FOR CAPTIVE REVIEW – ARTICLE ON CELL CAPTIVES
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Protected Cell Captives: ART for All Seasons

Captive insurance companies that are structured in separate protected cells provide great legal and financial benefits to their owners and occupants. But to the industry at large there is an equal marketing benefit: expansion of alternative risk transfer (ART) through lower cost of entry and often streamlined regulatory processes.

The number of captive entities has increased markedly since captives have been legally enabled to present themselves in protected cells – in effect, mini-captives spun off from a central core whose assets are protected from any liabilities of occupants of other cells.

With generally lower financial thresholds, lower management costs and usually quicker regulatory approval, the protected cell captive concept becomes attractive to smaller corporations or nonprofits as an efficient, convenient risk management strategy. The net effect is to broaden the market. While this report will not be weighted down with statistical landscapes, information about the growth of captives is readily available at www.captive.com or other sources.

And here's the point for timely consideration: in times of economic difficulty or turmoil, captives – and by extension the protected cell variety – become even more attractive. Even in the best of times they bring benefits as noted but are particularly engaging in times of tight capital or hardening commercial insurance markets.

In the U.S. we have recently experienced this market-broadening effect as our state domiciles began to adopt advanced captive regulations. Vermont and South Carolina provided segregated cell structures earlier this decade. The District of Columbia adopted its advanced regulations more recently, and Montana is currently working on its own approach to protected cell captives.

Protected cell captives are an outgrowth of the rent-a-captive concept that began as a bookkeeping function in Bermuda and Guernsey in the early 1980s. Soon the

industry asked domiciles for laws that would protect the assets of individual rent-a-captive units, and legislators complied. Suddenly a captive could make sense to a middle market or smaller organization as a way to test how the ART world could meet its needs.

Amendments to the District of Columbia captive law in 2006 provided the most advanced regulatory structure in the U.S., one that was frankly patterned after new laws that took effect the same year in Jersey and Guernsey. That moved Washington DC a step closer to its goal to become a world financial center in addition to its pivotal political position.

The DC law was shaped to provide the greatest possible security to firewalls separating cells from each other and the core captives, with the added convenience of incorporation. The law enables cells to take separate incorporated status and contract with each other or with the parent captive. In addition it allowed for conversion to protected cell status as well as transfers of protected cells between captives. The law enabled such applications as creation of super-cat or risk-pooling cells, securitization and enhanced rent-a-captive facilities.

So far, there have been no legal tests of the firewall surrounding a protected cell captive in DC or, as far as we know, elsewhere in the U.S. This could mean that the laws are well crafted, that risk management and actuarial projections have been prudent, or that the notoriously litigious American society has mellowed out. Somehow, we don't think it's the latter.

Early protected cell regulations restricted the practice to actual insurance companies that could offer "sponsored" cell captives. Companies such as CNA, Liberty, AIG and others formed such captives.

The DC law was the first to allow so-called "pure" protected cell captives that did not require sponsorship by an insurance company. This really opened up the market.

U.S. tax laws also have spurred development of protected cell captives. The IRS has proposed a regualtion that protected cell captives may receive a federal tax number for each cell and be taxed as if they were separate incorporated entities, and we expect it to be enacted early this year. DC's law adds the ability to form actual corporations as well as such virtual versions for tax purposes.

Another U.S. tax advantage to smaller captive cells is that an insurance company that receives less than $350,000 in annual insurance premiums is tax exempt, subject to certain restrictions.

Advanced captive laws have opened up the opportunity to establish a protected cell structure to virtually any entity subject to all the financial and regulatory requirements.

As DC is the world capital of trade and professional associations (more than 5,000 at last count) the protected cell captive structure has found broad acceptance in that environment.

Associations that provide sponsored insurance programs to their members are particularly well served. Just as one example, the American Society of Association Executives (ASAE) has multiple sponsored programs and, understandably, doesn't want liabilities to be spreading from one to another. By using a protected cell structure, the losses of any member association have no effect on any other member.

In an example of entrepreneurial ingenuity, ASAE also provides protected cells for unrelated organizations that may be small corporations or even other associations. There is no barrier to providing a risk management cell to any qualifying entity.

Associations in general have found resistance among members to join sponsored insurance programs because of the fear of sharing risk with other members, or even sharing information about their risks to competitors. With protected cells, proprietary information is protected along with any liabilities.

Similar opportunities exist among agents and brokers who provide protected rent-a-captive cells to their own blocks of business. Some actually participate in risks such as blocks of specific and aggregate coverage of employee benefits stop-loss insurance. They may also allow TPA clients to have their own cells for their clients' self-insured retentions.

Corporations find protected cell captives to be an easy way to separate property and casualty risk from employee benefit risk, for example. This structure also allows multinational companies to separate risks geographically or by subsidiary. Each cell can be capitalized to meet its own requirements.

Even with all of these benefits and all of the recent growth in advanced U.S. domiciles, the broader captive industry being built on the protected cell structure is still in its infancy. When you think about it, every corporation or nonprofit entity that buys insurance is a candidate for recruitment to the ART world.

And even with all we know now about ART-derived risk management solutions, the only certainty is that it will continue to evolve in future years to meet new challenges over the horizon.

It's for the best of times and the worst of times: it's ART for all seasons.

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