Eye on the Experts

CAPTIVE INSURANCE COMPANY DISCLOSURE DOCUMENTS: BEST PRACTICES

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By Lisa M. Kaderabek

Many captive insurance programs utilize a "Disclosure Document," sometimes called a "Confidential Information Memorandum," "Private Placement Memorandum" or "Prospectus," that details program ownership, governance, exit and other rights and obligations. When is a Disclosure Document required or desirable? What information should be included? How often should it be updated? Who approves the Disclosure Document? Who gets a copy? This article traces the origins of the captive Disclosure Document in the U.S. Securities laws, and discusses how Disclosure Documents have evolved to meet the specialized needs of the captive insurance marketplace.

U.S. Securities Laws – Briefly

The U.S. federal Securities Act of 1933, as amended (the "1933 Act"), regulates the offer and sale of securities in the United States; its companion Securities Exchange Act of 1934, as amended (the "1934 Act"), generally, regulates securities exchanges and the ongoing disclosure requirements applicable to publicly traded companies. In addition, many of the U.S. states adopted state-specific securities laws in the 1930s and earlier. These state securities laws are sometimes referred to as "blue sky laws," because they were passed initially in reaction to unregulated attempts to sell a "piece of the clear blue sky" to gullible investors. The core philosophy of the 1933 Act, the 1934 Act and the current versions of most blue sky laws is to require full disclosure of the risks, rights and obligations of securities, rather than prohibiting outright certain securities or terms deemed to be inherently unfair or fraudulent. The U.S. Securities and Exchange Commission ("SEC") has adopted extensive regulations, forms and interpretations under the 1933 Act and the 1934 Act.

Certain securities and certain transactions in securities may be exempt from regulation under the 1933 Act and/or the blue sky laws. There are many types of exemptions available. Some of the most important (and the most familiar to securities lawyers) types of exemptions are those applicable to small offerings and to offerings made only to sophisticated purchasers. The rationale for the small offering exemptions is that there is not sufficient public interest to regulate non-public offerings; the rationale for the sophisticated purchaser exemptions is that sophisticated purchasers do not require government intervention because they are able to protect their own interests.

Since the goal of the 1933 Act and most blue sky laws is full disclosure, the extensive regulations, forms and interpretations adopted under these laws over many years have identified and developed the specific types of disclosures that are thought to be relevant to a reasonable person making a securities investment decision.

Form S-1, Regulation S-K (governing disclosure generally) and Regulation S-X (the financial statement rules), all promulgated under the 1933 Act, together constitute the set of disclosure rules for a company making an initial public offering of its securities: it is the most comprehensive disclosure regulation, includes extensive instructions and commentary and has spawned interpretations, Releases and No Action Letters that practitioners and regulators have built on over time. It is the "gold standard" for disclosure, and is often referenced or used as guidance, even when it is not directly applicable.

However, the broadest and fullest scope of the disclosure requirements directly applies only to registered public offerings of securities. These disclosure requirements are scaled back in the rules applicable to smaller offerings, and most of them do not apply at all to securities and securities transactions that are fully exempt from registration.

While the full set of disclosures applicable to public offerings of securities does not apply to all securities and securities transactions, especially securities and securities transactions exempt from registration with the SEC or sold in non-public offerings, the 1933 Act, 1934 Act and the blue sky laws contain "anti-fraud" provisions. Rule 10b-5 under the 1934 Act, the most-referenced formulation of the anti-fraud rule, provides (in addition to other prohibitions on fraudulent schemes and acts), that:

> It shall be unlawful for any person, directly or indirectly … to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading … in connection with the purchase or sale of any security.

The anti-fraud rules apply to "any security," not just those subject to the full disclosure requirements of the 1933 Act and Form S-1, or any pared back disclosure rule applicable to more limited securities offerings.

What Is a Security?

Form S-1, or any pared back disclosure rule applicable to more limited securities offerings.

The 1933 Act and the blue sky laws define a "security" via "laundry lists" of types of financial instruments. The 1933 Act definition is typical (although the definitions used in some states explicitly purport to be broader than the 1933 Act definition):

> "Security" means any note, stock, treasury stock, security future, security based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing arrangement, collateral-trust certificate, preorganization certificate or subscription. . . [etc.] . . . or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, . . . guarantee of, or warrant or right to subscribe to or purchase any of the foregoing.

Putting aside the circularity of this definition, there are two obvious problems with it. First, fraudsters are creative. For instance, one recurring scam involves "prime bank certificates." The hucksters who make false statements to entice the purchase of worthless securities cannot be allowed to escape liability under the securities laws merely by creating a new name for what they are doing. Second, many of the instruments included in the list are not commonly treated as securities in particular contexts. Thus, a public offering of "notes" by a corporation to raise money for its operations is correctly a "security" transaction per the definition, but a homeowner who gives a promissory "note" or "evidence of indebtedness" to a bank in connection with a home mortgage is not offering the bank a security (while it is arguable that such a note or evidence of indebtedness is a security, but a security that is exempt from regulation, this is a needless complexity – calling a contract to pay for an appliance to be delivered in the future a "certificate of interest" would not change such an arrangement into a security). Therefore, it is clear that a definition that relies on naming and terminology – mere words – is not sufficient. What is needed is a definition based on function.

In 1946, the U.S. Supreme Court faced this issue in its opinion in *SEC v. W. J. Howey Co.* ("*Howey*"), which discusses the characteristics of an "investment contract." As a follow-up in 1975, the U.S. Supreme Court expanded on the functional definition provided in *Howey* in *United States Housing Foundation, Inc. v. Forman* ("*Forman*"). "*Howey* and *Forman*" are understood by securities lawyers as controlling, definitive precedent, and are still cited as such today. While there have been other important Supreme Court cases discussing what constitutes a security (and, importantly, what does not) – such as *Reves v. Ernst & Young* (1990) (which as part of its analysis asked whether the instruments in question were marketed to the public in a manner similar to that typically used in marketing securities) – *Howey* and *Forman* provide the basics for our in-depth analysis of whether or not captive insurance company instruments constitute "securities."

Under the 1933 Act, an "investment contract" falls within the definition of a security. *Howey* defined an "investment contract" as:

1. An investment of money;
2. In a common enterprise;
3. In the reasonable expectation of receiving profits from the significant managerial efforts of others.

Then, in Forman the court identified the following five characteristics of a "security:"

1. The right to receive dividends contingent upon an apportionment of profits;
2. Negotiability;
3. The ability to pledge or hypothecate the instrument;
4. Voting rights proportionate to the number of shares owned; and
5. The potential for appreciation in value.

Are Captive Instruments Securities?

As we have seen, the name applied to an instrument does not alone determine if the instrument is functionally a security. Thus the common captive structure where a participation agreement is utilized to provide a contractual participant with a share in captive risks and rewards (in lieu of the issuance of a preferred share) is not automatically "not a security." Conversely, a common or preferred share of capital stock in a captive is not automatically "a security" despite "stock" being second in the 1933 Act laundry list definition. Instead, in each case, the functionality of the instrument must be tested under the *Howey* and *Forman* factors described above. Because of certain factors inherent in many typical captive insurance program structures, it is often clear that rights in captive insurance companies do not constitute securities. However, each captive arrangement has some unique facets, and whether certain structures constitute securities or not may be unclear.

So, let's consider some common captive attributes in light of the *Howey* and *Forman* factors.

- Captives often are structured to provide their insured owners with governance control (Board seats) of the captive (even where a management company handles day-to-day operations, the Board controls the strategic direction, policies and oversight of the captive). Typical (non-captive) securities provide voting rights and corporate control based proportionately on the number of securities held (as contemplated in prong 4 of the *Forman* tests). Captives on the contrary may have one-member, one-vote governance, or may provide control tied to premium size rather than share ownership: in other words, captive voting rights are often not like the voting rights of regular business securities where a larger investment brings more control. Even where captives may allocate ex-officio or founder Board seats to identified insureds, founders or service providers, these seats are also usually not based on the number of shares owned.

- Captive interests are usually non-transferable (the captive doesn't want its interests transferred to a non-insured that has no ability to support captive performance by controlling losses, or to eliminate that incentive for the insured owner that does). This means that these captive interests are not negotiable (transferable) per the second item in the *Forman* list of characteristics of securities. For the same reasons, a captive's governing documents/shareholder/participation agreement will typically prohibit the pledge of the interests to third parties since a default on the obligation secured by the pledge would result in an unwanted third party owner seizing the interests; thus the third *Forman* characteristic is also often absent.

- Captives typically provide a return based substantially on the loss experience of the insured owners (many captives establish internal accounts (or segregated cells) for each insured owner and credit and debit the insured owner's premiums, losses and investment returns in whole or in part to these accounts); dividends are then paid solely from positive balances in these accounts. Dividends therefore are not based on the number of shares owned or the amount of capital invested. Thus, the *Forman* factor that looks to the receipt of dividends upon the "apportionment" of profits may be missing from these captive arrangements: profits are apportioned and dividends are paid not based on share ownership but rather based on loss performance or other formula provisions. Captives that utilize policyholder distributions rather than dividends on shares to pay-out profits will also not meet this *Forman* factor.

- Captive interests may not be designed to be redeemable for a profit at member termination (if profit is tied to a loss experience formula, there are typically restrictions on exit that would further inhibit treatment of the captive's interest as an ordinary financial investment). Many captive formulas return initial capital without interest or increase in value at program exit since the expectation is that any profits will be the result of favorable loss and claims developments, and that such profits will be paid out entirely as dividends as a result of these formula factors, leaving no room for any increase in the equity value of the contributed capital held by the captive when a member exits. Thus the lack of any expectation that the capital contributed will increase in value may cause the captive to fail the fifth *Forman* test.

- Similarly, these types of formulas that allocate most program profits to the members that best control their losses are contrary to the *Howey* factor that posits that investors in securities have a reasonable expectation of receiving profits from the significant managerial efforts of others. Most captives are not typical passive investment vehicles: only insureds bringing their own risks to the program may participate or expect a return, and the expected return is most often not based on the amount of capital provided to the captive or the business acumen of an unrelated board. Rather the owner's own loss performance, and often its participation in the captive's governance, is what drives profits for many captive owners.

- Captive owner eligibility requirements (often embodied in a shareholder or participation agreement) may prohibit passive investors and require both active ownership and insurance program participation. The captive's interests by their terms are typically not available to, and are not marketed to, public investors such as hedge funds, widows and orphans who need the protections of the securities laws or other casual or unconnected sources of capital. A captive Business Plan may emphasize that the fixed purchase price/capital contribution of the captive interests does not represent a market price, but rather is akin to a membership fee, dues or earnest money to gain admission to the Insurance Program. Good Disclosure Documents, Business Plans and shareholder/participation agreements will consistently emphasize that the interests in the captive are not purchased as ordinary investments but are the vehicle used by the insureds to gain access to and provide capital to an insurance program through which they obtain insurance. These similarities to co-operatives, membership associations, mutual companies and other collaborative organizational structures are helpful to the analysis because there are a number of instructive SEC and state securities commission no action letters and interpretations that recognize that these sorts of arrangements do not need to be treated as securities offerings or are non-public offerings and therefore exempt from regulation. The rationales articulated in these rulings are similar to (and therefore indirectly supportive of) the positions described in this article. Even the natural tendency to use the terms, "members," participants" and "shareholder insureds" in lieu of "investors" or "shareholders" when discussing captives supports this understanding of the captive as a participatory group enterprise (rather than a passive investment and therefore a security).

- The analysis applies to segregated accounts, protected or incorporated cells and rent-a-captive portfolios, as well as stand-alone captives. The factors that indicate that shares are or are not "securities" also apply equally to "participation interests" in cell arrangements. A cell arrangement for a single reinsurance contract for a single layer in a single policy year may more clearly be a negotiated business arrangement, while the lack of a controlled board specific to the cell may slightly weaken the portion of the analysis that looks at the "managerial efforts of others" (i.e., a rental captive's core board may not be controlled by the cell owner). In some cases, a captive may be wholly-owned by a holding company entity, with the holding company, not the captive, issuing interests to the ultimate owners. Again, if the holding company has no business other than owning the captive, the "not a security" and "exempt security offering" analyses discussed should still, in most cases, apply. (A holding company structure is sometimes used if there is a reason that one or more captive owners cannot purchase or own an insurance company directly.)

If a Security, Disclosure

To recap the discussion at the beginning of this article, if a captive instrument is a security, the assumption of the U.S. federal and state securities laws is that there should be full disclosure of the terms of the security and the business of the issuer, including its finances, operations and prospects, so that potential owners can make an informed investment decision. When considering whether certain details should be disclosed, the determining question should be whether a reasonable investor would think that such details are material to his or her participation decision. Form S-1 is an important resource: the information disclosed in a Form S-1 filing for a public offering represents an accumulated set of factors which have proven to be important in many prior investment decisions. Recall that even where Form S-1 disclosures are not mandated because there is an available exemption for the proposed sale of a security, if any disclosure is made, it must be complete and not misleading under the anti-fraud rules (such as Rule 10b-5). Thus, the information provided in a captive Disclosure Document is informed by the disclosure principles we have been discussing even if (as discussed in the following paragraphs) an exemption from the securities laws is available.

Exemptions (Even if a Security)

Some captives may have attributes, such as no member Board representation coupled with the ability of the non-representative Board to amend member distribution and participation rights, that make the "not a security" analysis less certain (because the return from such a captive may be less dependent on loss experience and more dependent on the judgment of these third persons, the "managerial efforts of others"). Additionally, captives that facilitate risk pooling among captives may be structured such that the insureds in one pool own a pool of the risks of other unaffiliated businesses only – in such cases the owners do not benefit from controlling their own losses but are instead relying on the managerial and structuring determinations made by sponsors or others, and on the loss control efforts of unrelated insureds. Ownership interests in such arrangements are more likely to constitute securities.

Further, even where it is clear that the "not a security" determination is available, there is no explicit rule or regulator position statement to this effect that provides complete certainty (indeed any such rule or position statement could never address all possible permutations that we might see in captive program arrangements). Some insureds with high profiles, prior regulatory problems or other pre-existing political concerns may not be able to tolerate even the remote possibility of a regulatory dispute (sometimes made more acute by the captive's off-shore domicile which may independently attract negative comment, particularly for governmental insureds such as public hospitals or universities).

However, even if specific attributes make the "not a security" analysis less certain, or even if an insured is not comfortable with any uncertainty, there are often one or more exemptions from the securities laws that will apply.

In other words, colloquially, we can take a "belt and suspenders" approach: even if the "not a security" analysis is unclear or not enough in the circumstances, we can rely on a "back-up" exemption from the securities laws just in case the instrument may ever be deemed to be a security.

Looking to the 1933 Act, we find in Section 4(2) a statutory exemption from the law for "any offering not involving a public offering." That is another term which needs definition: what is a "public offering?" Regulation D promulgated under the 1933 Act provides a detailed "safe harbor" with steps for small offerings to take to avoid being deemed "public offerings." Compliance with this "safe harbor" provides assurance that a transaction will not be a deemed a public offering, but the safe harbor's existence does not mean that other offerings may not also be non-public and therefore exempt under Section 4(2). An offering within a safe harbor is safe, but other offerings may also be non-public directly under the statute without compliance with all of the technical requirements of the safe harbor specified in Regulation D. Nonetheless, Regulation D is instructive as to the types of securities offerings which will be of concern to securities regulators, and offerings that are far outside its boundaries deserve heightened scrutiny.

Regulation D provides that small offerings made to no more than 35 "non-accredited investors" plus any number of "accredited investors," if made without solicitation or advertising to the general public, made only to investors that plan to hold and not further distribute the securities, and which satisfy certain disclosure requirements if any of the investors are not "accredited" (among other requirements), are not public offerings; a filing reporting the private offering on Form D is required. Similarly, the states are required (by a pre-emptive federal law) to provide exemptions that conform generally with Regulation D. Many states also have additional blue sky law exemptions for sales to a limited number of purchasers, for sales made only to accredited or sophisticated purchasers or for offerings where the total number of owners does not exceed a small, specified number. It is not uncommon to find multiple exemption options available for a captive interest under the blue sky law of a single state.

"Accredited Investors" as defined in Regulation D include individuals and entities with net worth or income above certain thresholds; this is a proxy for the sophistication level deemed sufficient for self-protection. Generally, the most useful accredited investor categories for captive insurance companies are: (1) entities with $5 million in total assets; and (2) individuals (or entities wholly-owned by such individuals) with at least $1 million in net worth (exclusive of primary residence) or $200,000 in annual income. Many insured businesses participating in captives will either have $5 million in assets or be family businesses owned by accredited individuals. (This is a summary: there are rules that address trusts and minors, as well as special types of investors such as banks and investment companies; there is also a rule that prevents a newly-formed entity from being an accredited investor if the entity was formed for this purpose; the annual income requirement is $300,000 for a married couple if both incomes are counted; etc.)

Thus, in the captive context, the most important factors in determining whether a sale of a captive interest is not a public offering or qualifies for a similar small, non-public offering exemption are the number and sophistication of the insured participants. The number of participants is usually clear: by their nature, most captive programs have a limited number of insured participants, at least for a significant period after inception. The sophistication of the insured participants can be demonstrated through minimum eligibility requirements such as the accredited investor test, minimum premium size and the insureds' understanding and education about the operations of the captive's insurance program.

(Note: Risk Retention Group ("RRG") interests are explicitly exempted from the federal securities laws by the Liability Risk Retention Act of 1986 (the "LRRA") (except that the anti-fraud rules again continue to apply); the LRRA also pre-emptively provides that RRG interests are not considered to be securities under the state blue sky laws. This is an important and helpful provision because there is an RRG rule that all insureds must be owners (and all owners must be insureds), meaning that RRGs are typically group captives with multiple owner-members. Where there are a large number of individual owners (as in the case of, for example, physician medical professional liability RRGs), a Disclosure Document may still be good practice to fully explain program terms to these non-corporate individual insureds.)

Some Conclusions

Taking the above analysis as a whole, it is clear that single parent captive instruments: (1) are not securities ("forming a business" with no other investors is not a transaction that is deemed a security; none of the captive's success is dependent on the "efforts of others" because the single parent retains control); and (2) if unexpectedly deemed to be securities, their sale is nonetheless exempt from federal and state securities laws because a sale to a single purchaser, sophisticated enough to develop, structure and control its own insurance company, does not constitute a public offering.

For similar reasons, interest issuances by group captives with a small number of large members (say two to eight health systems or publicly traded enterprises) are also safely non-public offerings (in addition to not constituting securities if the terms are appropriate). Recall that a statutory Section 4(2) non-public offering of securities does not require any federal securities law filing and typically may not require state securities filings. Additionally, where there are both a small number of initial participants and high levels of sophistication, the assumption is that the terms of the captive are developed or influenced by all of the founding participants who have "a seat at the table" in forming the captive's Business Plan, and therefore the ability and wherewithal to protect themselves: they are the founders who establish the terms of the captive's instruments rather than being on the receiving end as offerees of these instruments; they are "forming the captive's business."

For captives with roughly 10 or more projected insured members (there is no statute or regulation that provides a definitive number – this is a rule of thumb based on experience. the numbers in Regulation D and other exemptions) that are mid-market or smaller family businesses, it is not as likely that all of the members will be active in forming the captive – someone has to take the lead and it is not workable for a large number of participants to have an effective voice on how all aspects of the captive program are structured. Here, the "not a security" argument relies on the idea that captive profits result primarily from the loss experience of each insured member, not the "efforts of others," and that the member treats the interest in the captive as part of the cost of its insurance arrangements, not as an investment. That is the "belt" portion of the analysis. On the "suspenders" side, even larger group captives can often safely take the position that the sales of their interests, even if deemed to be securities, are exempt from securities registration as non-public offerings: only insureds (and affiliates), not the general public, can purchase interests, the interests are not transferable, minimum premium and accredited investor mandates insure a level of sophistication, etc.: these are attributes of a non-public offering. ("Larger" captives will want to include being an "accredited invester" in their owner eligibility requirements since having more than 35 non-accredited purchasers is an indication that an offering may be public per the guidance found in Regulation D.) While a federal filing is not required under the Section 4(2) non-public offering exemption, at higher numbers it becomes more likely that one or more states (determined by the principal office locations of the shareholders/participants) may require a private offering notice filing (and fee) for offerings in this range: if there is doubt about the "not a security" position (because, for instance, the program may have a higher level of investment in portfolio securities than required for the operation of an insurance company and the distribution formula pays out investment returns in a manner not in tandem with individual insured loss results), we may treat the program as an exempt security for safety's sake. And, when we may have a security, a requirement of the securities laws is that any disclosure made be accurate and complete (see Rule 10b-5 discussion above): thus, a Disclosure Document becomes recommended.

Some "producer" captives, such as vehicle warranty captives or insurance agency captives, reinsure risks generated by the insureds developed by the captive's owners, which may be groups of auto dealerships or insurance agencies. The owners of these captives may be the dealerships or agencies, as well as their officers, employees and owners (and family members of those persons); the vehicle owners or insureds ultimately generating the covered risks are not themselves typically owners of these captives. In these situations, the "not a security" argument may be weaker because the owners of the captive interests do not control the captive's success through loss control of their own risks (a vehicle dealership may, for example, have the power to put only the warranty risks of financially sound vehicle owners with good safety records into the captive, but it cannot provide the ongoing training or oversight that insured owners in other types of captives can directly deploy to reduce claims and thereby improve captive returns). Further, there may be more participating owners and a lower level of wealth and sophistication if multiple vehicle dealerships or insurance agencies participate in the program, and each permits participation by local employees (such as salespersons who may be offered participation to incentivize warranty or policy sales). The salesperson at a local auto dealership is not generally purchasing captive interests in order to obtain access to a warranty reinsurance program for the risks of his or her customers (although this motivation may apply in the case of the dealership itself and the dealership's owners). In any event, where we have a larger number of less sophisticated participants who do not control the claims that the captive will eventually have to pay, we do look for an exemption from the securities laws because of increased uncertainty about the "not a security" analysis. A Disclosure Document will almost always be advisable for these types of captives because the Section 4(2), Regulation D and related securities exemptions likely to be utilized, as well as the anti-fraud rules, require disclosure in these circumstances.

Even if a captive's shares, participation, membership or similar ownership instruments are not securities or are exempt from registration under circumstances where a Disclosure Document is not required for securities law compliance, the Disclosure Document which results from assembling all of the program's material aspects and details in a single definitive place often becomes an excellent reference for guiding captive operations for many years. For a start-up group captive, the process of preparing the Disclosure Document will often force the founders to identify, focus on and resolve open points about complex risk-sharing structures, reinsurance terms, collateral, governance, run-off, exit rights and member expectations that might otherwise not be surfaced and addressed at the outset. Additionally, a good Disclosure Document will present a persuasive case for the captive as a long-term self-governed venture. Full written disclosure of program terms and expectations can also reduce the risk of future member disputes. The Subscription Agreement included in the Disclosure Document will ask prospective owners to acknowledge the captive's structure and risks; such acknowledgements can provide "moral suasion" against disputes whether or not a particular captive structure has been tested in a court of law. Thus, the Disclosure Document is a prod, a reference point and protection in the event of disputes: a best practice for most group captives.

What to Include?

So, in order to comply with either a securities law exemption or the anti-fraud requirements (in the event an instrument may be deemed to be a security), or because it is a best practice to have a complete statement of the captive program for guidance into the future, we decide that a particular captive should have a Disclosure Document. What should the document include?

Form S-1 has a lot of suggestions, as discussed above. A reasonable participant will want to know who runs the captive, what business it does, how it is regulated, what taxes apply to the captive and the participant, what the risks of the business are, etc., all as in the case of any ordinary business. Importantly, however, captive operations typically deviate from ordinary business operations in several key respects: risk-sharing (and assessment obligations), run-off and exit waiting periods tied to policy year loss development and distribution and expense allocation formulas (often based on loss experience or premium size, rather than contributed capital as would be the case in an ordinary business investment). Terms of this nature are not only unfamiliar to ordinary business investors, they also vary from captive to captive: these are the material terms which determine the participant's likely expenses and profits from the captive.

These captive specific details about risk-sharing, assessments, run-off, distributions, allocations and the like are the most important disclosures, they are not intuitive, and they are the ones the Disclosure Document should focus on: they are what a reasonable participant really needs to know.

If a captive has done the hard work of drafting a definitive risk-sharing and distribution formula, that can be made part of the Disclosure Document. In fact, many of the categories of disclosures suggested by Form S-1 may be addressed in a captive's underlying documents, and these documents can be assembled to form a substantial part of a Disclosure Document.

Here are some of the key documents, often containing terms that are material to prospective members, that may be included in full as exhibits to a captive Disclosure Document, depending on their materiality in the circumstances:

- Memorandum/Certificate/Articles of Formation
- By-laws/Articles (governing corporate functions)
- Shareholder/Member/Participant Agreement
- Business Plan
- Formula for premiums and risk and profit sharing
- Policies/Procedures for captive operations
- Segregated Portfolio/Cell/PIC materials
- List of fronting, reinsurance, and other service providers (often updated annually by supplement)
- Subscription/Joinder Agreement (may include a Power of Attorney)
- Investment Policy
- List of owners, directors, officers, committees
- Consulting/Captive Management/other service provider agreements
- Policy Templates/Terms/Reinsurance Terms
- Collateral/Security Agreements

It is not typical, however, to find a pre-prepared discussion of the risks or the tax aspects of a captive. Those sections in particular often have to be drafted specially for the Disclosure Document. A discussion of applicable insurance or domicile regulations may also need to be drafted if not included in a pre-existing Business Plan.

The Disclosure Document should support the "not a security" position, if taken by the captive, by avoiding thoughtless usages of investment and securities terminology. Since many Disclosure Documents have their origin in private placement memoranda prepared for small, exempt securities offerings, it is not uncommon for them to look and sound like these memoranda: careful customization is important to avoid conceding that the interests are securities if this is not the intent. That success is expected to result from good loss control, as well as the eligibility and other limits that prevent ownership by the general public, should be highlighted.

Updating

How often must a captive Disclosure Document be updated? There are two considerations: (1) are new members still joining, and (2) have there been any material changes to the captive's operations or operational documents? As we have discussed, even if a captive Disclosure Document is not legally required, it is often an excellent way to establish, and thereafter readily reference, all program terms. Nonetheless, if no new members are on the horizon, a captive's board may decide to dispense with the effort and expense of a Disclosure Document update: current program results, new board members and service providers and document amendments can be disseminated to existing members in other formats. Also, if a captive's program has operated as expected and described in the Disclosure Document without material change, the captive may utilize the Disclosure Document for an extended period of time. A supplement providing updated information (financial results, new board members) may be provided as an accompaniment to the Disclosure Document as needed for fair disclosure even if a full update is not done.

However, if a captive experiences a material change that is inconsistent with statements made in the Disclosure Document (such that a supplement will contradict the Disclosure Document instead of merely updating it, or such that reading a supplement together with the pre-existing Disclosure Document may be confusing), then an update is called for. Additionally, a badly out of date Disclosure Document is not a positive message to give to potential participants: legal counsel for potential participants in particular may legitimately question the validity of outdated materials as part of their captive diligence review.

What kind of change is material? Again, we look at the types of information deemed important by Form S-1 and Regulation S-K, but the key question to ask is whether the change would make a difference to a reasonable person considering participation in the captive. Material changes can result from an amendment to the formula that governs risk and profit sharing, changes in board leadership (although some group captives that give a representative of every member a board seat, thereby effectively providing equal potential to control the captive to its members, may not deem these changes material), changes due to growth in captive size (allowing further retention of risk, for instance), member disputes, changes in types of risks covered, changes in length of anticipated run-off periods for policy years, etc., may result in a decision to update. Additionally, tax law and domicile law changes may or may not be material, and may or may not be able to be succinctly addressed via supplement in an understandable manner. Captive litigation, depending on the size and type, may also be very material from the perspective of a potential member.

Who Approves?

A captive Disclosure Document prepared for a new captive is usually initially developed and drafted by the captive's law firm or another service provider. The drafter will use the available materials – particularly the Business Plan and the corporate documents – to create a summary of how the captive is expected to operate. The Disclosure Document will be reviewed and approved by the initial shareholders and directors of the captive (shareholder approval is appropriate because many of the components of the Disclosure Document, such as the corporate documents discussed above, require shareholder approval under domicile corporate law).

Additionally, the corporate governance documents, the Business Plan, policy forms and certain related materials likely require filing with and/or approval by the domicile corporate formation authority and the domicile insurance regulatory authority. Note that the Disclosure Document itself does not have to be filed and approved by a governmental corporate formation or insurance licensure authority. While some of the state blue sky securities exemptions may require the filing of a Disclosure Document with the state securities authorities, it is unusual not to find an exemption that does not require a filing; additionally, the need to identify state securities law exemptions occurs only if the captive interests as structured are deemed to constitute securities; finally the non-public offering exemptions under the 1933 Act do not require that the Disclosure Document be federally filed. Because the Disclosure Document is not usually filed with any governmental agency, it can be revised by director action at any time, subject however to agency approval if any filed exhibits to the Disclosure Document (corporate formation documents, Business Plan, etc.) are modified as part of the revision process; additionally, while the Disclosure Document itself is the purview of the captive's directors (or equivalent governing body), shareholder approval of any changes made to the corporate governing documents is usually required by domicile corporate law; finally, the shareholder/participation agreement by its internal contractual terms usually specifies that shareholder/participant approval is required for any amendment to that agreement.

The Disclosure Document is typically set up in a way that requires any new captive member to review and agree to be bound by the terms of the Disclosure Document and all of the attached exhibits. The subscription agreement or participation agreement, which is the agreement which actually effectuates the new member joining the captive, typically contains representations to this effect.

Who Gets a Copy?

As discussed above, a captive insurance program Disclosure Document, when prepared, is usually not filed with any securities authority or other governmental entity (although some of the exhibits may be) and is therefore generally not available to the public. Recall that one of the requirements of the Regulation D safe harbor is that no public advertising or solicitation can be utilized: a typical captive should readily meet this requirement. Maintaining the confidentiality of the Disclosure Document supports the "not a security" and "private offering" positions discussed above: typically, only insureds or their affiliates (and sometimes founders or service providers) participate as captive owners, not the general public. Further, the Disclosure Document should not be used as a marketing tool: only potential insureds, often industry participants already known to current members, that meet specific insurance parameters should be eligible, appropriate recipients of the Disclosure Document. Thus, typically, the potential recipients are motivated by the ability to obtain insurance in the program, and the potential recipients constitute a small, targeted, non-public group. Another reason to track and police the confidentiality of the Disclosure Document is that program specifics, such as any formula that allocates losses and assesses premiums, as well as details about program size, expansion plans, investment strategies and preferred participant characteristics, may be seen as competitively-sensitive proprietary business information.

Thus, ideally, the Disclosure Document is presented to a potential program participant only after initial educational meetings and vetting have established that the candidate shares a common loss control philosophy with the captive, has sufficient premium size to meet captive parameters, understands the basics of how captive insurance works and is otherwise a suitable participant. The Disclosure Document can then be delivered and studied and questions can be addressed in a robust interactive process. Additionally, it is best practice to provide a copy of any Disclosure Document that is updated (as discussed above) to existing participants so that it is available for reference on an on-going basis. Because the Disclosure Document should provide as complete a picture of program operations as possible and usually includes the captive's underlying governing documents, Business Plan and other key contracts and policies, it is also fully appropriate to provide a copy of the Disclosure Document to any existing member upon request – educated, informed members support program success through understanding program operations and incentives.

Note that the U.S. federal and state securities laws cannot be avoided by an offshore captive requiring that its subscription agreement be delivered and signed offshore: the applicable law in a securities action will generally be that of the headquarters of the subscribing insured. To avoid being deemed to be doing business in the U.S., however, an offshore captive will likely counter-sign and accept the subscription agreement offshore, and some offshore captives do require the insured's signature to occur offshore (often at an initial meeting with the Board), because this is viewed as helping to demonstrate a record of personalized discussions and education with the new participant.

Broker-Dealer and Investment Company Laws; Remedies

U.S. federal and state laws that regulate broker-dealers and investment companies are closely related to the securities laws we have been discussing.

A broker-dealer or agent of a broker-dealer, engaged in "the business of selling securities" is subject to registration and regulation as such. Could the persons participating in the regular sale of captive interests be subject to these rules? Generally, an issuer of "securities" (assuming the captive interests are of the sort that may be thought to be securities) is exempt from broker-dealer and agent registration if the issuer itself (in this case, the captive insurance company) offers the interests in question through its officers, directors or employees, and does not charge a commission. Thus, preferably, the Disclosure Document should be delivered by the captive (using the captive's email, email server and letterhead), not a consultant or service provider to the captive. While ministerial acts (such as document delivery) may be handled by a captive manager, this should occur at the specific direction of an officer of the captive. While the risk of a broker-dealer/agent problem for typical captives is low, it is best to avoid the situation where a consultant or service provider regularly and without direction undertakes solicitations of new captive members. In addition to the risk of being deemed a securities business subject to broker-dealer registration, this also could be uncomfortably more like public solicitation than a controlled, limited, private offering. It is almost never appropriate for a captive to pay a commission on the sale of its interests because this treats these interests as if they are securities and undercuts the idea of collaborative group action. The payment of an insurance commission to a licensed insurance agent as part of the captive's program upon policy issuance, however, should not be an issue (assuming the commission is tied to premium size and not to mere entry into the program or the amount of capital contributed to the captive).

Investment companies whose primary business is to pool funds to invest in securities are subject to regulation, particularly under the Investment Company Act of 1940 (the "1940 Act"). A captive insurance company invests in securities with its funds on hand while it awaits the development and payment of claims. Captives may have substantial investment programs. However, it is important for a captive to act like a true insurance company and not let its "investment business" side overwhelm its insurance side. To the tax and insurance operational reasons for avoiding this situation, add the 1940 Act rules. An exemption from the Investment Company Act may well be available for many captives (as under the securities laws, there is a private investment company exemption for companies with under 100 owners), but this is another layer of regulation that most captives will be able to avoid by operating as true, functioning insurance businesses, not as disguised investment vehicles.

In the event that a captive's instruments are determined to be securities and no exemption is available, an unhappy owner may sue the captive based on violation of the securities laws, including the anti-fraud rules, due to incomplete or inaccurate disclosures in connection with the purchase of the captive interest. The most likely remedy in such a lawsuit based on the securities laws (in the absence of criminal or bad faith conduct) would be rescission: i.e., the subscriber would get its initial capital back (this effectively gives the subscriber a "free-ride," since the subscriber would only ask for its initial capital back if the arrangement was not profitable; otherwise it would elect to keep the interest). In the absence of intentional fraud, an action by the SEC or the state securities commission is less likely. However, the securities laws have a full range of penalties including fines and jail time, as this is needed to address fraud and criminal schemes. While the structure of a typical captive puts it at low risk for the most extreme penalties, it is not possible to say that they would never be applicable.

Conclusion

In conclusion, good captive insurance company Disclosure Documents contain the information that is material to an insured making a decision to participate in the captive's insurance program. The securities laws and regulations provide extensive guidance on the types of information likely to be material in making a participation decision. A single member captive does not require a Disclosure Document; additionally, many group captive instruments will not constitute "securities" or will be exempt from registration under the non-public offering exemptions of the securities laws. Nonetheless, even if a Disclosure Document with specified information is not legally required by the securities laws, the anti-fraud rules may make a Disclosure Document advisable if any summary information is provided to potential captive program participants; additionally a good, comprehensive Disclosure Document requires that complex program aspects be considered and fully addressed at the program's outset, provides a unifying roadmap for program participants to refer back to, prevents misunderstanding and disputes and can guide ongoing program operations.

About the Author

Lisa M. Kaderabek is a partner in the captive insurance and healthcare practices of the Chicago office of the law firm of **McDermott Will and Emery LLP** focusing her practice on captive insurance, risk transfer, reinsurance and related matters for health care entities and other businesses. Ms. Kaderabek may be reached at lkaderabek@mwe.com. Special thanks to McDermott Will and Emery LLP partners Tom Jones and Kristen Hazel who provided comments on this article.

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