whose aggregate annual premium for insurance on all risks is at least $25,000, and has at least 25 full-time employees." Finally, Tennessee allows for pure captive insurance companies; however, pure captives, as in other states, are only entitled to write insurance on the risks of their parent organization.

All Tennessee captives are entitled to write professional liability, property, casualty, E&O and CGL policies. An association captive insurer may also write workers' compensation, D&O liability, and public officials liability insurance. As in other states, Tennessee prohibits its captives from issuing any insurance or reinsurance coverage on private passenger automobiles or homeowners insurance coverages (*See* Tenn. Code Ann. 56-13-103). Tennessee's pure captives may write malpractice insurance pursuant to Tenn. Code Ann. 56-13-104, provided that total gross annual premiums are at least $500,000 per year. The association and industrial insured captives must demonstrate prior to licensure that the insurance markets in Tennessee and in the United States are not adequate to cover the risks and liabilities of their putative members or that the coverage is only available at excessive rates. The industrial insurer group must demonstrate to the Commissioner that they will develop a gross annual premium of at least $1 million and an association captive must demonstrate to the Commissioner that it will be able to develop a gross annual premium of $500,000 per year.

Tennessee pure captives must maintain capital and surplus of $750,000 whereas association and industrial insured captive insurance companies must maintain capital and surplus of $1 million. The capital and surplus requirement may be satisfied with an irrevocable letter of credit on behalf of the captive insurance company for the capital portion of the capital and surplus requirement. However, the cash surplus of a captive insurance company must be funded by cash or securities. An exception is provided for association captives created for non-profit or 501(c)(3) members by allowing initial capital and surplus of only $750,000 rather than the $1 million required of for-profit members of an association captive. Finally, no Tennessee captive insurance company is compelled to join any guaranty or insolvency fund of the state, and the captives are subject to premium tax assessments.

Virginia

Virginia law only recognizes Virginia domiciled association captives or pure captives (Va. Code Ann. 38.2-1100). Virginia defines a "pure captive insurer" as one which "transacts insurance business only for its parent or associate or affiliate or subsidiary companies of that parent." Captive insurers must be licensed by the Virginia Corporations Commission and are limited to underwriting certain lines of business. The Commission may not issue a license to a pure captive unless total

limited to underwriting certain lines of business. The Commission may not issue a license to a pure captive unless total insurance to be provided by that captive equals a minimum aggregate annual premiums of $500,000. By contrast, an association captive insurer must project aggregate annual premiums of $1 million or more and must further demonstrate that the "association" has been in existence for at least one year. (38.2-1102). Forms and rates must be approved by the Commission prior to writing any business. Captives in Virginia are prohibited from writing any personal lines coverage. In particular, they are not permitted to directly write motor vehicle or homeowners insurance or reinsure these two lines. Also, Virginia captives are not considered part of the Virginia Property and Casualty Guaranty Association. (*See* Va. Code Ann. 38.2-1601.) Although authorized by law, there are currently no captives in operation in Virginia.

Virginia allows individual employers to qualify as self-insurers for workers' compensation purposes, and also recognizes group self-insurance associations formed by "two or more employers having a common interest . . ." (Va. Code Ann. 65.2-802). In order to form a group self-insurance association, the groups must provide documentation satisfactory to the Commission as to the solvency of each proposed member of the group. Each group member must execute a written agreement assuming joint and several liability of any other member of the group. The Commission also has the right to enforce the joint and several obligation for any unpaid contributions or assessments of the group. The group association funds must maintain a security deposit of acceptable securities or a surety bond of at least $250,000. After the first year, the Commission may determine to raise or lower the security deposit requirement, depending on the financial position of the group association. The security deposits are held by the Virginia State Treasurer and can be in the form of general obligation bonds issued by states, local subdivisions or municipalities if they meet certain rating thresholds as set forth in the regulations. Associations can also comply with the security deposit requirement by posting a surety bond, provided the surety bond is issued by an admitted surety carrier in Virginia.

In addition, persons wishing to provide services to group associations must be separately approved by the Commission. The Commission may also require a deposit of securities or a bond or a purchase of excess insurance coverage for either specific or aggregate excess of loss policies as required under the circumstances of each particular group self-insurance fund.

The regulations further provide that the Commission can require additional security deposit amounts depending on their determination of the financial condition or availability of excess insurance policies maintained by the association. Alternatively, Virginia group self-insurance associations can qualify for the security/surety bond requirement by obtaining a special excess insurance endorsement which would cover any amount the fund fails to pay. These special assessment excess insurance policies eliminate the need for any assessment under the joint and several provisions of the member agreement and power of attorney document described above. There are currently 17 funds operating in Virginia, including those sponsored by governmental organizations.