HUNTON ANDREWS KURTH

Lawyer Insights

To Incorporate or Not to Incorporate? That is the Captive Cell Question.

By Lorelie S. Masters, Patrick M. McDermott and Latosha M. Ellis
Published in Business Law Today | March 17, 2022



As the use of captive insurance companies continues to grow, one issue businesses may face is whether to incorporate cells within a captive cell program. This article addresses some of the relevant considerations.

In simple terms, a captive insurance company is an insurance company owned by the entity to which the captive issues insurance. Captive insurance companies can take several different forms. A single-parent captive is one owned by a single entity. A group or association captive is a captive that is owned by two or more different entities. A rental captive is created by a third party and, for a fee, allows other entities to obtain the benefits of captive insurance without needing to form their own captive insurance company. This often takes the form of a captive cell; in that form, each “rental captive” is created as a captive cell within the larger captive such that the assets and liabilities of each cell are shielded from other entities’ “rental captive.”

As an alternative, a single entity could create a captive cell program. In that circumstance, the entity would create a cell captive insurance company and then create captive cells within that company. Cells could be created to segregate different types of insurance, thereby protecting the assets held to insure low-risk types of coverage from those held to insure high-risk types of coverage. Cells may also be created to segregate insurance of different projects.

An issue businesses confront when creating a captive cell is whether to form the cell as an incorporated entity or an unincorporated entity. One possible advantage of unincorporated cells is that they may be easier to form and maintain. An unincorporated cell can avoid the administrative burdens and costs of an incorporated cell. It may not need to prepare more standard formation documents like articles of incorporation or bylaws. In addition, unincorporated cells usually do not need to have officers and directors, hold annual board meetings, or file separate tax returns. Because unincorporated cells are not legal entities, they generally cannot enter into contracts, requiring the core captive to do so. Depending on the jurisdiction, however, captive laws and regulations may still protect the assets and liabilities of an unincorporated cell from those of the core captive and other cells within that core captive.

A potential advantage of an incorporated cell is that it can further establish the goal of segregating cell assets and liabilities. For example, unlike unincorporated cells, incorporated cells can enter into contracts and thus can issue the insurance policies to the policyholder. Likewise, they can sue and be sued. Each of those characteristics of an incorporated cell can further protect the cell’s assets and liabilities from those of other cells and the core captive. However, incorporated cells may impose additional administrative burdens and costs that are not imposed by unincorporated cells.

Case law on these issues is sparse, to say the least. In one of the few decisions addressing the issue, a federal court in Montana ruled on one consequence of an unincorporated cell. *Pac Re 5-AT v. Amtrust N. Am., Inc.*, 2015 WL 2383406, at *4 (D. Mont. May 13, 2015). There, the court found that, without a separate legal identity, and absent a statutory grant to the contrary, the unincorporated cell there lacked the capacity to sue or be sued. *Id*. As a result, and contrary to the unincorporated cell's and the core captive's arguments, the court found that the core captive was properly named as a party in a demand for arbitration for alleged breaches of a captive reinsurance agreement and would be appropriately bound by the results of the arbitration. *Id*. at *5. However, that court also recognized the Montana statute that protected the assets of a cell from the liabilities of other cells or the core captive. *Id*. at *4 (quoting Montana Stat. § 33-28-301(4), which provides that "[t]he assets of a protected cell may not be chargeable with liabilities arising from any other insurance business of the protected cell captive insurance company").

Cell captive insurers could be brought into litigation involving insurance issued by an unincorporated cell. For instance, when a policyholder requests coverage from other insurance companies, those other insurers may argue that the policyholder's captive insurance must provide coverage first. Those arguments can be based on other-insurance clauses or on contribution principles. They could also involve a policyholder seeking coverage under a vendor's insurance policy or seeking indemnity from a vendor. In those circumstance, those other insurers may bring the captive insurer into any litigation between the policyholder and those other insurers. But, even if the core captive is a party to the arbitration, its assets may still be protected from paying the liabilities of a protected cell.

Ultimately, the decision of whether to incorporate cells within a captive cell program will likely depend on a variety of factors, including the goals and needs of the business as well as state-specific laws and regulations.

Lorelie S. Masters *is a partner in the firm's Insurance Coverage group in the firm's Washington D.C. office. A nationally recognized insurance coverage litigator, Lorie handles all aspects of complex, commercial litigation and arbitration. She can be reached at +1 (202) 955-1851 or lmasters@HuntonAK.com.*

Patrick M. McDermott *is a counsel in the firm's Insurance Coverage group in the firm's Richmond office. Patrick counsels clients on all aspects of insurance and reinsurance coverage. He assists clients in obtaining appropriate coverage and represents clients in resolving disputes over coverage, including in litigation and arbitration. He can be reached at +1 (804) 788-8707 or pmcdermott@HuntonAK.com.*

Latosha M. Ellis *is an associate in the firm's insurance coverage group in the firm's Washington D.C. office. From advising clients at policy renewal and through the claims process to representing clients in litigation or alternative dispute resolution of coverage disputes, Latosha delivers comprehensive end-to-end counsel. She can be reached at +1 (202) 955-1978 or lellis@HuntonAK.com.*