

FEDERATION OF REGULATORY COUNSEL, INC.

THE 2006 D.C. CAPTIVE ACT AMENDMENTS

Crossing the Next Frontier

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On March 14, 2007, in an effort to keep pace in an ever-changing field, the District of Columbia (the "District") amended its captive insurance laws by enacting the Captive Insurance Company Amendment Act of 2006 (the "2006 Amendments"). The 2006 Amendments, which updated segregated cell provisions included in the previous Captive Insurance Company Acts of 2000 and 2004, help reaffirm the District as one of the most innovative captive domiciles in the nation by providing increased flexibility with respect to the formation and structure of protected cell companies while simultaneously enabling cell companies to benefit from the many progressive captive provisions already in place under District law.

A captive is generally defined as an insurance company created by its owners for the primary purpose of insuring the risks of its parent, affiliates or members of an association.¹ Captives, which first appeared in the 1960s², continue to remain significant and ongoing business opportunities because of their lower insurance costs, customization, better risk control and possible tax advantages.³ In 2004, the District expanded its captive insurance laws to allow for greater flexibility with respect to the formation of segregated or protected cell captives, ⁴ which are single legal entities that provide insurance through separate financial divisions, or cells, for each insured client or activity.⁶ Under this framework, the captive itself has a core capital, but each division also has its own additional capital provided by the client using that cell.⁷ The segregated cell structure is attractive both to small organizations seeking to take advantage of the captive insurance market and to larger companies with high premiums and difficult exposures⁸ because the assets of each individual cell are secure and are statutorily protected from the creditors of another cell.⁹ Similarly, a segregated cell's assets are protected against incursion by adverse selection, losses and underwriting, which creates a regulatory and accounting wall around each captive division.¹⁰

The 2006 Amendments represent the next generation of protected cell legislation. Following the lead of Jersey and other alien domiciles, the 2006 Amendments authorize the formation of separately incorporated cells and provide greater detail to the scope of authorized transactions involving protected cells. The enhanced specificity included in the 2006 Amendments is extremely appealing because it provides greater certainty to captive owners, managers and regulators regarding the status and actions of protected cell companies. No other U.S. jurisdiction has similar protected cell legislation. According to Commissioner Thomas E. Hampton of the District's Department of Insurance, Securities and Banking (the "DISB"), the amendments to the protected cell statute "will put the District ahead of other jurisdictions in our captive insurance regulation and attract more captive insurance companies to the District."¹¹ In addition, Larry Smith, Chairman of the Captive Insurance Council of the District of Columbia, an organization that was instrumental in ensuring the passage of the 2006 Amendments, has stated that the amendments to the District's segregated cell laws "should make the District an even more attractive location for the formation of new captive insurance companies" and establish the District's captive laws as "the most advanced in the United States in terms of . . . forming protected cell insurance companies."¹²

Protected Cells and Incorporated Cells

The 2006 Amendments authorize the creation of two types of protected cells: traditional protected cells and incorporated protected cells.¹³ A traditional protected cell, as generally described above, is a separate account

FEDERATION OF REGULATORY COUNSEL, INC.

established and maintained by a segregated cell captive insurer that has no legal identity separate from that of the protected cell captive insurer of which it is a part.¹⁴ Conversely, an incorporated protected cell is a protected cell that is formed as a corporation or other legal entity and has a legal identity independent from that of its parent protected cell captive insurer.¹⁵ As such, an incorporated cell may hold assets, sue and be sued in its own name, and do anything else that an ordinary corporation can do under District law. This structure is intended to eliminate any doubt as to the strength of the firewall between cells, as assets and liabilities are segregated as effectively as they would be among subsidiaries in a corporate group structure, although the incorporated cells are not subsidiaries of the protected cell captive insurer. It is anticipated that an incorporated cell would have its own federal employment identification number ("FEIN") and file its own tax return. A protected cell captive would be part of the protected cell captive insurance company's tax return. Moreover, unless otherwise provided for in the articles of incorporation or other organizational documents of a protected cell captive insurer, each incorporated protected cell of a protected cell captive insurer will have the same directors, secretary and registered office as the protected cell captive insurer,¹⁶ which translates into significant administrative benefits and cost savings for captive owners and managers.

Relationship Between Cells and Cell Companies

Pursuant to District law, each protected cell shall be accounted for separately on the books and records of a protected cell captive insurer to reflect the financial condition and results of operations of each individual cell, including net income or loss, dividends or other distributions to participants, and such other factors as may be provided by the Commissioner of the DISB (the "Commissioner") or any applicable participant contract between the entities.¹⁷ Consequently, if a protected cell captive insurer enters into a transaction with respect to a particular protected cell or incurs a liability arising from an activity or asset of a particular protected cell, a claim by any person in connection with the transaction or liability shall extend only to the general assets of that individual cell.¹⁸ Likewise, if a protected cell captive insurer enters into any transaction or incurs any liability in its own right and not in respect of any of its protected cells, any claim in connection with the transaction or liability shall extend only to the general assets of the protected cell captive insurer.¹⁹ A protected cell captive insurer may also create and issue shares in one or more classes or series for one or more protected cells, and the proceeds for the issuance of such shares will be included in the assets of the protected cell that issued the shares.²⁰ Similarly, a protected cell captive insurer can pay a dividend on protected cell shares of any class or series whether or not a dividend is declared on any other class or series of protected cell shares or any other shares.²¹

The 2006 Amendments provide even greater flexibility with respect to the relationship between cells and cell companies by permitting a protected cell to enter into an agreement with its protected cell captive insurer or with another protected cell of the protected cell insurer that is enforceable as if each protected cell were a separate legal entity, even if the protected cell is not organized as an incorporated protected cell.²² This enhanced contracting capacity will help eliminate the uncertainty that has previously hindered the use of the protected cells and should facilitate the creation of reinsurance or risk pooling cells within a protected cell structure.

Conversion To or From a Protected Cell Captive Insurance Company

One of the strengths of the 2006 Amendments is the flexibility they give to the protected cell captive structure. Under the 2006 Amendments, a captive insurer already licensed in the District may amend its organizational documents to become a protected cell captive insurer upon receiving the approval of (i) two-thirds of the captive's shareholders and (ii) all of the creditors of the captive insurer.²³ Alternatively, the 2006 Amendments permit a protected cell captive insurer licensed under District law to cease to be a protected cell captive insurer and to become a traditional captive upon receiving the approval of (i) two-thirds of the captive's shareholders; (ii) all of the creditors of the captive insurer; (iii) two-thirds of the participants of each protected cell; and (iv) the Commissioner.²⁴ The 2006 Amendments also allow for a protected cell,

FEDERATION OF REGULATORY COUNSEL, INC.

including an incorporated cell, to transfer from one protected cell captive to another upon receiving similar shareholder, creditor and regulatory approval.²⁵ Furthermore, under certain circumstances, the revised legislation gives existing captive insurers the flexibility to become a protected cell of a protected cell captive and permits a protected cell to separate from its protected cell captive and become an independent captive insurer.²⁶

Best Practices and Captive Investments

In addition to expanding the law with respect to protected cell captive insurers, the 2006 Amendments continue to allow segregated cell captives to benefit from many of the progressive captive provisions already in place in the District. Perhaps the most innovative of these provisions is the "best practices" statute adopted in 2004 that enables the Commissioner to effectively keep up with advances in other captive domiciles. Under this provision, the Commissioner is empowered to authorize a captive insurer otherwise qualified to conduct business in the District to engage in any activity in any form permitted to a captive insurer in any other jurisdiction.²⁷ This broad authority allows the District to immediately capitalize on improvements in other jurisdictions' captive laws and avoid the lengthy process of amending its legislation every time a new innovation arises in the field. Moreover, the "best practices" statute enhances the Commissioner's ability to better meet the particular needs of individual captive insurers by enabling him to apply general provisions enacted in other jurisdictions to specific situations within the District. Current District law also provides investment flexibility in that any captive insurer may file a schedule of its proposed investments, and all material changes thereto, with the Commissioner, who shall approve the investments if he determines that they do not threaten the captive's solvency or liquidity.²⁸

Forming a Captive in the District

District law provides that in order to incorporate and obtain a license from the DISB, a captive insurer must apply for a certificate of authority with the Commissioner.²⁹ All applications must include a proposed copy of the captive insurer's organizational documents, a pro forma financial statement, a feasibility study and a strategic business plan.³⁰ Additionally, the DISB requires captive applicants to submit evidence of the following: the amount and liquidity of its assets relative to the risks it intends to assume; the expertise and experience of its managers; the overall soundness of its operational plan; the adequacy of the loss prevention programs implemented by its parent or member organizations; and satisfactory minimum capital and surplus requirements.³¹ Significantly, because it permits the Commissioner to issue both a simultaneous certificate of authority and a certificate of incorporation or organization for all business entities, District law creates a more streamlined and convenient filing process for applicants. Moreover, the District's captive laws also ease administrative burdens by providing that prior to final formation, the Commissioner may issue a provisional certificate of authority that enables a captive to engage in limited insurance and reinsurance activities while its application is pending with the DISB.³²

An application by a captive insurer or segregated account for a certificate of authority shall include a non-refundable application fee determined by the Commissioner, and in some cases the Commissioner may require an applicant to retain independent legal, financial, and examination services from outside the DISB to review and make recommendations regarding its qualifications.³³ If the DISB determines that the materials filed by the captive insurer or segregated account are complete and satisfactory, the Commissioner will issue an applicant both a final certificate of authority and a certificate of incorporation or organization within thirty days.³⁴ All licensed captive insurers or segregated accounts must renew their certificate of authority on an annual basis.³⁵ Further information regarding captive formation in the District is available at <http://www.disb.dc.gov/>.

Captive Powers

FEDERATION OF REGULATORY COUNSEL, INC.

Pursuant to existing law, a captive may be structured in any business form permitted in the District and can offer all types of insurance except for direct personal motor vehicle or homeowners' coverage.³⁶ A captive may also provide workers' compensation to its parent and affiliates unless prohibited by the laws of the state in which the insurance is transacted.³⁷ Similarly, a captive insurer or segregated account may take credit for the reinsurance of risks or portions of risks ceded to reinsurers in compliance with the District's Law of Credit Reinsurance Act of 1993,³⁸ which has the effect of lowering capital requirements.³⁹ To provide increased flexibility, however, District law also grants the Commissioner discretion to allow a captive to take credit for the reinsurance of risks that do not comply with the NAIC Credit for Reinsurance Act.⁴⁰ In addition, a captive insurer or segregated account may take credit for the reinsurance of risks or portions of risks ceded to a pool, exchange or association acting as a reinsurer which has been authorized by the Commissioner.⁴¹ The Act likewise enables a captive operating in the District to write insurance or reinsurance for parent or affiliate employee benefit plans subject to the Employee Retirement Income Security Act of 1974 ("ERISA").⁴² A captive may also pay dividends under an ongoing plan approved by the Commissioner if, at the time of payment, its retained capital exceeds the minimum statutory requirements.⁴³

Minimum Capital and Surplus Requirements

Once licensed, a captive insurer, including each segregated account of a protected cell captive insurer, operating in the District must at all times maintain minimum capital and surplus amounts. Although all captives must maintain a minimum unimpaired capital of \$100,000, the Commissioner may require additional unimpaired paid-in capital or surplus based on the type, volume, and nature of a captive's insurance business.⁴⁴ Both the capital and surplus minimums must be in the form of either cash or an irrevocable letter of credit.⁴⁵ A letter of credit used by a captive insurer or segregated account as evidence of capital or surplus shall be on a form approved by the Commissioner, automatically renewable annually, and issued by a bank that is chartered in the District or by a branch located in the District of a bank which is a member of the Federal Reserve, or insured by the Federal Deposit Insurance Corporation.⁴⁶

Requirements for Transacting Business

The District's captive law requires that a captive must merely maintain an office, as opposed to a principal place of business, in the District, appoint a registered agent in the District to receive service of process, and require its board of directors to meet in the District at least once a year.⁴⁷ Additionally, a captive must make adequate arrangements with a District bank, retain a pre-approved individual or business organization to manage its affairs, employ a qualified certified public accountant, contract with an attorney knowledgeable in captives who is licensed to practice law in the District, and obtain experienced actuaries to perform reviews and operation evaluations.⁴⁸ A segregated account maintained by a captive insurer must comply with these requirements for transacting business if it is organized as a separate legal entity.⁴⁹

In order to transact business in the District, a captive insurer must also pay annual premium taxes not later than March 2 of each year.⁵⁰ The minimum tax is \$7,500 on District captives and \$10,000 on risk retention groups, and the total tax paid by a captive insurer in any given year shall not exceed \$100,000.⁵¹

Except as provided under applicable law, District captives are not subject to any other insurance laws.⁵² In addition, unlike other insurance companies, captives are not required to either join or make financial contributions to guaranty funds or rating organizations.⁵³ Finally, captive insurers are exempt from the regulatory assessments imposed on insurers and health maintenance organizations under the District's Insurance Regulatory Trust Fund Act of 1993.⁵⁴

Annual Reports and Periodic Financial Examinations

FEDERATION OF REGULATORY COUNSEL, INC.

District law requires that each captive insurer operating in the District submit an annual financial report by March 2 of each year.⁵⁵ This filing must be prepared by a certified public accountant and in accordance with generally accepted accounting principles ("GAAP"), and a captive insurer must file a consolidated report on behalf of each of its segregated accounts.⁵⁶ Additionally, the Commissioner also retains the right to visit each captive insurer at any time he deems necessary to inspect the financial affairs of the captive insurer or any of its segregated accounts.⁵⁷ In conjunction with such an examination, the Commissioner may require a captive to employ qualified independent legal, financial and examination services from outside DISB to conduct inspections and make recommendations.⁵⁸

Conclusion

It is widely noted that the administrative benefits of a protected cell company structure can be significant. Once such a protected cell company is established, repeat transactions can be executed rapidly, as a new cell can be added at a fraction of the cost and time that would be needed if the structure were to be established from scratch. The District of Columbia's new protected cell legislation offers clear advantages over other domestic domiciles with respect to protected cell flexibility, including the choice of incorporated or unincorporated cells, the right of cells to transact with each other, and enhanced freedom in connection with the ownership, uses and operations of cells. Coupled with the innovative and progressive body of captive insurance law already in place in the District, the 2006 Amendments undoubtedly mark a cross into the next frontier of captive regulation and effectively establish the District as one of the most flexible and cutting-edge captive jurisdictions in the world.

Endnotes

1. Kathryn A. Westover, *Captives and the Management of Risk* 4-5 (2002).
2. Elizabeth R. Costle & Kathleen A. Shauer, *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 Ins. Advisor Monthly, Issue 11, Jan. 2002, at 22.
4. See, e.g.,
5. Arthur D. Perschetz, *The New D.C. Captive Act: A Creative Response to an Evolving Market*, FORC Quarterly Journal of Ins. Law and Regulation, Vol. XV, Ed. Vii, December 1, 2004.
6. Lori Widmer, *Protected Cells: The Next Generation Captive*, Risk & Ins., Oct. 1, 2000.
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*
11. Press Release, Government of the District of Columbia, Department of Insurance, Securities and Banking, *District Adopts New Captive Insurance Laws: Changes Will Give the District Competitive*

FEDERATION OF REGULATORY COUNSEL, INC.

Advantage as a Captive Domicile (Mar. 28, 2007)

12. *Id.*
13. D.C. Code § 31-3931.04(a)
14. *Id.* § 31-3931.04(b)(14)
15. *Id.* § 31-3931.04(a)(1)
16. *Id.* § 31-3931.04(a)(6)
17. *Id.* § 31-3931.04(a)(18)
18. *Id.* § 31-3931.04(a)(33)
19. *Id.* § 31-3931.04(a)(34)
20. *Id.* § 31-3931.04(a)(21)
21. *Id.* § 31-3931.04(a)(23)
22. *Id.* § 31-3931.04(a)(15)
23. *Id.* § 31-3931.04(a)(49)-(50)
24. *Id.* § 31-3931.04(a)(51)-(52)
25. *Id.* § 31-3931.04(a)(55)-(57)
26. *Id.* § 31-3931.04(a)(66)-(67)
27. *Id.* § 31-3931.02(c)
28. *Id.* § 31-3931.07
29. *Id.* §§ 31-3931.09(a); 31-3931.11
30. *Id.* § 31-3931.09(a)
31. *Id.* § 31-3931.09(b)
32. *Id.* § 31-3931.11(f)
33. *Id.* § 31-3931.09(c)
34. *Id.* § 31-3931.09(d)
35. *Id.*
36. *Id.* § 31-3931.02(b)

FEDERATION OF REGULATORY COUNSEL, INC.

- 37. *Id.*
- 38. *Id.* § 31-501 *et seq.*
- 39. *Id.* § 31-3931.08
- 40. *Id.*
- 41. *Id.*
- 42. *Id.* § 31-3931.02(9)
- 43. *Id.* § 31-3931.06(k)
- 44. *Id.* § 31-3931.06(a), (c)
- 45. *Id.* § 31-3931.06(b)
- 46. *Id.* § 31-3931.06(d)
- 47. *Id.* § 31-3931.11(c)-(d)
- 48. *Id.* § 31-3931.11(c)
- 49. *Id.* § 31-3931.11(e)
- 50. *Id.* § 31-3931.12

Annual District Tax Rules	Direct Business, Paid to the District	Assumed Reinsurance, Paid to the Mayor
First \$25 million	0.250%	0.225%
Next \$25 million	0.150%	0.150%
Over \$50 million	0.050%	0.025%

- 51. *Id.*
- 52. *Id.* § 31-3931.22
- 53. *Id.* §§ 31-3931.16; 31-3931.17
- 54. *Id.*
- 55. *Id.* § 31-3931.13(a)

FEDERATION OF REGULATORY COUNSEL, INC.

56. *Id.*

57. *Id.*

58. *Id.* § 31-3931.14(a)

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