



Delaware: Renowned Business Expertise Focused on Insurance Securitization

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World renowned as a preeminent jurisdiction for finance transactions and corporate and entity law, Delaware has had a long-standing relationship with the capital and financial markets. With its business-friendly background, experienced professional industry and distinguished judiciary, legislature and regulators, Delaware is an established leader in corporate mergers and acquisitions, corporate finance and secured transactions. Delaware has now become the leading jurisdiction for insurance securitizations through recent updates to its captive insurance law.

The SPFC Statute

On July 18, 2007, Delaware Governor Ruth Ann Minner signed legislation that provides a comprehensive scheme for the formation of special purpose financial captive insurance companies ("SPFCs"). SPFCs have become popular vehicles for the securitization of insurance risk (i.e., funding by the capital markets of carefully defined segments of such risk). The new legislation continues Delaware's cutting edge approach in offering the business community flexibility through which to conduct business. Already the forum of choice when it comes to organizing corporations, limited liability companies, limited partnerships and statutory trusts, Delaware now achieves a comparable position for SPFCs by providing the most advanced captive insurance legislation that can be used in conjunction with these forms of entities.

The newly enacted legislation (the "Delaware SPFC Statute") is the next step in the advancement of captive insurance legislation and, coupled with its current place in the capital and financial markets arena, makes Delaware the perfect jurisdiction for transactions involving insurance securitizations. The financial community now has the opportunity to utilize the advantages found in the Delaware SPFC Statute in structuring transactions requiring the use of a captive insurance company.

One of the key advantages of Delaware's captive insurance laws is the ability to use a variety of certain business entities in the formation of an SPFC or a sponsored captive insurance company, including a stock corporation, nonstock corporation, limited liability company, partnership, limited partnership or statutory trust. This flexibility creates a multitude of opportunities. In choosing the entity form, a company avails itself of the many benefits provided by Delaware's business entity laws. In addition, the Delaware SPFC Statute allows a company to utilize a foreign entity, thereby offering expanded structural flexibility.

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The Delaware SPFC Statute streamlines the licensing requirements for an SPFC. An SPFC must first apply for a certificate of authority. In so doing, the SPFC initially files a plan of operation with the Delaware Insurance Commissioner (the "Commissioner"). The Delaware SPFC Statute details the requirements of a plan of operation. These generally include a description of the contemplated special purpose financing transaction and the SPFC contract; copies of all material agreements and documents required to effectuate the special purpose financing transaction; a description of the proposed investment strategy; a description of the underwriting, reporting and claims payment methods by which losses covered by the SPFC contract are to be reported; and projections demonstrating the performance of the SPFC under stress-case scenarios. These clear guidelines established by the Delaware SPFC Statute establish comfort and certainty in the application process.

The Delaware SPFC Statute eliminates repeated appeals to the Commissioner by articulating a number of material changes that will not require additional approval of the Commissioner. Commissioner approval is not required before issuing subsequent securities when such issuances were approved in the plan of operation. Nor is Commissioner approval required to change a swap counterparty if approved by the plan of operation and if the replacement counterparty carries the same or a higher rating than its predecessor.

An SPFC is required to maintain capital and surplus of not less than \$250,000, while a sponsored captive insurance company, used to establish protected cells and licensed as an SPFC, is required to maintain capital and surplus of not less than \$500,000. Again evidencing the flexibility and responsiveness of the Delaware law, companies may be permitted to meet the capital and surplus requirement through a variety of means, including cash, irrevocable letters of credit or other assets as approved by the Commissioner.

The issuance of securities is an important matter to a company forming an SPFC. The Delaware SPFC Statute provides wide latitude in regards to the issuance of securities and allows for the issuance of any form of debt obligation, equity, surplus certificate, surplus note, funding agreement, derivative or other financial instrument that the Commissioner designates, by rule or order, as "securities."

Notably, the Delaware SPFC Statute explicitly provides that an SPFC security will not be subject to regulation as an insurance contract and that an investor in such a security or a holder of such a security will not be considered to be transacting the business of insurance in Delaware solely by reason of owning a security. The Delaware SPFC Statute also makes clear that persons involved in the underwriting of a special purpose financing transaction shall not be considered to be conducting business as an insurance company.

Wide latitude is also permitted with respect to dividends and distributions. Dividends or distributions may be declared and paid if they do not jeopardize the fulfillment of the SPFC's obligations or threaten the solvency or liquidity of the SPFC. By statute, insolvency occurs when an SPFC is unable to pay its obligations when due or when an SPFC's liabilities exceed the value of all assets as determined under the accounting method utilized by the SPFC and in accordance with statutory law. In response to the business need for certainty in the declaration of dividends and distributions, the Delaware SPFC Statute permits an SPFC to submit periodic written requests to the Commissioner for advance approval for payments of dividends or interest and repayments of principal. Ongoing dividend or interest payments and principal repayments may be approved by the Commissioner provided that they are made in accordance with the plan of operation.

Reinsurance is another issue that often arises for an SPFC. The Delaware SPFC Statute provides that an SPFC shall insure only the risks of a counterparty, which may be but need not be the parent or an affiliate of the SPFC. An SPFC may also only cede risks assumed through an SPFC contract to third-party reinsurers through the purchase of reinsurance or retrocession protection if set forth in its plan of operation.

Protected Cells

The Delaware SPFC Statute extensively overhauled the provisions regarding sponsored captive insurance companies and protected cells. The first significant change is the express allowance for a sponsored captive insurance company, licensed as an SPFC, to establish protected cells that can in turn engage in insurance securitizations. The Delaware SPFC Statute also establishes a number of requirements and allowances for a sponsored captive insurance company. In order to remain a sponsored captive insurance company, a company must segregate the assets of each protected cell from the assets of other protected cells and from the assets of the sponsored captive insurance company's general account. A sponsored captive insurance company is permitted to combine the assets of two or more protected cells for purposes of investing such assets, and such combination shall not be construed as defeating the segregation of such assets. A special purpose financial captive insurance company that is organized as a sponsored captive insurance company may add or eliminate one or more protected cells under a single certificate of authority upon approval by the Commissioner of a plan of operation specific to such protected cells.

Investments

The Delaware SPFC Statute focuses on flexibility and opportunities for the SPFC. Another instance where this is evident is in the broad authorization for an SPFC to enter into a myriad of agreements incidental to the purposes of an SPFC contract and special purpose financing transactions contemplated by the plan of operation. This wide latitude should help alleviate many of the concerns that arise when an SPFC is involved with related transactions. Flexibility is also evident in the area of permitted investments.

Pursuant to the Delaware SPFC Statute, an SPFC is not subject to any restriction on investments other than the Commissioner's power to prohibit or limit those that threaten the solvency of an SPFC. The Delaware SPFC Statute allows a sponsored captive insurance company to combine the assets of two or more protected cells for purposes of investing. This change alleviates any fear that such a combination could be viewed as defeating the segregation of the assets.

As you can see, Delaware has taken the next step in the advancement of captive insurance legislation and has established itself as the leader in the area of insurance securitization. We look forward to welcoming your new captive insurance company to Delaware.

Richards, Layton & Finger, P.A. is a founding member of the Delaware Captive Insurance Association. For more information regarding this article, please contact:

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