

## MEMORANDUM ON 'RENT-A-CAPTIVES'

### **Captives**

A Captive is an insurance company established (generally in a tax neutral jurisdiction) which is owned by one or more non-insurance organizations to underwrite the risks of those particular owners. A variant is an 'Agency Captive', which is owned by independent agents who wish to participate in the underwriting results of the business they produce. A Captive can also be owned by a number of unrelated companies from within a particular industry (a homogeneous Group Captive), by a number of unrelated companies from different industries (a heterogeneous group Captive) or by a trade or industry association (an Association Captive) to insure the risks of the group owners or association.

### **Rent-a-Captives**

A Rent-a-Captive is an independently owned and operated insurance company that allows unrelated companies to use or "rent" its capital, surplus and corporate structure to enable those companies to participate in the underwriting results of the risks they insure into the Rent-a-Captive. Companies interested in utilizing a Rent-a-Captive include associations and independent agents. The Rent-a-Captive performs on a "turn-key" basis the same functions and achieves the same goals as a Captive insurance company, but the participant ("lessee") does not own, control or capitalize the Rent-a-Captive.

The costs of capitalizing and operating a Captive insurance company (usually on an after tax basis) are typically higher than utilizing a Rent-a-Captive. Operating a Captive also requires more management time than participating in a Rent-a-Captive. Furthermore, programs in a Rent-a-Captive are much easier to exit than a Captive which requires formal liquidation or sale. In summary, participation in a Rent-a-Captive eliminates the substantial organizational requirements and the need to commit funds for capitalization.

## **Advantages**

The advantages of both Captives and Rent-a-Captives include the following:

- i) the ability to participate in underwriting profits on an individual or industry-group basis;
- ii) the ability to purchase insurance related services on an unbundled basis;
- iii) the ability to determine levels of risk assumption;
- iv) the ability to reduce and control costs;
- v) the ability to carry less administrative and legal costs than those passed on by the insurer;
- vi) the ability to earn investment income on premiums paid; and
- vii) to accumulate investment income on premiums received.

## **Disadvantages**

The Rent-a-Captive participant does not own the Rent-a-Captive and therefore has less control over the insurance company than if he owns a Captive. A Captive owner also has greater flexibility over the risks he can place into a Captive. In the case of both Captives and Rent-a-Captives, insureds who participate may not be entitled to tax deductions for premiums paid and all participants could stand to lose their contribution.

## **Features of Rent-a-Captive**

The primary cost reduction factor is the element of risk retention by the participant. Under a Rent-a-Captive structure, the participant retains a portion of its own risk at a level mutually acceptable to both the participant and the Rent-a-Captive. In the event of a loss, the participant is responsible to pay claims up to that retention level. However, by

"self-insuring" to this retained limit, the organization reduces its premium costs because the cost of obtaining coverage for limits of insurance above the retention is less than purchasing insurance that attaches at the first dollar of loss., i.e. without any retention. These reductions in costs take place over time and are generally not applicable to agent participants.

## **Risk Management**

Risk management, or loss control, plays a major role in the Rent-a-Captive structure and provides a means for further cost reduction for the participant. Good loss experience is reflected in the rates to participate in the Rent-a-Captive. By employing effective loss control measures at your organization, you can reduce your insurance exposure thereby potentially increasing underwriting profits available to the participant and, at the same time, keeping premium costs down. Agent participants can also benefit from risk management by improving loss control. A reduction in loss costs should result in increased funds available for investment.

## **Why Bermuda?**

Bermuda has long been an attractive domicile for the insurance industry. Aside from tourism, insurance is one of Bermuda's largest industries. What makes Bermuda attractive, in part, is a regulatory environment that is well suited to responsible but flexible development and distribution of innovative insurance products. Bermuda is home to approximately one third of the world's Captive insurance companies. Bermuda law also permits "segregated cell" Rent-a-Captives which allow participants to legally segregate their premiums and losses from those of other participants in the company. This means that a participant's program is legally protected from any adverse results of other participants or the Rent-a-Captive as a whole. In addition, Bermuda has a well established legal, accounting and management infrastructure to support its Captive insurance industry.

## **Participation in Rent-a-Captives**

There is no specific formula for determining who should participate in a rent-a-Captive program. However, the program is generally suitable to organizations having total annual premium costs in excess of \$1,500,000, for agents who can direct a book of business in excess of \$5,000,000 and for groups or associations having total annual premium costs in excess of \$1,500,000.

Under a typical rent-a-Captive program, an insured or agent obtains primary insurance coverage from a direct insurer. The primary insurer will then cede, or transfer, to the rent-a-Captive a portion of the primary insurance coverage in an amount equal to the limit that the insured wishes to retain itself. The net premium received by the rent-a-Captive from the primary insurer for the risk transferred is tracked in a "separate account" maintained by the rent-a-Captive on behalf of the insured. Each participant in the rent-a-Captive Program purchases an account certificate (the "Certificate") for a specified sum ("Purchase Price"). The participant provides contingent capital to the Captive to cover the difference between the loss fund ceded to the Rent-a-Captive and the aggregate limit it assumes. The contingent capital, together with the net ceded premium, is invested primarily in cash equivalents and other low risk investments, as permitted by Bermuda law and is available to satisfy any claims against the insured within its retained limit.

### **Costs of Participation**

The basic costs to a participant of a rent-a-Captive program are:

- i.) Fronting fees charged by the insurance carrier to cover policy issuance, taxes and other related costs;
- ii) Fees charged by the Rent-a-Captive to access and manage the facility;
- iii) Fees for providing letters of credit to the insurance carrier and to cover any contingent capital;
- iv) Costs of any excess reinsurance required to limit the participant's exposure;
- v) Costs of contingent capital.

### **Distributions to Participants**

In the event a participant's cell produces a profit (i.e. premiums plus investment income exceed losses and program expenses), distributions to the participant are made pursuant to an Accountholder Agreement entered into between the participant(s) and the rent-a-Captive. The participant is entitled to a portion of the undistributed underwriting profit and investment income earned, to be paid at specific intervals as set forth in the Accountholder Agreement. Timing for distribution payments is typically agreed in advance between the participant and the rent-a-Captive, and the first such payment is not expected to be made prior to 24 months following the effective date of the Agreement.

## **Settlement of Claims**

In the event of a claim, payment is made to the claimant by the primary insurance carrier or by a third party administrator ("TPA"). The rent-a-Captive reimburses the primary insurance carrier or the TPA up to the amount of loss retained by the participant using the funds held in the participant's cell. If claims exceed the premiums (net of expenses) received into the participant's cell, the rent-a-Captive can use the contingency contributions (or the letter of credit) provided by the participant to satisfy the claim or it may seek a contribution from the participant.

## **Segregated Accounts or "Cells"**

The segregated account or "cell" established on behalf of each participant is protected by Bermuda law against claims asserted against the rent-a-Captive and participants in other cells. In other words, a participant in the rent-a-Captive Program will only be responsible to pay for claims arising from its own losses, not those of other participants. However, if the cell is owned by more than one participant, then the participants will share pro rata in each other participant's losses or on some other agreed upon basis. In no circumstances will a general creditor of the rent-a-Captive be able to attach any participant's account.

## **The Segregated Accounts Companies Act 2000 ('the Public Act')**

The Segregated Accounts Companies Act 2000 came into force on 1 November 2000. This Act is a Public Act distinct from a Private Act.

Prior to the Public Act, a Private Act was the only method available in Bermuda to establish legally segregated accounts within a company. Today, the Public Act provides for the registration of segregated accounts companies and the rules governing the operation of segregated accounts by companies registered under the Public Act.

A company which operates segregated accounts under the authority of a Private Act is not required (i.e. not mandatory) to register under the Public Act. However, such a company is required to give Notice to the Registrar of Companies on or before 31 April 2001. This Notice of the company's right to operate segregated accounts must have attached a copy of the Private Act conferring the right and a copy of the company's most recent audited financial statements.

A company which operates segregated accounts under the authority of a Private Act may register under section 8 of the Public Act. Where such a company has registered, the Registrar of Companies may impose such conditions on the registration of the company as he considers necessary to ensure compliance with the Public Act, the sufficiency of the

vetting procedures for the beneficial owners of segregated accounts and the reputation of Bermuda.

It must be noted that contracts to which the company was a party on the date of registration, will continue to be construed in accordance with the relevant Private Act, but contracts renewed or entered into after the date of registration will be construed in accordance with the Public Act.

Further, if inconsistencies arise between the provisions of the Public Act and those of the relevant Private Act, the provisions of the Public Act will prevail.

A Bermuda licensed insurance company may be established to offer "rent-a-Captive" services. This can be achieved by registering the insurer under the Public Act or by Private Act. In both cases, such registration permits companies to be registered as "segregated account" companies.

In either case, whether registered under the Private Act or the under the Public Act, an insurer may establish legally segregated separate accounts for Contracts of Insurance issued which will, amongst other things, protect the premium and related income from such Contracts of Insurance from the claims of general creditors of the Company or other insureds. Absent such powers, the premiums received by the Company are generally commingled and would be available to meet all claims against the Company without matching a claim to a particular premium payment or Contract of Insurance. The separate account feature that will be provided by a Private Act will offer the insureds the security that the premium and subsequent investment income attributable to their program will not be utilized to meet claims arising on other programs. In the context of rent-a-Captive companies this special feature is important because it will provide the Company and the insureds with a structure that would help meet each Insured's specific needs and at the same time provide the desired protection.

The formation of companies with segregated accounts allows for the creation of certain rent-a-Captive companies in recent years. The additional feature of this approach is that it provides not only for the issuance of Securities (example: preferred shares) in order to confer rights with respect to a Separate Account for purposes such as returning profits from that account but enables it to be done also through contractual agreements such as Participation, Accountholder and Contingent Agency Commission Agreements.

### **Transfer of interest in Segregated Cell**

Under the terms of the Accountholder Agreement, an accountholder is prohibited from selling, transferring or otherwise encumbering its interest in the account.

### **Termination of interest in Segregated Cell**

Termination of the account may only occur at a time when all liabilities under the insurance contract have been satisfied, run-off or commuted. The Accountholder Agreement identifies this time as the "Repurchase Date", i.e. the date upon which the rent-a-Captive will make final distribution to the accountholder of the original amount contributed as the Certificate purchase price and any underwriting profit.

### **Losses**

If a participant's liability for losses exceeds the premiums received (net of expenses), it is possible that the participant would lose its initial contribution, i.e. pay more than the standard premium for the policy, as well as the contingent funds provided. The rent-a-Captive makes no representation that an account will be profitable, nor does it guarantee the participant's initial contribution or any returns thereon.

### **Retention of Risk by Rent-a-Captive**

Under a rent-a-Captive Program, the risk is shared between the participant and the primary insurance carrier.

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