CAPTIVE INSURANCE COMPANY REPORTS

A "Good" Captive Is in the Owner's Hands

Benjamin Whitehouse
June 2019

Editor's Note: Former Tennessee regulator **Benjamin Whitehouse,** now an independent attorney, offers to us his view on how a well-managed captive is structured. He can be reached at ben.whitehouse@butlersnow.com.

A captive insurance company makes sense for many businesses. As a former captive insurance regulator and now in private law practice, I'm often amazed at the creativity and ingenuity of captive owners, captive managers, and insurance professionals who design and implement unique risk management solutions through the use of a captive. Captives often provide solutions to problems that the commercial insurance market cannot solve.

I'm often asked by captive owners or seasoned captive insurance professionals to review a captive program and opine if it is a "good" captive. The motivations for this question vary. Some want to make sure the captive is ready and able to cover the risks it is insuring. Others want to make sure that the proposed captive complies with both state regulations and eligibility for the appropriate federal tax status while meeting the captive owner's risk management goals.

Virtually every captive owner or captive board member whom I meet with will tell me their strong desire to have a "good" captive that is run the right way. My advice to the captive owner or board member is that they should understand that each captive insurance company is unique and the actions of the owner are more important to the success of the captive than the technical design by the professionals. Let me explain these two principles.

Each Captive Is Unique

No two captives are the same. If you've seen one captive—then you've seen one captive! Even captives designed by the same captive manager for businesses in the same industry can look and operate differently. Instead of comparing one captive to another, the focus should be how well the captive handles the unique risk management needs and claims of the owner/insured.

Like the difference between an off-the-rack suit and a bespoke suit, the best-looking captives are often ones that the owners have tailored to fit their individual risk management needs of the business and make changes as

©2019 IRMI®

needs arise. This tailoring includes integrating the captive into the overall risk management function of the business, updating claims reporting, and designing other customized applications. Proactive captive owners sometimes recognize in advance that they will need to add additional capital and surplus to shore up reserves.

Owning your own insurance company also means that you, the owner, are the ultimate authority on the terms of the policies that fit your needs best. Outside advisers assist and provide recommendations, but the owner has the final say.

Is the Owner in Control?

The question of whether an arrangement looks like insurance doesn't depend on whether those appearances flowed from professional advice but *what actually happened.*

> —*Avrahami v. Commissioner,* 149 T.C. 144 (2017) (from the order denying petitioner's motion for reconsideration; emphasis added) ~Hon. Mark V. Holmes

The captive owner (or insured) has control and is primarily responsible over at least five key duties that, if properly done, make it a "good" captive. These are owner duties that, by their nature, can't be delegated to outsiders. These duties include making policy decisions, filing claims, managing the captive's assets, ensuring that the captive has strong corporate governance, and keeping up to date with the educational resources that are available for captive board members and owners. As will be shown below, the owner really has control over "what actually happened."

The standard of care required to satisfy these duties should not require captive owners to become as knowledgeable about captives as their service providers (although some do). But the standard is certainly higher than doing nothing.

Decisions on what to insure. No captive insurance service provider is going to know the insured's business better than the owner. It is incumbent on the captive owner to take control of the risk management review process and discuss these issues with the captive manager and other service providers. Similar to how the owner approaches buying commercial insurance, a captive owner can, and should, rely on the service providers to advise on technical issues such as coverage limits, policy terms, and capital reserves. However, as with commercial insurance, the owner makes the captive insurance buying decision based on the needs of the insured.

Filing claims. I've rarely met someone who just "forgets" to file a claim with their commercial insurance company. This is because controls are usually already in place to identify when a loss occurs on a commercial policy, and then a business decision is made whether to file the claim with the commercial insurer. On the other hand, sometimes captive insureds do not file claims. There are various reasons for this.

First, those with knowledge of a possible loss event may not recognize that a captive policy covers such event. Captive policies often insure risks not covered by commercial insurance. Often, the existence of the captive and what it covers are not well understood by the insured's employees.

Second, captive owners or insureds may dismiss the need for filing captive claims as an immaterial exercise of moving money back from one company business unit to another. However, the proper approach is to file the claim and, if valid, the captive pays the loss amount to the insured.

It is the duty of the insured business to identify and report claims insured by the captive.

©2019 IRMI®

The outside professionals servicing the captive have little to no ability to do this very important function. Further, the outside professionals generally have no knowledge of whether an insured loss event has occurred.

Some captives with little claim activity have good intentions to file all claims, but since the captive is insuring an area that was previously self-insured, the controls may not have been put in place by the insured to identify claims throughout the year. This should be rectified. The insured must implement a process to understand what is covered by the captive, to identify potential occurrences, and then report the claim to the captive.

There is a learning curve with integrating a new captive into an organization. While the captive manager has a role in teaching the captive owner the key responsibilities in owning a captive, the captive owner and insured also have a responsibility to be willing to spend time and resources to integrate the captive.

A captive should not pay claims that are not covered by a captive insurance policy. Likewise, a captive insured should submit claims, and the captive should pay claims that are covered by a captive insurance policy. Depending on the lines of coverage in the captive, some captives will pay many claims annually, and others may properly operate for years without paying a claim. However, a captive insurance company that pays no claims, especially when it can be later shown that claims could have been paid, runs the dire risk of not being viewed as a real insurance company at all!

CICR comment: As evidenced by *Syzygy Ins. Co. v. Commissioner,* T.C. Memo 2019–34 (2019).

Management of captive assets. Is the owner managing the captive's assets properly? Most captives I have seen invest assets in the same manner as a prudent investor: with a widely diversified portfolio that preserves capital, provides liquidity for the payment of claims, and builds income. Some captives, however, fall into the trap of running their captive investments along similar terms and with a similar philosophy as other company assets or personal investments.

A captive that is likely to pay claims within a short period of time after the premium is paid needs to invest mostly in liquid and safe investments. Conversely, a captive with potential liabilities that may not need to be paid out for many years may have an investment policy focused on growth so that the captive assets will be available to pay future claims when due.

When I was a regulator, I received many requests from captive owners to either lend money to the insured or pay a dividend to the captive owner. While these actions are permissible, I reviewed whether the request to remove assets from the captive would impair the captive's ability to cover its obligations. Maintaining the solvency of the captive is a key regulatory oversight responsibility. If a loan is taken, the owner must create loan documents and follow the repayment terms on that loan, just like the owner would have to if the loan was taken from a bank. Many regulators will not even consider a dividend request until 3 or 4 years after the company is formed.

Even if a regulator approves a loan or a dividend, the responsibility to handle those assets properly rests with the owner. Captive insurance regulations are meant to be broad so that the regulator can, as much as possible, stay out of the owner's way. The important thing to note is that, even though the regulator doesn't object, it still might be a bad idea. During the Apollo 7 moon mission, **Deke Slayton,** then the National Aeronautics and Space Administration's chief astronaut, once told the crew: "It's your neck, I hope you don't break it." As a regulator, I sometimes felt like I should say the same thing to captive owners!

©2019 IRMI®

Corporate governance. Is the owner following good corporate governance with the captive? Corporate governance covers many areas, including executing on corporate formalities, having an engaged board of directors and officers, having sufficient knowledge of the insurance program and its risk management goals, and hiring competent service professionals.

Owners are not expected to be experts in insurance. That is why captive owners hire actuaries, financial professionals, captive managers, and other service providers. A good litmus test here may be to ask the owner whether they know as much about the captive's insurance program as he or she does about the commercial insurance program covering the insured businesses.

I often recommend that owners consider engaging a knowledgeable independent director to serve on the captive's board. An independent director who is knowledgeable about captive insurance and not affiliated with any other service provider can provide valuable insights to the board and lends the captive a great deal of legitimacy in the eyes of state and federal regulators and to others such as reinsurers.

Educate yourself and your board. Educational opportunities abound for captive owners. There are many webinars, professional education courses, and captive association conferences available nearly year-round. Some captive managers even provide educational webinars and conferences for clients to attend. These events are designed for owners and other stakeholders in captive insurance companies to become more knowledgeable about captive insurance. Take advantage of these educational opportunities so you may learn about captive insurance companies and the valuable role they play in risk management for your business enterprise.

Closing Thoughts

My experience and opinions are that the captive owner has the primary responsibility for ensuring that its captive is well run. No two owners are alike; there is a wide range of competency and compliance. Some captive owners fully embrace the responsibilities of ownership. However, other captive owners seem annoyed with the smallest imposition necessary to manage a captive, such as attending an annual captive board meeting. These captive owners fail to realize that much more is required of them to have a successful captive.

My focus on the owner's duties does not ignore the responsibilities placed on the outside professionals servicing the captive. These service providers include the actuary, resident agent, lawyer, financial adviser, tax return preparer, and captive manager. These professionals should be well qualified with experience in captives to effectively perform their duties. Many captive regulators, including Tennessee, put on their website (https://www.tn.gov/commerce/insurance/captive/how-to-form.html), a list of service providers who have been approved to work with captives in that domicile. Such lists are a good place to start when looking for a service provider.

As Judge Holmes cautioned in the *Avrahami* decision, captive owners cannot simply delegate their responsibility for ensuring that their captive is run and treated like a real insurance company. That obligation, ultimately, resides with the captive owner.

Reproduced from the June 2019 issue of *Captive Insurance Company Reports*. Opinions expressed in this article are those of the author and are not necessarily held by the author's employer or IRMI. This content does not purport to provide legal, accounting, or other professional advice or opinion. If such advice is needed, consult with an attorney, accountant, or other qualified adviser.

©2019 IRMI®