Case Study: How One Company Thwarted International Risk with a Captive

Coverage Shortcomings

We live in a global marketplace connected by imports, exports, and the outsourcing of needed services. Domestic risks to which U.S. companies are exposed are generally understood and can be managed through commercial insurance. International risks are much more difficult to manage and commercial insurance is expensive, especially for middle market companies.

One of Capstone's clients, a distribution company working within the oil and gas industry, works directly with growers and manufacturers overseas, contributing to a healthy global network.

Established in 2001, the company has traditionally provided dry powder guar to pressure pumping companies for use in hydraulic fracturing operations and oilfield completions. Guar gum comes from the beans of the guar plant, which is mainly grown in India and Pakistan.

Guar is typically used as an emulsifier to help prevent oil droplets from coalescing or as a stabilization mechanism to help prevent solid particles from settling. It has also been used by the food industry for use as a thickening agent.

Recently, there has been increased demand for guar gum from the oil and gas industry, as it uses guar as a biodegradable gelling agent for the hydraulic fracturing fluids. Capstone's client has ambitiously expanded its product catalog to include guar slurries, cross-linkers, breakers, friction reducers, clay stabilizers and other stimulation chemical solutions to fully support the hydraulic fracturing industry, helping its vendors to be more efficient in extracting raw materials with minimal effect on the environment. Despite the company's success, its executive team members began to have some concerns about the comprehensiveness of their risk coverage.

In August 2011, it had become painfully clear that its conventional insurance coverage was exceedingly insufficient, with gaping holes in coverage. The company would be left to its own devices if an unexpected interruption in business operations were to have occurred. In turn, irreparable financial damage had become an ominous reality.

The company's existing policy would only be effective when certain "triggers" came into play, such as bodily injury or property damage. Other risks went completely unaddressed. For example, the possible contamination of water resources during product transport was covered by a pollution line item, but carried with it an exclusion that would leave the company liable for damages that were not sudden and accidental. Fines, fees, and even jail time could be placed on employees should environmental government entities press charges.

What was even more worrisome for the executive team was the threat of violence while working in some of the most dangerous areas of India and Pakistan. Would their existing policy address kidnap and ransom? Would the loss of key employees, vendors, or clients be supported? A resounding "no" was the answer.

Having realized the shortcomings of its coverage, the hugely successful, growing midmarket guar gum distribution company made the choice to connect with Capstone and learn about the benefits of forming a captive insurance company.

Dangerous Environments

Capstone's client continues to rapidly expand in its operations, distributing several grades of guar to the oil and gas industry throughout the United States for use in the hydraulic fracturing of oil and gas wells. 20% of the guar is sold in powder form for the end users to perform the mixing, with the remaining 80% blended into guar slurry per requested formulations.

The company purchases a majority of its supply of high quality guar gum directly from manufacturers and distributors in India. A sample of each batch of guar is collected and tested before it is accepted and shipped.

Products are insured by the manufacturers while in transit on water and once the products land at a U.S. port, it goes through the U.S. Customs and Border Protection before being released. At this point, the company takes possession of the products, and transports the products to their warehouses using its own trucks or third party transporters.

With the constant movement of employees and products by air, sea, and roadway, workers can fall victim to their environments. The threat of working in India and Pakistan is very real. According to a report released in Islamabad by the Human Rights Commission of Pakistan, the political and civil unrest in these countries is worsening.

Another report titled "The State of Human Rights in 2013" sites that journalists, teachers, students, and human rights defenders were targeted in various areas of the country. In 2012, at least 690 civilians were victims of violence there.

Women continue to be vulnerable in certain areas of India. One item of consideration is that the client established a sister company in Mumbai, India to provide quality control oversight, raw material sourcing, logistics coordination and business development services. Management often travels to visit this sister company, as well as suppliers in India.

In the months leading up to November 2011, the company's insurance policy did not cover kidnap and ransom to protect the personal safety of employees who travel to dangerous parts of the world. Also, in the event of a serious illness or injury to one of its employees, there would be significant expense involved with urgent repatriation to the U.S. or to the nearest country capable of properly treating the condition.

Essentially, the company needed to consider how it would manage this risk…and many others.

Feasibility and Resolution

Capstone conducted a feasibility study to determine what coverages the distribution company would be eligible for, supplemental to its existing insurance coverages. The company was deemed an ideal captive candidate and was approved for captive formation– international risk coverage was swiftly added to the new policy through its captive.

It was determined that this coverage would be one of the most effectual because of the company's business operations overseas. Foreign political risk is another category of international risk that that was added because it relates to a governmental authority and its impact.

Significant risk from selective discrimination, embargos and blockades, forced abandonment of property, unilateral termination of contracts by the applicable government, and cancellation of authority to conduct business in that jurisdiction would all be addressed.

The Foreign Corrupt Practices Act (FCPA) makes bribery of foreign government officials a criminal offense that can involve significant fines and penalties. FCPA charges are costly to defend and usually involve complex international business practices.

The grey area between making illegal payments and permissible 'facilitation expenses' creates risk in many facets of international trade. Insuring this exposure through a captive insurance company was a top priority for Capstone.

Other coverages were underwritten by the captive as well, with full protection against reasonably unpredictable losses. Pollution coverage provided through the captive would supplement the existing policy covering financial losses. The company had coverage for general liability, but it specifically excluded all products and completed operations liability. This exclusion could have negatively impacted the company since its products are mainly used in hazardous drilling conditions.

Even if it was discovered that its products did not contribute to any property damage or bodily injury, the company would not get legal defense coverage because of this exclusion. The company's new, supplemental coverage through the captive would now cover this potential loss.

The company has contracts to provide guar gum and slurry to several major players in the industry, including big players in the industry. Four of these entities make up approximately 75% of the company's revenues. Loss of one of these major customers to a competitor could be irreplaceable and generate a significant decrease in revenue.

In addition, an extended downturn in the oil and gas drilling industry would ripple through to the client and significantly decrease revenue.

Again, the captive insurance company would now provide full coverage for this risk should a claim be submitted by the operating company. Overall, the various coverages provided through the captive protects the client against dangerous situations, both fiscally and operationally.

With Capstone's true captive insurance turnkey solutions, the company can now rest assured that it is prepared for the unforeseen.