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# ENTERPRISE RISK CAPTIVE REPORT 2015

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# Introduction

**C**aptive Review's first *Enterprise Risk Captive Report* analyses the key issues surrounding the use of smaller captives.

This form of captive, primarily serving the United States' middle market, has experienced a surge in popularity thanks in part to comprehensive reform of the US insurance regulatory system, such as the Solvency Modernization Initiative.

*Captive Review* hears from leading industry experts to examine these reforms and their effect on the US captive insurance industry.

We study some of the risks surrounding tax motivated formations and debunk some of the myths surrounding the use of 'micro captives'.

This report also looks in detail at the dos and don'ts a prospective captive owner should consider when choosing service providers, as well as defining the roles and responsibilities all top captive managers should be maintaining.

The advantages and challenges involved in the formation of a risk enterprise captives are also discussed and we hear the states of Delaware and Missouri's take on regulatory oversight.

**Drew Nicol, report editor**

# CAPTIVE

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Published by Pageant Media,  
Thavies Inn House, 3-4 Holborn Circus,  
London, EC1N 2HA

ISSN: 1757-1251 Printed by The Manson Group

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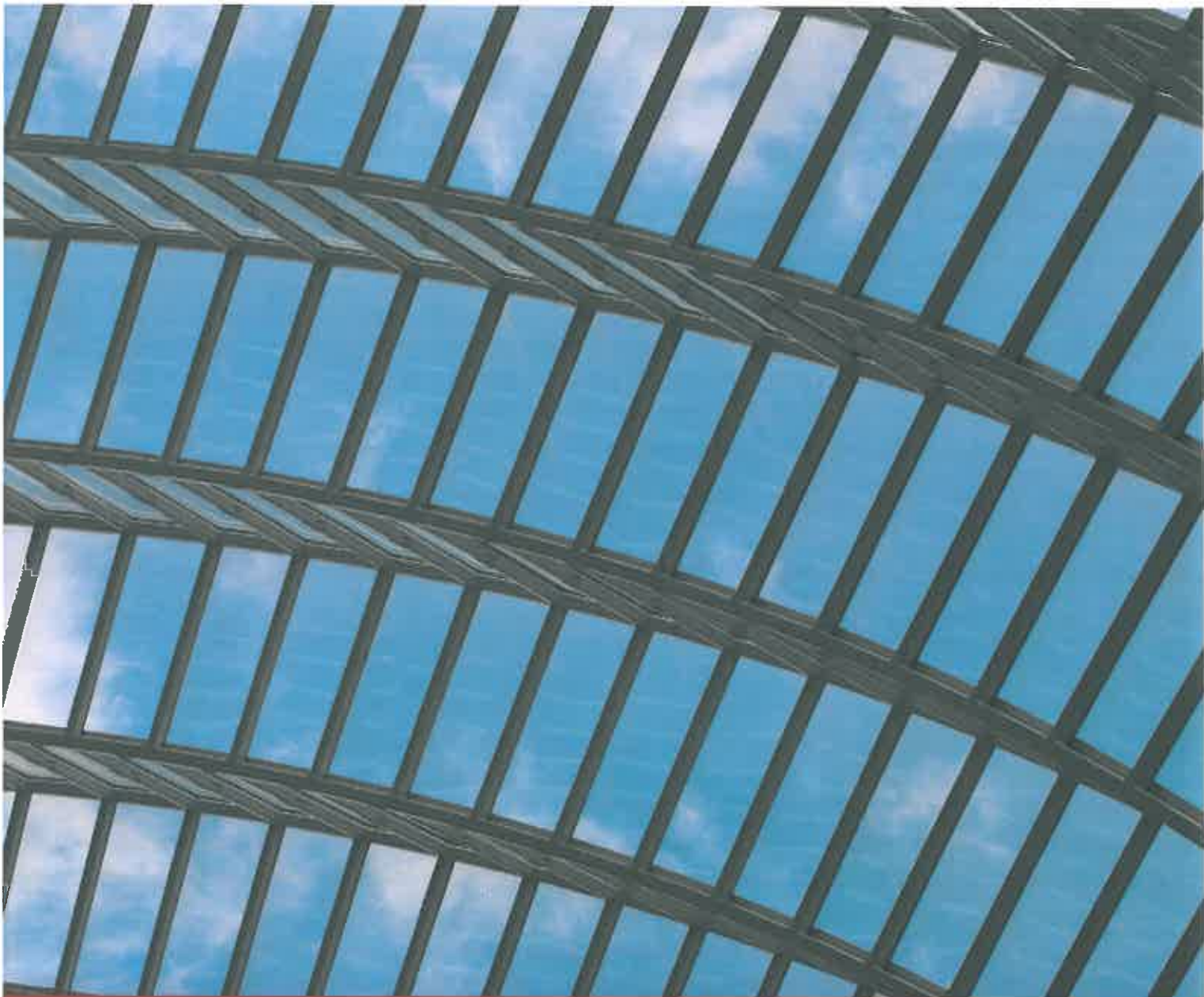
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# SELECTING AND WORKING WITH A CAPTIVE MANAGER

Frederick E. Turner, founder of Active Captive Management, LLC, explains the correct process for choosing a captive manager

**O**f the many choices any captive owner will make, one of the most crucial is the selection of a captive manager. In fact, the relationship between a captive and its manager can make or break the captive's success. So, what makes a captive manager a good one? And, what makes the captive/manager relationship strong?

### Finding a competent captive manager – what's the role of the manager?

The role of the captive manager is generally to assist the captive to perform its necessary insurance operations and to communicate on its behalf with regulators. There are four main insurance functions that a manager helps the captive with: (1) performing underwriting; (2) performing claims handling; (3) assisting with financial recordkeeping and financial management; and (4) ensuring captive regulatory compliance.

#### Underwriting:

Underwriting is the process of evaluating risk for coverage. It necessarily involves reviewing information submitted by insureds in an application or renewal process and evaluating this information to determine what would be appropriate insurance policy lines to cover the risk to be transferred to the captive and then what should be the price of the insurance, i.e., its premium rates.

In the captive context, underwriters also qualify insureds to purchase policies. For example, in the single-parent context,

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insureds must be either a parent entity, an affiliated entity, or a controlled unaffiliated business entity. Underwriters also write the policy lines and as the drafters of the coverage, are often called on to work with the claims department to help interpret the intent of the coverage when a claim is at issue. Underwriters also coordinate with commercial insurance brokers to ensure a seamless marriage between the captive and commercial program, where the captive is filling in the gaps in the commercial program. In fact, where commercial insurance is being replaced in whole or in part, the captive manager works in tandem with the commercial broker and the client to determine what would be appropriate captive policy lines.

#### Claims handling:

Claims handling is the function through which a captive evaluates whether or not claims are covered. Captive managers with an in-house

claims department help their captive clients to make claims decisions (some managers might act directly as a TPA for the captive, others provide coverage recommendations to the captive). Claims personnel also coordinate with actuaries to evaluate and manage exposure and loss data and set reserves. The issuance of policy lines coupled with the ability to pay covered claims encompasses the primary functions of any insurance company; a captive is no different than a traditional carrier in this regard.

#### Financial management:

Managers also help their captive clients to maintain accounting and financial records and facilitate making financial records available to regulators, examiners, auditors and company shareholders. Managers also work with a captive's outside advisors, like the captive's CPA, tax counsel, or investment advisors to ensure proper accounting treatment for captive financials, that tax considerations are handled appropriately by professionals employed to address tax issues and to ensure a captive is diverse in its investments.

#### Compliance:

On the compliance and regulatory side of the equation, captive managers also prepare formation documents for the captive, like captive business plans, submit application documents to the regulators in order to secure a captive's license and engage the services of actuaries to prepare feasibility studies. Managers also provide board meeting services,



including coordination of meetings and preparation of materials, and provide for local director services.

These are but a few examples of compliance functions performed by a manager: but, the bigger picture, working hand in hand with the domicile that regulates the captive is in our view, the key and primary function of every manager. So captives need not only managers experienced in insurance and risk management, with deep resources in both areas, they also need a manager that has developed and maintains strong relationships with regulators.

Thus, at the center of captive management is captive compliance – captive managers need strong, solid in-house resources to provide regulatory related services, such as ensuring that the captive is in compliance with governing insurance code in the captive's domicile, overseeing the preparation and filing of regulatory reports like the captive's annual statement, maintaining captive records as per regulatory requirements, and helping the captive to respond to regulatory examinations and inquiries.

**Is there anything a captive manager shouldn't do?**

A captive manager cannot – and should not – be everything. There is a line between the captive and the manager and then another line between the manager and necessary outside resources. Each part of this makes up the operations triangle for any captive;

with the owner on one side of the equation, the manager on another, and with outside resources as the third side to a successfully managed and well run captive.

The road to a captive starts with organizational risk management. In other words, captive managers should act in concert with the captive owner and/or the insureds' risk management team and a well thought-out risk program includes both organizational risk management and risk management at the captive level, where one necessarily benefits from the other. The captive also needs outside advisors in the fields of audit, legal, actuarial, and tax.

The captive manager can help the captive retain qualified outside resources in these fields – do not believe any captive manager that tells you they can be everything to the captive. The truth is that every captive needs more than just a manager; it needs an aware owner, a diligent regulator, and outside resources (like tax counsel, CPAs and actuaries). Captive owners should watch out for captive managers that outsource all or most of the four functions noted above or that tell you it's one-stop shopping with them and that they can do absolutely everything to meet the needs of the captive. It takes a team, where a quality manager is but one part.


**Having a strong and successful relationship with your manager – the Active Captive difference:**

At Active Captive Management, we listen to

our clients, we listen to the industry, and we listen to regulators. As with any other relationship, communication is key. Our philosophy is one that marries the risk and captive management needs of our clients to the requirements of the governing domiciles to create and manage compliant captives that serve risk management purposes and meet the insurance needs of our diverse business base. We specialize in the formation and management of captive insurance companies for small and medium-size companies.

Captive insurance as an alternative risk management strategy is being used by more than half of the Fortune 1500 US and multinational corporations. Active Captive has in-house veteran insurance industry personnel, many of whom came to Active Captive with decades of experience working for or with commercial insurance companies.

We don't outsource the four chief functions of a captive manager. We have the necessary internal resources in claims, underwriting, accounting and compliance that work in concert with each other and can act quickly and competently to service the needs of our managed business.

We are an approved captive insurance manager in the following domiciles: Alabama, Delaware, District of Columbia, Florida, Hawaii, Kentucky, Missouri, Montana, Nevada, New Jersey, North Carolina, Oklahoma, Oregon, South Carolina, Tennessee, Utah, Nevis, Bermuda, Puerto Rico, and St. Christopher (St. Kitts). 

# US SOLVENCY MODERNIZATION

Maria Sheffield, of the Missouri Department of Insurance, speaks to *Captive Review* to explain the creation of the Solvency Modernization Initiative (SMI)

Over many years US insurance regulators have developed a detailed and uniform financial regulatory system. However, global and national developments made it clear that the US insurance regulatory system was due for another comprehensive review, which led to the Solvency Modernization Initiative (SMI).

**Captive Review (CR):** In the early 1990s, the NAIC's Solvency Policing Agenda resulted in a number of major changes to financial regulation (e.g., RBC, accreditation, IRIS system, FAWG) which provided more early warning systems and standards for regulation. What is SMI's focus?

**Maria Sheffield (MS):** Launched in 2008, the SMI Task Force was charged with performing a critical self-examination of the United States' insurance solvency regulation framework and a review of international developments regarding insurance supervision, banking supervision, and international accounting standards and their potential use in US insurance regulation. While US insurance solvency regulation is updated on a continuous basis, the SMI Task Force focused on five key solvency areas: capital requirements; international accounting; insurance



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valuation; reinsurance, and group regulatory issues with an objective to ultimately improve the US solvency system.

The State of Missouri has been an active participant in the SMI as Missouri's Insurance Director John Huff served as the last appointed chair of the national SMI Task Force spearheading this initiative. Having spent 11 years as an executive with leading insurers and reinsurers, including Swiss Re and GE Insurance Solutions where he led global teams; Director Huff was uniquely qualified for this position.

From the start, SMI's objective has been to improve solvency regulation in the US and implement best practices from around the

world. US insurance regulators believe that well-executed risk management improves a company's chances of continuing to operate in a strong and healthy manner. A further uniformly accepted belief is that quantitative analysis should improve the regulator's ability to assess when a company is in a hazardous financial condition: assist with risk-focused examinations; and aid in evaluating the industry's overall ability to withstand certain stresses.

**CR:** Financial solvency core principles underlie the active regulation that exists today. Can you expand on these principles?

**MS:** A core principle, for purposes of this article, is an approach, a process, or an action that is fundamentally and directly associated with achieving the mission. Seven core principles have been identified for the US insurance regulatory system including: (1) regulatory reporting, disclosure and transparency; (2) off-site monitoring and analysis; (3) on-site risk-focused examinations (4) reserves, capital adequacy and solvency; (5) regulatory control of significant, broad-based risk-related transactions/activities; (6) preventive and corrective measures, including enforcement; and (7) exiting the market and receivership.

**CR:** You mentioned previously, the SMI has focused on five key solvency areas which can be grouped into the categories of corporate governance, ORSA, group solvency, principle-based reserving and credit for reinsurance. Can you provide some additional details for these key areas?

**MS:** Details for these key areas are as follows: Corporate Governance: after performing a

**"From the start, SMI's objective has been to improve solvency regulation in the US and implement best practices from around the world"**



comparative analysis of existing requirements to regulatory needs and international standards, the NAIC developed a number of specific enhancements. The proposed enhancements do not prescribe a list of explicit governance requirements, but instead seek to gain a better understanding of an insurer's governance practices and to use that information to modify supervisory monitoring accordingly.

These proposed enhancements have led to the development of a new model law to facilitate the annual collection of confidential information on insurers' corporate governance practices. The development of the Annual Reporting of Corporate Governance Practices of Insurers Model Act provides a means for regulators to get a better understanding of the governance practices of their domestic insurers. The development of this model law also ensures the confidentiality of governance information collected from insurers and assists US regulators in achieving greater consistency with international standards.

**ORSA:** the NAIC adopted the Risk Management and ORSA Model Law in September 2012 and the initial ORSA Guidance Manual in March 2012. The regulators completed pilot projects in 2012 and 2013 to study ORSA Summary Reports to improve the ORSA Guidance Manual. The 2014 ORSA pilot project is currently underway. Presently, 20 states have adopted the model law in full or part with legislation under consideration in five states.

The ORSA is an insurer's own process for assessing its risk profile and the capital required to support its business plans in normal and stressed environments on a forward-looking basis. The model law requires insurers/insurance groups to carry out this risk and solvency assessment process on a regular basis. The ORSA is also a regulatory filing. On an annual basis insurers will be required to provide a regulatory filing that explains their ORSA process and results. The filing does not have a prescribed format but needs to contain three sections: 1) description of ERM framework; 2) assessment of risk exposure under normal and stressed environments; and 3) group capital adequacy and prospective solvency assessment.

**Group solvency/supervision:** the solvency framework of state insurance regulation has included a review of the holding company system for decades, including approval of certain affiliate transactions with a domestic insurer, but with emphasis placed on taking actions to protect the legal insurance entity writing the policies.

The NAIC adopted revisions to its Model Insurance Holding Company System Regulatory

Act and Regulation in 2010 to enhance the 'windows and walls' approach to group supervision. The revisions call for enterprise risk reporting at the ultimate controlling entity

regulation of licensed reinsurers, the US uses an indirect approach to reinsurance financial supervision through statutory accounting requirements for US primary companies (or

**"Quantitative analysis should improve the regulator's ability to assess when a company is in a hazardous financial condition"**

level, enhanced regulator access to data and information from non-insurance operations, clear authority to participate in supervisory colleges, and enhanced information sharing between regulators.

The Insurance Holding Company System Regulation has been adopted in full or part in 14 states and is under consideration in another six states while the Model Insurance Holding Company System Regulatory Act has been adopted in full or part in 38 states with legislation under consideration in six states.

**Principle-based reserving (PBR):** The purpose of PBR is to replace the existing formulaic reserve requirements with a model based framework, to improve accuracy of reserves and to account for continuously evolving products that constantly make the formula outdated. Outdated formulas can result in reserves too high or too low. Reserves that are too high create unnecessary surplus drain. Reserves that are too low create insolvency risk for the insurer and policyholders.

The Model Standard Valuation Law (SVL) establishes requirements for PBR valuation and what the Valuation Manual must provide. The Valuation Manual is to include all reserve requirements for life and health companies including details of PBR and non-PBR reserve methodologies. The Valuation Manual was adopted by the NAIC in December 2012.

Eighteen states have adopted the amended SVL and Valuation Manual. Implementation of PBR will only occur when at least 42 states (writing at least 75% of life insurance premium) have adopted the amended SVL and Valuation Manual.

Actuarial guideline 48 is currently under development and is a PBR based solution to address standardization concerns with insurer's use of captives to finance life reinsurance reserves through captives.

**Credit for reinsurance:** reinsurers licensed in the US are directly regulated through financial regulation (similar to primary insurers). In addition to direct financial

'ceding' companies) that transfer business via reinsurance.

Revised reinsurance model laws (#785 and #786) were adopted in November 2011. These revisions serve to reduce reinsurance collateral requirements for non-US licensed reinsurers that are licensed and domiciled in qualified jurisdictions. 17 states have adopted both #785 and #786, six states have adopted only #785 and five states are presently considering legislation related to the two model acts.

Generally, the following changes are expected through the adoption of these model laws: Potential collateral reduction for reinsurers meeting certain financial strength and business practices; and reduced collateral requirements for assuming reinsurers that are not otherwise licensed or accredited in a state, but have been 'certified' as reinsurers by the state. A certified reinsurer is one domiciled in a 'qualified jurisdiction' and that meets other criteria relating to capital and surplus, financial strength ratings and other matters. Foreign jurisdictions will be treated as qualified jurisdictions if they meet standards as to 'appropriateness and effectiveness' of the reinsurance supervisory system of the jurisdiction. Individual states must designate each qualified jurisdiction or can rely on the NAIC list.

The NAIC will produce a list of qualified jurisdictions. In 2013, the NAIC conditionally approved the supervisory authorities in Bermuda, Germany, Switzerland and the United Kingdom. In 2014 the NAIC is considering full approval for these jurisdictions as well as Japan, Ireland and France. Additionally, work is underway to standardize the initial and renewal requirements for certified reinsurers in these jurisdictions as well as an efficient process where reinsurers may be passported as a certified reinsurer through an abbreviated filing process in other states upon review by the NAIC Reinsurance Financial Analyst Working Group. 

# #1



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# CAPTIVE BOOM FOR MIDDLE MARKET

*Captive Review* speaks with Doug Deitch and Mike Bonesteel, of Keystone Risk Partners, to discuss captive options for middle market businesses

**K**eystone Risk Partners (KRP), based in Philadelphia, specializes in establishing captive and alternative risk solutions. Specifically, it uses its technical expertise in underwriting and risk finance, working in partnership with insurance agents and brokers, to bring the highly successful solutions of the Fortune 500 business to a wider audience of middle market insureds seeking a tailored captive insurance company solution.

**Captive Review (CR): Why is there growing interest in captive solutions for the middle market insured?**

**Doug Deitch (DD):** To understand the growth in this segment of the captive market, we need to look at some of the underlying factors causing this change.

The most common complaint we hear from middle market insureds (those with primary casualty insurance premiums in the \$1m to \$5m range) is that the traditional commercial insurance market tends to only offer limited 'off-the-shelf' insurance products. These structures often fall short in critical areas of coverage design and financial impact when attempting to address the risk management and financial goals of this market segment.

As an example, once an insured becomes

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Written by  
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too large for the appeal of a guaranteed cost insurance program, the commercial market seems content with simply shifting the underwriting risk back to the insured in the form of a large deductible or retention and allowing the insured to pay the majority of

their own losses as they go. It is this shift in underwriting risk to the financial statement of the insured that creates the greatest opportunity for a tailored captive insurance solution.

**CR: What problems can the middle market insured face as a result of this shift in underwriting risk?**

**Mike Bonesteel (MB):** We generally find that the middle market customer wears a number of operational hats but often struggles in the role of acting as an insurance company for their selected layer of risk. They experience cash flow volatility on a monthly and annual basis, with wide variances in claim payments. This is a problem that compounds with each subsequent policy renewal creating instability in their cash forecasts. They often assume long-tail exposures, such as workers' compensation, where the ultimate cost will develop over many years, without the technical insurance/actuarial resources to create an effective accrual strategy. This may lead to unwelcome surprises to earnings when these long-term liabilities are due. Additionally, these insureds often struggle with understanding the concept of collateral requirements for these long-term liabilities, and are routinely frustrated with the stacking of letters of credit that negatively impacts their working capital.

In summary, the shift of underwriting risk from the commercial market to the insured, often via a large deductible or self-insured retention, does not change the fundamentals of insurance. However, often it leaves the insured without the same tools as the insurance industry.

**"We generally find that the middle market customer wears a number of operational hats but often struggles in the role of acting as an insurance company for their selected layer of risk"**



**CR:** So a conventional insurance solution can have a long-term impact on the balance sheet, income statement and cash flow projections of a middle market insured. How can a captive solution address these challenges?

**DD:** A captive, like a commercial insurance company, can assume risks, accept premiums, issue policies and for qualifying arrangements take a tax deduction for the majority of their loss reserves. In addition, captives are often used to provide collateral to a fronting carrier for future claim obligations. By developing a private captive solution, a middle market insured can effectively and efficiently transfer the underwriting risk they assume under a commercial large deductible arrangement while maintaining the control they seek over the financial decisions involving claims.

which can be made within a single parent or an individual cell or series captive entities. Captives making the 831(b) election, often referred to as micro captives, can be an excellent risk financing tool for middle market insureds if their annual captive premiums are less than the \$1.2m threshold. The 831(b) election allows a qualifying insurance company, including captives, to be taxed only on its taxable investment income and not on its underwriting (or insurance) income. The absence of federal income taxes on their underwriting income will allow a captive with this election to rapidly increase its asset base for the developing claim obligations it is insuring. The ability to retain the underwriting margin as equity will help the micro captive address the volatility that invariably exists within smaller insurance programs while

**CR:** With the value that a captive brings to the middle market, are there specific characteristics you see in insureds that make them an ideal fit for these types of solutions?

**MB:** There are no defining attributes that make all businesses with 'XYZ characteristic' an inherently perfect fit for a captive solution as the process tends to be more holistic. That said, we do see some recurring characteristics that make this approach very attractive. These include insureds with:

- Fragmented programs with multiple policies and/or insurance carriers looking to form a consolidated risk management program and more efficiently assume a portion of the insurance risk.
- Diversity in their operating subsidiaries that create coverage gaps or significant uninsured exposures.
- The unique ability to allocate or pass through insurance premiums to third parties.
- Privately held ownership looking for innovative ways to retain key employees or achieve estate/succession planning objectives.
- Difficulty in obtaining letter of credit capacity or dedicating working capital towards traditional commercial insurance solutions.

**"Captives making the 831(b) election, often referred to as micro captives, can be an excellent risk financing tool for middle market insureds"**

It is the simplicity of the solution that creates the appeal for this market. The insured purchases a policy from the captive to insure their large deductible layer. The premium for this policy can be tailored to the funding objectives of the insured while remaining commercially reasonable for the risk as supported by an independent actuary.

The premium can be paid on installments (monthly, quarterly, etc), which creates a stable cash flow budget for the insured while transferring the volatility of the paid losses to the captive. The captive 'banks' the premium as an asset and establishes an actuarially supported, tax efficient reserve for future claim obligations. Finally, the premium and capital received by the captive provide assets that can support outgoing collateral requirements of the large deductible insurer, thus eliminating the drag on the working capital of the insured.

A captive solution can provide the insured with the same tool box as a commercial insurer to efficiently handle the shift in underwriting risk.

**CR:** What is driving the growing popularity of captives making the 831(b) election, particularly for middle market insureds?

**MB:** We would certainly agree that there is a lot of attention given to the 831(b) election

creating stability in the annual premium requirements of the middle market insured. This election serves as another financial tool to help this segment of the insurance market enjoy the stability that is typically only attained by a much larger captive solution.

**CR:** What do you see as the main issues regarding captive solutions focused on the 831(b) election?

**DD:** The main concern we have when evaluating a middle market captive solution with prospects and other advisors is the temptation to 'put the cart before the horse' and allow the tax benefits to dominate the initial planning context. We are strong believers that the decision to make the 831(b) election should come at the end of the process once the feasibility of the non-tax business purpose has been fully vetted, not the beginning. This ensures that captives are formed first and foremost for risk management purposes, a characteristic of any insurance company regardless of size.

If the underwriting analysis and actuarial feasibility concludes with a recommended premium amount of under \$1.2m, then the 831(b) tax election is often the clear choice. Efficient tax structuring is an important part of the process, but cannot be the dominant or initial focus.

**CR:** What do you see as the best way for a middle market insured to explore a captive solution?

**DD:** First, visit with your insurance broker to do a complete risk management needs analysis. This will help identify and prioritize areas of exposure that are not fully addressed by the commercial market. This process can also determine an insured's willingness and ability to assume a portion of their risk to gain greater control over their long-term costs.

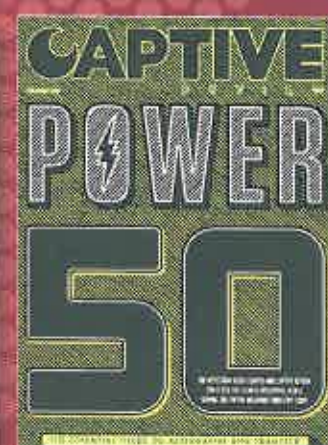
Once this review is complete, it is appropriate to contact a captive insurance professional to begin the evaluation process. Our recommendation is to begin with an education-driven overview to ensure the structure makes sense conceptually before the financial commitment of a feasibility study.

If the decision is made to move forward, it is then appropriate to bring actuaries, accountants, tax advisors and attorneys into the process as necessary. Combining these resources along with the traditional insurance broker, the captive insurance professional can build a cohesive advisory team to establish a cutting edge alternative risk financing structure. ☺

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Written by  
**Paul Golden**

A hand holding a magnifying glass over the text "SCOURGE OR SAVIOR?". The magnifying glass is held by a hand from the bottom left, and the lens is focused on the text. The background of the page is a blurred image of a document with text.

# SCOURGE OR SAVIOR?

Depending on your viewpoint, they are either the next big thing in the US captive space or one of the industry's most potent threats. We take a closer look at 831(b) captives – a fast-growing sector of the US captive industry attracting all the wrong kind of attention from the IRS

831(b) captives, or 'micro-captives', are proliferating in the US – particularly in the US's younger captive domiciles – and are a key entry route into the captive industry for the much-coveted middle market. Yet their eye-catching tax advantages threaten to put the industry's reputation to the test once again.

The IRS tax code section 831(b) is designed to assist small insurance companies in their start-up phase by allowing captives who write less than \$1.2m in premiums to enjoy tax-free underwriting profits. For a captive making the 831(b) election, federal income taxes are payable only on investment income. Premiums paid to the captive by the company are typically tax deductible and since no federal income taxes are paid on underwriting income, a captive with low losses relative to premiums can generate significant tax advantages for its owner.

Utah licensed 87 new captives in 2013 – the majority of which were micro-captives. David Snowball, director of the Utah Insurance Department's captive insurance division, says these vehicles are being set up in Utah by companies from a range of sectors, from assisted living and construction to specialty businesses, such as underwater welding.

Strategic Risk Solutions managing director Patrick Theriault says that while captives owned by mid-size organizations often have premium amounts that fall under the section 831(b) threshold, not all of his captive clients elect to do so.

However, 831(b) captives are proving popular, and it is widely accepted that some dishonest providers are selling these captives as tax avoidance mechanisms rather than as genuine insurance companies. Derek Freihaut, principal & consulting actuary at Pinnacle, says: "We have seen several instances where the IRS is examining all types of captives, including those making the 831(b) election, but there does seem to be increased scrutiny of captives that have certain characteristics."

Red flags for the IRS, Freihaut explains, include promotional materials that emphasise the income tax goals of the captive

**WHAT IS A SECTION 831(B) CAPTIVE?**

A captive insurance company may elect under 28 USC section 831(b) to be taxed on its investment income only, as long as the company receives less than \$1.2m in premium each year. The 831(b) election is filed along with the company's first tax return and cannot be revoked without the consent of the Secretary of the Treasury.

The 831(b) election does not affect the deductibility of the premiums paid by the operating business to the captive. This has the effect of creating up to a \$1.2m tax deduction for the operating business through the combination of the tax deductibility of the premiums transferred to the captive and the captive's tax-free underwriting profits

and coverages that bear little resemblance to the underlying exposure. "The IRS is also looking at inadequate risk distribution, premiums bearing little resemblance to market premiums and lack of an actuarial study," he adds.

Professor Beckett Cantley from John Marshal Law School in Atlanta explains that some promoters advise small business owners to establish a captive for the supposed purpose of insuring business risk and having it invest in life insurance on the captive/business owner's life. He warns that in an insurance transaction, the nature of captive premiums funneled into personal life insurance on a common owner will likely make it difficult to prove the captive was created and funded for non-tax business purposes.

Cantley also points out that the IRS has considerable experience in this area, having previously pursued promoters and taxpayer participants seeking tax deductible life insurance premiums through schemes such as IRC 419 and IRC 412(e)(3) plans, corporate-owned life insurance financing arrangements and producer-owned reinsurance companies.

Theriault agrees that the IRS is taking a greater interest in captives. "That said, we have more than 200 captive insurance clients

and have not noticed a material increase in the amount of direct or indirect IRS audits/reviews conducted on these companies," he says. "I think an increase in activity is to be expected when you are looking at an industry that continues to grow and we expect that the IRS will continue to look at captives when it sees what it perceives to be abusive practices."

**Industry concern**

The Captive Insurance Companies Association (CICA) is so concerned about the abuse of 831(b) captives that it released a public statement accusing wealth managers of marketing the vehicles as tax shelters, putting the reputation of the captive insurance industry at risk.

These micro captives "are often over sold as tax shelters without adequate attention to whether these companies are truly insurance companies and meet the requirements of operating as a legitimate insurance company with risk shifting, risk distribution, and arms-length pricing," CICA states.

"Although there is nothing wrong with the utilization of the 831(b) election when a small captive insurance company is truly engaged in insuring the risk of its parent company/owner(s), the traditional captive insurance industry strongly opposes the utilization of small 831(b) captives primarily for tax sheltering purposes," the Association adds, urging: "Do them right, or don't do them at all."

However, Chaz Lavelle, a partner at Bingham Greenebaum Doll, says his practice has no experience of captives abusing the 831(b) election. Theriault is also not convinced that CICA's assessment is proportionate, believing that although unscrupulous activity may occasionally occur, the majority of US captive owners, regulators and managers act within the law.

Captive insurance company consultant and financial adviser Tony Kendzior observes that the cost of setting up a captive continues to fall for small businesses, and that more and more states across the US are setting up departments to encourage 831(b) captives in their jurisdictions. But he claims the IRS has done a good job of "intimidating" the CPA community and, by extension, small business owners whose companies could benefit from an 831(b) captive.

"The line between what is okay and what is not is deliberately vague. As a result, there are far fewer captives in place than one might expect. But their acceptance is increasingly apparent, given the frequency of sessions


and discussions at CPA meetings and forums. Couple that increasing awareness with a shrinking cost of implementation and it is likely there will be more captives in place over the coming years."

Given that 831(b) captives are relatively recent phenomena, Kendzior expects more teething problems. "However, trending patterns suggest a maturing and evolving concept. Whether driven by a need for asset protection, better risk management, empowering key employees, a more favorable environment to accumulate retirement assets or to take advantage of trusted estate planning techniques, an 831(b) may have a role to play," he says, adding: "Yes, there are numerous tax advantages, both in the short term and the long term. But tax advantages should not be, nor need they be, the primary motivating force behind the adoption of this idea to benefit a successful small business and its owners."

He acknowledges the existence of abusive micro captives, but claims that whether they were actually implemented and shut down or were simply floated by the IRS to scare people is anyone's guess. "I heard about a case in California where someone paid a premium to their captive of \$1.2m for terrorism risk - that wouldn't pass muster in New York City. Or a case where 100% of the reserve was 'invested' in a life insurance policy naming the business owner as the insured and his family as the beneficiary. Something like that is going to draw attention. Some money going to life insurance seems to be okay, but how much is too much?"

**Here to stay**

For Utah's Snowball, micro-captives will continue to be the domicile's bread and butter. Yet he expects more scrutiny from the IRS. "There are some who may be creating a captive primarily for the tax benefit and not meeting all the requirements to qualify for the 831(b) designation, yet they are using it. We all need to remember that a captive is first an insurance company - and must be developed for that purpose - and then we can take advantage of other captive perks," he says.

He doesn't think the abuse is at a level that would negatively impact perceptions of the captive insurance industry, but accepts that it could become a greater issue in the future. "Any time people get so irresponsible that they are willing to go beyond what is appropriate, it increases the possibility of ruining the entire industry." 

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professionals is one of the reasons many captive managers and their clients use Anguilla.

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# DELAWARE: SETTING THE STANDARD

*Captive Review* catches up with Steve Kinion, Delaware's captive insurance director, to talk about Delaware's captive insurance success

**Captive Review (CR): Please provide an overview of Delaware's captive industry?**

**Steve Kinion (SK):** Delaware is the third largest captive domicile in the US and the sixth largest worldwide. In terms of annual premium volume, Delaware ranks as the third largest US domicile with \$6.6bn for 2013.

**CR: What do you attribute to Delaware's captive success?**

**SK:** Delaware's captive success is attributable to the leadership of Insurance Commissioner Karen Weldin Stewart. For any captive domicile to be successful, there must be a commitment from the top of the organization. She has devoted the necessary time and resources to make Delaware a captive success. When she entered office in January 2009 she committed to making the captive program into a self-standing bureau. In July 2009, when she formed the captive bureau, Delaware only had 38 captive insurers. In a little more than five years, Delaware has become one of world's preeminent captive insurance domiciles.

**CR: What types of captives does Delaware license?**

**SK:** Delaware licenses pure, association, industrial insured, agency, branch, special purpose, special purpose financial and sponsored cell captives.

**CR: In terms of premium, how large are Delaware's captives?**

**SK:** The types of captives licensed vary from those which create a small annual premium volume of around \$500,000 to those with annual premium measured in the hundreds of millions of dollars. There is a significant range of sizes.

Written by  
**Steve Kinion**



**Steve Kinion** became director of the Bureau of Captive and Financial Insurance Products in July 2009. Prior to his appointment, he was the senior advisor for regulatory policy for Insurance Commissioner Karen Weldin Stewart.

**CR: Are captives that make the section 831(b) election popular?**

**SK:** Yes. The most popular forms of captive in Delaware are those which assume less than \$1.2m in annual premiums, which are commonly referred to as falling under the 831(b) election.

**CR: What type of overall industry growth do you expect for those captives making the 831(b) election?**

**SK:** Over the next 18 months I believe that for captives making the 831(b) election the industry will grow at a pace of around 10%.

**CR: Delaware is one of the few states that license the series business unit (SBU/series). Could you explain what these entities are?**

**SK:** The SBU is formed under either the Delaware Limited Liability Company Act or Statutory Trust Act. It contains a two-part structure. The first structure is the limited liability company or statutory trust, referred to as the core. The second is an unlimited number of SBUs. This structure is similar to the sponsor and cell structure seen in other domiciles. Despite the segregation of assets and liabilities that exists between each SBU and the core, a SBU itself is not a legal entity under Delaware law.

For purposes of the captive insurance laws, where any liability arising is attributable to a SBU, the assets of the SBU will typically only be used to meet the liability of that SBU. Each SBU is ring-fenced from the others that may be under the same LLC in terms of the structure. Even so, they do not have to be separate. Under Delaware's freedom of contract the SBU owners can decide if they wish to share assets and liability with the others in the series. This contractual flexibility makes the SBUs very popular.

**CR: May SBUs assume both direct insurance and reinsurance premium?**

**SK:** SBUs may be used for reinsurance, insurance and captive business. Within a series structure, the SBUs are approved to write insurance or reinsurance business. The

**"The most popular forms of captive in Delaware are those which assume less than \$1.2m in annual premiums, which are commonly referred to as falling under the 831(b) election"**



core, on the other hand, may or may not be authorized to write insurance or reinsurance. Again, whether the core is a risk bearing entity is a matter of freedom of contract.

**CR: Are series LLCs used in other industries?**

**SK:** Yes. Unlike cells which are a creation of the insurance laws, series are a creation of Delaware's business entity laws. The series LLC or series statutory trust structure is used in multiple other areas of business such as mutual funds.

**CR: How does the mutual fund industry use series?**

**SK:** Mutual funds separate different funds into different series. For example, series number one may contain the international bond funds, series two could contain European stock funds, series three may have only US stock. When using the series structure mutual fund managers are able to segregate and encapsulate the assets and liabilities of each fund, as they reside in a different series. This is the beauty of the Delaware Limited Liability Company (LLC) Act Law, as it allows for the formation of these types of series.

**CR: How many SBUs are in Delaware?**

**SK:** We have between 580 and 600 SBUs at the moment and most, but not all, of these make

the 831(b) election. It has become an easy, low-cost and efficient way for a captive prospector to enter the industry. After a period of time, some owners may even decide to graduate these entities into full, stand-alone captives.

**CR: For micro captives, many managers complement Delaware for pioneering this type of captive. Why?**

**SK:** The series LLC captive allows a company or individual access into the captive insurance without having to post a large amount of initial capital. The advantage to a series is its ease of formation and dissolution. Instead of creating a new legal entity, a series is created or dissolved by changing the business plan and series agreement. This reduces administrative costs making captive insurance far more palatable for the newcomer. In many cases, a captive owner will decide to move to the next level by converting their series into a pure or other form of captive. Of course, a series is also available for the large captive market. Since the Internal Revenue Service recognized the series as an individual taxpayer in 2009, the series captive has become Delaware's flagship product.


**CR: What else has spurred Delaware's success?**

**SK:** I must credit the Delaware Captive Insurance Association. A cornerstone of

Delaware's insurance industry is what is known as the 'three legged stool', or the interaction between regulator, statute and industry. What is key to this relationship is collaboration. We work very closely with DCIA and we will consistently meet with captive managers once or twice a year, at least.

I personally like to speak with captive managers as much as possible. We want to find out what the state of Delaware can do to better serve managers and their clients, and what they see in the industry that we do not. The relationship is reciprocal. We can inform captive managers what we are seeing from our end. In 2009, Delaware was not even under consideration as a captive domicile for most people but today we are one of the most popular – so the relationship has clearly worked well for all concerned.

**CR: You were named in the Captive Power 50 as one of the three most influential figures in the captive insurance industry. What is your reaction?**

**SK:** I am honored by this recognition. Even though the Captive Power 50 individually named me, this recognition is a reflection of the hard work and dedication of the Delaware captive staff. Without their efforts, Delaware would not be where it is today and I would not be listed in the Power 50. 

# THE SMALL CAPTIVE CONTROVERSY

Capstone Associated Services' CEO and general counsel, Stewart A. Feldman, describes the ongoing debate in the US over the proper use of small captives

## Captive Review (CR): What are the current tax issues relating to smaller captives?

**Stewart A. Feldman (SAF):** As a threshold matter, it is important to understand the significance of federal income tax issues upon captive insurance. To a large extent, captives exist because US tax laws encourage and facilitate the operation of captives. More specifically, a US property & casualty insurance company can currently deduct future, unidentified losses based upon estimates of those future losses. For a P&C insurer, premium revenue is recorded currently with a present value discounted reserve established for future claims.

The point is that a captive is a creature of statute – specifically, the US Internal Revenue Code. By contrast, the nominal number of captives affiliated with, for example, Canadian businesses is a function of the tax law in Canada, which severely restricts the deductibility of such premiums.

The takeaway is that US tax law is a huge factor in the life of a captive. Our clients hear us explain that a captive is basically 60% tax law, 30% insurance and 10% other. US tax law has developed, over many decades, the requirements that a captive insurance company must meet to be respected for US tax purposes. To be clear, the fact that a domicile licenses a company as a captive insurer means very little to the IRS.

Written by  
**Stewart A. Feldman**

**Stewart A. Feldman**, CEO and general counsel for Capstone Associated Services, Ltd, has more than 30 years of experience in a variety of sophisticated legal, tax and financial transactions involving a wide range of industries. He is one of the foremost national experts on captive insurance/alternative risk planning, having headed up over 150 captive formations and operations.

So, what are the current tax issues with small captives? Firstly, achieving federal income tax recognition as an insurer is more problematic when dealing with a small insurer. As a first instance, the number of policies, the number of risks and the number of insureds is limited by definition in the case of a 'small captive'. With the recognition that most captives are sponsored of sorts by a 'captive manager', it appears that the IRS has come to the conclusion that many of the entrants into the captive management business are not producing a tax compliant program. To be sure, most of the so-called captive managers in the captive insurance market – regardless of the size of captive – specifically disclaim responsibility

for tax compliance and other legal issues. Even sophisticated clients are not sensitized to the consequences of such disclaimers.

What we've seen frequently in the market place is half-baked planning that the client thought was air-tight. Much of tying up the loose ends of the planning is left to the client, with specific disclaimers of tax, accounting and other professional services.

More technically, in determining whether the requirement of risk distribution is present in a captive arrangement, the IRS has focused on an arithmetic count of the number of insureds consistent with its safe harbor set forth in Rev. Rul. 2002-90, which was expanded upon in Rev. Rul. 2005-40 (12 insureds with each representing between 5% and 15% of the total risk of the captive). Unfortunately for the IRS, the decisions in two recent US Tax Court cases have clearly rejected the IRS's continued focus on the number of insureds and instead looked at the number and nature of the independent insurable risks. See *Securitas Holdings, Inc. and Subsidiaries v. Commissioner*, T.C. Memo 2014-225 (*Securitas* is the parent company of *Burns Security* and *Pinkerton Security*) and *Rent-A-Center and Affiliated Subsidiaries v. Commissioner*, 142 TC No. 1, (*Rent-A-Center* operates more than 3,000 rental facilities for furniture, appliance and electronics). In these two taxpayer victories, neither met the tests demanded by the IRS.

Our law firm and our Capstone affiliate have seen over the last four years a comprehensive examination of small captives (typically Section 501(c)(15) based, and to a lesser extent, Section 831(b) captives). During the audit process, the IRS makes multiple information and document requests (IDRs) of the taxpayer, spread over a number of months (sometimes a couple of

**“What we've seen is the IRS figuring out the holes in the planning and focusing on the clerical providers masquerading as captive managers. It certainly is a caveat emptor market place”**



years). By the end of this thorough fact-finding process, the IRS has all the information needed to make its case. Work directed by many captive managers inevitably fails the rigid tax requirements imposed on captive insurance companies.

**CR: Can you give an example of this sort of issue?**

**SAF:** By way of example, the IRS has inquired as to the marketing materials that the captive sponsor provides to the captive's beneficial owners. The usual tenor of these marketing materials focuses little on risk financing and insurance in favor of federal income tax savings. This is the death knell to the planning.

Often we see policies priced at hundreds of thousands of dollars with little analysis by the captive manager or the captive's officers and directors (or the insureds) as to the basis for the pricing. Sometimes policies are but a few pages long and may overlap with conventional coverages. An on-site feasibility study by a CPCU or qualified underwriter is rarely done. Often bogus or meaningful actuarial reports, produced en masse for a few thousand dollars, form the basis for the policy pricing when a closer reading of the actuarial report acknowledges the complete lack of data to support it.

In summary, what we've seen is the IRS figuring out the holes in the planning and focusing on the clerical providers masquerading as captive managers. It certainly is a caveat emptor market place. As adverse IRS audits are further publicized, this will become more evident.

**CR: What is the likelihood of the law changing around smaller captives?**

**SAF:** US tax law providing favorable treatment for small P&C captives pre-dates 1920. Of course, the law has changed over time, expanding at times and narrowing at others. The common thread is that the law will change; corporate structuring is not static. What will happen is anyone's guess.

However, as far as what is before Congress, the only relevant legislation that we have identified are HR 4647 proposed by Rep. Erik Paulsen and SR 1346 introduced by Sen. Tom Harkin, both of which would inflation-adjust the cap on Section 831(b) insurance companies from the \$1.2m limitation set in 1986. The House bill would set the 2014 limitation to \$2.025m and index the limitation for inflation going forward. The Senate bill would set the base limitation at \$2.012m indexed for inflation. During the last Congress, Rep. Paulsen and Sen. Harkin both introduced

similar bills to increase the limit and adjust for inflation, and in prior years other congressmen have attempted the same.

**CR: How much of a motive are the tax advantages to perspective captive owners?**

**SAF:** First and foremost, the captive must be done for insurance or risk planning purposes. This is a tenet of US tax law. If a transaction lacks economic substance (that is, it does not change a taxpayer's economic position apart from Federal income tax effects, and the taxpayer lacks substantial purpose for entering into the transaction apart from Federal income tax effects), the transaction will be disregarded for tax purposes.

This is not to say that the tax consequences of the transaction do not play a role. A client may be interested in purchasing a cement mixer or a new water tank. Clearly, the tax consequences of the acquisition plays a part; however, for example, if the client doesn't need another cement mixer or a water tank, all the tax benefits in the world do not make an otherwise nonsensical investment into a good business decision.

**CR: How does Capstone sell the advantages of a smaller captive to small businesses?**


**SAF:** If a client has ever filed for a significant commercial claim, such as a business interruption claim, product liability claim or pollution claim, the client understands the difficulty in collecting from a conventional insurance company.

The horror stories of collecting on commercial claims exist because they are true. Even Exxon was engaged in more than a decade long struggle with its insurers to collect on its Valdez claims. There aren't many businesses that can survive such a struggle.

The fact that many conventional coverages do not fit well with a client's business operations, leaving holes and gaps in coverages, often leads to a client's desire to take firmer control over his business's own risks. Captive planning is the result.

**CR: Is there a misconception surrounding the use of smaller captives?**

**SAF:** Again, as a result of the lack of expertise or concern, some captive managers have created an environment in which smaller captives are viewed as non-compliant. This misconception makes thorough planning and documentation even more important.

Smaller captives need to ensure they are being properly advised by a team of competent professionals. 



[www.activecaptive.com](http://www.activecaptive.com)

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DCIA was formed to support the development and growth of the industry through marketing, networking, education and legislative initiatives. DCIA provides educational and networking events for companies and individuals doing business in Delaware or who want to learn more about captives and domiciling in Delaware.



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Keystone Risk Partners is a firm headquartered in the suburbs of Philadelphia that specializes in establishing captive and alternative risk solutions. Specifically, they use their technical expertise in underwriting and risk finance, working in partnership with insurance agents and brokers, to bring the highly successful solutions of the Fortune 500 business to a wider audience of middle market insureds seeking a tailored captive insurance company solution.



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**MISSOURI DEPARTMENT OF INSURANCE, FINANCIAL INSTITUTIONS & PROFESSIONAL REGISTRATION**

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The Captive Section of the Missouri Department of Insurance fosters the growth of the captive insurance industry in the state, and maintains an efficient and effective regulatory system to ensure a solvent and viable insurance marketplace. Missouri is strategically focused on creating a solid captive program that serves as an asset to companies doing business in the State. The result is a well-rounded domicile that offers real opportunities for success.

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