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# Top Ten Regulatory Best Practices: How To Ensure Your ERC Captive Is Compliant With State Insurance Regulation

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Like so many of our generation, we miss our old, late night friend, David Letterman. Nothing will ever be as ridiculously hilarious as Letterman hanging from the wall in that Velcro suit or maybe that guy who stopped a fan with his tongue! As silly as his show could be, Letterman was also something of a social commentator, and Letterman would certainly have had something to say about the Enterprise Risk Captive (“ERC”). He might have had Paul Shaffer write a song about how brilliant is the person who thinks it a good idea to refer to a risk management vehicle by a section of the tax code.

But the unfortunate trend of calling ERCs “831(b) captives” has created an unfair public perception that the tax tail always wags the captive dog in the context of an ERC. As a result of that tax focus, the air these days is filled with questions about ERCs: What will happen now that Congress has changed the language of IRC 831(b)? Will the Tax Court help as some ERC cases go to trial? Is it possible to ever satisfy the IRS that a captive is for real?

Of course, these tax questions have nothing to do with the risk management purpose of ERCs – helping small to mid-sized privately held enterprises fill gaps

in their commercial insurance programs and efficiently build up reserves and free surplus to cover risks they had historically been self-insuring. Frankly, a focus on the risk management objective would moot many of the tax questions surrounding ERCs and could even lead to the Holy Grail of actually satisfying the IRS!

In an effort to educate, our industry is seeing more and

regulated insurance company. ERCs are regulated entities and as such these companies, their owners, and service providers should have a good understanding of what it means to be regulated and how to run any ERC captive to ensure its ongoing compliance with state insurance regulation.

So, in the spirit of David Letterman’s best known and maybe longest running bit, we



more best practices articles and conference sessions on important ERC topics such as how the insurance program should work and how corporate governance should be implemented. But another very important discussion is on the topic of how to be a

bring you the following “Top Ten List,” as an attempt to help ERCs understand how to be regulated, and not just how to be compliant with laws and regulations, but how to do it well and do it in a manner that is efficient and constructive and serves both

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the insurance company and its regulator.

## **10. Know Your State Captive Insurance Code.**

Your ERC is a regulated entity; it was licensed to conduct insurance business by a governing domicile and as such, it is regulated by the captive insurance code of that domicile. The insurance rules that apply to one captive domiciled in state X might be different than the rules applied to another captive domiciled in state Y.

Because regulators have great leeway in interpreting the laws they enforce, it is also important to understand how your regulator interprets the captive insurance code. Sometimes statutory language is clear, everyone agrees what it means, and state regulators will follow their captive insurance code to the letter. Other times, statutory language is unclear or is susceptible to more than one meaning, and regulators must follow their interpretations of the captive insurance code, which can differ from other people's interpretations.

For example, every state captive insurance code has basically the same language with regard to investments: "a pure captive insurance company ... is not subject to any restrictions on allowable investments, except that the Commissioner may prohibit or limit any investment that threatens the solvency or liquidity of the company." But, captive codes typically do not define "allowable investments," and not all regulators interpret this phrase the same way,

which means that one state could, and often does, have a different interpretation of what is allowable, from another.

For your ERC to be a good regulatory citizen and avoid mistakes and problems, you need to know both what the captive insurance code says and what

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your regulator thinks it means. Good captive managers and advisors should already know this information and be able to share it with you.

## **9. Get Required Prior Approvals.**

There are certain transactions that require the prior approval of regulators. For ERCs, failure to get that approval can have several bad results that include later having to unwind a transaction, being penalized during the examination process, or having the IRS challenge the validity of your captive with an assertion that you ignored state regulatory requirements because you only really cared about the tax benefit.

To avoid those kinds of consequences, you should know when you need prior approval and you should get that approval. For example, certain transactions, like dividend distributions and loans to affiliates, always require prior approval. Accordingly, your ERC should not issue dividends or make other capital or surplus distributions (stock redemptions,

etc.) without prior regulatory approval. Likewise, your ERC should not loan money to affiliates without prior regulatory approval. In addition, some domiciles require prior approval for any investment, transaction or operational change that is "material." But, "material" can mean different things to different regulators. You should ask your captive manager or other relevant advisor if there are any transactions that require prior approval based on a materiality standard, and if so, what is the standard.

In general, regulators do not like being asked for retroactive approvals, and some regulators simply will not give them. ERC owners should check with their captive manager in advance of funding any dividend distribution, any loan to an affiliate, or engaging in a possibly "material" transaction so that the manager can make sure to obtain prior approval of the transaction or determine whether prior approval is needed.

## **8. Get Business Plan Changes Approved.**

State regulators also have different rules with regard to approvals for business plan changes. For example, if the captive in renewal wants to write new policy lines besides those originally disclosed in its business plan, all states require some form of notification and request for approval of the new lines of business. Where the states can differ is with regard to the form of the notification – some states require the captive

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to submit a redlined business plan highlighting the changes against the original submission, while other states will allow the captive to submit a letter describing line changes or some other less formalized notification of line changes.

Captives should also notify regulators when they are increasing limits. Sometimes this will require the captive to submit pro formas so that the regulators can see the financial impact of an increase in limits. Some regulators do not require the captive to notify them if the captive is discontinuing a line of business, while others would like notification and to provide approval for every business plan change that happens in renewal, from changing insureds, to adding or subtracting policy lines.

Regulators do not like to see retroactive approvals for line changes when prior approval was expected. The consequences of failure to submit a business plan change can include voiding a coverage or policy, and as we discussed above, being penalized during the examination process, or having the IRS challenge the validity of your captive with an assertion that you ignored regulatory requirements because you only really cared about the tax benefit. The most important thing for the ERC is to always ask about reporting and approval requirements when considering adjusting an insurance program on renewal.

### **7. Don't Mess with the Money.**

ERCs, like all captives, must maintain minimum capital requirements at all times. No exceptions. These requirements will differ depending on the type of captive. For example, capital requirements for a pure captive are different than those required for a series business unit ("SBU") captive. The premium to surplus ratio adopted by domiciles can



**It's Not A Bank Account**

also differ, depending on the state and again, the type of captive. Regulators also watch out for any captive that tries to double-count a portion of its first-year premium as both premium and minimum capital. Minimum capital requirements are separate and apart from premium.

As a corollary consideration, do not just take money out of your ERC. If an ERC owner would like to take money out of the ERC's bank account to invest or distribute funds, the owner should advise the manager in advance of any such transaction. Regulators will see funds withdrawn from captive accounts eventually so there is always some form of

accountability down the line. All financial transactions become part of the captive's financial record and both auditors and regulators will demand explanations for all transactions.

Don't mess with the money. Maintain minimum capital and remember your ERC is not a bank account. There is no faster way to lose your license and have your ERC shut down than to disrespect its separateness and use its assets for other purposes.

### **6. Follow the Investment Plan.**

ERCs file proposed investment plans with their license applications. When the domicile licenses the ERC, the proposed investment plan becomes the approved investment plan.

That approved investment plan lays out how the ERC intends to invest its assets, and the ERC must follow its approved investment plan. Deviation from the approved investment plan or revision to the approved investment plan, requires regulatory approval in advance.

With regard to investments, regulators are principally concerned with protecting solvency and liquidity. Therefore, regulators generally dislike large illiquid investments. If an investment plan is going to allow for illiquid investments, regulators will typically insist on limiting those illiquid investments in ways that protect the ERC's ability to pay claims.

Regulators also like to see

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diverse investment portfolios in ERCs. In fact, they do not want to see any captive putting all its investment eggs in one basket. Some regulators have specific percentages that they will apply in approving or disapproving investments. By limiting percentages of certain assets or types of assets, regulators help to ensure diversity in a captive's investment portfolio.

ERCs must comply with their approved investment policies. Because the investment policy exists to help the ERC stay appropriately liquid and solvent, ignoring the approved investment policy can draw the wrath of a regulator. Importantly, under most captive statutes, regulators have the authority to prohibit or limit any investment that threatens the liquidity or solvency of a captive. Practically speaking, this can mean that a regulator can force the disposition of an investment made outside of the approved investment policy, which can be problematic and costly.

#### **5. *Respect the Terms of the Insurance Policies.***

A hallmark of ERCs is flexibility in the insurance arrangements and an opportunity to design a program that is more convenient and typically more liberal than commercial insurance. However, despite the inherent flexibility, there are certain aspects of the insurance program, particularly the terms of the insurance policies, that an ERC should view inflexibly and should be respect rigidly.

Policy premium should be paid per the terms of the policy. Sometimes insureds pay the

entire premium immediately upon inception or renewal. Other times, insureds are paying under a premium finance plan or per monthly or quarterly installments with scheduled invoicing. In either case, premium must be paid timely according to the contracted payment arrangement. Otherwise, the ERC may have to cancel policy lines. ERCs should enforce timely payment of premium by using cancellation in those instances where premium cannot be deemed collectible or could only be collected in too untimely of a fashion. ERCs should avoid scenarios where premium receivable (i.e., uncollected premium) exceeds unearned premium on the financial statements, because regulators may view this as indicative of financial distress or as the provision of free insurance.

Another key condition to coverage is timely reporting of claims. Whether the policy is occurrence or claims made, claims must always be timely reported in order to qualify for coverage. With occurrence policies, an untimely reported claim can be construed as "late notice" such that the claim is ultimately denied. With claims made policies, these lines usually condition coverage on the fact that the claim is timely reported during the policy period or the claim reporting window. So, if a claim under a claims made policy is not reported in the window, the claim result will also be a denial of coverage. In either case, accepting claims outside of the reporting period is inconsistent with the insurance contract and potentially problematic because it

can defeat financial assumptions on which the ERC program is based.

#### **4. *Meet Filing and Payment Deadlines.***

In addition to timely payment of premium and reporting of claims is timely meeting state regulatory and payment deadlines. Timely responses to regulatory deadlines inspire the confidence of the regulators, and frankly, that investment in confidence can pay big dividends if an ERC were ever to find itself in any real difficulty.

Viewed from the regulators' perspective, for example, what does it say if the ERC asks every year for an extension to submit its annual report or audited financials? This is not to say that ERCs should never ask for extensions, only that meeting original regulatory deadlines without extension really is ideal and if an extension is needed, it should be the exception and not the rule.

Further, regulators are also running a business and need to be timely paid too. So, pay taxes and annual fees on time. Timely and accurate reports and annual filings tell a big part of any captive's story; including but not limited to, how well run and organized it is.

#### **3. *Build Your Written Record.***

In the end, any captive insurance company, ERCs included, is merely a succession of financial transactions. An ERC does not leave behind its products or its facilities or its employees to tell its story. The only legacy of an ERC's existence is its written record. Since we know that auditors will be reviewing

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the ERC's activities annually, regulators may review the ERC's activities periodically, and the IRS might review the ERC's

files. Maintain complete accounting records to help the auditors perform their job with regard to the filing of annual

regulators, to underwriters, to claims personnel, to accountants, to captive managers, to actuaries and auditors and so on. The individuals and companies who have established themselves among the best providers of services to ERCs tend to be those who have adopted industry standard best practices and are also engaged in service to the industry to refine and disseminate those best practices. So inquire about best practices and ask your service providers about their service to the industry.

It truly takes a village to run an ERC, but it helps to have the right villagers.

### **1. Communicate Pro-actively.**

As with so much in life, communication with regard to your ERC is key. The relationship your ERC has with state regulators can make or break your insurance program. So, build trust and credibility with regulators by being transparent about captive operations. Regulators, like so many of us, hate surprises. But, if there is going to be a surprise, captive managers that are trusted by regulators get a lot more wiggle room than those that do not have a reputation for candor, full disclosure and transparency. Trust us, the regulators know who the transparent, communicative managers and service providers are.

Transparent communication starts at the captive board level, with interested officers and directors who understand the business of insurance. Then those officers and directors

activities occasionally, we had better pay close attention to the written record, because it will be all that we have to show.

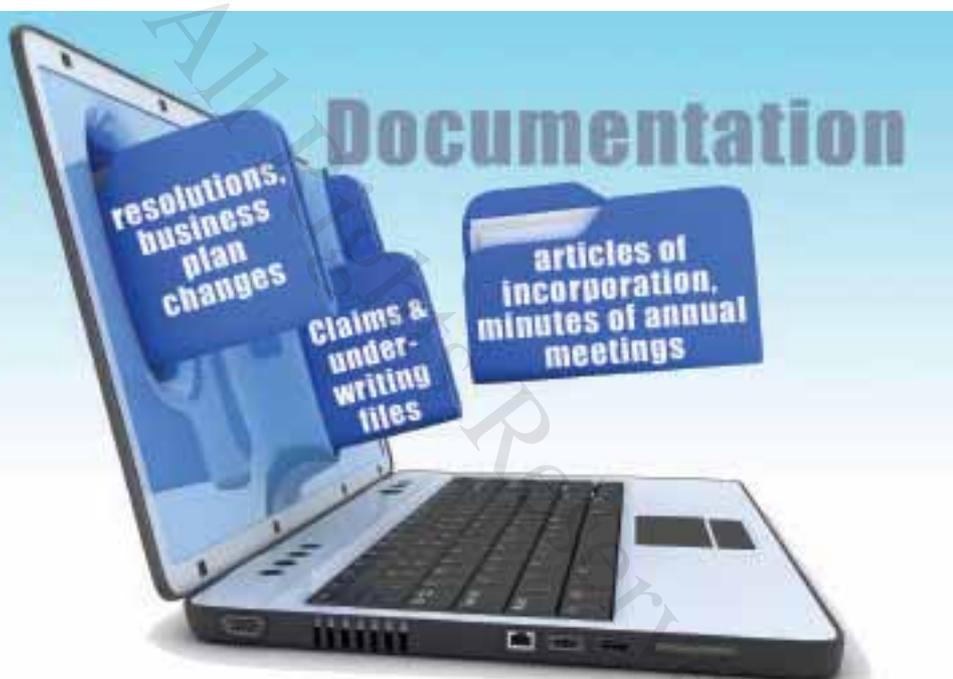
It is simply not possible to pay too much attention to the ERC's documentation. An ERC owner should respect corporate governance formalities and maintain complete corporate records from articles of incorporation to annual minutes. Document all meetings, resolutions, and the rationale/reasoning for everything the captive does. These documents will show not only that the ERC has followed statutory governance requirements, but can also support and articulate business purpose and rationale for design, implementation and ongoing adjustments of the insurance program. Timely complete and execute all policy contracts. Maintain complete claims and underwriting

audited financials. Document, document, document!

### **2. Hire the Right People.**

Background and experience are important. Make sure you have the right team to help you with your ERC. The insurance industry and the captive arena offer many training and credentialing opportunities that are specific and unique to insurance or captive insurance. So ask for credentials. There are a lot of professionals and firms that are very new to the captive insurance space. So ask about the specific captive insurance experience of people and their firms. Even as it grows, the captive insurance industry is a small world where practitioners know one another. So investigate reputations.

Everyone in the ERC industry has a role and all the roles are different: from



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connect with the manager and advisors to promote a culture of transparency on the day to day operational level. This transparency will translate to the regulators.

But even if your manager has a good relationship with regulators, that relationship can be compromised if the captive does things on its own without the guidance of the manager. Even the most respected captive managers and service providers cannot save a captive owner from his own consistent disregard for these Top Ten rules. Captive owners should do their part to ensure transparency with managers and advisors so that the manager can ensure timely, consistent, open communication with the regulators. Don't get your ERC in a position to have to beg for forgiveness from state regulators. Advise your team in advance – be proactive in communicating anything and everything about your ERC to your village of regulators and advisors.

### **Conclusion**

Regulatory best practices for ERCs are really about understanding your obligations and doing the things you are supposed to do when you are supposed to do them. Do you remember when Drew Barrymore jumped up on Letterman's desk to pull up her top and flash him? Well, the Top Ten ERC Regulatory Best Practices are the opposite of that!

The Top Ten ERC Regulatory Best Practices are the opposite of spontaneous or impulsive – they are methodical and consistent and will keep your ERC out of the

headlines, protect its reputation and let the regulator know that you and your ERC are good actors who can be trusted to

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*Don't get your ERC in a position to have to beg for forgiveness from state regulators. Advise your team in advance – be proactive in communicating anything and everything about your ERC to your village of regulators and advisors.*

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behave responsibly. The upshot is that you and your ERC get much more flexibility and leeway from regulators, sometimes even help and support, when you need it.

Moreover, recent tax court cases have confirmed that treatment of an arrangement as insurance for federal tax

purposes can depend, at least in part, on whether that arrangement was treated as insurance for state regulatory purposes. So, best regulatory practices not only keep your ERC compliant from a state insurance perspective,

they can make the difference in whether your arrangement is insurance for federal tax purposes too. 



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