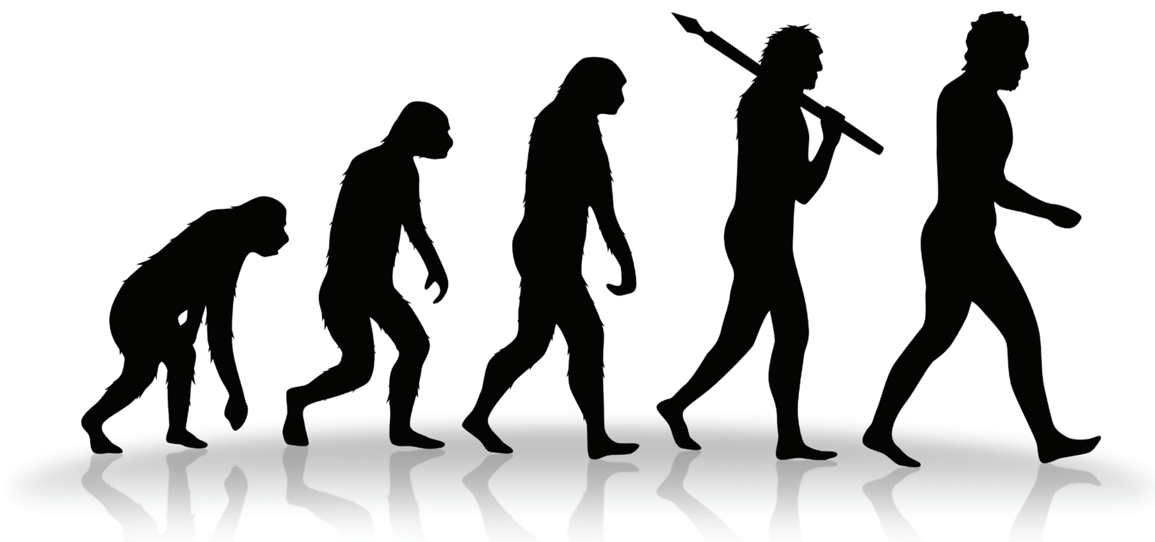
HOW TO FORM A PROTECTED CELL CAPTIVE



Martin Eveleigh, of Atlas Insurance Management, explores each stage in the formation of a protected cell captive

As we approach the 20th anniversary of the passage of Guernsey's Protected Cell Companies Ordinance, the landscape of insurance companies with statutory risk segregating capabilities is broader than ever. The basic Protected Cell Company concept survives under a variety of different names and segregation is also achieved by series LLCs, Separate Accounts, Statutory Funds and so on.

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A PCC background

PCC legislation provides statutory segregation between assets and liabilities of different users or owners using a single corporate structure. A PCC is composed of two distinct parts; a core and any number of cells that attach to that core. The assets of one cell are not available to meet the liabilities of other cells, nor those of the core. The common standard is that the assets of the core are not available to meet the liabilities of any cell. However, most jurisdictions will allow the core to opt for exposure to cell liabilities.

Most PCCs have been established as rent-a-captive facilities, either by insurance companies to provide captive facilities to their own policyholders and perhaps to deter them from establishing their own captives or by captive managers to attract prospective clients with a convenient, cost-effective alternative to a stand-alone captive.

PCCs in use

There are many other potential and actual uses for PCCs beyond acting as rent-a-captives. For example, a group captive may be established as a PCC with each member owning a cell. This would allow each cell its own individual tax status and the opportunity to determine its own investment preferences and, of course, provide enhanced segregation and protection of assets.

Major corporations can use PCCs to manage global insurance programmes and cater for the different risk exposures, financing capabilities and local regulatory requirements of their operating subsidiaries. Risks can be segregated between cells according to country, region or subsidiary or by line of business. This can allow the group parent to establish a group retention level while subsidiaries are free to choose other, lower retentions. A cell structure enables captive capital to be provided by subsidiaries rather than by the group alone and makes for the easy identification of subsidiary risk information as well as profit identification and participation. The separateness of cells within the overall captive structure is also advantageous when subsidiaries are acquired or sold and cater for the different ownership interests of joint-venture partners.

Anyone forming a PCC or a cell within one should understand the corporate nature of the PCC and its governance. A PCC is a single legal entity. Neither the core nor the cells within the PCC have separate legal personalities. It follows that a PCC can have only one board of directors, which governs the activities of all parts of the company. The business of the individual cells is conducted on their behalf by the directors of the company. While the directors may delegate certain decision making powers to a committee charged with the operation of a particular cell, the fiduciary duties owed by the directors to the company are their responsibility and theirs alone. They must act for the overall good of the PCC, rather than specifically for the good of any individual cell or shareholder.

A PCC will be incorporated using corporate documents very like those of any other company. However, these corporate documents will deal with the company's ability to form cells, specify how that is to be done and empower the directors to do so. The relationship between cell owner and the PCC will be governed by a Participation Agreement that will, subordinate to the central corporate documents, govern the operation of the cell, how it is to be capitalised, what business it will conduct, the rights to distribution of assets, etc.

PCCs and cells

Frequently, a PCC will issue different classes of share with common, voting, shares issued in respect of the core and separate classes or series within a separate class being issued in respect of each cell. Cell shares are typically non-voting shares.

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The formation of a new cell is a simple enough matter. Like any other captive, regulatory approval is required for the new cell's formation and operations. The submission made to regulators in respect of the formation of a cell will not differ greatly from that for a stand-alone captive. The regulator will need no details of the directors as these will be the PCC's directors. However, he will want to see details of cell ownership and capitalisation as well as a business plan and feasibility study with financial projections. He will especially want to see the Participation Agreement and to understand whether and to what extent the core of the PCC may be exposed to any risks of the new cell.

Both the PCC directors and the regulator will be concerned to understand the risks to be written by any new cell and how they will be funded. They will want to ensure that the cell can meet its financial obligations, in particular its obligations to its policyholders and reinsureds. One question, in particular, arises. How will any risk gap be funded? After the application of any available reinsurance, the gap is likely to be covered by capital contributed to the cell, letters of credit in the cell's favour or other types of guarantee. Alternatively, the core of the PCC may offer its assets (or some of them) to fund the risk gap in whole or in part. In this case, the PCCs directors will likely seek to charge a premium for the facility as well as seeking collateralisation of the core's exposure.

While a PCC is a single corporate entity, it need not be a single taxable entity. It is, generally, open to each individual cell to establish its own tax identification and file separately from the PCC as whole and from other cells. To achieve the tax status of an insurance company, a cell must qualify as such in its own right. Risk distribution at the individual cell level is not achieved merely by the presence of many risks insured by other cells but must be present within the cell. By contrast, the core of the company, assuming that it does not issue insurance policies and is not exposed to the risk of any of the cells, may not be an insurance company so much as a service company. PCC owners should consider the implications of this, especially in the case of PCCs established outside the US.

The statutory risk segregating powers of a PCC are, broadly, shared by a series LLC. Like the PCC, the LLC is one corporate entity. However, there are, potentially, significant differences in corporate governance. While the managers (directors) of the core have responsibility for the governance of the company as a whole and for the relationship between the core and the series, it is possible to appoint different managers for each series with the power to conduct its business. Managers of the core will want to give careful consideration to the terms of the Participation Agreement, the extent to which series managers have autonomous powers and the reputational, regulatory and financial risks arising from this delegation of powers. Core managers are well-advised to ensure that one of them serves as one of the managers of any series, which helps them oversee the activities of the series.

A unique company

Because of the convenience of cell arrangements, their broad acceptance and the ease of formation and operation from a corporate as well as from a regulatory point of view, cell companies of one kind or another are fairly ubiquitous these days and there are thousands of active cells. Nonetheless, the formation of a PCC rather than a separately incorporated captive, limits the owner's control over his captive, imposes significant fiduciary duties upon the PCC's directors and creates relationships between many parties needing careful consideration by all involved and clear governance, particularly by the Participation Agreement that is really the cornerstone of the whole arrangement.