

## FEDERATION OF REGULATORY COUNSEL, INC.

# DELAWARE'S NEW CAPTIVE INSURANCE STATUTE

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Hoping to capitalize on its well established reputation as a center for corporate and financial services, in 2005, Delaware completely revised chapter 69 of the Delaware Insurance Code respecting captive insurance companies, with the intention of developing Delaware as a preferred captive domicile. These revisions, combined with: 1) the creation of a special division within the Delaware Insurance Department devoted to captives, and 2) the formation of the Delaware Captive Insurance Association, dramatically changed the outlook for captive insurance in Delaware.

Captive insurance companies have been permitted under Delaware law for some time; however, Delaware has attracted but a handful of captives since the statute was first enacted over 20 years ago. Notable amongst this handful, however, is Nuclear Electric Insurance, Limited (“NEIL”). NEIL became a Delaware domiciled industrial insured captive in 1988 and today insures every nuclear electric generating unit in the United States as well as a number of units in Europe.<sup>1</sup> At year end 2005, NEIL boasted annual net premiums in excess of \$215 million and capital and surplus in excess of \$3.5 billion.<sup>2</sup>

### **History**

Delaware became a captive domicile in 1984, when Senate Bill 527 was signed into law, creating a new chapter, Chapter 69, of the Delaware Insurance Code.<sup>3</sup> Patterned after Vermont’s captive statute, SB 527 was intended to take advantage of changes in federal tax laws making offshore captives less attractive.<sup>4</sup> It was hoped that Delaware would generate increased revenue from the growth of an indigenous captives industry, and that this would further enhance Delaware’s reputation as a financial center.<sup>5</sup>

Chapter 69 underwent two changes in the late 1980s and again in the mid 1990s. In 1988, House Bill 406 was adopted, adding a new subsection to then-section 6906.<sup>6</sup> The purpose of this change was to allow captive insurers organized under the laws of jurisdictions other than Delaware to elect regulation as if such captives were organized under Delaware law. The impetus behind House Bill 406 was to allow NEIL, a Bermuda company, to move its principal place of business to Delaware and to become regulated as a Delaware domestic.<sup>7</sup> The final substantive amendment to the pre-2005 version of Chapter 69 was embodied in Senate Bill 208, signed into law in 1995. This amendment was intended to allow association captives and industrial insured captives to write up to 50% of gross direct premiums outside their respective industrial insured or association groups.<sup>8</sup> Both of these amendments granted unique flexibility to Delaware captives and, in concept or in letter, are preserved under the new law.

Despite the progressive nature of Delaware’s captive statute, even as amended in 1988 and 1995, captive insurers did not flock to Delaware. Indeed, at the time of the revisions to the statute in 2005, Delaware had just five domiciled captives.<sup>9</sup>

### **Development of the New Statute**

In response to the lackluster industry response to Delaware as a captive domicile, in early 2005, representatives from the financial services industry; legal, actuarial and accounting communities; the State Chamber of Commerce; the Delaware Department of State; the Delaware Economic Development Office and the Delaware Insurance Department convened a series of meetings throughout the winter and spring of 2005.

## FEDERATION OF REGULATORY COUNSEL, INC.

The goal of these meetings was to completely revamp Chapter 69 to embody the latest statutory innovations in use in the most progressive domiciles, and to foster a business and regulatory climate that would accommodate innovation and flexibility without compromising regulatory oversight.

The result of these meetings was House Bill 218, introduced into the Delaware General Assembly on June 8, 2005.<sup>10</sup> Typical of Delaware economic development legislation, HB 218 met with virtually unanimous approval in the General Assembly, and was amended only one time on its way to passage in both houses.<sup>11</sup> Just 34 days after its introduction into the House, HB 218 was signed into law by Governor Ruth Ann Minner.

### **The New Captive Insurance Statute**

Although the new statute retains a number of features from its earlier form the captives statute is, in fact, entirely rewritten. The following are some of its more noteworthy features:

#### Flexibility as to corporate entity

As noted, the prior version of Chapter 69 expressly permitted non Delaware corporations to become regulated as Delaware domiciled companies. However, whether alien, foreign or domestic, a captive was limited to the corporation as the form it was required to take. As revised, Chapter 69 allows a captive to opt from a range of business organizations, i.e., corporation, limited liability company, partnership, limited partnership or statutory trust.<sup>12</sup> Moreover, the statute does not require that such companies be formed in Delaware, thus preserving the ability of a captive organized under the business laws of a jurisdiction other than Delaware to choose Delaware as its place of domicile for regulatory purposes.

#### Non-Captive business

The new statute preserves the unique ability of Delaware association and industrial insured captive insurers to write up to 50% of their business outside the association or industrial insured groups.<sup>13</sup> The only limitations are that such business be limited to entities in the same, related or similar business as the members of the industrial insured or association group and that the business be in the same or similar insurance lines as that written for group members.

Subject to rulemaking by the Insurance Department, the new statute also allows a pure captive to write risks for an unaffiliated company if the captive's parent or any affiliate thereof is (through contract) exercising control over the risk management function for such non-affiliated company.<sup>14</sup>

#### Permitted lines of business

Delaware captives are virtually unrestricted in the lines of business for which they can potentially obtain a certificate of authority, with the sole exception of workers compensation insurance.<sup>15</sup> As for workers compensation, Delaware captives are permitted to write so-called "excess workers compensation insurance" for parent and affiliated companies.<sup>16</sup> Excess workers compensation is a concept whereby a captive may begin insuring at or above a per incident or aggregate layer prescribed by the local insurance regulator. Under the new Delaware statute, however, the Commissioner is prevented from setting this limit at a point in excess of the level at which a parent or affiliated company is authorized to self-insure its own risks under applicable federal and state law. Thus, if a parent company is authorized to self-insure its workers compensation risks at dollar one, a Delaware captive can insure those risks at dollar one.

#### Captive investments and accounting

## FEDERATION OF REGULATORY COUNSEL, INC.

Delaware law previously extended great latitude to the ability of a pure or industrial insured captive to make investments of all types, and this has been retained.<sup>17</sup> However, under the new statute, Delaware captives of all types are expressly permitted to own the securities of, or interests in, another captive.<sup>18</sup> This allows a parent company or industrial insured group greater flexibility to segregate risks in multiple captives and to arrange those captives vertically in the corporate structure rather than horizontally. More importantly, the ability of one captive to hold another captive means that a captive can set up a subsidiary captive as a “special purpose reinsurance vehicle” for extraordinary purposes that might include issuing catastrophe bonds for use in covering the parent’s exposure to otherwise uninsurable risks.

The new statute expressly allows a captive to prepare its annual report under generally accepted accounting principles (“GAAP”), statutory accounting principles (“SAP”) or international accounting standards (“IAS”).<sup>19</sup> Although many jurisdictions provide varying degrees of flexibility as between GAAP and SAP, Delaware is the first to expressly allow the use of IAS. Delaware had previously eliminated all restrictions on a pure or industrial insured captive’s investments; accordingly, additional provisions in the new statute permit a captive using SAP to record as “admitted” those assets that SAP would otherwise require be “non-admitted” and thus ignored for purposes of the insurer’s balance sheet.<sup>20</sup>

### Protected cells

This is one aspect of captive insurance where Delaware law clearly lagged behind that of other jurisdictions. Under the new statute, Delaware has adopted “sponsored captive” provisions much like those in place in other progressive domiciles.<sup>21</sup> Accordingly, Delaware captives may be organized to serve multiple members, each of which has the ability to segregate its risks in a protected cell that is insulated from the liabilities of other cells. The new statute makes clear that the Commissioner has the authority to take remedial action, specifically including rehabilitation or liquidation, against a single cell in the event that cell becomes impaired or insolvent, without such action spilling over into other, financially sound, cells.<sup>22</sup> More important, members of a Delaware-sponsored captive need not be members in a particular association or industrial insured group in order to participate in a sponsored captive, and need not be the owners thereof.<sup>23</sup>

### Taxation, fees, and “bricks and mortar”

Business as a captive in Delaware naturally comes with a price. Fees associated with licensing are significantly steeper than under the prior version of the statute, with a \$200 application fee and \$3,000 processing fee required with each application.<sup>24</sup> Annually, each captive is also required to pay a \$300 fee to maintain its certificate of authority.<sup>25</sup>

Under the new statute, Delaware taxes its captives through a flat, capped premium tax structure which now provides a modest .2% (+.1% for reinsurance) tax capped at \$125,000.00 for direct written business and \$75,000.00 for reinsurance.<sup>26</sup> The aggregate maximum tax payable by a sponsored cell captive is \$200,000.<sup>27</sup> If a captive has 25 or more full time employees in Delaware, the cap on taxation is reduced to just \$50,000.<sup>28</sup>

What one must also consider in addition to fees and taxes is the ongoing “bricks and mortar” requirements that a jurisdiction imposes in return for the privilege of being domiciled in that jurisdiction. A Delaware captive is required to maintain its principal place of business in Delaware.<sup>29</sup> Notably, however, there is no requirement to retain a Delaware based “captive manager” – although for smaller captives without an indigenous staff, retention of a manager in Delaware will satisfy the principal place of business requirement as well as provide the expertise and resources necessary to operate the company. While a Delaware captive with fewer than five full-time employees in Delaware is required to have at least one meeting of its governing body in Delaware,<sup>30</sup> another provision of Delaware law may serve to ease this requirement. The Delaware General Corporation law provides that directors may participate in a board meeting by conference telephone or other communications equipment, which participation constitutes the “presence in person” of such director.

## **FEDERATION OF REGULATORY COUNSEL, INC.**

Accordingly, a Delaware captive organized as a corporation can comply with the Delaware board meeting requirement even though most of the directors are participating by phone from outside Delaware.<sup>31</sup>

### **Regulatory requirements**

Delaware captives, naturally, are required to meet certain standards in order to obtain and maintain a certificate of authority. First and foremost, Delaware captives are required to maintain minimal levels of capital and surplus ranging from a low of \$250,000 for a pure captive to a high of \$1,000,000 for a risk retention group.<sup>32</sup> § 6905(a). The Commissioner is given the discretion to require additional levels. These minimal levels must be maintained in Delaware, and can be in the form of cash, an irrevocable letter of credit, or other securities approved by the Commissioner.<sup>33</sup>

An applicant for a certificate of authority must supply the Commissioner with information respecting the amount and liquidity of its assets, the competence and character of its personnel, its insureds' loss prevention programs and such other information as the Commissioner may require.<sup>34</sup> Importantly, each applicant must satisfy the Commissioner of the overall soundness of its plan of operation.<sup>35</sup>

Once granted a certificate of authority, the Commissioner is required to conduct triennial examinations of the captive,<sup>36</sup> and the Commissioner is broadly empowered to revoke the Certificate of Authority if he finds that the captive is insolvent, has failed to maintain minimum capital and surplus, has failed to file an annual report, is not in compliance with its organizational documents, has failed to pay its taxes, or is otherwise using methods that render operation detrimental to policyholders or make its condition unsound.<sup>37</sup>

Delaware's new statute requires that captives provide the Commissioner with 30 days prior written notice of certain "material transactions." These include the dissolution of the company; sale, lease, mortgage, assignment, etc. of all or substantially all of the company's assets; the incurrence of "material indebtedness" or the making of a "material loan"; a material payment out of capital and surplus; a merger or consolidation involving the company; its conversion to another form; transfer of domicile or any material amendment to its organizational documents.<sup>38</sup> The statute does not define "materiality" for purposes of material transactions reporting, and the Commissioner has yet to publish regulations that would otherwise accomplish this.

### **Activity beyond the statute**

Delaware's prior experience with its captive statute demonstrated clearly that having a progressive statute is not enough; to the contrary, without a business and regulatory climate that fosters the development of the domicile, the best statutory language imaginable will not populate the state with new applicants. This seems especially self-evident considering the recent proliferation of captive domiciles both domestically and off shore.

On October 13, 2005, the Delaware Captive Insurance Association (the "DCIA") was organized. The purpose of the DCIA is to "promote the common business interests of and improve business conditions among persons employed by or in, practicing or otherwise doing business in, or otherwise connected with the captive industry in Delaware."<sup>39</sup> The current membership of the DCIA includes captive insurance companies, captive managers, law firms, accounting firms and actuarial firms.<sup>40</sup> On October 4, 2006, the DCIA held its first annual captive insurance conference in the Hotel DuPont in downtown Wilmington, Delaware. The event was well attended for a first-time event – attracting over 100 attendees representing a broad spectrum of the captive insurance industry – and included speakers from Delaware captive insurers, service providers and regulators.<sup>41</sup> Governor Minner was the event's keynote speaker.

Perhaps the most critical element beyond the statute itself is the regulatory regime established to administer it. In the past, Delaware did not regulate captive insurers apart from, or substantially different than, conventional

## FEDERATION OF REGULATORY COUNSEL, INC.

insurers. As of August 2006, this has changed. Under Commissioner Matthew Denn, the Delaware Insurance Department has established a separate captives unit charged exclusively with regulating Delaware captives. This unit is headed by William P. White, the former director of the Captive Insurance Division for the District of Columbia Department of Insurance, Securities and Banking.

### **Conclusion**

Delaware has enacted sweeping changes to its captive insurance statute which make it comparable to the most progressive domiciles available. These changes have enjoyed the backing and support of Delaware's General Assembly, its Department of State, its Economic Development Office and its Insurance Commissioner. With the creation of the DCIA, the Delaware business community is committed to developing Delaware as a domicile of choice. Finally, the creation of a specialized captives unit within the Insurance Department, headed by a director with substantial captive experience, will bring a greater level of sophistication to Delaware's regulation of these special purpose entities.

The three legs of the captive insurance tripod are now firmly in place in Delaware. It remains to be seen whether this effort will bear fruit, or whether the "market" for captive domiciles is too saturated to attract real interest in Delaware as a viable and attractive alternative.

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### **Endnotes**

1. 2005 NEIL Annual Report.
2. *Id.*
3. 64 Del. Laws c. 454 § 1.
4. *Id.* at synopsis.
5. *Id.*
6. 66 Del. Laws c. 223 § 1.
7. *Id.* at synopsis. At the time NEIL was, in fact, two separate companies – Nuclear Mutual Limited and NEIL. Nuclear Mutual Limited was merged into NEIL in 1995. The author refers to both companies as "NEIL" for the sake of simplicity.
8. 70 Del. Laws c. 107 § 1.
9. Source: Delaware Department of Insurance.
10. 75 Del. Laws c. 150.
11. House Amendment No. 1 to HB 218 made technical corrections regarding the repeal of chapter 69 and the election of a previously licensed captive insurance company to become subject to the application of the new chapter 69.
12. 18 *Del. C.* § 6906.

**FEDERATION OF REGULATORY COUNSEL, INC.**

13. 18 *Del. C.* § 6903(a)(2) (for association captives); 18 *Del. C.* § 6903(a)(3) (for industrial insured captives).
14. 18 *Del. C.* § 6919.
15. 18 *Del. C.* § 6903(a).
16. 18 *Del. C.* § 6903(a)(8).
17. 18 *Del. C.* § 6910(b). Association captives, risk retention groups and special purpose captives are still required to comply with investment requirements applicable to conventional insurers under chapter 13 of the Delaware Insurance Code.
18. 18 *Del. C.* § 6910(d).
19. 18 *Del. C.* § 6907(b)
20. *Id.*
21. 18 *Del. C.* §§ 6931 – 6938.
22. 18 *Del. C.* § 6938.
23. 18 *Del. C.* § 6936.
24. 18 *Del. C.* § 6903(d).
25. *Id.*
26. 18 *Del. C.* § 6914(a) – (b). Under this provision, two or more captives under common ownership are taxed as though they were a single company.
27. 18 *Del. C.* § 6914(c).
28. 18 *Del. C.* § 6914(h).
29. 18 *Del. C.* § 6903(b)(3); *Del. C.* § 6906(f).
30. 18 *Del. C.* § 6903(b)(2).
31. 18 *Del. C.* § 141(i).
32. 18 *Del. C.*
33. 18 *Del. C.* § 6905(c).
34. 18 *Del. C.* § 6905(c).
35. 18 *Del. C.* § 6903(c)(2)(C).

**FEDERATION OF REGULATORY COUNSEL, INC.**

36. 18 *Del. C.* § 6908(f). These examinations are to be conducted in accordance with those requirements applicable to conventional insurers.
37. 18 *Del. C.* § 6909(a).
38. 18 *Del. C.* § 6922.
39. DCIA Certificate of Incorporation at Article III.
40. Source: DCIA Website [www.delawarecaptive.org](http://www.delawarecaptive.org)
41. *Id.*