# Servicing the middle market

Stewart A Feldman, of Capstone Associated Services, on the growth in captive uptake among smaller, middle-market companies

For years the largest US companies have realised the benefits of alternative risk financing/captive planning. Principal among the reasons is the ability to customise coverages to the insureds' needs rather than simply relying on standard conventional policies riddled with restrictive exclusions. Also, captives are often more cost-effective than the traditional carriers, which pay out only a very small part of their claims in actual losses, reserving much of the actual premiums for marketing costs, executive compensation, commissions, investment losses, litigation with insureds and other uses of proceeds unrelated to the interests of the insureds.

More recently, other good reasons for captive planning have developed. Many of the largest conventional insurance companies are suffering as a result of poor investment decisions. Because of huge losses in these insurers' core businesses, their stock values have declined significantly and, in some cases, insurers are now dependent on the US government for their survival. The disasters that have befallen Hartford, AIG and others have made many insureds question the advisability of conventional carriers. The situation has become sufficiently extreme that some insurers have petitioned the US government to become bank holding companies in order to further secure emergency government aid.

As a result of the growing uncertainty, more middle-market companies are looking to captives as a viable risk-planning alternative. Long the bastion of the largest publicly held companies, captives have become viable for the substantial, closely held business that seeks to supplant or supplement current property and catastrophe coverages. For the business owner, a captive provides the insureds with greater influence over the financial health and well-being of the insurer, rather than being at risk of having coverages effectively negated due to poor investment decisions by conventional insurers or the traditional propensity to deny commercial claims.


## Funding claims

Some conventional insurers have long enjoyed a reputation for not paying claims. Yet businesses depend on these same companies for coverage when they are sued. Middle-market companies are looking for more certainty from their insurance company when filing a bona fide claim. It is almost commonplace for some conventional insurers to deny even bona fide claims as part of the 'negotiation process', especially when facing a large commercial loss. As a result, businesses have to sue their insurance companies to recover unpaid claims or face declaratory judgement actions. The certainty of payment from a captive is, for many, a better alternative.

Commercial insurers often tend to rely on policy exclusions, which create uncertainty among the insureds regarding what is actually a 'covered risk'. In contrast, policies issued by captive insurers can be custom-designed to supplement 'holes' in existing commercial policies, or to provide cost-effective coverage not offered or unacceptably priced by conventional insurers. In some cases, the captive's policies specifically take over when the conventional carrier denies coverage on the underlying policy.

## Controlling claims payments

Captive insurance claims payments mean no more red tape and no more coverage litigation when it comes to claims handling. Due to the special relationship between the captive insurer and its insureds, claims handling is no longer the adversarial relationship that many businesses have come to expect from their conventional liability carrier. Claims investigations, verifications, adjustments and payments can all be done expeditiously and efficiently through a captive.

### Choosing the right domicile

Choosing the right domicile is critical and will certainly have ramifications over the captive's life. Domiciles are not fungible and must be matched with the intended operations of the captive insurer.

For example, some domiciles specialise in larger captives for publicly held companies or involving hundreds of millions in annual premium. Regulating a small captive requires far different expertise than regulating a captive formed by a conventional insurer, such as Berkshire Hathaway, which would typically be domiciled in Bermuda or Ireland. A jurisdiction like Bermuda may be well positioned to regulate captives for large public companies, like Exxon, which has a legal staff to handle the ever-changing regulatory requirements. However, Bermuda is not a jurisdiction appropriate for the captive insurer of, for example, a regional general contractor. The nature of Bermuda's regulation, required reporting and legislative and regulatory mandates negates this otherwise recognised insurance domicile as being practical for the small and intermediate captive markets.

Not all domiciles – whether onshore or offshore – are the same. For a captive to be economically feasible, it must operate in a jurisdiction with an efficient and accessible regulatory environment. In recommending a jurisdiction and its regulatory regime, the key criteria are that the domicile is responsive, efficient, well respected and capable of providing cost-effective services to its regulated entities. A jurisdiction skilled in handling larger companies, which have a legal staff able to deal with changing regulatory requirements, may not be appropriate for the smaller middle-market company. For this reason, demonstrated expertise in the regulation of captives for middle-market companies is critical. In contrast, some jurisdictions, especially those in the US, view captive regulation as a means of creating tourism dollars, employment for local professionals or new streams of income to tax.

Finally, as with life generally, things change. When a domicile decides, for example, to focus on attracting larger insurers (and in doing so make the regulatory environment unattractive for small captives), a client needs to be prepared to move to a new jurisdiction. By way of example, in recent years there has been an exodus of captives out of the British Virgin Islands as its environment has changed, with those captives moving about equally between other onshore and offshore jurisdictions.

### What about the Obama administration's proposals for offshore entities?

Prevalent in the news recently has been the Obama administration's promise of greater scrutiny of the taxation of offshore entities. However, these proposals have little application to alternative risk planning, at least for the middle market.

Alternative risk planning for the middle market can be done either domestically or offshore. The choice of domicile (choice of regulator) is unrelated to federal income tax issues because, as properly implemented under the Internal Revenue Code, there is no tax difference between onshore and offshore captives, at least for the middle market. More specifically, a captive owner has the ability to take 'offshore taxation' off the table by domesticating the non-US domiciled captive in the US so that it is always a domestic US company for tax purposes. Under a special provision of the US Internal Revenue Code, a foreign insurer with Internal Revenue Service approval may become a 'US insurer'. In this regard, qualified and highly experienced US tax advice is a must.

When properly structured, whether the captive is formed in the US (for example, Vermont) or abroad (for example, Bermuda or Anguilla), the captive is always a US company for tax purposes. Capstone-administered captives file US tax returns and have taxpayer Employer Identification Numbers (EINs). They are taxed under special and longstanding US tax provisions that encourage the formation of property and casualty insurers providing coverage to US businesses. Longstanding provisions under the Internal Revenue Code provide for either full or partial federal income tax exempt status. However, not complying with this highly technical legal area leads to significant penalties. It is for this reason that our affiliated law firm remains highly involved in the administration of alternative risk planning.

### Proper tax structuring and management of the insurer is critical

It is well recognised that captive insurers, at least in terms of 'for profit' companies, are in large part a creation of the Internal Revenue Code. This is because the Code only allows an 'insurance company' to currently deduct future, as yet unidentified, losses. In contrast, a business entity, other than an insurer, can only deduct losses once they occurred. Proper tax structuring and management of the insurer in order to satisfy the many requirements of the Internal Revenue Code is critical to the ongoing success of the insurance arrangement if a current tax deduction is to be achieved. Combined with the management of the insured risks and the investment of the insurer's assets, these are among the key lynchpins to the insurer's success.

Captive insurance enables small business owners to better manage insurance needs, including cost, coverage, service and capacity. In 2009, the middle market will continue to be a valuable source of captive formations. The option remains an attractive one as companies focus on the overriding need to reduce costs and manage their risks effectively.

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