Bureau of Captive and Financial Insurance Products

Delaware Captive Insurance Association Spring Forum
May 8, 2019

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Delaware Insurance Department

DELAWARE DEPARTMENT OF INSURANCE
INSURANCE COMMISSIONER TRINIDAD NAVARRO
Bureau of Captive and Financial Insurance Products
Delaware is the 3rd Largest U.S. Captive Domicile
and the World's 5th Largest Captive Domicile

Agenda for Presentation

- Delaware's captive status
- Examinations
- Conditional license
- Orphan captives
- Fronting arrangements
- OPTins
- Tax court cases and future regulatory considerations
  - Avrahami
  - Reserve Mechanical
  - Syzygy

Delaware's Captive Status

Delaware Licenses

as of May 6, 2019

Variety of Captive Types	*Number Licensed*
Agency	2
Association	2
Cell	10
RRG	3
Industrial	2
Pure	346 (includes 14 conditional)
Series	545 (includes 13 conditional)
Special Purpose	43 (includes 35 LLC core)
SPFC	6
Sponsored	3
Total Active	962
Dormant	8 pure
	22 series
Total Dormant	30

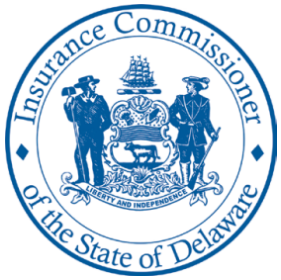
Delaware Licenses

as of May 8, 2018

Variety of Captive Types	*Number Licensed*
Agency	2
Association	3
Cell	11
RRG	3
Industrial	3
Pure	330
Series	616
Special Purpose	41 (35 are for Series Structure)
SPFC	6
Sponsored	2
Total	1,017 (Dormant 48 series, 2 pure)

Delaware Licenses

as of May 6, 2019

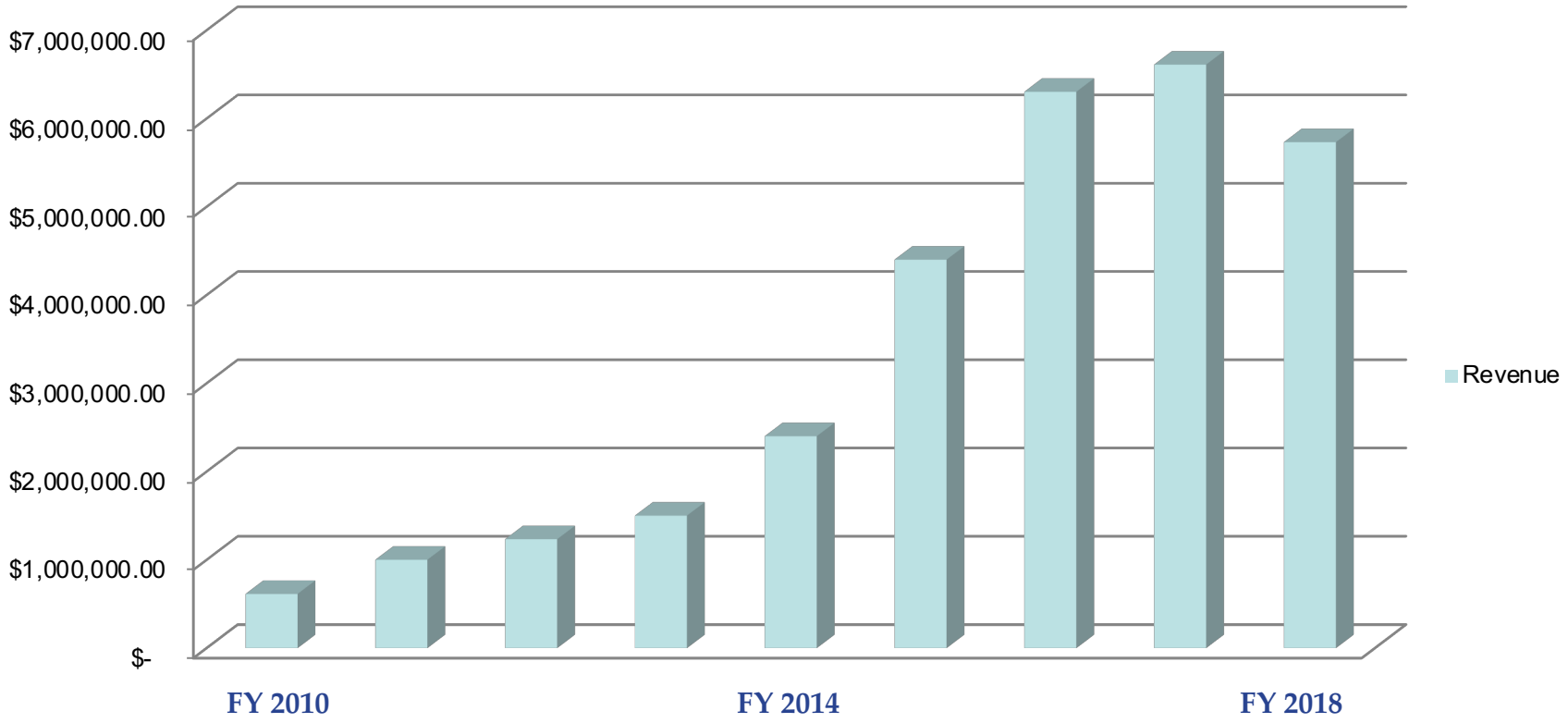


Dormant Captives	**8 pure**
	22 series
Total Dormant	**30**

Dissolutions since January 1	**16 pure**
	19 series
Total Dissolutions	**35**

Karrie Hyatt. "Captive Growth Restrained in 2018. *The Self-Insurer.* May 2019.
https://www.sipconline.net/files/Captive%20Growth%20Restrained%20in%202018.pdf

Captive Bureau Revenue Growth



U.S. Captive Insurance
Total Annual Premium

- **2016**

1. Vermont $30.6 billion
2. Arizona $7.4 billion
3. Hawaii $5.7 billion
4. Delaware $4.4 billion
5. Texas $3.8 billion
6. Missouri $3.4 billion
7. South Carolina $1.9 billion
8. New York $1.7 billion
9. Montana $1.1 billion
10. Tennessee $1 billion

- **2017**

1. Vermont $20.1 billion
2. Delaware $12.5 billion
3. Arizona $11.2 billion
4. Hawaii $7.1 billion
5. Dist. of Columbia $5 billion
6. Texas $4.6 billion
7. Missouri $3.8 billion
8. Nebraska $3.1 billion
9. South Carolina $2.9 billion
10. Michigan $2 billion

Source: NAIC

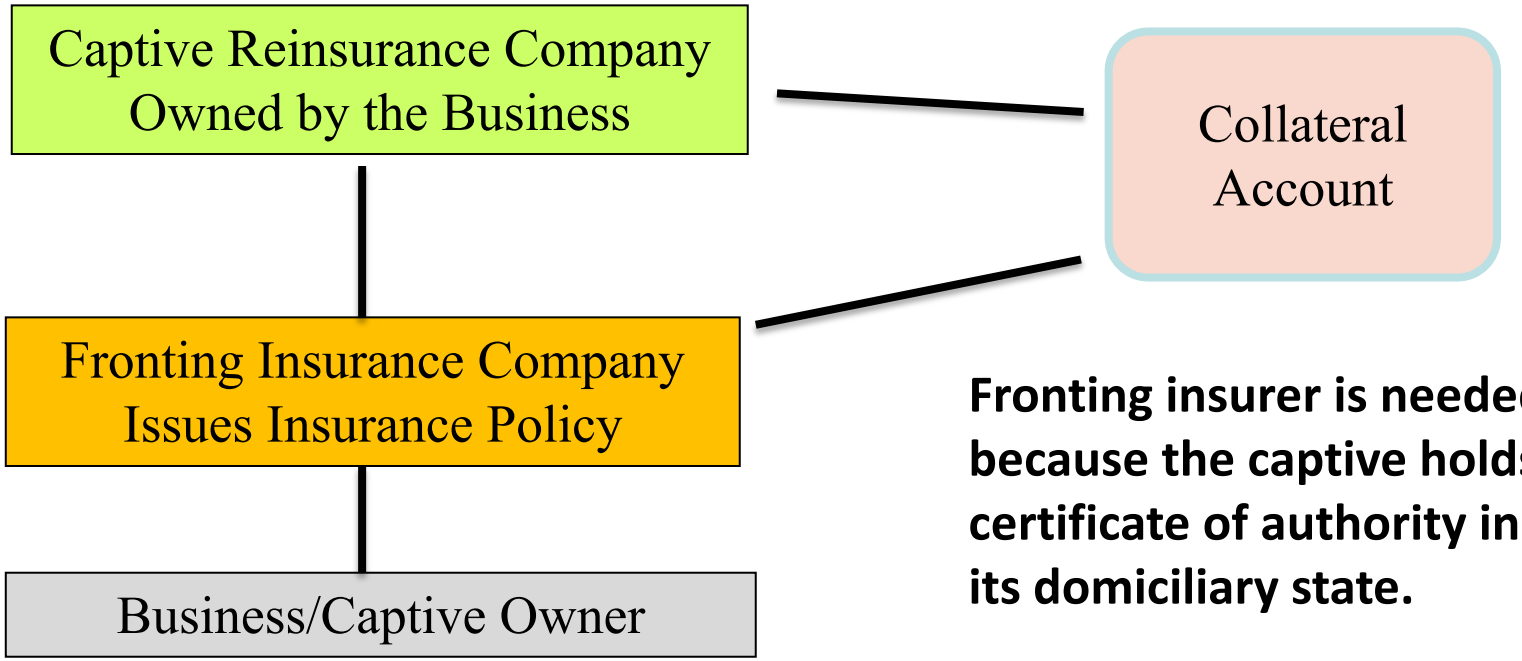
Captive Exams

Examinations

- **Open exams - 70 captives.**
- **Draft exam reports being processed under the 30 day letter – 9 captives.**
- **Completed exams by the examination team waiting to be processed for the final exam report – 78.**
- **Handout contains the most common exam findings for 2016 and 2017.**

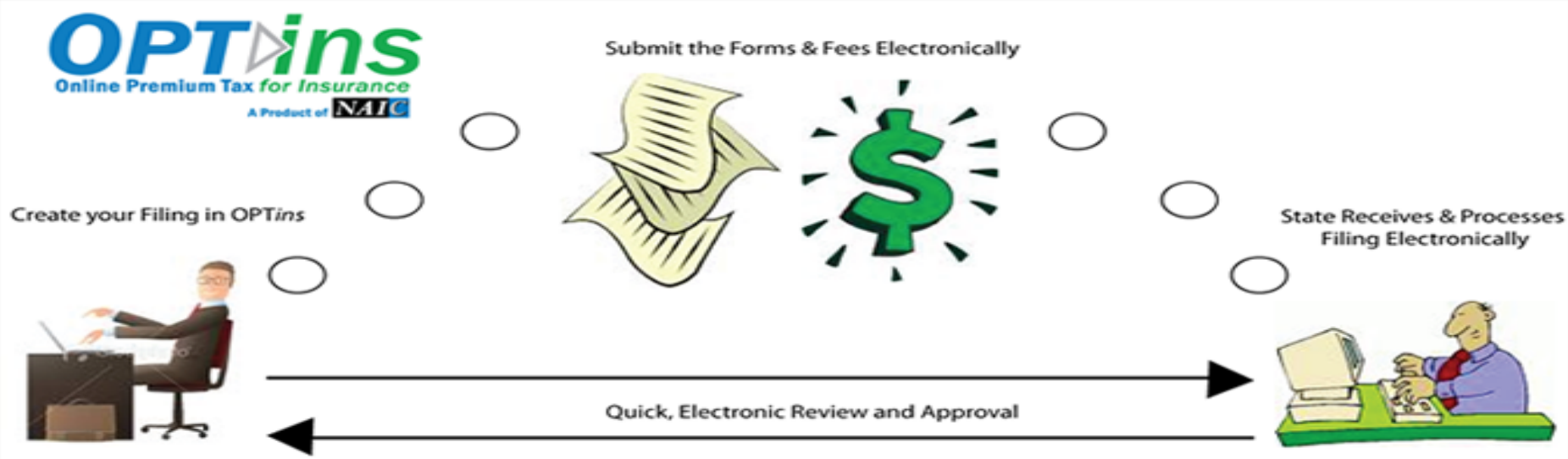
Conditional Licensing
Orphan Captives
Fronting Arrangements
OPTins

Captive Reinsurance Fronting Arrangement



Fronting insurer is needed because the captive holds a certificate of authority in only its domiciliary state.

NAIC OPTins Online Tax Filing



The OPT*ins* Filing Process

Fees and forms are submitted to the states simultaneously and securely.

All forms and information are easily accessible, in one location, and interactive.

Unlike a paper check, payment is secure.

Filings are never lost or misrouted.

All correspondence between state and industry is electronic.

Quicker Process = Less Man Hours = Improved Bottom Line

NAIC OPTins Online Tax Filing

- **Online payment of premium tax, surplus lines tax, assessments, and other state specific filings.**
- **Mandated in Delaware for non-captive/commercial/traditional insurers.**
- **$10 transaction fee.**

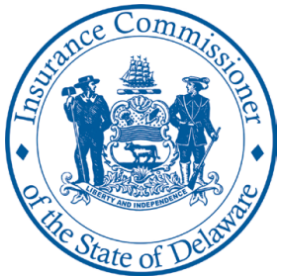
Tax Court Cases

Captives and the IRS Status Quo

- Five straight years on the dirty dozen list.
- 500 cases in docketed in tax court.
- Three straight adverse tax court decisions for owners of small captives.
- Related party transactions are scrutinized.
- Numerous income tax examinations of the participants in small captive arrangements, as well as promoter investigations.
- Notice 2016-66 continues and someday the IRS will use this data. No pressure on the IRS to use the data, but it continues to collect it.

Avrahami

Avrahami's owned six companies and one captive insurer



2007 American Findings	2007 BYS	2007 2008 Chandler One	2007 O&E	2007 2008 White Mountain	2007 2008 White Knight

Policies ↑ ↓ Premium

Feedback Insurance Company, Ltd. (Avrahami owned captive insurer)

← Terrorism Risk

Pan-American Re (pooled 3rd party risk) Not owned by Avrahamis

Avrahami – No Risk Distribution

2007 American Findings	2007 BYS	2007 2008 Chandler One	2007 O&E	2007 2008 White Mountain	2007 2008 White Knight

Policies ↑ ↓ Premium

Feedback Insurance Company, Ltd. (St. Kitts)

Revenue Ruling 2002-12. To achieve risk distribution there must be at least 12 operating subsidiaries, no one of which accounted for less than 5% nor more than 15% of the captive premium net and gross. For an association there must be 7 policyholders.

Pure captive under § 6902 captive insurance company that insures risks of its parent and any of such parent's affiliated companies and any controlled unaffiliated business.

Avrahami – No Risk Distribution

Premium from Pan American to Feedback consisted of 33% in 2009 and 31% in 2010 of Feedback's premium. The Harper Group and other cases have said that at least 30% of premium must be from outside third-party/unrelated business to have risk distribution.

Tax court did not like the circular flow of funds which was to pay $360,000 and to receive $360,000 and the excessive premium price American Findings paid for the terrorism coverage. Tax court found that Pan American was not an insurance company which means that Feedback isn't an insurance company. No mutuality. Pan-American Re members had no duty to pay a claim for any other member who didn't or couldn't pay their share.

Chapter 25 of the Delaware Insurance Code says rates shall not be excessive, inadequate, or discriminatory. This chapter does not apply to captive insurers.

2009
2010
American Findings

American Findings paid Pan American $360,000 for terrorism coverage

↓

Pan-American Re (pool 3rd party risk)

Pan American paid Feedback $360,000 to reinsurer > 2% of Pan American's losses

←

Feedback Insurance Company, Ltd. (St. Kitts)

Avrahami – Loans

Belly Button

Unsecured promissory note with interest at 4% simple interest accruing from time to time. Promissory note said, "No Security: The Indebtedness is unsecured."

$1.5 million loan

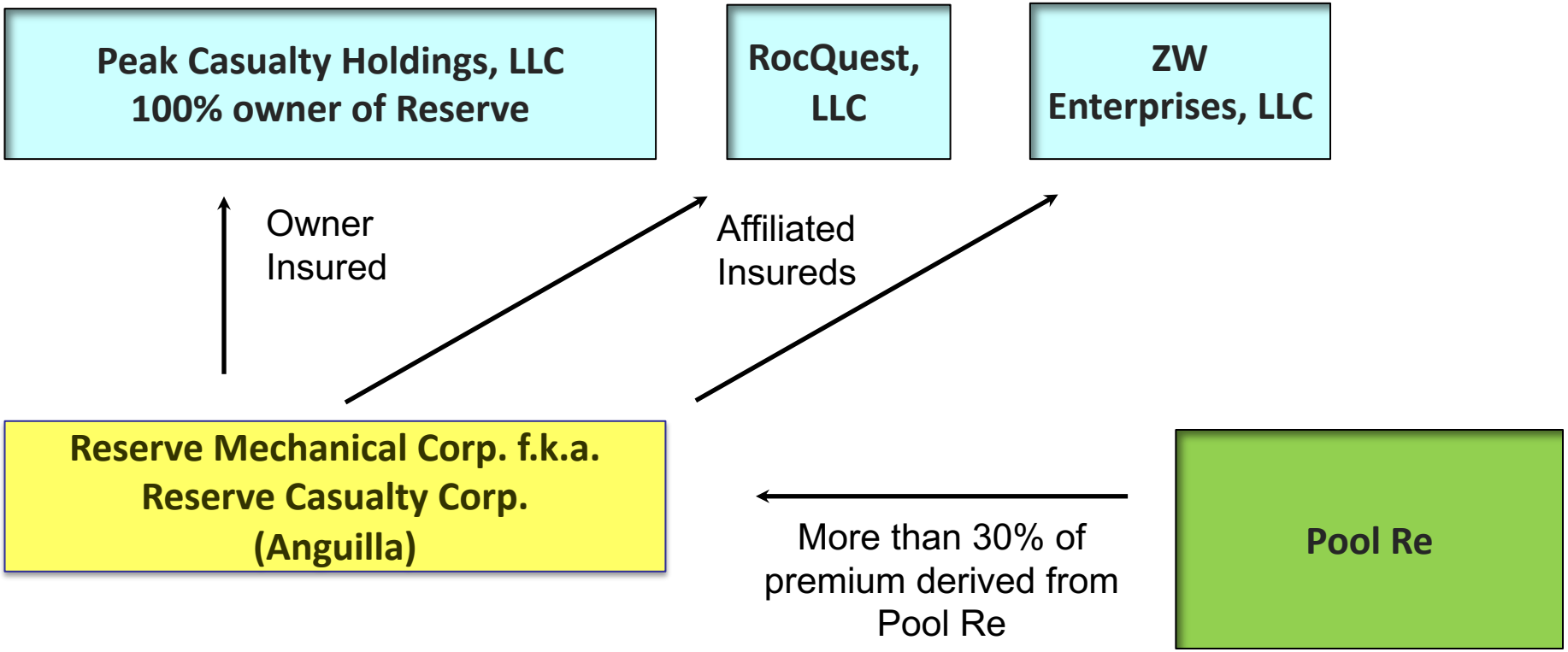
Section 6922(4) says any making of a material loan or other material extension of credit by the captive insurance company requires 30 day written notice to the Commissioner.

Feedback Insurance Company, Ltd.
(St. Kitts)

Page 200 of the TC memo provides six criteria to determine if a loan is bona fide.

Reserve Mechanical

Satisfies a Pure Captive Definition



Reserve Mechanical

No Risk Distribution

Premium from Pool Re to Reserve consisted of > 30% of Reserve's premium. The Harper Group and other cases have said that at least 30% of premium must be from outside third-party/unrelated business to have risk distribution.

Tax court did not like the circular flow of funds and concluded these were not arm's-length transactions. It said, "The same amount that Peak and the other insureds were obligated to pay PoolRe for the stop loss coverage was to be paid to Reserve pursuant to the quota share arrangement. Reserve has not explained why these amounts were the same. It has not explained how all Capstone clients in the quota share arrangement would be able to transfer a particular set of risks (i.e., those associated with their affiliated insureds) and assume in exchange a blended portion of completely different risks for exactly the same premium price."

Peak, RocQuest, and ZW

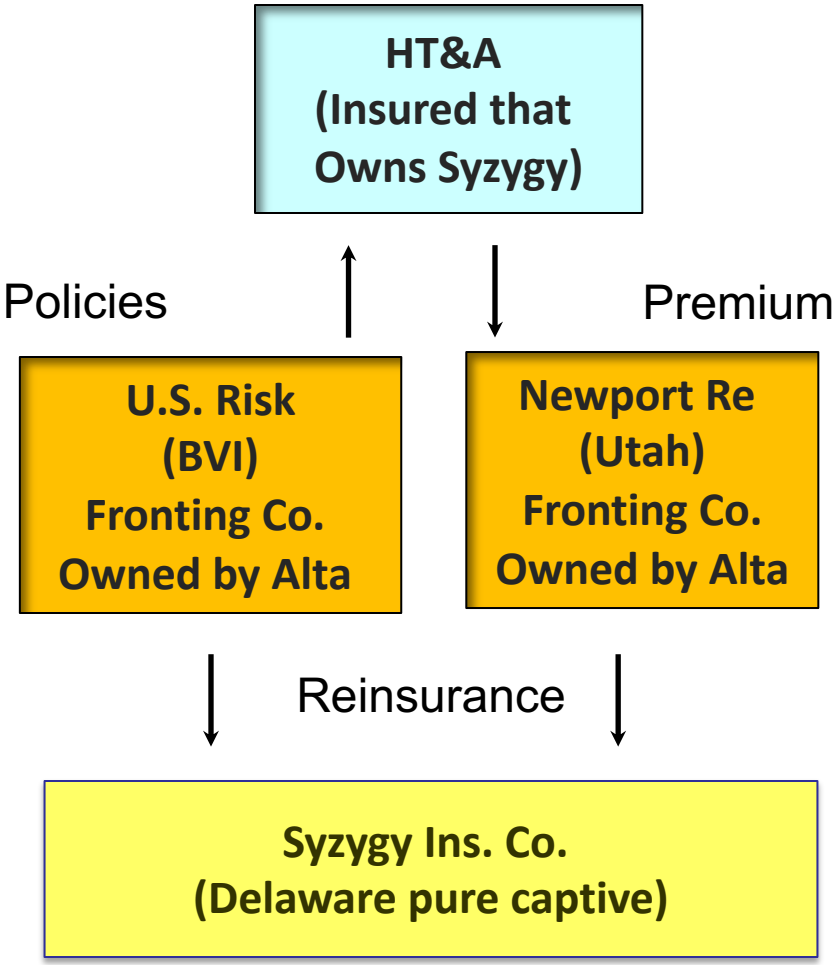
Payment for stop-loss coverage

Pool Re (pooled 3rd party risk)

Pool Re paid to Reserve the same amount of premium it received from Peak, RocQuest, and ZW

Reserve Mechanical Corp. f.k.a. Reserve Casualty Corp. (Anguilla)

Syzygy

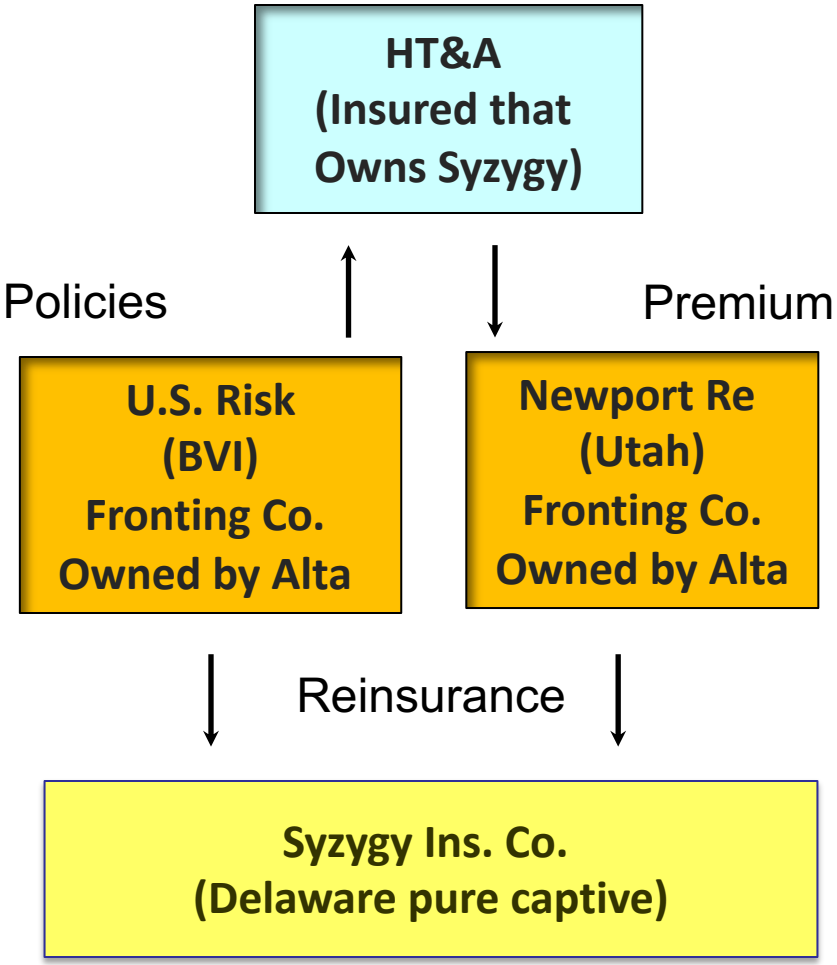


Syzygy distributed risk by providing reinsurance for a diverse array of approximately 857 policies issued to unrelated companies in the fronting carriers' pools. Syzygy reinsured approximately 40 to 50 unrelated companies per pool.

Circular flow of funds. HT&A paid the fronting companies $1.373,500 of premium and fronts paid Syzygy reinsurance premiums of $1,319,055.

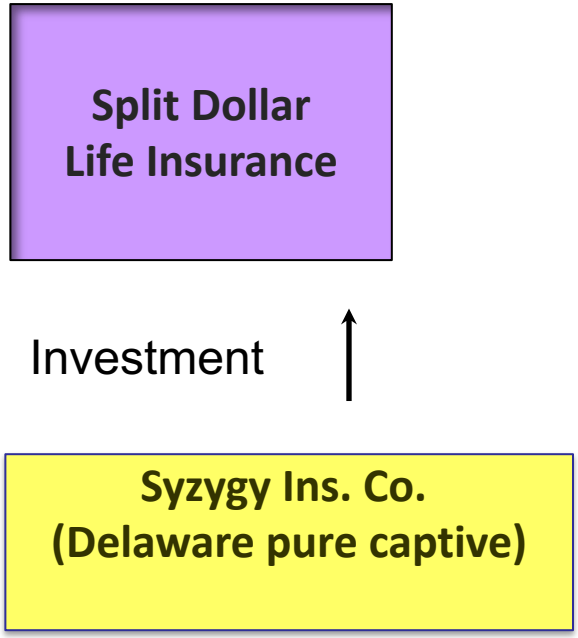
Section 910 allows captives to cede risk to a reinsurer and accept it as a reinsurer.

Syzygy



The Tax Court did not consider the policies issued by the fronting companies to be arm's length contracts. The policies did not provide for pro rata refunds if they were canceled during the policy terms. Claims could be made only within seven days after the policy period closed, and there was no option to purchase an extended claims reporting period. "There is nothing in the record that justifies why HT & A, on average, paid higher premiums for policies with more restrictive provisions than their commercial policies. The higher average rate-on-line coupled with the policies' restrictive provisions leads us to conclude that the policies were not arm's-length contracts."

Syzygy - Investments

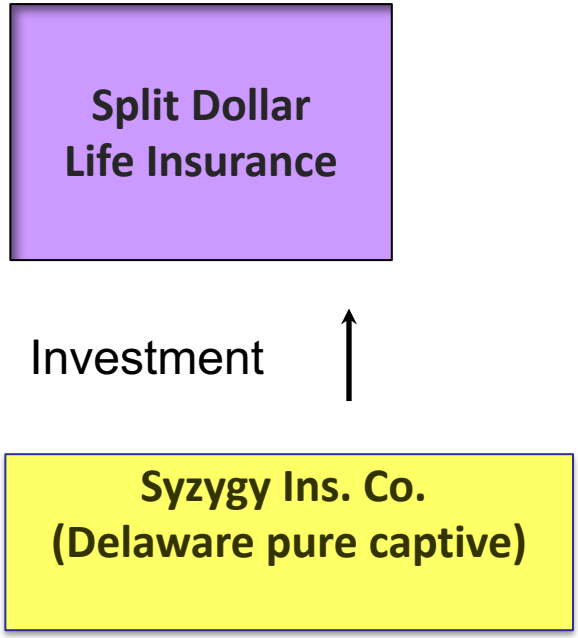


The Tax Court concluded that Syzygy was not operated as an insurance company.

At the end of 2011 the life insurance policies insuring Syzygy's owners totaled more than 50% of Syzygy's assets and were its largest investments. Under the terms of the split-dollar agreements, Syzygy could neither access the cash value of the policies, borrow against the policies, surrender or cancel the policies.

We (the Tax Court) do not think that an insurance company in the commonly accepted sense would invest more than 50% of its assets in an investment that it could not access to pay claims.

Syzygy - Investments



Section 6910 says a pure captive shall not be subject to any restrictions on allowable investments whatsoever, including those limitations contained in this title; provided, however, that the Commissioner may prohibit or limit any investment that threatens the solvency or liquidity of any such captive insurance company.

From 2009 through 2011 Syzygy was able to withstand a full limit loss, with remaining capital & surplus levels being greater than the required statutory minimum of $250,000 for a pure captive, even when the life insurance assets are removed from consideration.

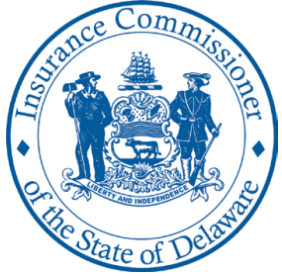
Summary

"The Arrangement is not Insurance in the Commonly Accepted Sense" – Tax Court

- Directors and a management team substantially weaker in numbers and ability than those of a normal insurer. Examples - Norman Zumbaum was Reserve's 50% owner, president, and chief executive offer and yet knew nothing about its operations; resident director in Avrahami testified that he was a "courtesy" director only.
- No or few claims filed and handled on an ad hoc basis.
- The feasibility analysis was not complete when Reserve issued policies for 2008 and 2009.
- In Syzygy the insurance policies were not issued – reliance on binders.
- Investment choices only an unthinkable insurance company would make.
- The above is not a comprehensive listing of what the court didn't like.

Signed Insurance Policies

This is a Compliance and Exam Issue.



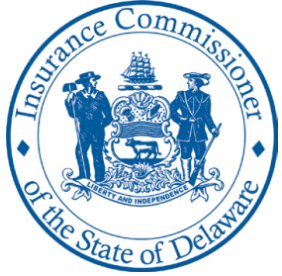
- **Section 2716 of Delaware's insurance code requires that policies issued by captive insurers be signed by an officer, attorney-in-fact, representative, or employee. The rationale for this amendment is that nearly every state insurance code mandates the execution of policies. This is a common requirement for insurance policies and policies issued by captive insurers should not be different. Applies to captives since 2015.**

- **We (the Tax Court) have held that policies were valid and binding when "[e]ach insurance policy identified the insured, contained an effective period for the policy, specified what was covered by the policy, stated the premium amount, and was signed by an authorized representative of the company." *Syzygy* p. 43.**

Do Regulators Look at Premium Pricing?

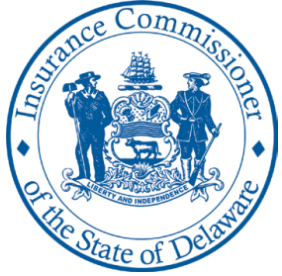
- Yes – at the time of application.
- Regulators consider the reasonableness of premiums in the first few years of captive formation. These contain a larger risk margin in order to build up surplus for solvency purposes.
- Regulators review the pro forma financial statements, which contain projected premiums and losses. Regulators review how the projected premiums and losses were derived and review that the pro forma financial statements are in sync with the business plan.
- What law is relied upon for the above? Section 6903 which includes the sentence, "Such other factors deemed relevant by the Commissioner in ascertaining whether the proposed captive insurance company will be able to meet its policy obligations."

Should Regulators Continue Reviewing Premium Pricing?



- If so, then at the time of examination.
- It would be a different review since at the time of the examination, there has been actual premium and loss experience.
- At the time of application, the regulators are looking at premium projections, and other information that does not include actual losses related to the captive.
- What's the benefit? In Syzygy the tax years under audit were 2009, 2010, and 2011.
- The Department's regulatory examination of Syzygy was from December 31, 2008 to December 31, 2012 and the exam was finalized in 2015.
- Syzygy went to trial in 2017.
- To do this then captives would need to be subject to Chapter 25.

No Reliance on the Captive Manager Avoiding Tax Penalties



- **Captive owners need an advisor who is (1) a competent professional who has sufficient expertise to justify the reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment.**
- **Reliance may be unreasonable if the adviser is a promoter of the transaction. A promoter is "an adviser who participated in structuring the transaction or is otherwise related to, has an interest in, or profits from the transaction."**
- **Captive managers are not fiduciaries. See *Stewart v. Wilmington Trust SP Services, Inc.* 112 A.3d 271 (2015).**

Questions & Answers

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