



Cell Captives Explained: Benefits, Structures and Popularity

by Karrie Hyatt

In the last twenty years, the concept and use of cell captives has become widespread. There are dozens of domiciles worldwide that allow for this structure for captives and that number is growing every year. The popularity of these types of alternative risk transfer vehicles is based on their flexibility – they are more easily launched, they generally require less capital, they can separate risk by lines of business, they can be easily expanded and they can be quickly shut down – as compared to a pure captive.

There are three different types of cell captive structures, with new uses and concepts always in development. The most well-known cell captive

structure is the original type – the Protected Cell Captive – also known as a segregated portfolio company, a separate accounts company or a private act company, depending on the domicile. However, there are also Incorporated Cell Captives and, most recently, Series LLC Captives.

The idea of a cell captive is a relatively new one which grew out of the rent-a-captives concept utilized by Bermuda and other offshore domiciles from the late 1980s on. The concept amounts to an insurance company allowing outside organizations to access its captive operations for a fee without the financial commitments by those outside companies that would be required to set up their own captive. Based on this idea, in the late 1990s the domicile of Guernsey passed the first official law legalizing cell captives. This law took the rent-a-captive idea and legally segregated the assets of each section of the company from that of the other, creating individual cells. Many other captive domiciles quickly passed similar law, with the first U.S. domiciles, South Carolina and Kentucky, joining the rush in 2000.

According to Kirk Mooneyham, managing director, Captive Management Services, Wilmington Trust, cell captives are popular because of the flexibility they can offer to owners, “The ability to separate risks by lines of business, geographic region or risk/responsibility centers can be an attractive tool for some prospective

captive owners. A cell structure also gives the ability to easily expand the captive operations to include new types of risks or new insured entities.”

Cell Captives Defined

So what exactly are cell captives? A Protected Cell Captive is a legal, corporate entity in which the assets and liabilities are segregated and protected within one or many “cells” within the company, also called the “core.” Each cell is legally independent from the other cells and often from the main core itself. Therefore, each protected cell’s finances must be separately accounted for on the books of the core company. With this structure, the assets of one cell cannot be affected by the liabilities of another.

Another type of cell captive structure is the Incorporated Cell Captive. This entity is very similar to the Protected Cell Captive except that each individual cell is incorporated and is considered its own separate legal entity. The core company and the incorporated cells must file separate premium tax returns and are each required to meet the minimum and maximum premium tax limits as legislated by their domicile. The cells segregated by this structure are considered to have “higher and thicker” walls separating them from one another.

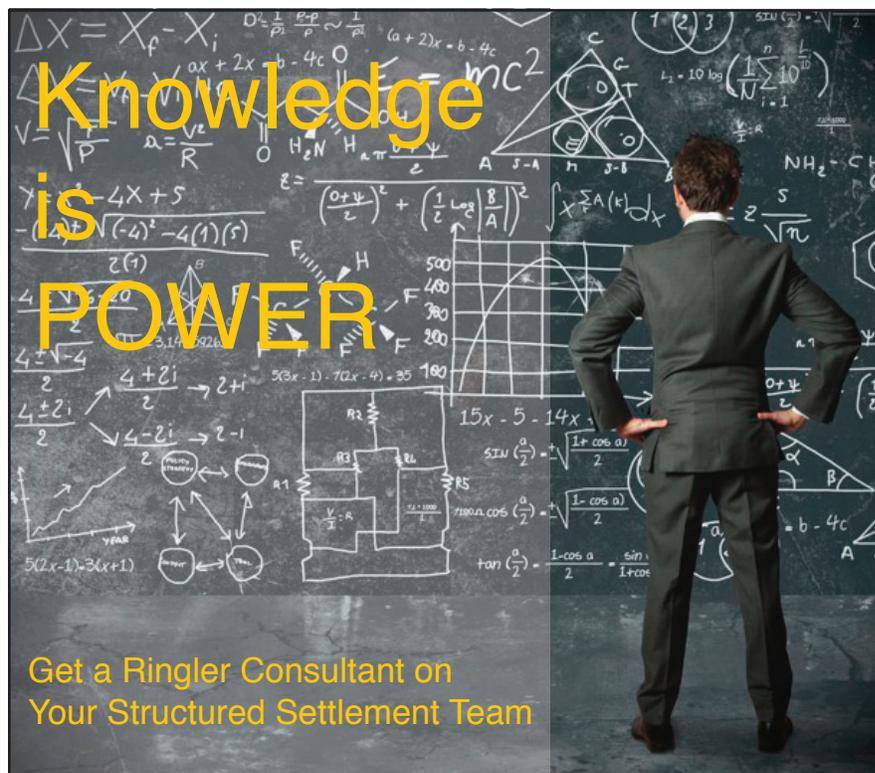
The third type of cell captive structure is the most recently developed, the Series LLC Captive. A Series LLC is made up of a number of cells, in this case called a Special Business Unit (SBU), where each is treated, for all intents and purposes, as a pure captive. The core company has a minimum capital requirement (that is often quite lower than for regular captives) and when those requirements are met, the SBUs can generally begin operation. Each SBU can obtain its own tax number and will file its own tax returns. One

limitation is that an existing SBU will often only allow a limited range of permitted lines of coverage.

Cell Captive Advantages

The segregation of the assets and liabilities of each individual cell of a company is what makes cell captives advantageous. Like pure captives, cell captives enjoy such benefits as lower premiums, more control of risks covered, potential dividends for owners, as well as tax benefits and other tax saving opportunities. The cell captive structure also offers other advantages.

- The structure of cell captives appeals to potential captive owners who want the cost benefits associated with captives but who are concerned about
- the sharing of risks and financial assets with owners not in their own geographic area or line of business, or only indirectly related to their business.
- Once the core company of the cell captive is established, it is relatively quick for new cells to begin operations.
- Another appealing aspect is that cell captives can cleave away from the main company and readily transition into a regular or pure captive. This is especially true of Incorporated Cell Captives that will already have separate finances and their own board of directors.
- The cell captive structure is very flexible in nature allowing for a



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captive that best meets the needs of its owners. According to Mooneyham, "The biggest advantage cell captives bring to the table is the flexibility they allow for with the design of an overall captive structure. Assets and liabilities can be walled off in number of different ways to make an overall structure much more appealing than a pure captive arrangement."

- Because the capital resides in the core company, cell captives are easier and quicker to close down than a regular captive.

Why So Popular?

The advantages listed above explain why cell captives have been taking off over the last decade. Secured assets, lower capital requirements and flexible structure all have their appeals, but another reason may also be driving the growth of this sector of captives. Fewer large companies are forming pure captives, leaving an opening for smaller companies utilizing different types of captive structures to fill in the gaps.

"Looking at the captive market in its entirety, larger companies that have formed traditional captives... there are less and less of those companies out there without captives, so we're going to get to a point where [pure] captive formations and growth of large captives will plateau," said Ellen Charnley, managing director, Marsh Captive Solutions. "I think companies will always form captives, but we'll see the real [growth] in the small captive space."

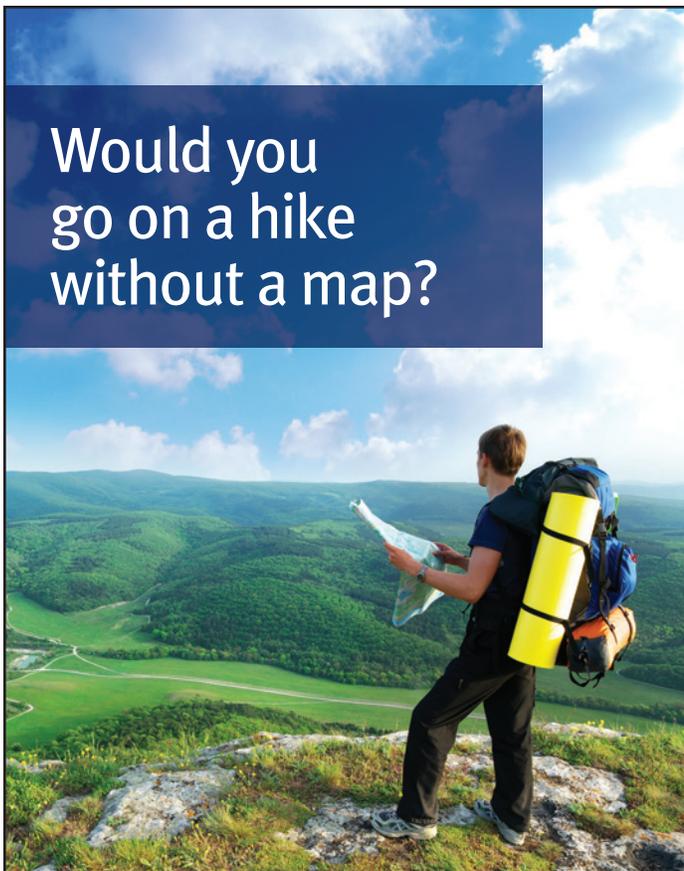
Part of this growth in the smaller captives sector, including cell captives, is that many of the emerging risks tend to be categorized as "high severity, low frequency" risks. Examples of these types of risks are employment practices liability insurance, product recall, errors and omissions, catastrophic, cyber and reputational risk. While many of these risks may never occur, when they do the losses tend to be very high. The cell captive structure is perfectly suited to those types of risks. According to

Charnley, "There are many risks that an organization could be exposed to but typically wouldn't want to go out and buy traditional coverage for because it would be cost prohibitive to do so."

Mooneyham agrees that cell captives have to potential to meet the needs of some of the emerging risks in the insurance market. "I see activity with enterprise risks that are difficult to current place in the general insurance market. Risks such as cyber liability, reputational exposures and supply chain elements."

As the cell captive structure heads towards its twentieth anniversary, there seems to be no end to their growth potential. Given their flexibility and ease of set-up, there is plenty of opportunities for cell captives to grow. As this sector of the industry matures, cell captives will no doubt evolve even further. ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for nearly ten years. More information about her work can be found at: www.karriehyatt.com.



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