

Property & Casualty Newsletter

January 2019: Captives

Captive Insurance Companies: Underwriting Risks Out-of-State

The number of captive insurance company domiciles has rapidly grown worldwide in the last few years. In the US, general counts put the amount of states, districts, and territories with captive-enabling legislation at 39, including Guam, Puerto Rico, USVI, DC, and the Delaware Tribe of Indians (based in Oklahoma). Many of the remaining states have varying levels of captives under regulation with some being so few they could arguably be considered non-viable domiciles.

The growth around the world has also been impressive with small and large countries and autonomous regulatory regions in the Caribbean, Europe, Asia, Micronesia, and Central America allowing captives to be formed within their borders.

Utah continues to be a shining star in the captive industry, being the 2nd-largest domicile in North America (based on number of captives under regulation) and by some counts the 4th-largest worldwide.

One subject that received much trade press in the US within the last year is how captives are treated outside of their domicile. First let's look at what captives are in their own domiciles: (1) a regulated insurer by the commercial insurance department granting a Certificate of Authority to operate in that state, (2) an "admitted" insurer that pays premium taxes or regulatory fees to its domicile, (3) usually not protected by their domicile's guaranty fund (in place to safeguard insurance buyers if commercial insurers become insolvent – since captives generally only insure their owners, most jurisdictions do not allow this "public" guaranty fund to apply), and (4) can underwrite in their domicile most business risks faced by their owners (a notable exception is Workers Compensation, but there are means around that too complicated to review here).

Where a captive owner may operate in other states outside a captive domicile, the captive is generally not considered an admitted insurer, or even given the status of an excess or surplus lines insurer (and most states will not grant a captive this latter status). A captive underwriting insurance policies for entities outside of its domicile state would then be considered an "alien" insurer, and the captive or the buyer of the coverage would likely be subject to self-procurement tax statutes.

In a recent court case in the state of Washington, the WA Office of the Insurance Commissioner sued Microsoft Corp.'s AZ-based captive Cypress Insurance Company for operating illegally in WA without permission. Rather than fight the suit, Microsoft and Cypress agreed to a settlement to pay \$876,820 in back taxes, interest, and penalties (calculated on roughly \$91M in collected premium over many years). Going forward, Microsoft took some steps to remove direct purchase of coverage from Cypress.

Essentially every state has a self-procured-insurance-tax obligation if coverage is purchased from an "alien" insurer; however, the application of this authority is very rarely exercised. Even the WA Insurance Commissioner stated, "Captives are a gray area in state law and this is the first case where we've tested them." Many believe Microsoft erringly set a precedent, not only in WA but nationally, and the WA commissioner has vowed to investigate other captives that may be, in his opinion, operating illegally in his state. Of important note, WA does not allow captives to domicile there.



Except for a somewhat-similar case involving Johnson & Johnson with their New Jersey-domiciled captive, there are no other instances that have made national headlines. In our discussion with western regulators of captive-domicile states in UT, AZ, MO, MT, and OK, there does not appear to be an impetus for their respective insurance departments to seek tax payments from captives domiciled elsewhere.

This incident may have been avoided if Microsoft had an admitted fronting insurer that then ceded reinsurance to its wholly-owned captive. But “fronters” typically want a hefty fee (7.5%-15%) of gross written premium to “rent” their policy paper, and they usually mandate well over \$1M in premium flowing through before they will consider this type of arrangement.

While the captive insurance industry continues to grow, it is by no means a static regulatory environment, and the friction between “captive” and “non-captive” states can be real. If you have an interest in forming a captive for your business needs, you need a captive manager that stays abreast of the regulatory community, the overall legal status of the industry in many jurisdictions, a feel for national and international tax law, and has the risk management ability to guide you through this complex maze of interests. Moreton & Company’s captive staff can give you this guidance, helping you to weed through the difficulties. Give us a call to discuss your thoughts.



Jon Soules is a principal of our Risk Management department, specializing in captive formation and management. Jon has been an insurance and risk management professional for over 30 years.

Please contact your Moreton & Company consultant with any questions.

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