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# A Guide to Cell Captives

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# Agenda

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- ▶ Cell captive insurance evolution
- ▶ Domicile and structure differences
- ▶ The benefits of using a cell captive
- ▶ DC: an example of a cell captive law
- ▶ Accounting and tax issues
- ▶ Best practices
- ▶ The latest developments in cell captives

# Cell Captive Insurance Evolution

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- ▶ Offshore Rent-a-captives
- ▶ 1991 – Bermuda Separate Accounts Co.
- ▶ 1997 – Guernsey Protected Cell Co.
- ▶ 1999 – Vermont Sponsored Cell Captives
- ▶ 2000 – Bermuda Segregated Account Co.
- ▶ 2000 – South Carolina Protected Cell
- ▶ 2002 – BVI Segregated Portfolio Co.
- ▶ 2005 – Jersey Incorporated Cell Captive
- ▶ 2006 – DC Incorporated Cell Captive
- ▶ 2009 – Delaware Series LLC

# Where in the World – Cell Domiciles

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## US Onshore

Arizona

Delaware

District of Columbia

Hawaii

Kentucky

Montana

Nevada

South Carolina

Utah

Vermont

## N. America Offshore

Anguilla

Bahamas

Bermuda

British Virgin Islands

Cayman

St Lucia

## Europe

Gibraltar

Guernsey

Isle of Man

Jersey

Malta

## Rest of World

Dubai

Mauritius

Namibia

South Africa

Guam

Vanuatu

# Differences Between Domiciles

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- ▶ Capital Requirements
- ▶ Limitations on Business
- ▶ Sponsor
- ▶ Corporate Structure
- ▶ Core Liability
- ▶ Cell to Cell Agreement
- ▶ Incorporated Cells

# Variously known as:

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- ▶ Protected Cell Company
- ▶ Segregated Cell Company
- ▶ Incorporated Cell Captive
- ▶ Segregated Accounts Company
- ▶ Sponsored Captive Insurance Company
- ▶ Segregated Portfolio Company
- ▶ Special Purpose Vehicle
- ▶ Special Purpose Financial Captive

# Semantics or Substance

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Separate Account, Segregated Account,  
Segregated Portfolio, Sponsored Captive,  
Protected Cell, Incorporated Cell, Series LLC

- ▶ So many alternatives.....
- ▶ Are they really one and the same at the end of the day?
- ▶ Which is the best alternative?

# Who Uses Cell Captives

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Most of Today's Cell Growth is Profit Center Focused

- ▶ Insurance Company Owned
- ▶ Insurance Produced Owned
- ▶ Associations
- ▶ Entrepreneurs
- ▶ Single Parent Captives

# Cell Advantages

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- ▶ Can be Less Expensive to:
  - Organize
  - Capitalize
  - Cost Sharing of Service Providers
- ▶ Turn Key Operation
- ▶ Rapid Implementation
- ▶ Use someone else's capital

# Benefits of Segregated Accounts

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- ▶ Helps insulate the assets and liabilities of independent insureds
- ▶ Ensures individual cell assets will remain secure and protected from creditors of other cells or parent captive
- ▶ Guards against harmful effects of adverse selection, losses and underwriting by creating a regulatory and accounting wall around individual cells

# District of Columbia Captive Law

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## Liability of Segregated Cells and Parent Captive

- ▶ Enables any individual or entity to organize a separate cell captive
- ▶ Captive assets must be classified as either “segregated account accounts” or “general assets”
- ▶ Permits segregated cell captives to form one or more protected accounts to insure individual risks of independent insureds
- ▶ Segregated assets can only be used to satisfy creditors’ claims with respect to a particular protected cell
- ▶ General assets of captive insurer not attributable to an individual cell will only be used to satisfy captive liabilities to the extent that such liabilities exceed existing statutory minimum capital requirements

## District of Columbia Captive Law:

# Cells and Cell Companies

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- ▶ Meaningful legal description of the relationship between core and cell and cell and cell in D.C. law
- ▶ Two Types of Cell Companies
  - Protected Cell Companies (PCC)
  - Incorporated Cell Companies (ICC)
- ▶ Two Types of Cells
  - Protected Cells (PC) – defined legal characteristics
  - Incorporated Cells (IC) – own legal identity
- ▶ DC law clearly defines the relationship of each type of cell to core
  - Incorporated Protected Cell means a protected cell that is established as a corporation or other legal entity from the protected cell captive insurer of which it is a part
  - Protected Cell means a separate account established and maintained by a protected cell captive insurer

## District of Columbia Captive Law:

# Key Points

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- ▶ Agreements between cells specifically permitted
- ▶ A Protected Cell of a PCC may enter into an agreement with the PCC or a cell of the PCC that shall be enforceable as if each cell of the CC were a separate legal entity
- ▶ Protected Cell (PC and IC) may transfer from one protected cell captive to another
- ▶ Existing captive insurer may become a protected cell of a protected cell captive
- ▶ A protected cell may leave protected cell captive and become a stand alone captive
- ▶ A PCC may issue one or more classes or series for one or more cells – proceeds to cell

# Other Examples of Incorporated Cell Companies

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- ▶ Commercial Program
  - Formed by property – owner manager
  - cell for own property
  - cell for joint ventures
  - cell for third parties
- ▶ Builders Risk Insurance
  - Formed by Agent
  - Banks require lender/builder to carry insurance
  - Fronted program with banks assuming layer of risk
- ▶ Nursing Homes
  - Formed by owner of various facilities
  - Cell for owned facilities
  - Provide and manage cells for other non-owned facilities
- ▶ REIT
- ▶ Life Insurer

# Accounting Aspects of Cell Captives

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- ▶ Each protected cell must be accounted for separately on the books and records of the captive.
- ▶ Annual filing of financial statements detailing financial experience of each protected cell

# Financial Reporting

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- ▶ Financial reporting not yet consistent, may be domicile specific
- ▶ Cell structure is unique under U.S. GAAP and International Accounting Standards (IAS)
- ▶ No particular authoritative literature available at this time
- ▶ Possibility of inconsistent reporting
- ▶ Financial statement user needs may not be met
- ▶ Results of reporting may be insufficient for the purpose needed

# Historical Cell Presentation Styles

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- ▶ Columnar format presents separate columns on the statements and in the footnotes for the core and for each individual cell or series
- ▶ Singular summarizes all segregated cell/series, liabilities and equity as a line item within the asset and liability balances on the balance sheet. Only the core income statement items disclosed.

# Weaknesses

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## ▶ Columnar

- Proprietary and confidential information may be inadvertently disclosed
- Complicated presentation style

## ▶ Singular

- Unlikely to meet user needs

# Sample Balance Sheet

	Sponsor	Cell #1	Consolidated	Cell #2	Cell #3
<b>ASSETS</b>					
Cash and Cash Equivalents	753,373.26	3,608,475.41	4,361,848.67	100,000.00	100,000.00
Funds Withheld	-	-	-	180,000.00	-
Insurance Balances Receivable	-	300,826.42	300,826.42	50,000.00	100,000.00
Prepaid Expenses	4,140.94	10,000.00	14,140.94	-	-
Due from Other Entities	87,768.28	348,139.34	435,907.62	-	183,333.00
Federal Income Tax Receivable	30,000.00	-	30,000.00	-	-
Reinsurance Recoverable on Paid Losses	-	985,936.27	985,936.27	55,000.00	-
Cell 2: Total Assets	-	-	385,000.00	-	-
Cell 3: Total Assets	-	-	383,333.00	-	-
<b>TOTAL ASSETS</b>	<b>875,282.48</b>	<b>5,253,377.44</b>	<b>6,896,992.92</b>	<b>385,000.00</b>	<b>383,333.00</b>
<b>LIABILITIES, CAPITAL AND SURPLUS</b>					
<b>LIABILITIES</b>					
Payables and Accruals	128,845.67	108,510.90	237,356.57	30,250.00	203,500.00
Losses Payable	-	307,396.63	307,396.63	-	-
Reinsurance Premium Payable	-	81,143.32	81,143.32	55,000.00	153,291.28
Loss Reserves	-	1,163,970.00	1,163,970.00	100,000.00	-
Cell 2: Total Liabilities and Capital & Surplus	-	-	385,000.00	-	-
Cell 3: Total Liabilities and Capital & Surplus	-	-	383,333.00	-	-
<b>TOTAL LIABILITIES</b>	<b>128,845.67</b>	<b>1,661,020.85</b>	<b>2,558,199.52</b>	<b>185,250.00</b>	<b>356,791.28</b>
<b>CAPITAL AND SURPLUS</b>					
Contributed Surplus	762,500.00	2,810,211.15	3,572,711.15	25,000.00	-
Retained Earnings	(16,063.19)	782,145.44	766,082.25	174,750.00	26,541.72
<b>TOTAL CAPITAL AND SURPLUS</b>	<b>746,436.81</b>	<b>3,592,356.59</b>	<b>4,338,793.40</b>	<b>199,750.00</b>	<b>26,541.72</b>
<b>TOTAL LIABILITIES, CAPITAL AND SURPLUS</b>	<b>875,282.48</b>	<b>5,253,377.44</b>	<b>6,896,992.92</b>	<b>385,000.00</b>	<b>383,333.00</b>

# Sample Income Statement

	Sponsor	Cell #1	Consolidated Total	Cell #2	Cell #3
<b>UNDERWRITING INCOME:</b>					
Net Premiums Earned	-	4,725,663.06	4,725,663.06	1,375,693.68	3,854,227.30
<b>UNDERWRITING EXPENSES:</b>					
Total Losses Incurred	-	3,178,661.86	3,178,661.86	251,714.00	3,369,377.87
Policy Acquisition Expenses	-	39,666.38	39,666.38	89,393.87	19,782.00
<b>TOTAL UNDERWRITING EXPENSES</b>	<b>-</b>	<b>3,218,328.24</b>	<b>3,218,328.24</b>	<b>341,107.87</b>	<b>3,389,159.87</b>
<b>UNDERWRITING INCOME</b>	<b>-</b>	<b>1,507,334.82</b>	<b>1,507,334.82</b>	<b>1,034,585.81</b>	<b>465,067.43</b>
Interest Income	-	-	-	111.66	-
Participation Fee Income	112,511.97	-	112,511.97	-	-
Operating Expenses	128,575.16	595,434.78	724,009.94	77,194.97	78,263.07
<b>LOSS BEFORE TAXES</b>	<b>(16,063.19)</b>	<b>911,900.04</b>	<b>895,836.85</b>	<b>957,502.50</b>	<b>386,804.36</b>
Federal Income Tax	-	129,754.60	129,754.60	-	-
Net Loss	(16,063.19)	782,145.44	766,082.25	957,502.50	386,804.36
Cell 2: Net Income	-	-	957,502.50	-	-
Cell 3: Net Income	-	-	386,804.36	-	-
<b>TOTAL NET INCOME (LOSS)</b>	<b>(16,063.19)</b>	<b>782,145.44</b>	<b>2,110,389.11</b>	<b>957,502.50</b>	<b>386,804.36</b>

# Tax Considerations of the Cell Captive

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- ▶ Qualification as an insurance company depends primarily on:
  - Presence of insurance risk
  - Risk shifting
  - Risk distribution

# U.S. Tax Analysis of Cell Companies

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- ▶ Single Taxpayer? Or
- ▶ Multiple “mini-corporations?”
- ▶ Is Risk Sharing and Insurance Tax Treatment Determined on a Cell-by-Cell or on a Company-Wide Basis?
- ▶ Cell tax structure evolving from historically vague approach to focus on individual cell

# Forming a Cell Captive: Best Practices

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- ▶ Follow domicile Law
- ▶ All accounts in domicile depository
- ▶ Separate account for each cell
- ▶ Designate all disputes to be resolved in domicile
- ▶ All original books and records in domicile
- ▶ All company actions, board meetings, policy discussion to take place in domicile

# Latest Developments

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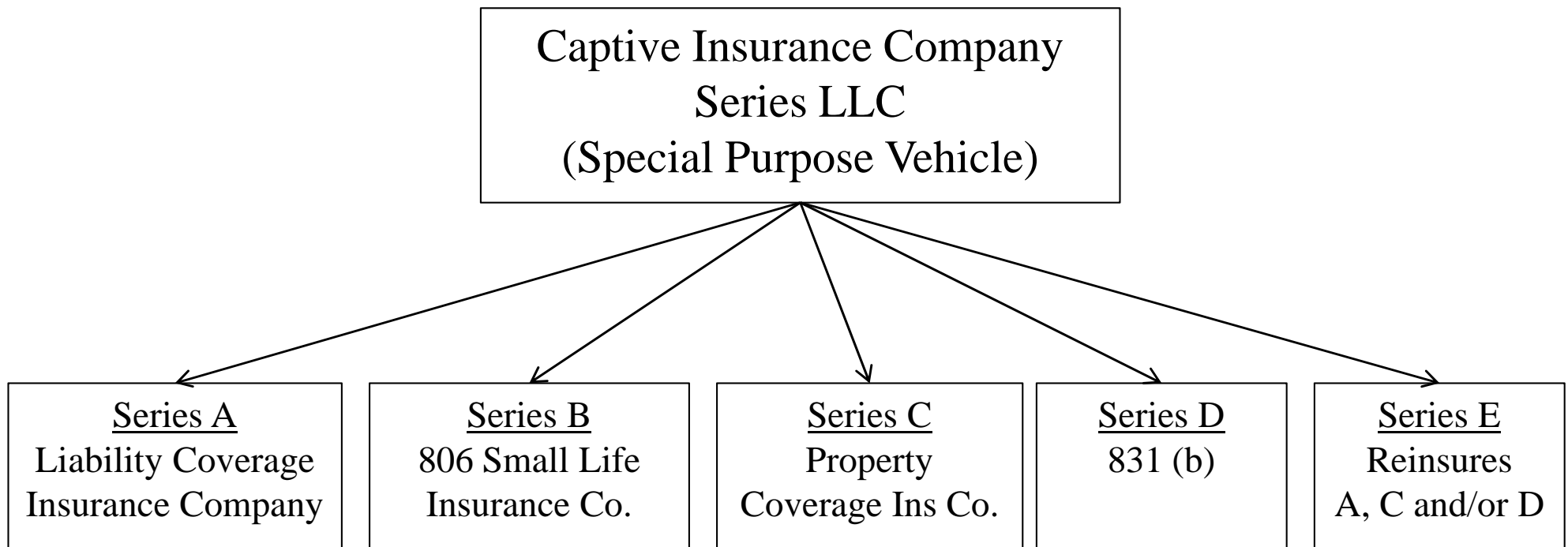
- ▶ Serial LLC
- ▶ Incorporated Cell being enacted by many states
- ▶ IRS Tax opinion supporting captives

# Series LLC or Trust

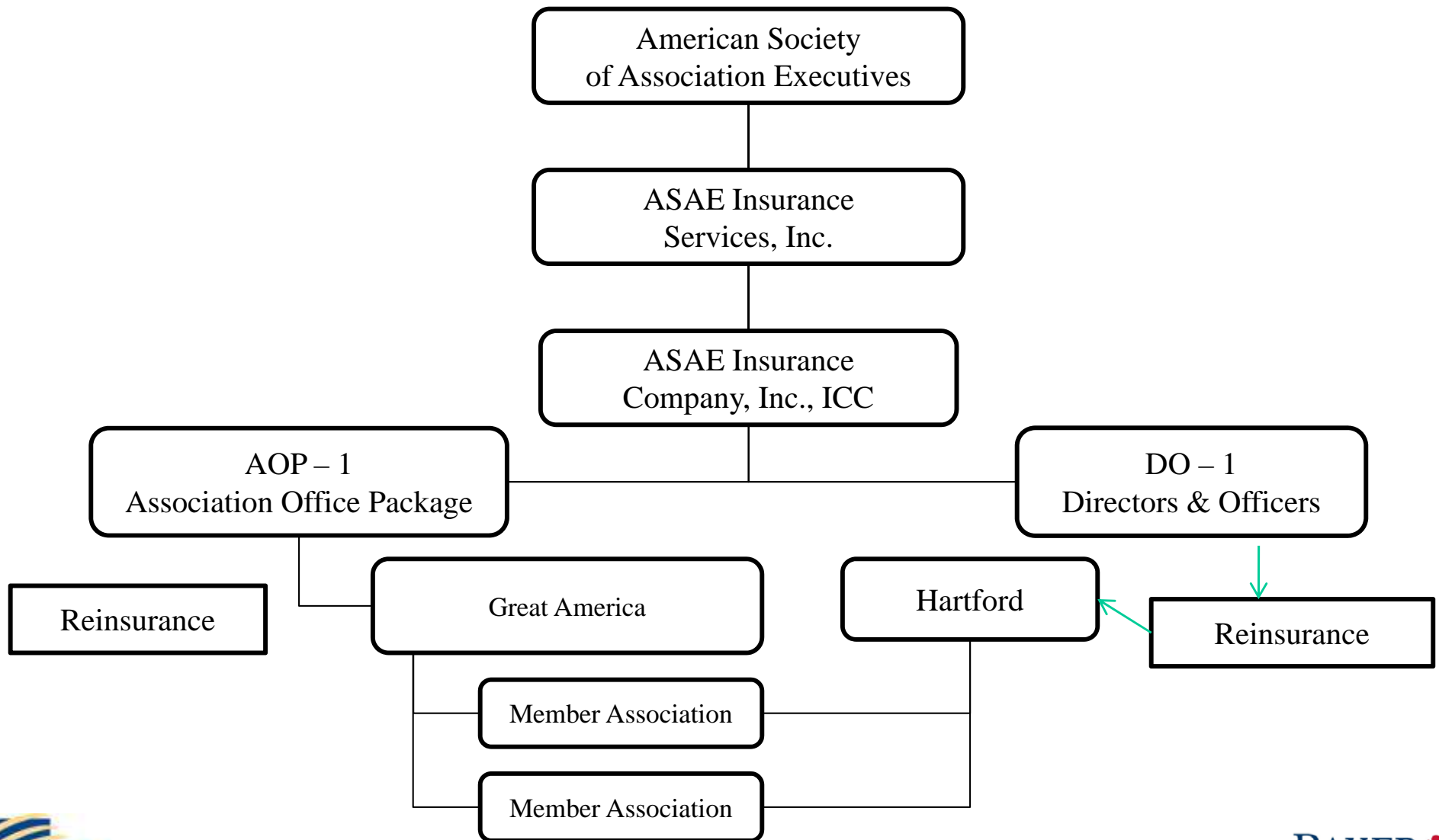
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One entity  
Flexible governance & economics  
Separation of Series

One premium tax  
Lower O&M expenses  
Freedom of contract



# Example of Incorporated Cell Captive



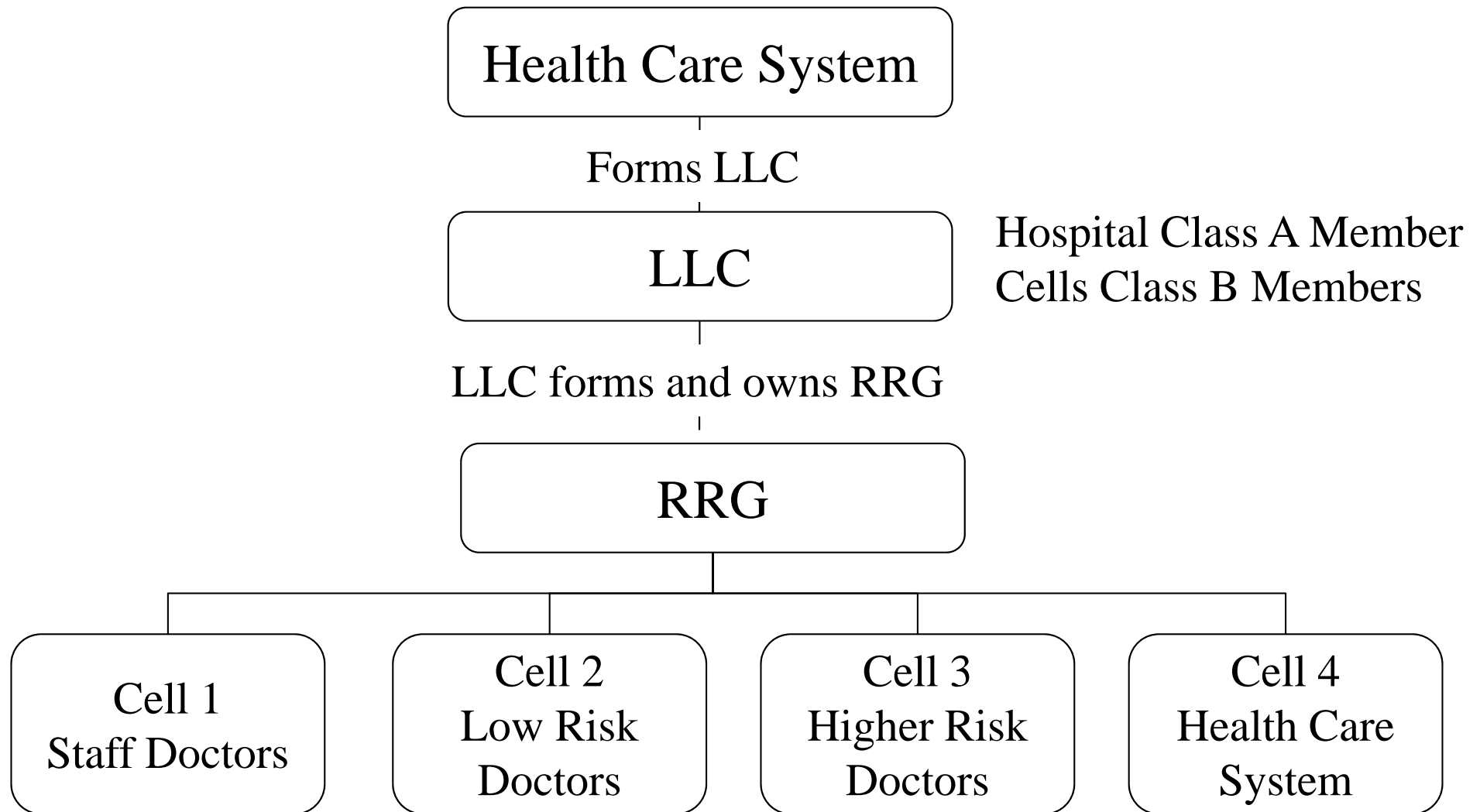
# The Future

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- ▶ Litigation challenging cell structure
- ▶ Segregated Cell Risk Retention Groups
- ▶ New and even more creative cell legislation and use

# Segregated Cell RRG - Alternative

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# Questions and Answers

## Experience

For the past 15 years, Strategic Risk Solutions (SRS) has earned the reputation as the “go to” firm for designing and managing captives. Our senior management has an average of 15 years experience in dealing with all facets of the alternative market. Our flat management structure results in quick turn around of consultative reviews and captive creations. SRS has experience in managing all types of captive facilities including:

- Single Parent Captives
- Risk Retention Groups
- Industrial Insured Groups
- Segregated Cell and Sponsored Captives
- Branch Captives
- Not-for-Profit Health Care Captives
- Special Purpose Captives

We have clients in all sectors including healthcare, energy, professional services, retail, transportation and manufacturing industries.

## Independence

SRS provides its clients with an independent team focused on service, value and creativity. The structure allows for the captive to be managed separate and distinct from insurer/brokerage relationships thus eliminating conflicts of interest while allowing for maximum transparency and customer flexibility in managing all aspects of the risk management program. The separation of roles and responsibilities also abides by Sarbanes-Oxley recommended independence guidelines.



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## Innovation

SRS continues to examine creative ways for companies to retain more risk while optimizing use of economic risk capital. As an example, SRS was instrumental in the development and ongoing management of the **Columbia Energy/NiSource** Long-Term Disability program which was the first successful single parent captive to reinsure employee benefits with less than 50% unrelated business.

## Breadth of Services

SRS is a fully staffed onshore and offshore captive manager with offices in:

- Arizona
- Bermuda
- Boston
- Cayman
- South Carolina
- Vermont

## Life Cycle Approach to Captives

SRS can assist clients in all facets of captive development from pre-feasibility through formation and on-going management. Activities often include:

- Pre-feasibility assessment
- Full feasibility study
- Formation/Business plan development
- Regulatory liaison
- On-going management
- Policy development
- Strategic planning
- Data/technology integration

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## Our Firm at a Glance

At Baker & Daniels, some things are not negotiable. Honesty. Integrity. Quality. Respect. Trust. Since 1863, clients have entrusted us with their legal and consulting needs. We have honored that trust every day with courtesy, care, and commitment. Our goal is to distinguish ourselves by unmatched client service. Our team of professionals offers a creative approach based on what matters most to each client. When it comes to effective counsel, there are no substitutes for experience and trusted relationships.

### Our Services

A firm is only as good as it is able to understand and respond to clients' needs. Since the beginning, Baker & Daniels has steadily grown to meet the challenges of the times. Today, we offer integrated services in more than 40 practices and industries.

### Captive Insurance Services

Baker & Daniels' insurance and financial services professionals assist clients with the formation and management of captive insurance companies, risk retention groups (RRGs) and other alternative risk mechanisms. Our professionals:

- Advise and assist state insurance regulators.
- Evaluate the form of captive (pure, association, protected cell, etc.).
- Prepare corporate and transactional documentation.
- Consult on a business plan, including product and reinsurance programs.
- Advise on corporate governance, securities law and tax requirements.
- Monitor the captive operating plan and results to ensure regulatory compliance.
- Advise on rating agency issues and implications.
- Form incorporated cell, protected cell, and serial LLC captives.

### Our Clients

Baker & Daniels is committed to delivering the highest standard of business and legal services to our most important asset – our clients. Whatever the industry and whatever the business endeavor, our legal professionals stay current on the laws. One of the ways we keep our clients informed is through practice-specific alerts and newsletters. They are structured to provide timely, succinct (and occasionally entertaining) legal developments, case analysis and pending legislation.

Our professionals also develop informative seminars and webinars on various topics. They are frequent speakers at conferences and meetings across the country – and sometimes in other parts of the world. From Fortune 500 corporations to regional businesses, local governments, nonprofit organizations and individuals, our clients are always No. 1 with us.

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