CAPTIVE & INSURANCE BUSINESS TRANSFER CONFERENCE

OKLAHOMA CITY

Protected Cell Captives

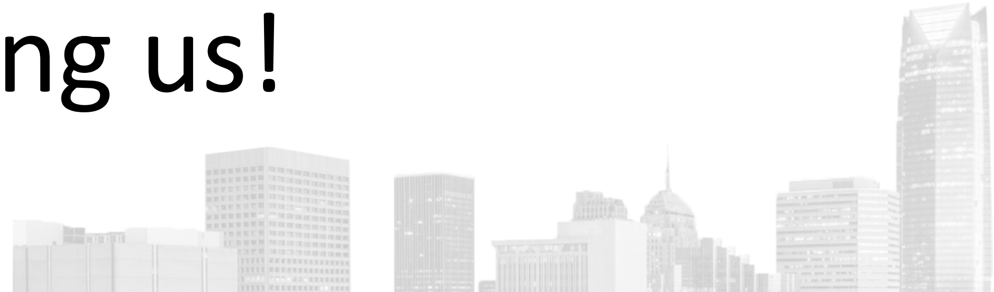
OKLAHOMA INSURANCE DEPARTMENT

WELCOME

We are glad you are here today

This is an interactive session
Please ask lots of questions

Thanks for having us!



YOUR PANEL TODAY

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Pro Group Captive Management Services

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Session Outline

- Insurance industry in transition
- State of the Industry
- Dynamic nature of industry and how cell’s respond
- Why use a Cell Structure
- What is a Cell
- Pros and Cons of Incorporated and Unincorporated Cells
- Cases Addressing Segregation of Assets and Liabilities
- Challenges and Opportunities
- Questions

The Case for a Cell Captive Insurance Company: The Insurance Industry is Undergoing Transition

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State of the Industry

- In 2021 the US program business sector grew to over $60 billion in GWP
- Talent is transitioning seeking out entrepreneurial opportunities
- Although distribution of insurance is consolidating, The risk business in general is growing in complexity and rapidly fragmenting
- New technological breakthroughs in medicine, manufacturing, data science and cloud computing, machine learning, resource extraction, and many other sectors is creating new business risk never before contemplated
- Companies have better information and resources to find creative ways to manage risk, better serve their customers, enhance productivity, and lower the cost of doing so

State of the Industry contd.

- Hard market conditions persist in areas such as natural catastrophe, public liability, and medical malpractice
- Emerging hard market conditions are effecting cyber, directors and officers liability, excess casualty, and equipment
- The “gig economy” is creating challenging conditions for traditional insurers ie. Employee or Independent contractor, work from home trends creating overlap in personal vs. commercial lines coverages
- Nuclear Verdicts are becoming more common as anti business sentiment exacerbated by the pandemic, is pervasive particularly in younger generations who want to “take a stand” against corporate greed and don’t view the value of money the way older generations do
- ESG trends are making certain coverages taboo ie. Energy, mining and logging, meat farming, etc.

Questions

Protected Cell Captives are more relative than ever and can help the insurance sector which is old and as an industry is slow in transitioning to the modern business world

How do Protected Cells take advantage of the dynamic nature of the industry?

- Protected cells can serve as incubators where ideas which are not fully developed can be tried, tested, and tweaked
- Changes typically only need approval from the PCC domiciliary regulator and can allow speed to market where business owners must sometimes adapt quickly to an economy in flux
- With almost 20 licensed fronting carriers, PCCs now have a necessary capacity infrastructure to aid in distribution and avoid licensing challenges
- PCCs can offer coverages which are hard to place or have become prohibitively expensive
- PCCs allow business owners to access international reinsurance markets and/or allow reinsurers access to direct business opportunities

Why not just have separate Captives?

- Especially important question for incorporated cell companies
- Fair question for any cell company
- Answer always the same:
  1. Sponsored structure = convenience
  2. Capital relief
  3. Economies of scale

So What is a Cell?

Definition	Subset of a corporation or LLC that can be treated for regulatory purposes, and sometimes for tax purposes, as a separate enterprise
Key Feature	Segregation of Assets and liabilities
Common Names	Segregated account, segregated portfolio, protected cell, series, Separate Accounts Company, Sponsored Captive
Analogy	Pure Captive = House Cell = Condominium

How do they work?

- Sponsor forms company
- Company gets licensed as protected cell captive insurance company
- Participant forms protected cell
  - ❖Contract between company and participant
  - ❖Governing instrument
  - ❖Separate application and license
- Company Allocates assets and liabilities to cell
  - ❖Maintains separate books and records
- Company acts "for and behalf of" cell

Protected Cells Are Not Separate Legal Entities

No Indicia of separateness

- Formed by contract, not by filing
- Cannot contract in its own name
    - ❖Company acts “for and on behalf”
- Cannot sue or be sued in its own name
    - ❖Pac Re
- Cannot participate in mergers

Common mistake: Protected cells = “Subsidiaries”

Series

- More than cell, less than a separate entity
- Indicia of separateness
  - Sue and be sued in own name
  - Contract in own name
  - Hold property in own name
- Formed under entity law rather than insurance law

Questions

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Incorporated Cells

- May be organized in any form permitted by the Commissioner (e.g., corporation, LLC)
- Is a "separate person" that may contract and sue and be sued in its own name
- Bound to the protected cell company via participation agreement – Generally Legal Counsel draws up
- Has its own Board of Directors, officers and register agent

Continuum of Cell Types and Characteristics

Minimum → Maximum

Separation
Protection from Liability
Capacity to Act on Own Behalf

Account	Unincorporated Cell (aka – Protected Cell)	Series	Incorporated Cell

Pros and Cons of Incorporated, Unincorporated Cells and Series

Pros and Cons of Unincorporated Cell

Pros	Cons
Capital Support	
Easy to set up	Lack of Control • Change in business plan • Investments • Dividends
Economy of shared captive services	Generally must use designated service providers
Can be used as incubator before forming owned captive	
Way to segregate risks within or between organizations without cost of forming and operating multiple captives	Segregation of cells not fully tested in court Enforceability of contracts between cells subject to some uncertainty

Pros and Cons of Series

Pros	Cons
Segregation is more certain • Separation is under the Entity Law, not the Insurance Law	Not easily portable
Series may contract with one another	Premium taxes increasing
Flexibility and options to customize • Protect or expose core capital (that is, you can choose open or closed) • Separate board or managed by core	Challenges opening accounts
	Sponsor retains much control
	Regulatory burden increases as indicia of separateness increase

Pros and Cons of Incorporated Cell

Pros	Cons
Segregation is more certain • Requires "piercing the corporate veil" • Test to pierce corporate veil applies in most jurisdictions	
Cells may contract between one another	
Own board and own governance	Own board and own governance
Owners may have greater control over cell	Participation Agreement may limit control
Portability	
	Premium taxes may be higher

Cases Addressing Segregation of Assets and Liabilities

Cases Addressing Segregation of Assets and Liabilities

- Bermuda cases
  - Tensor Endowment LTD. V. New Stream Capital Fund Ltd. (Sept. 23, 2010)
    - Insolvent hedge fund
    - Segregation of accounts not main issue but upheld
  - In the Matter of CAI Master Allocation Fund, Ltd (Sept. 26, 2011)
    - Segregation is "not merely a corporate veil but a statutory "Iron Curtain…"
    - "Compelling equitable grounds" such as fraud might be reason to depart from segregation
- Ambac Segregated Account
- Pac Re
  - Unincorporated cell
  - Beneficial owners of cell also owned core
  - U.S. Dist. Ct. Mont. Respected segregation but arbitration panel did not
  - U.S. Dist. Ct. S.D.N.Y refused to set aside arbitration decision

Designing PCCs to Avoid Trouble

Who will be motivated to sue?

Where can they sue?

Indemnification for sponsors

Business Cases

Business Case 1: Surety Capacity Solutions

- Following the 2008 Recession, credit criteria from corporate surety companies were tightened leaving many small trade contractors without the ability to pursue bonded work
- The PCC was formed to give these businesses capacity with a more flexible and broader underwriting approach
- Customized bond forms were developed to create more narrow and often clearer principal and beneficiary contractual obligations and create a fair tripartite agreement for smaller less capitalized principals
- Construction industry veterans were used in underwriting, risk management, and claims handling
- The PCC successfully navigated the pandemic due to having a low cost model which could quickly be adapted to changing business conditions

Business Case 2: Pet Professional Insurance

- The Pet Economy is a rapidly growing, highly resilient area of our economy and is expected to increase at a steady pace
- New pet businesses are being dreamed up faster than the insurance industry can fully evaluate them and PCCs were used to fill in while the standard market got comfortable
- The Gig economy created uncertainty and potential overlap with personal lines coverage where a PCC was able to deal with overlap with manuscript policy provisions
- Although Pets are property, the industry was perceived by pet professionals as not being sympathetic to the important place they served in society - they are Family to many pet owners
- Many insureds lacked sophistication and robust business infrastructure and the PCC was a good place for them to grow and transition
- The more direct link between underwriting and claims professionals in the PCC and the pet business owners created a higher service standard

Questions

Business Case 3: Cannabis Industry

- The cannabis industry is dynamic and changing by the day. Federal vs. State legal status created uncertainly and confusion
- The industry has been reluctant to provide coverage on an occurrence basis
- Often coverage could be changed multiple times in a policy period where legislatures are quickly modifying their cannabis laws
- Due to the pervasive nature of the “black market” self policing by insureds could be better accomplished in a PCC helping preserve insurance capacity in more challenging markets
- Claims data is difficult to come by. A major factor in feasibility is understanding IBRR (incurred but reluctant to report)
- Risk management is necessary. Property in the form of finished stock is high value subject to enhanced theft risk and greater likelihood of larger losses compared to other agriculture products. Chemicals in processing are new and it may be difficult to have adequate information about their long term effects on health and the environment
- Underwriters and captive participants can share information which would not happen in an arms length relationship
- The PCC provided much needed capacity when new legislation was passed by states or municipalities before the traditional market was comfortable with the risk profile and had time to develop rate, form, business processes, and received the multiple regulatory approvals necessary to begin offering the new coverage

Challenges and Opportunities

Challenges

- The IRS and other taxing authorities have taken interest in captives and have, in many cases, developed the view that they are simply a tax avoidance vehicle
- State Regulators have not taken a uniform approach to captives and how they are regulated
- The NRRA (non admitted and reinsurance reform act) left more questions than answers and has left captives exposed to inconsistent regulation and taxation
- Many agents and brokers are restricted from doing business with captive insurers do to restrictions from their E&O carriers
- The law concerning PCCs lacks supreme court precedent and rating organizations such as AM Best view the lack of legal certainty negatively

- The market in many areas will continue to harden and business owners may be able to save their companies by establishing a PCC
- Niche coverages can be brought to market quickly
- Many companies are expanding internationally and PCCs may help facilitate risk transfer with the uncertainty that that expansion brings
- Reinsurance Capacity which can be accessed by the PCC will create efficiency and savings to the business owner and help fill in coverage gaps
- The PCC sector will help keep the standard market in check as the captive industry grows and the barriers to entry are lowered
- PCC are perfect place for entrepreneurs building MGAs, TPAs, and administrators to differentiate themselves

Questions

Raise your hand to ask a question

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