Is a Captive Right for You?

by Robert B. Hille, Esq., Richard S. Mills, Esq. and Matthew P. Cohen, Esq.

Robert B. Hille

Richard S. Mills

Matthew P. Cohen

New Jersey has joined a growing number of states to permit the formation and licensing of Captive insurers.

A Captive is an insurance company that is created and owned by an entity or entities with an interest in the businesses it insures. Despite the commonality of ownership and control, a Captive operates as a separate entity. The Captive is licensed by the state as an insurance company, issues policies to policyholders, maintains surplus and reserves, and pays claims. It is subject to the same federal tax laws.

Because of its relationship to its insureds, a Captive may provide for a broader range of coverage to meet the specific needs of its insureds. Among the risks which the law allows are property and casualty, including general liability, professional liability and employment practices liability, health insurance, annuities, indemnity, and fidelity coverage. For this reason, Captives have an advantage over the commercial insurance market in providing coverage for these risks.

Because a Captive does not write for the market as a whole, it is subject to less stringent state regulation than traditional retail insurers and offers substantial benefits to its owners from both insurance and liquidity perspectives. The most widely recognized Captive benefit is its operation as a loss and premium control vehicle. It can also serve as a means to transfer value from the insured business to the Captive and also from the Captive to its owners with more favorable tax treatment, depending on the Captive's organizational and capital structure.

Through the use of a Captive, an insured business can protect itself against cost fluctuations and premium swings in the retail insurance marketplace and decrease administrative costs and brokerage commissions which form a part of industry pricing. For example, retail carriers experience "soft" markets when their income investments generate greater returns on premiums. Often in a soft market, because insurers are pressed to maintain market share and the insurer is operating at a surplus, lower premium costs are available for insureds because the insurer is able to price its products for less than the true cost of the assumption of risk. Conversely, in a "hard" market, premium investments may yield lower returns. Therefore, insurers tend not only to raise their premium prices to meet the actual costs of indemnity and related expenses, they may also raise pricing to account for their declining investment returns. Thus, in a hard market, premium pricing is artificially increased in response to deteriorating overall market conditions and the exposures of insureds throughout the retail insurer's entire risk pool, as opposed to a reflection of an insured's actual loss profile. The resulting premium spikes or loss in coverage also reflect the industry's effort to catch-up for inadequate pricing of the past.

By contrast, use of a Captive to underwrite these risks permits the insured business to experience more stable premiums reflective of actual loss where the insured's loss portfolio has out-performed expectations. This is because premium pricing can be based upon actual loss experience as opposed to factors external to an insured's risks and exposures.

With a conventional insurer, profits generated from premiums are generally kept by the insurer and the insured retains limited benefit from effectively managing their risks. With a Captive, efficient risk management is rewarded, as net income may be invested, finance existing surplus capital and reserves, or be redistributed to the Captive's owners as a dividend.

Captives also allow for increased control and oversight over claims and claims-related litigation. Success in these areas contributes directly to the Captive's bottom line and the impact on future pricing for its insured businesses.

In addition, a Captive can insure risks where commercial insurance is unavailable or prohibitive. As a Captive may underwrite various types of risks in a diverse spectrum of industries, it can tailor coverage for its insureds that may be nuanced or fit within a larger risk management scheme. For example, a Captive could under-write a risk that is unique to a company's operations, experiences, or business model. It could supplement commercial insurance coverage by specifically underwriting risks that are not covered by an insured's other insurance. It could also insure the deductibles of commercially placed risks. Each of these forms of coverage that a Captive could underwrite may give the insured business greater control over risk management and risk financing.

Regarding the commercial insurance deductible example, the retail marketplace may require higher premiums for high risk exposures like catastrophic coverage or business operations. One way that a business can lower its insurance costs is to obtain commercial insurance with higher deductibles, thus lowering the cost of premium. The company could then insure those higher deductibles through the Captive as an alternative method of financing that deductible exposure.

Since a Captive is an insurance company, it also may access the reinsurance marketplace. While reinsurance may require substantial premiums, ceding a Captive's risk to a reinsurer may be an effective way for a Captive to manage its own exposures, thereby enhancing its ability to oversee its insureds.

While a Captive operates as an insurance company, its unique status means that it is not regulated in the same manner as a commercial insurer. For example, with a Captive it is unnecessary to require a rate filing or obtain pre-existing policy approval from the Department of Banking and Insurance. This variation can result in significant administrative cost savings. These savings would go directly to the Captive's bottom line rather than be imposed as additional costs built into to the premium charged by a commercial insurer. Ultimately, the insured business reaps the benefit of such cost reduction.

Eventually, if successful in managing the risks of the insured businesses, the Captive should become a profit center able to expand within the risk marketplace.

Captives also allow insured businesses, in certain circumstances, to transfer wealth through tax deductible premium payments. Under the tax laws governing insurance companies, reserves are not taxable. When claims with reserves are closed out, those funds may be taxed at a lower rate, which would generate savings and operate as benefit to the Captive and its insureds.

A Captive may also operate to transfer wealth from the Captive to the sponsors or its owners. Depending upon how the ownership and financial model are structured, this may create the opportunity for significant tax savings. Therefore, when forming a Captive it is critical to evaluate the tax implications, not only in its structuring, but prospectively on an annual basis.

In competitive industries such as health care, which are constantly being subjected to rising costs that may result in slimmer profit margins, the significant cost savings and potential return as a result of profitability that can be gained by establishing a Captive is something worth consideration.

So, if your company's insurance costs are too high and coverage too limited, if the value of your company is taxed at a prohibitively high rate, if its wealth is subject to catastrophic claims and if transferring risk can improve your company's financial picture, then a Captive may be right for you.

Selecting the right type of Captive for your risk arrangement is the first crucial step towards formation. New Jersey permits the formation of four different types of Captives. These are (1) "pure" Captives; (2) "association" Captives; (3) "industrial insured" Captives; and (4) "sponsored" Captives. Each may be a vehicle to underwrite and transfer risk, yet each possesses a unique organizational structure, capital structure and requirements, and operational capability.

A pure Captive insures the risks of its parent and affiliated companies (generally common ownership or management with parent) or unaffiliated businesses contractually controlled by the parent. The parent may be a corporation, limited liability company, partnership, other entity, or an individual, subject to certain regulatory guidelines regarding the individual's percentage of ownership in the Captive and the Captive's corporate structure. A pure Captive may be formed as a stock insurer, non-profit corporation, or manager-managed limited liability company.

An association Captive insures the risks of the member organizations of an association and the members' affiliated companies. An association Captive differs from a pure Captive in that it may draw premiums and financing from a larger pool of potential insureds, and as a result, may underwrite a more diverse body of risk. New Jersey's regulatory scheme broadly defines an "association" as a legal association of individuals, corporations, limited liability companies, partnerships, associations or other entities in continuous existence for at least one year.

In practice, association Captives are designed to insure the risks of a particular industry among the industry's members. An association Captive may be formed as a stock insurer, mutual corporation or reciprocal insurer. If the association Captive is formed as a stock or mutual insurer, the members of the association, the association by itself, or a combination of the association and some or all of its members must own or control all the voting power. If the association Captive is formed as a reciprocal insurer, the voting power must rest with its subscribers.

An industrial insured Captive insures the risks of industrial insureds comprising the member industrial groups and their affiliated companies. The law defines an "industrial insured" as an entity with at least 25 fulltime employees and aggregate insurance premiums on all risks of at least $25,000 that procures insurance through a full-time employee acting as insurance manager or buyer. With an industrial insured Captive formed as a stock or mutual insurer, the member industrial insureds own or control all voting power over the Captive. With an industrial insured Captive formed as a reciprocal, the insured must constitute all of its subscribers.

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An association Captive or an industrial insured Captive formed as a stock or mutual company may be converted to or merged with a reciprocal. Should the Captive be successful, it ultimately may be converted or merged so as to increase its capabilities and enhance its ability to generate revenue.

A sponsored Captive insures the risks of one or more participants through contract and segregates each participant's liability through separate accounts called protected cells. The Captive's "sponsor" is an entity approved by the Department of Banking and Insurance to supply all or part of the capital and surplus required to operate the sponsored Captive.

A sponsored Captive may underwrite the risks of its participants without the participants retaining an ownership interest in the Captive. The participant may insure only its own risks through the sponsored Captive.

A participant may be an association, corporation, limited liability company, partnership, trust or any other business entity. A sponsor also may be a participant although it is not required. A sponsored Captive's assets are not chargeable with liabilities arising out of any other insurance business conducted by the sponsored Captive.

Which of these Captive approaches is best will depend upon the objectives and risk tolerance of the Captive's parent or sponsor. Is the goal to enhance profitability by lowering the insurance costs? Is it to transfer risks from the insured businesses books? Or, is it to lower taxation on assets from the operating business to the Captive? Or, is it a long-term ambition of generating a risk financing profit center that could be converted and expanded into a traditional commercial insurance company? Is the aim to transfer wealth from insured businesses to younger generations through operation of the Captive?

In the healthcare industry all of these considerations are present, and a Captive may be worth consideration depending on your business model.

Insurance is a business based upon risk. A Captive, like any insurance company, will only be as successful as the accuracy of the risk assessment and pricing. Through efficient risk evaluation and management, effective claims oversight, and proper planning, a Captive may be a viable and beneficial alternative that suits your insurance needs and business model alike.

About the authors

Robert Hille and Richard Mills are Partners in the health care and insurance practices at McElroy, Deutsch, Mulvaney & Carpenter, LLP, a 300-attorney firm with ten offices inn New Jersey, New York, Connecticut, Massachusetts, Pennsylvania, Delaware, and Colorado. Matthew Cohen is an associate in the insurance practice of McElroy, Deutsch, Mulvaney & Carpenter, LLP.