



Summary of S.2374 to broaden New York's captive law

A bill needed to fund liability coverage for the clean-up and rebuilding of lower Manhattan has been expanded into a sweeping revision of New York's captive insurer laws, as supported by Governor Pataki and the Insurance Department. But PIANY is questioning the long-term effects of these changes.

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New York City captive. Congress passed legislation directing FEMA to provide funds for claims against New York City and its contractors, arising from debris removal following the World Trade Center attacks. The federal legislation directs the city to use that money to set up an insurance mechanism. New York decided its preferred approach would be a captive insurer. However, S.2374 goes much further than simply authorizing this step. According to the sponsors' memo, "it also permits a broader range of sophisticated financial entities, including public entities, to form pure and group captive insurance companies and sponsored insurance companies in New York State."

S.2374 tracks closely with Vermont's law in setting financial criteria for pure captives, group captives and sponsored captives. Currently, New York's financial requirements are higher for pure and group captives, and New York's law does not contain a sponsored-captive option. A clear objective of the proposed changes is to make New York more competitive as a captive venue.

Vermont's law does not contemplate public entities forming captives. Current New York law authorizes captive formation by a public entity only for the Metropolitan Transportation Authority and its subsidiaries. The new law would expand this power to include many but by no means all public entities, primarily those related to state government.

Pure captives. A pure captive is one set up solely to insure a single owner or a group of closely related entities. Under S.2374, an "industrial insured" could operate a pure captive if it has a net worth of at least \$25 million (currently \$100 million). The definition of "industrial insured" would be expanded by S.2374 to include certain public entities and not-for-profits. Not-for-profit organizations and public entities with a total annual budget that exceeds \$25 million could form a pure captive.

Currently, a pure captive can insure only the risks of its parent and affiliated companies (i.e., companies that are part of the same holding company structure). S.2374 would broaden pure captives to include additional entities related by virtue of common ownership, control, operation or management.

The bill also would newly allow pure captives to insure other, unrelated companies that maintain a contractual or sub-contractual relationship with the entity (or entities) that set up the captive, provided such contractors voluntarily elect to

participate in the captive and have their risk management controlled by the captive's owners. In discussions, the NYSID said that one purpose of this provision is for state entity captives to provide surety and other coverage for contractors doing work on their behalf. In this respect, although "voluntary," it is similar to a wrap-up program, currently not permitted for most public construction. PIANY historically has opposed wrap-up insurance for public projects.

Group captives. New York's existing law allows group captives, organized by a group of unaffiliated "industrial insureds" engaged in similar or related businesses, to be formed only by entities with a net worth of at least \$100 million. S.2374 would permit group captives by entities that pay at least an aggregate annual premium for insurance on all risks total of at least \$25,000, and who have at least 25 full-time employees, or are public entities. Also, members of group captives would be required to have a full-time employee acting as an insurance manager or buyer. Public entities could form a group captive only with other public entities.

Sponsored captives. The bill would add a new type of "sponsored captive insurance company," which would be capitalized by one or more sponsors. A sponsor must be a New York-licensed insurer, an authorized or approved reinsurer or a captive insurer formed in New York. Sponsored captives would segregate the liability for each participant into a "protected cell." The assets of a protected cell could not be charged with liabilities arising out of any other insurance business the captive conducts. The business of a sponsored captive would have to be fronted by a licensed carrier and reinsured by one of several approved means.

Public entities. S.2374 would permit entities that are part of state government and certain other governmental bodies to form captives. The bill's definition of "public entity," for purposes of the captive law, includes: 1) any department, bureau, division, board or other agency of the state of New York, including any public benefit corporation or any public authority; 2.) any governmental entity, or combination of governmental entities, operating a college, community college or university; 3.) any city with a population of 1,000,000 or more (which is how legislation typically refers to New York City); 4.) any public corporation created pursuant to agreement or compact with another state or Canada (e.g., the Port Authority); and 5.) similar entities outside of New York. All such entities would need to be authorized by their own applicable governing laws to form and operate a subsidiary that could act as a captive insurer.

Public authorities. The state's public authorities would be authorized by the bill to form captive insurance companies on either a pure captive or group captive basis, to be operated as a subsidiary of the authority.

State Insurance Fund. The New York State Insurance Fund could form a pure captive or group captive as a subsidiary in the form of a public benefit corporation. Nothing in the bill specifically limits a NYSIF captive to writing workers' compensation. However, in discussions the NYSID said it does not believe the NYSIF could write anything other than workers' compensation for risks other than itself, under the terms of its charter.

Type of insurance authorized. Captives have broad authority to write most types of insurance and reinsurance except life, annuities, accident and health, title, mortgage guaranty and financial guaranty.

A captive is prohibited from writing workers' compensation, except a pure captive can insure the workers' compensation risks of its parent and affiliated companies if it meets the qualifications for a self-insurance program.

A captive also is prohibited from writing motor vehicle liability insurance or other insurance required as evidence of financial responsibility to obtain a license or undertake specific activities, when the financial responsibility requirement must be satisfied by obtaining insurance coverage from an insurer authorized in New York state. The prohibition applies to the minimum financial responsibility required by law. Again, however, a pure captive may write such coverage for its parent and affiliated companies if it qualifies as a self-insurer.

Back-door deregulation? One aspect of the bill that concerns PIANY is the similarity of the criteria for smaller insureds to those of the various bills that have proposed to deregulate commercial lines insurance. The sponsors' memo states: "captive insurance companies do not market or sell direct insurance to parties other than entities affiliated to the owners and, therefore, merit less stringent regulation than insurers that sell direct coverage to third parties." However, for smaller insureds, PIANY envisions captive arrangements as being marketed to, rather than initiated by, prospective participants.

In discussions, the NYSID confirmed that group captive participants and those insured by sponsored captives would not be subject to New York's policyholder protections such as those of Section 3426 or the rating laws. Also, except for captives formed as federal Risk Retention Groups, New York's captives are not subject to the state's unfair claims settlement laws or prohibitions against deceptive, false or fraudulent practices.

Other issues. Captives are not permitted to be part of New York's property liability insurance guaranty fund. They are largely free of the ordinary restrictions on allowable investments. They appear to enjoy a substantial tax advantage over other types of insurers, being taxed at a maximum of .4 percent based on premium volume.

Although the bill's sponsors' memo, under "Budget Implications," says simply "None," PIANY believes that the substantial tax breaks granted captive insurers could not help cutting into state revenues if significant amounts of business now insured conventionally were written in this form; and that this deficit would put upward pressure on the taxation of traditional insurers. Moreover, PIANY is concerned about the potential impact of funding the state's guaranty fund obligations and residual market costs by means of a smaller premium base written by traditional insurers. These are among the aspects of S.2374 that PIANY is discussing with the bill's sponsors.—Kiehl