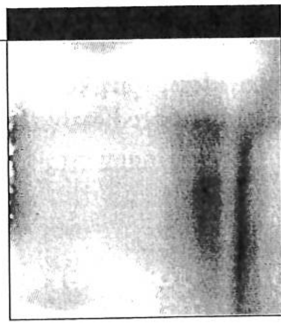

Questions to Consider in Forming a Captive Insurance Company

Weigh potential cost savings and control over policy terms against the time and capital commitments of establishing a captive insurance company.

KEITH LANGLANDS

Captive insurance companies have become an alternative means of covering certain liabilities for many mid- to large-size organizations. Forming a captive enterprise provides a variety of benefits, ranging from filling in gaps in coverage, to asset protection and tax incentives.

Whether forming a captive makes fiscal sense for estate planning clients requires an understanding of the requirements as well as the time and financial investment necessary to form and maintain a captive insurance company. Organizations or individuals who are considering forming a captive, should ask themselves, their estate planners, and their prospective captive management company the questions that are discussed below.

Captive insurance versus commercial provider

Forming a captive insurance company requires a certain level of commitment in both time and capital. For some, the benefits of forming a captive insurance company outweigh the expense, while for others, staying with a commercial insurance provider may be the best way to go. The following questions are prudent to ask one's clients before pursing the formation of a captive insurance company.

Is the client satisfied with its commercial insurance provider? Those considering forming a captive should assess their satisfaction with the current level of service and protection provided to them by their commercial insurance providers. This includes assessing the level of customer service and degree of agent responsiveness, the turnaround time taken to process and pay out claims, the expense of one's premiums, and the types of risks the insurer is willing to insure.

Specifically, it is wise to assess any gaps in one's current coverage. Commercial insurers are often averse to covering certain risks, risks that may be extraordinarily relevant to a client's line of work. For example, those operating in the franchise space usually cannot insure against the loss of a franchise due to the reorganization of the franchisor as a result of bankruptcy proceedings. At other times, a commercial insurer may cover a certain liability but cap coverage at an inadequate amount. These uninsurable and under-insured risks may be eligible for coverage with the formation of a captive insurance company.

Would the client like more control over the terms of its policies? Commercial insurance providers often engage their customers in boilerplate contracts that are not open for negotiation. For some, these

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standard terms may be perfectly acceptable. Some policyholders, however, may prefer to negotiate the specific terms of the contract. For example, commercial liability insurance contracts usually provide that in the event of a claim against the insured, the insurer has full control over the selection of legal representation. For those that would prefer to rely on the insurer for settlement negotiations and potential litigation, this could be seen as a benefit. But the formation of a captive insurance company might be a better option for those that would rather select and direct the counsel of their choosing.

How stable are the client's commercial insurance costs? Commercial insurance companies are in the business of insuring many disparate parties across multiple geographic regions. Due to factors beyond the clients' control, they may periodically see their premium prices rise. This could be because a certain segment of the insurer's policyholders have recently suffered a catastrophic loss, such as in the event of a hurricane. A client that has experienced premium price increases despite a relatively clean claims records may want to consider the formation of a captive insurance company, which can isolate captive insurance members from more at-risk policyholders thus keeping premium prices down.

Furthermore, commercial insurance companies are large enterprises with significant overhead costs. At times, premium prices may increase to help the insurer cover some of this overhead. Although the initial capitalization required to form a captive can pose significant upfront costs, a captive insurance company's overhead expenses are much leaner than commercial insurance providers, thus keeping premium prices at predictable levels.

Unlike commercial insurance companies, captive insurance companies have the ability and flexibility to insure risks that are traditionally thought of as uninsurable.

Does the client have the commitment required to form and maintain a captive insurance company? One of the major benefits of opting for a commercial insurance company is that the commercial insurer maintains itself. A captive insurer, on the other hand, requires the captive members to form and maintain a separate business entity. This can require a significant commitment of time and attention, including annual meetings and regulatory reports. To gain the full benefits of a captive insurance company, those looking to form a captive should plan on operating the related entity for at least several years. Further underscoring this point is the fact that opting to form a captive with the intention of liquidating it within a short period is likely to garner regulatory scrutiny.

Besides the commitment of time required to successfully form and maintain a captive, there is a degree of financial commitment as well. In addition to the costs associated with licensing the captive in the chosen jurisdiction, laws dictate that the captive must have a certain threshold of capitalization in order to be able to pay out claims from the start. Clients should expect this investment to stay tied up within the captive for at least several years before they are able to remove money.

Finally, clients should consider whether they and the other captive members are committed to investing the time and money required to reduce their risks. Forming a captive insurance company should incentivize the client to make efforts to mitigate the risk that the captive is insuring against. This may require assessing and revising current business policies and practices and even hiring third-party vendors, such as a human resources consultancy, to help decrease risk exposure.

Understanding the risks and benefits of captive insurance

Forming a captive can present multiple benefits to estate planning clients. That said, it can also pose risks. It is important to understand the risks and benefits in full before recommending the formation of a captive. As mentioned, the time and capital required to form and maintain a captive insurance company can be significant. The following questions will help in understanding the benefits and risks associated with forming a captive.

What are the risks of forming a captive insurance company? The insurance arena is a highly regulated industry. Dipping one's toe into the marketplace should not be taken lightly. The many benefits that a captive affords to the captive creators also come with a certain level of regulatory scrutiny. This includes gaining regulatory approval of the initial captive business plan, tax compliance, investment management and reporting compliance, and audit compliance. Furthermore, the captive insurance company is, after all, an insurance company and may encounter many of the same issues that commercial insurance companies deal with regularly. This includes the prospect of incurring unexpectedly large claims losses and ensuring that captive members timely pay their premiums.

What are the benefits of forming a captive insurance company? Estate planners should weigh the aforementioned risks associated with forming a captive insurance company against the benefits, which are numerous. As mentioned, unlike commercial insurance companies, captive insurance companies have the ability and flexibility to insure risks that are traditionally thought of as uninsurable. For those looking to acquire a certain type of specialty coverage unavailable on the commercial marketplace, a captive can be a solid strategy. Furthermore, forming a captive insurance company can grant captive members access to the reinsurance market, thus enabling them to further spread and insure their risks.

Despite the initial financial investment associated with captive formation, the long-term financial benefits of operating a captive can be great. Premiums prices may be lower than those quoted by commercial insurance companies as the overhead of operating a captive is significantly less. Additionally, unlike premiums paid to a commercial insurance company, the premium dollars that the captive members pay are not siphoned outside of the corporate family. Rather, captive owners can invest these premium dollars and reap the benefits of any interest generated. In addition, once a certain level of surplus capitalization is achieved, captive owners can pay themselves dividends or take out loans using captive dollars. And once the captive owner decides to liquidate the captive, the premium dollars accrued over time remain available.

Finally, and of particular importance to estate planners, captive insurance companies afford their owners certain asset protections and tax breaks. First, by forming a separate corporate entity that retains investable premium dollars, the captive owners can protect these assets from frivolous lawsuits and litigation threats. Additionally, under Section 831(b), captive insurance companies can elect to be taxed solely on their investment income, provided the company receives less than $1.2 million in premiums annually. This means that a captive owner can receive $1.2 million in premiums without having to pay income tax on this amount.

Forming a captive

Although captive management companies do provide turnkey solutions to help prospective captive owners form their companies in compliance with domicile rules and regulations, it is still wise to understand the decision-making and documentation requirements necessary for captive formation. The following questions speak to factors that influence the formation of a captive insurance company.

Should the captive be registered in an offshore or onshore jurisdiction? Many still associate captive insurance companies with offshore tax havens. Increasingly, however, captive owners are opting to establish their insurance companies in domestic jurisdictions. This is largely due to the regulatory scrutiny that offshore captive insurance companies face. With the Stop Tax Haven Abuse Act of 2009, Congress has taken strides to curb the development of captive insurance companies that were largely formed to serve as offshore tax shelters. Additionally, more and more states are beginning to pass favorable legislation to encourage the formation of captive insurance companies within their jurisdictions. This legislation often aims to reduce the costs associated with forming and registering a captive.

In which domestic domicile should the captive be registered? Currently, not all states have enacted legislation that enables the formation of a captive insurance company. That said, the captive insurance company can provide policies and services to captive members regardless of the state in which the member operates. Choosing which domestic domicile to register a captive insurance company depends on certain factors unique to the estate planning client as well as an assessment of the current state-specific rules and regulations around captive insurance companies. If time is of the essence, an estate planner may want to recommend a state that has a quick turnaround time for processing a captive insurance application, such as Montana. Others may opt for the state with the lowest registration cost or capitalization requirements.

What is the cost of forming a captive? Costs of forming a captive vary somewhat depending on the needs of the estate planning client and the choice in domicile. That said, the overall cost to establish a captive with a captive management company costs about $50,000. In addition, the captive owner must meet certain depository requirements so that the captive insurance company can pay on claims from the start.

This usually ranges from $100,000 to $500,000.

Along with these initial start-up costs, other ongoing costs are associated with maintaining a captive. These include the fees paid to the captive management company and any other third-party captive-related vendors, such as asset managers and auditors. Some jurisdictions also impose an annual premium tax, which can cost as much as 20% of premiums collected.

What type of captive should the client form? In the broadest sense, there are two categories of captive insurance companies.

1. *Single-parent captive.* This type of captive is appropriate for larger organizations with the need and available resources. The captive is formed to provide insurance to the single-parent owner. Thus, the cost of forming and maintaining the captive falls squarely on the shoulders of the single parent. The benefit of a single-parent captive is that it provides the parent company with full control over the captive insurance company.
2. *Group or association captive.* Suitable for smaller organizations, these captives are usually formed by entities that operate within a similar line of business and share similar risk exposures. The advantage of group and association captives is that multiple entities can band together to share the time and expense of forming and maintaining the captive. This type of captive formation also enables captive members to spread risk of losses among a larger group. However, because the captive is jointly created among multiple parties, all entities with ownership must share control.

What outside professionals are needed to form a captive insurance company? Forming and maintaining a captive insurance company requires a combination of legal, accounting, actuarial, and asset management expertise. Captive insurance management companies often provide turnkey solutions that incorporate these professionals, which diminishes the hassle of locating outside expertise on a piece-meal basis.

What documents are required to incorporate a captive insurance company? A prospective captive insurance owner must take various critical steps in order to form a captive insurance company compliantly. These include the following:

- Conducting a feasibility study.
- Developing a business plan.
- Contracting with a captive management company.
- Completing a licensing application.
- Completing formation documents.

What does a feasibility study entail? One of the cornerstones of captive insurance company formation is the completion of a feasibility study. The feasibility study is conducted to ensure that the captive insurance company will be able to adequately insure the risks it protects against. Not only is the feasibility study often a regulatory requirement, depending on the domicile, but it is simply good practice for those looking to form a captive insurance company. A thorough feasibility study includes:

- Multi-year cost-benefit analysis.
- Tax analysis.
- Identification of the lines, limits, rules, rates, and policy forms the captive will use.
- Documentation assessing the business purpose behind captive formation.

What should be included in a captive business plan? The purpose of the captive insurance company's business plan is to make clear the structure and business lines of the captive. It is also the document that auditors and regulators, including the IRS, may refer to in order to assure the captive is operating as originally outlined. The captive business plan will contain certain elements that are universal to all business plans, including information pertaining to management and forward-looking financial estimates, such as those that depict the effects of various negative scenarios, such as a bad loss year. In addition to these standard elements, the captive business plan should incorporate a narrative version of the feasibility study and include sections that speak to coverage and limits offered, financial resources, claims management, safety and loss prevention programs, and reinsurance and risk management.

How are premium prices determined? Premiums for captive insurance members are determined, in part, by historic loss levels. An actuary conducts tests using this historical data to determine a member's projected loss profile. The metric determined from these tests is then added onto certain fixed costs to determine a final premium.

Maintaining a captive insurance company

While forming a captive requires significant legwork, or at least a significant effort on behalf of the captive management company, maintaining the captive over the years also requires additional time and costs. The following questions speak to the ongoing needs of the captive insurance company.

What annual reporting requirements must a captive meet? The domicile of choice for a captive usually requires the submission of an annual report to the domicile's appropriate regulatory body. The report includes annual financial statements, which should be certified by an independent public accountant, as well as an actuarial opinion. Captives also need to file specific tax information annually, particularly premium tax returns. In addition to these reporting requirements, captive board members are required to meet within the captive's domicile annually. Minutes of the board meeting should be notated.

What if a claim is filed against the captive? Captive insurance companies are insurance companies, and thus they are expected to process, analyze, and pay out on claims received. If a client is part of a group or association captive, the likelihood of a claim arising may be higher, as there are more members from which a claim may arise. The key is to have an established process by which to process and respond to claims. This includes providing legal counsel for claimants engaged in litigation or paying for alternative dispute resolution services. Many captive insurance owners opt to use the services of an experienced third-party claims management service provider to handle incoming claims efficiently.

Conclusion

For companies and individuals, the decision to form a captive insurance company requires a thorough assessment and understanding of the business purpose behind the impetus to form a captive. They also should assess whether the benefits of forming a captive make up for the cost and time investment required to form and maintain the captive company. By knowing what questions to ask a captive management company from the onset of engagement, estate planners and their clients can best position themselves to maximize the benefits of captive formation. ■