APRIL 2019

Crafting Cell Captives

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Introduction

Entities are increasingly looking to utilize cell captive structures to achieve various business, financial and risk management goals. The evolution of cell structures using incorporated and unincorporated cells has resulted in various financial reporting and regulatory models, which are important for business leaders to understand while crafting such programs. Obtaining an understanding of the various requirements can be slow and cumbersome, given the complexity of accounting guidance on consolidation found in the Generally Accepted Accounting Principles (GAAP) in the United States. Complexity from the GAAP ultimately leaves many cell programs with financial reporting that do not align with the business purpose of the entities.

To avoid this pitfall, entities need to understand the evolution of cell structures, how cell financial reporting has developed, and how the GAAP guidance is applied to cell structures. It is not necessary to know each nuance of the GAAP guidance; however, it is important to sufficiently understand the specific guidance from a cell structure's perspective to structure a cell program where the business purpose aligns with the entity's financial reporting.

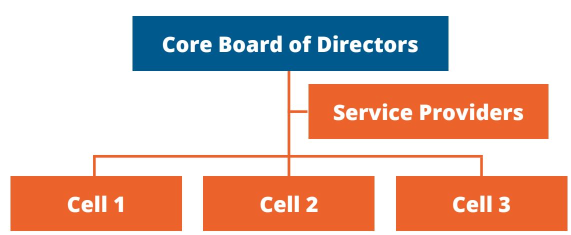
To help business leaders make better informed decisions and find new ways to use this uniquely adaptable captive structure, a summary of the GAAP guidance applicable to cell structures follows. We also highlight key obstacles cell structures can avoid and provide illustrations of cell structures.

Background / History:

Unincorporated Cells

Traditionally, sponsors creating cell structures used unincorporated cells and looked to participation agreements to protect the sponsor's interest and equity of the core. The cell structures typically included requirements to contract certain service providers, further protecting the cell sponsor's financial interest. Accordingly, these programs typically resulted in operations of the core and cells being consolidated or combined within the core annual financial statements, due to the lack of direct ownership by the cell participants, combined with the core having control over the cell's operational decisions. Over the years, the contracts are refined and the same level of control may not exist in some newly formed cell structures.

Unincorporated Cell Structure:



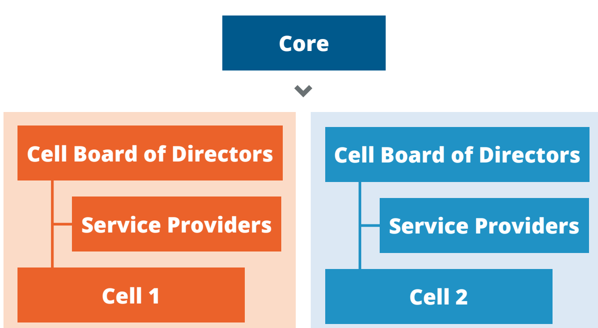
Incorporated Cells

With the evolution to incorporated cells, programs can be created where the core does not have control over the cells. Cell structures have been created where each cell has its own Board of Directors and makes decisions independently. In this situation, practice has developed to present the core financial statements through a fiduciary oversight model, in which the core financial statements include one asset line item for the assets of the cells and an offsetting liability for the liabilities and equity of the cells. This presentation model, shown in the sample to the right, allows the financial statements to portray the core's fiduciary oversight of the cells while not misrepresenting the activities or financial interests of the cells as that of the core.

Many programs that use the fiduciary oversight model also include supplemental combining balance sheets and income statements outlining the operations of each cell to further provide a picture of the program. Regulatory approaches for these programs vary by domicile, with some requiring separate stand-alone audits for each cell, while others rely upon the audited statements of the core including supplemental schedules of cell activity.

Many business leaders looking to form cell captives have questions regarding the financial reporting models – e.g., when is the consolidated or combined presentation model appropriate, vs. the fiduciary oversight model? These questions are typically asked to ensure the financial reporting and presentation align with the business purpose of the cell structure.

Incorporated Cell Structure:



Incorporated Cells - Fiduciary Oversight Model

Sample Core Balance Sheets:

Assets		**2018**
Cash and cash equivalents	$	284,367
Facility fee receivable		473,801
Expenses recoverable from cells		96,504
Assets held on behalf of incorporated cells		10,385,382
Total Assets	$	11,240,054
Liabilities and Shareholder's Equity		
Liabilities:		
Accounts payable and accrued expenses	$	52,914
Premium and surplus lines taxes payable		16,842
Federal income taxes payable		6,084
Liabilities and equity of incorporated cells		10,385,382
Total Liabilities		10,461,222
Shareholder's Equity:		
Common stock		300,000
Retained earnings		478,832
Total Shareholder's Equity		778,832
Total Liabilities and Shareholder's Equity	$	11,240,054

When using this presentation, supplemental combining financial statements for all cells may be included as a supplement to the core financial statements.

GAAP Overview: To Consolidate or Not to Consolidate

GAAP consolidation guidance is set by Accounting Standards Codification (ASC) 810, which requires the consolidation of an entity in instances where the reporting entity has a controlling financial interest, either through voting interest or by other means such as a variable interest entity (VIE). Consolidation evaluations for cells or any entity start with an evaluation under the VIE model to determine if the cell is controlled by circumstances other than direct voting interest. To the extent that an entity is not controlled by other circumstances, GAAP then points to the traditional voting interest model and ownership interest to determine control.

Variable Interest Entities

At its heart, GAAP looks to two key concepts to determine if an entity is a VIE and controlled through means other than direct financial ownership, and indicates that the controlling entity or primary beneficiary is the one that:

- Has the ability to direct operational decisions most critical to the success and economic performance of the entity.
- Has an obligation to absorb losses or receive benefits created by the entity.

Using participation agreements and incorporated cells, cell captives can be structured to give this controlling interest to either the core, sponsor of the core, or the company participating in the cell. Even through incorporated cells are clearly owned by the participants, the participation agreement and other management or reinsurance agreements can be too restrictive, causing the cell to be controlled by the core or its sponsor rather than the participant.

To determine who has the controlling interest in a cell, industry looks to the following critical factors:

- Equity at Risk – Does the cell participant have sufficient equity at risk to finance its activities?

  Generally, cells are considered legally segregated by state law and the equity of the core and other cells is not at risk. As such, the obligations of the cells are typically restricted to the equity of the cell by the insurance policies issued. Legally this means that the core does not have the obligation to absorb losses of the cell. In some circumstances, the core or core sponsor also holds an ownership interest in the cell through preferred shares or surplus notes. Alternatively, guarantees, letters of credit, or other instruments are used to secure operations. These items can cloud the analysis of control and cause cell structures to be a VIE and controlled by the core. As a result, the core or core sponsor should ensure adequate equity is provided by the participant to support the risks being underwritten. This requires entities to be careful to ascertain that any equity ownership of the cell by the core or core sponsor doesn't transfer the right to cell operating profits or cell obligations to the core or core sponsor.

- Participation Agreements – Does the participation agreement, in combination with other agreements such as reinsurance and management agreements, give the core the ability to mandate the most significant operational decisions?

  Cell captives often look to the participation agreement to restrict operations of the cells to protect the sponsor's financial interest or provide for operating efficiencies. If the program's goal is to allow participating companies to consolidate their cells, they will need to be careful with such restrictions. Mandating the use of a common auditor, investment or tax advisor to enable operating efficiencies may be allowed under the guidance; however, requiring that the cell sponsor be appointed as the managing general agent or captive manager as a prerequisite for participation could create difficulty. Documenting the cell participant's ability to direct significant operational decisions such as underwriting specific lines of business, determining whether to continue operations, selecting reinsurance providers and providing input into claims settlement decisions will be important considerations when considering such entities.

Ensuring cell participants control the cell can be a difficult stumbling block for prospective sponsors of cell structures because it can give the participant more flexibility to terminate agreements with the sponsor. Relinquishing control of these decisions allows cell participants more freedom to leave the program and may be perceived as putting sponsor revenue streams at risk. Ultimately, that control needs to be weighed against the desired financial reporting structure and the increased marketability that such programs may have.

- Are fees for services paid to the sponsor or core at market rates?

Cell programs aiming to use the fiduciary oversight reporting model and enable participating companies to consolidate their cells need to make sure fees paid to the sponsor or core for management, MGA, reinsurance and other services are set at market rates. Fees for these services that are deemed to be excessive or not "arms-length" can cloud the determination of who has the right to receive benefits created by the cell, and can cause the service provider to become the primary beneficiary or controlling entity.

These items highlight the complexity of VIE considerations under GAAP and how they interact with cell company structures. The VIE analysis needs to be done for each cell further complicating the process. As such, the core or core sponsor that desires consistent financial reporting for each cell needs to ensure consistency in the key agreements and program structure across all cells. Changing integral terms of agreements to meet the desires of multiple cell participants may initially seem harmless, but can result in increased financial reporting, legal and management complexity.

Business Purposes of Cell Captives:

Developing successful cell structures with consistent reporting requires entities to develop a business plan that will result in a consistent business goal across cells. To that end, we have provided some examples below:

1. **Traditional Structure** – Insurance producer creates a cell structure to allow customers to participate in their own risk. Producer may want to control the entity and consolidate or, alternatively, may want to allow cell participants more control - allowing the cell participants or Parent to consolidate.

2. **Joint Venture Model** – A captive owner may want to reform a pure captive as a cell captive to allow several Joint Ventures entered into by the Parent to be insured through cells jointly owned by the Joint Venture owners.

3. **Business Operation Model** – A parent company may want to legally separate risks associated with certain business operations deemed as having more risk, without putting the other operations of the captive in danger. The goal could be to consolidate the insurance operations of each cell into the core or parent or alternatively to carry the insurance operations at the operating unit level (i.e. each operating unit consolidates and is responsible for their cell).

4. **Skin in the game** – A large family-owned business may want to give the senior management of its operating subsidiaries risk management skin in the game, by allowing the senior management team to own incorporated cells insuring the subsidiaries they run either directly or via the operating entity they manage.

Conclusion

These are just a few examples of how entities can utilize an unincorporated or incorporated cell captive approach to align the organizational structure with the business, financial and risk management goals of the entity. It will be important for captive leaders to consider the GAAP consolidation guidance when exploring new uses of cell structures. As the use of cell structures continues to evolve, we are excited to see new and creative ways emerge to utilize this uniquely adaptable captive structure.

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Josh has 20 years of audit and consulting experience. For the majority of his career, Josh has been focused on serving various property-casualty and life insurers including captive insurance companies, risk retention groups, and commercial insurance entities. He has extensive experience with investments, reinsurance transactions, taxation, and other insurance-related topics. Josh is the Vice Chair of the Vermont Board of Public Accountancy, a former member of the AICPA's Auditing Standards Board, and an alumni of the AICPA Leadership Academy.

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