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## PCCs: Why Is Pac Re Such a Big Deal?

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*Editor's Note:* We now read about the importance of the recent *Pac Re* ruling in a piece by **Jeffrey K. Simpson, Andrew J. Rennick,** and **Daniel L. Fitzgerald.** The ruling reveals more in the analysis than in the headlines. The authors are all associated with the law firm of Gordon, Fournaris & Mammarella, P.A. They can be reached at jsimpson@gfmlaw.com, arennick@ gfmlaw.com, and dfitzgerald@gfmlaw.com, respectively.

The recently decided case of *Pac Re 5-AT v. Amtrust North America, Inc.* CV-14-131-BLG-CSO, 2015 WL 2383406, 2015 U.S. Dist. LEXIS 65541 (D. Mont. May 13, 2015), has attracted a great deal of commentary in the captive insurance community. The case involves a Montana protected cell structure and considers the judicial status of an individual protected cell and the relationship between the individual protected cell and the company of which it is a part. This article briefly describes the nature of protected cell companies, summarizes the *Pac Re* case, and discusses its import, including a discussion of how sponsors can mitigate the uncertainty associated with the treatment of protected cells.

### Protected Cell Structures

Numerous jurisdictions, both onshore and offshore, have adopted statutory provisions that permit protected cell arrangements. A protected cell captive (PCC) is a segregated account that exists as a subset of a licensed captive insurance company. The assets and liabilities of each cell are segregated from the assets and liabilities of every other cell and of the company itself (often called the "core"). Each cell is therefore able to operate as if it were separate from the core and the other cells while still being administered and regulated in conjunction with the core. As a result, cells can often provide the benefits of a separate captive insurance company more quickly and at lower cost.

Also, if the business within an individual cell constitutes insurance for tax purposes, then the Internal Revenue Service (IRS), pursuant to Rev. Rul. 2008–8 and the subsequent proposed regulations, will treat the cell as a separate taxpayer, allowing it to obtain its own federal employer identification number and file its own tax return as an insurance company. Because they are faster, less expensive, and can


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be treated as insurance companies for tax purposes, cells have become popular vehicles.

In a protected cell arrangement, a captive insurance company establishes a number of protected cells by creating segregated accounts for the benefit of participants in the captive insurance program. The applicable captive insurance statute typically requires that each protected cell be governed by a contract between the participant and the company. This participant contract allocates to the protected cell certain risk and premiums written by the company, while the applicable protected cell statute provides for segregation of the assets and liabilities of the protected cell from the assets and liabilities of the other protected cells and the core. Since forming a protected cell is a contractual and regulatory matter which requires no filings with the Secretary of State and no registered agent or office in the domicile, the protected cell structure offers cost efficiencies to the participant, particularly if the captive statute allows for reduced capital requirements for protected cells. Since the protected cell is part of the company and operates under the company's license, there may be administrative efficiencies as well.

There are, however, two primary challenges related to protected cells, namely that the segregation of assets and liabilities has not been tested in court, and protected cells generally cannot contract in their own names. First, notwithstanding clear statutory language supporting the segregation of assets and liabilities in a cell, no known caselaw affirms that segregation, and, in fact, no case has yet addressed the question. Some practitioners interpret the absence of applicable caselaw as indicative of uncertainty over whether the segregation will be respected. Second, protected cells generally lack the statutory authority to contract in their own names. Where a cell cannot contract in its own name, the core generally contracts for and on behalf of the cell. Some practitioners believe that having the core contract for and on behalf of the cell unnecessarily exposes the core. It can also preclude contracts between and among cells because the core cannot contract with itself.

Attempts to address the shortcomings of cell structures have led to the availability of a variety of similar vehicles, including protected cell companies, incorporated cell companies, and series limited liability company (LLC) captives, each with unique features and strengths and weaknesses. However, the absence of applicable caselaw continues to be the Achilles' heel of protected cell companies, and *Pac Re* is important because it goes directly to the issue of the separateness of protected cells.

## *Pac Re*

*Pac Re* is interesting, even exciting, as the first case to directly address the separateness of a protected cell. While the court found that a protected cell is not a separate legal entity and cannot be sued apart from the protected cell company that houses it, the court also noted that the assets and liabilities of a protected cell are, in fact, segregated.

The *Pac Re* case involved a protected cell company domiciled in Montana. Pac Re, Inc. (the core) established Cell 5-AT ("Cell 5") to reinsure general liability risks written by a fronting insurer. Pursuant to the applicable reinsurance contracts, Cell 5 was required to maintain a minimum level of assets and provide security for its reinsurance obligations. The fronting insurer alleged that Cell 5 did not comply with the minimum asset and security requirements, and, on that basis, the fronting insurer demanded arbitration. But the fronting insurer did not make its demand against Cell 5. Instead, the fronting insurer sued Pac Re, the core. Pac Re then moved to dismiss the claim, arguing that Pac Re was the wrong party, and the suit could only be brought against Cell 5 itself.

The federal court for the District of Montana denied Pac Re's motion and concluded that Pac





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Re was the proper party. In denying Pac Re's motion, the court distinguished between the segregation of assets provided by Montana's captive insurance statute and the separateness of Cell 5's identity. The court noted that Cell 5 was not a separate legal person and could not be sued independently from Pac Re. The court cited sections of the Montana captive statute providing that the formation of a protected cell creates a separate legal person only if "the protected cell is an incorporated cell."

The Montana court concluded, correctly in our opinion, that Cell 5 could only be sued through Pac Re for and on behalf of Cell 5, in the same manner that Pac Re entered contracts for and on behalf of Cell 5. This case stands simply for the proposition that, to sue a cell of a protected cell company, one must sue the protected cell company for and on behalf of the cell. Since cells do not exist as separate legal entities, the conclusion makes perfect sense. Frankly, no one should be surprised by this outcome.

This ruling was limited to the procedural matter of how to sue a cell. Accordingly, assertions by some commentators and practitioners that this case in any way implies that Pac Re's core assets are potentially exposed, or that the segregation of assets and liabilities will not be respected, are both premature and unsupported. This case did not address those issues and cannot reasonably be read to have done so.

While finding that Pac Re was the proper party, the court nevertheless noted that the Montana protected cell statute provides for the segregation of assets and liabilities. If anything, this is an indication by the court that it would respect that segregation.

## Importance of *Pac Re*

The *Pac Re* court was exactly right. The importance of the case is not that it casts doubt on the integrity of protected cell companies or the segregation of assets and liabilities, because it does not. In fact, it suggests that the segregation will be respected. The importance of the case is that it confirms the conventional understanding of the structure and operation of protected cell companies—protected cells are not separate legal entities and cannot contract or be sued in their own names, but they nevertheless segregate assets and liabilities.

If there is a lesson in *Pac Re,* it is that protected cell companies should be designed and operated in a manner that maximizes the likelihood that the statutory segregation of assets and liabilities will be respected. This includes following the formalities applicable to cells, contracting in a manner that minimizes the likelihood of lawsuits and operating in domiciles that will be inclined to understand and respect the structure.

The first step in getting a court to enforce the segregation of assets and liabilities is respecting the formalities that yield that segregation. Every protected cell statute includes language about the formalities applicable to protected cells. Generally, those formalities are that the cell be formed pursuant to a contract, that the assets and liabilities of the cell be identified with sufficient specificity, and that separate books and records be kept for each cell. Compliance is relatively simple. First, form each protected cell pursuant to a professionally prepared contract designed to conform to the requirements of the applicable protected cell statute. Second, although the core must contract for the protected cells, it should do so "for and on behalf of" a specific and clearly identified protected cell, and maintain separate bank or other accounts in the same manner—"for and on behalf of" a specific and clearly identified protected cell. Finally, the books and accounting records of the protected cell company should include a separate record exclusively for the financial results of each protected cell.

Another step in defending the segregation of assets and liabilities is not having that segregation challenged in the first place. The owners of protected cell companies (typically called "sponsors") should design their protected cell


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companies to minimize the potential for lawsuits. While we do not agree that the absence of applicable caselaw is a reason for not using protected cell companies, we do see it as a reason to be cautious and not invite challenges. Accordingly, we encourage sponsors to consider who might be motivated to sue and what their objectives in the suit might be. We suggest that sponsors avoid allowing or simply prohibit protected cells from entering the kinds of contractual relationships that could result in unrelated or unknown creditors who might have an interest in challenging the integrity of the protected cells.

Finally, a third step in protecting the segregation of assets and liabilities is ensuring that any challenge occurs in a jurisdiction that should be inclined to respect that segregation. Generally, as occurred in *Pac Re,* courts in the jurisdiction where a captive is formed should understand and be inclined to enforce the local laws providing for the captive's existence. Accordingly, we encourage sponsors to design their protected cell companies to maximize the likelihood that any dispute will be addressed in the state of domicile. Contracts should include provisions for exclusive venue and jurisdiction in the state of domicile, and the captive's activities should occur entirely and exclusively within the state of domicile.

## Summary

The *Pac Re* case highlights a disadvantage of the protected cell structure—namely, that any contracting and litigation involving a protected cell must necessarily implicate the core, as the protected cell does not have sufficient indicia of separateness to contract and litigate on its own. *Pac Re* did not address the segregation of assets and liabilities in protected cell companies. However, the case did not threaten that segregation, and it even appears the court signaled that it would respect the segregation.

While the lack of a court ruling expressly affirming the segregation of assets and liabilities in protected cell companies has some practitioners and commentators advising against their use, we view the absence of applicable caselaw as a business risk that should be clearly explained to prospective sponsors and participants, and that can be mitigated. By incorporating appropriate features into a protected cell program, including following the formalities applicable to cells, contracting in a manner that minimizes the likelihood of lawsuits and operating in domiciles that will be inclined to understand and respect the structure, sponsors and participants can minimize the likelihood of a negative outcome.

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