



# Warning: do not try this at home!

The series captive insurance company in Delaware takes cell-type captive structures to another level of flexibility and premium efficiency

by *Jeff Simpson and Randall Beckie*

**I**n January 2010 when Delaware announced that it had licensed the world's first series limited liability company (LLC) captive, the reaction in the captive insurance industry was to wonder what that is.

A series LLC captive bears similarity to a protected cell captive: the LLC is a separate legal entity that can form one or more series business units (SBUs) that are not separate legal entities but which can have limited liability and operational independence, much like a protected cell.

The differences between a series LLC captive and a protected cell captive include:

- A series captive insurance company (which could be an LLC or another form of legal entity, such as a statutory trust) may enjoy more flexibility to define its governance mechanisms and more certainty as to the

enforceability of those tailor-made arrangements, than a traditional protected cell captive might have;

- Whereas a Delaware protected cell captive is subject to premium tax at the cell level, a series LLC captive is not subject to premium tax at the SBU level;
- A series LLC captive can be designed (if desired) for simpler administration than a protected cell captive. For example, one annual meeting of a single board of managers could satisfy the minimum governance requirements of the LLC as well as its SBUs.

#### What is a series entity?

A series entity (typically an LLC or a statutory trust) is formed under a law that permits intra-entity segregation of assets,

liabilities or ownership into separate pools called series (we call them series business units).

Series entity law protects the assets of one SBU from the debts and obligations of other SBUs. Relatively few states, including Delaware, provide for such 'serialisation' of non-corporate entities. Under Delaware law, several types of alternative (non-corporate) entities, most prominently LLCs and statutory trusts, can have series. Delaware series entities are commonly used as investment fund vehicles.

Legally, SBUs differ from cells in that SBUs exist pursuant to alternative entity laws and not pursuant to the captive insurance statutes that define protected cells. Protected cell captive statutes generally link back to the traditionally rigid governance requirements of corporation law. Some jurisdictions, including

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Delaware, allow a non-corporate entity, including a series entity, to obtain a captive insurance licence.

Delaware alternative entity law tends to favour freedom of contract and generally allows parties to structure the governance of their entities in the manner they wish. The upshot is that series captive insurance companies enjoy the flexibility of the alternative entity law under which they are created as well as advantages afforded by the captive insurance law under which they are licensed.

Delaware's recent distinction is to be the first domicile to issue a captive insurance licence to a non-corporate series entity, specifically a series LLC.

### Belt and suspenders

Several years ago, when Delaware attorneys were drafting the state's current captive insurance statute, they attempted to maximise the law's ability to accommodate the creative problem-solving needs of captive insurance regulators and captive owners.

Various features of the statute are designed to afford flexibility, such as the allowance for captive licensure of non-corporate entities and the authorisation of protected cell companies and 'special purpose' captives, among other types of captive insurance companies. Knowing that segregating assets and liabilities in a protected cell had not yet been tested in court, the statutory draftsmen anticipated that benefits might be found in coupling a series entity with a protected cell company statute.

The idea was that because series entity law can be used to cabin liability within an SBU, as with a protected cell, a series entity could be licensed as a protected cell captive, each SBU paralleling a protected cell, with the result that both series entity law and the protected cell

company statute could segregate liabilities, if challenged. This was intended as a belt-and-suspenders option for protected cell captives.

Delaware's protected cell captive statute imposes premium tax (including minimum premium tax of \$5,000) on each cell captive. This ultimately presented a problem for those who sought the advantages of a protected cell structure but (owing to the small scale of each cell) found it infeasible to incur premium tax at the cell level.

So, drawing on the flexibility in Delaware's captive statute and alternative entity laws, lawyers made the case to Karen Weldin Stewart, Delaware's insurance commissioner, that a series LLC could obtain a licence as a special purpose captive insurance company, without being a protected cell company, thereby achieving intra-entity partitioning of assets and liabilities but avoiding the assessment of premium tax at the cell level.

After weighing the statutory issues and policy considerations, the commissioner agreed. Thus the concept of a series LLC captive took on a life of its own, essentially duplicating the function of a protected cell captive arrangement but dispensing with the cell-level premium tax burden.

Delaware's protected cell company statute was designed to impose premium tax at the cell level to avoid premium tax-driven incentives for forming protected cell companies (in other words, to prevent a rush into forming protected cells in lieu of more appropriate captive arrangements thereby undermining Delaware's revenue from other types of captives).

However, through 2009 there were few applicants wanting to form protected cell companies in Delaware and therefore the state faced no loss of premium tax revenue by allowing the formation of a series LLC captive. At this stage, it appears that Delaware is aiming to accommodate the

formation of more series LLC captives. Indeed several more are in the pipeline.

Stewart retains discretion for approval of each new series captive. To date, each proposed new series LLC captive formation seeks to optimise the ownership structure of related captive insurance enterprises that would operate under the same roof. Arguably the public policy objective of Delaware's growth as a captive insurance domicile is bolstered rather than undermined by licensing series LLC captives.

Until other jurisdictions adopt rules allowing a series entity to obtain a captive insurance licence, forming a series LLC captive remains a choice that is peculiar to Delaware. Because a series LLC captive becomes viable at the crossroads of Delaware's series entity laws (which are complex) and captive insurance statutes, forming one is not something you should try to do at home. To form a series LLC takes the right statutes, the right regulatory environment and the right professional advisors.

### Perfect partners

Ideal transactions for a series entity captive are similar to those that could work in a cell captive. One example involves enabling each participant in a group captive arrangement to set up its own SBU as the participant. Another is ceding a captive's premiums to multiple series reinsurers or retrocessionaires that could be owned by interested or related parties and offer tax advantages or wealth transfer advantages. A third is forming joint venture captives.

Series entities can house any number of coverages or be put to any number of uses, possibly all at the same time. They can simply mimic cell companies, and they can be rent-a-captive vehicles or pooling vehicles. Series entities can house programmes for related parties or

unrelated parties. And the law is flexible enough that they might house both insurance businesses and non-insurance businesses, potentially without compromising or complicating the tax treatment of either.

**Organisational advantages**

Organisationally, a series entity captive offers versatility for governance and structuring. Series entity captives can be organised to minimise the formalities and administrative requirements of adding, terminating or maintaining SBUs.

Series entities can be structured to limit or eliminate fiduciary duties. This may be advantageous over more restrictive corporate forms.

**Regulatory advantages**

The series entity provides the cell-like framework of a protected cell captive with the added flexibility of a special purpose captive. For a series entity licensed as a special purpose captive, minimum capital and surplus is \$250,000, not \$500,000 as for a protected cell captive. Minimum capital and surplus in a series entity can be segregated so it is not exposed to liabilities of an insolvent SBU.

Many US states, including Delaware, impose restrictions on ownership of sponsored captives and on sponsored captives' investments, but such are avoidable by licensing a series entity as a special purpose captive.

**Premium taxation**

In jurisdictions where no captive premium tax applies, a captive's purchase of insurance coverage from a US commercial reinsurer subjects the commercial reinsurer to state premium tax.

However, if premium that goes to the commercial carrier comes from a captive that has already paid captive premium tax on premiums that the captive received directly from the insured, no further premium tax would apply to the commercial carrier's reinsurance premium assumed.

In effect, a sort of arbitrage between state premium tax rates may arise from letting the captive be the buyer of commercial insurance

coverage (in the form of reinsurance) so that the captive can incur captive premium tax at a low premium tax rate, thereby eliminating state premium tax at a higher premium tax rate on the commercial carrier.

A series LLC is subject to Delaware premium tax on aggregate premiums written or assumed by the LLC and its SBUs combined (excluding intra-entity reinsurance premiums).

Considering that an SBU's direct written premiums are subject to captive premium tax, albeit at the series entity level and not the SBU level, arguably an SBU could benefit from state premium tax arbitrage in the same way that a pure captive could.

**Federal income tax treatment**

The federal tax treatment of a series LLC captive and (separately) an SBU is based on authorities that are recited in Rev. Rul. 2008-8, which reminds us that, regardless of its legal form, an insurance business will be treated as a corporation for tax purposes.

Just as each protected cell conducting an insurance business would be treated as a separate insurance company, likewise each SBU should be so treated, provided that:

- 1) The activity of the SBU constitutes an independent trade or business. A hallmark of an insurance business is issuing contracts of insurance or reinsurance in the name of that business. A risk pool or purchasing group that does not issue insurance contracts might not qualify as an 'insurance business'. Furthermore, a truly separate business should demonstrate independent financial capacity and governance.
- 2) The SBU's business passes muster as 'insurance' under the tax definitional criteria set forth in tax case law or various revenue rulings.

An SBU meriting treatment as a separate insurance company for federal tax purposes may claim exclusions or reductions of taxable income under Internal Revenue Code sections 831(b), 501(c)(15) or 806 within limitations applicable to those sections.

The tax advantage of a series LLC captive's tax advantage is not that new tax planning opportunities arise, but rather that SBUs make sophisticated tax planning opportunities more cost-effective to implement.

**Potential problems**

Uncertainties that are traditionally associated with series entities include:

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- Firewalls around SBUs remain untested in court;
- The SBU could encounter difficulties with contracting parties;
- Courts or regulatory or enforcement agencies might misunderstand the structure;
- The benefits of serialisation could be lost by failure to comply with the notice and record keeping requirements of the law under which the series entity is formed.

While these are valid concerns, there are techniques for addressing them. For the most part, these risks can be managed by good governance and proper supervision by professional advisors.

Although a multi-participant captive programme would be an obvious candidate for a protected cell captive or a series LLC captive, we have found that (especially among closely-held businesses) a traditional pure captive arrangement can often be enhanced by structuring it as a multi-captive arrangement. CR

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