CAPTIVE INSURANCE COVERAGES

BRIDGING THE GAP
CHAPTER 6
CAPTIVE INSURANCE COVERAGES – BRIDGING THE GAP

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CHAPTER 6

CAPTIVE INSURANCE COVERAGE – BRIDGING THE GAP

I. OVERVIEW – CUSTOMIZING RISK COVERAGES FOR A CAPTIVE

One of the most compelling advantages of a captive insurance company over conventional insurance is that a captive can customize coverages to meet the needs of the affiliated insureds. Nonetheless, the risk being underwritten must be an insurable risk, as such is commonly understood in the insurance industry. That is, the event giving rise to the claim must be fortuitous and outside of the discretionary control of the insured. This requirement of fortuity ensures that an operating business cannot insure against an event that is already certain to take place. That is, the time to buy a fire policy is not the day after the building burned down.

Said another way, the risk must be insured on a commercially reasonable basis and be reasonably priced. That is, the premium cannot be in support of an investment contract. Many risks that are insured by a captive are the types of risks where commercial coverage is not readily available from commercial insurance companies, or where the only coverage offered is available from a surplus lines carrier with high prices and tight terms and conditions. Nonetheless, this does not lessen the need for an operating business to fund these types of risks.

To be sure, the types of policies typically issued by conventional insurers are those that are issued in large numbers and often involve a number of relatively small claims. Auto policies are a case in point. Hundreds of thousands of policies are issued covering hundreds of thousands of vehicles and drivers. The average policy face amount might be $50,000, with a large policy being $250,000 but rarely as much as $500,000. Yet the average loss is small and the predictability regarding the size of the average loss is high given the large number of independent risks. Further, the average loss data is widely available to conventional insurers because the large number of insureds is very high.

Contrast the auto policy described above with a policy providing coverage for rising water (e.g., flooding) in a geographical location like New York City that had not seen a Storm Sandy situation (in 2012) since the Great Long Island hurricane of 1938. The proposed insurer in 2011 underwriting flood insurance prior to this significant loss event lacked credible loss data and might not have considered multiple losses “stacking” in the same geographical area arising from the same loss event. Additionally, when a loss occurs in the case of flooding, it is often a total loss under the policy; there is no “fender bender” loss of a couple of thousand dollars in the event of a major flood.

The same problematic facts are seen with windstorm coverage for high rise commercial buildings.
To compensate for the risk or lack of predictability, premiums may be higher than the market is willing to accept, which means that many customers will elect to forego insurance coverages and not insure the exposures.

An operating business may have a specific risk that is either unique to the market or may have an exposure that is not common enough for the market to have enough experience with the risk to be comfortable underwriting it. In these types of situations, absent the captive alternative, the insured is left with having minimal insurance options. The captive can design specific coverages to insure the related insureds in a manner that meets the specific needs of the insured.

Another advantage of having the captive write insurance is the availability of flexible terms. Since a captive is flexible, the captive insurance policy can be underwritten for the precise needs of the operating business. By way of example, in the case of rising water/flood coverage, the insureds can have their captive insure specific layers of coverage. Perhaps the insureds will hold the first $100,000 in each loss, or a 50 percent co-insurance requirement through a $2 million coverage limit. This saves considerable premium outlays and conforms to the risk appetite of the insureds, given the nature of their operations. The captive is then left as the best alternative. The captive becomes an even more compelling alternative since, if the loss event doesn’t actually happen or is mitigated by “best in class” loss control efforts, the captive owners will still have access to the captive’s assets.

This is analogous to the “rent” vs. “buy” decision. If the insured “rents” insurance, that is, pays a conventional carrier for coverage, if there is no loss, the premium is nonetheless lost. If the “buy” approach is taken, even where there is no loss, the money is still left in the captive with the opportunity to earn significant investment returns on the “float” that is created when premiums exceed paid losses. By way of example, in 2016, the float for Berkshire Hathaway was $83 billion – nice for Warren Buffett, but not for his customers!

II. DESIGNING COVERAGES

When considering what coverages are appropriate for a captive to write for its business, a company need not look any further than reviewing its operations relative to its risks. With a captive, the operating business can identify those risks that it is currently self-insuring and write policies to cover those risks without concern for conventional market limitations. In other words, the prospective insureds look at their specific activities in light of the existing commercial coverages to determine the areas of potential exposure which are uninsured. For example, a distributor may have a customer concentration that puts it at risk both on a credit basis with outstanding receivables and puts it further at risk due to the potential loss of business from the same key customer. In this instance, a captive could provide coverage to protect the business against losses that it might suffer related to an event that might harm the relationship with this key customer.

After a company has determined the appropriate coverages for the captive and has identified the precise risks to be insured by the captive, the terms of the policy are then developed and the pricing of the coverage is developed (see Chapter XX for a discussion of policy pricing for captives). Ultimately, the nature of the operating company will determine the needed coverages and affect the premium levels. This is in contrast to the traditional market approach, which looks at the broad market as opposed to the individual company to determine its coverages and the terms of coverage.
The operating company must select the specific risks that make sense to be insured by a captive and determine which business risks are more appropriate to be insured by a commercial insurance company on a continuing basis. Where commercial coverage is readily available, renting risk capital from an insurance partner often presents a more attractive option than the captive, usually because the larger number of independent risks leads to less volatility of losses and more competition among insurers, resulting in a tighter pricing of premiums for such coverage. Still, few “for-profit” commercial insurance companies can survive if they pay out more than 70 percent of premiums in losses (all with the recognition that a publicly-held insurer has the equities markets to deal with, marketing and distribution costs, and other costs and expenses not seen with a captive). A for-profit insurance company cannot rely on its investment income to finance payment of insured losses in the current low interest rate environment. The periods of 22% prime interest rates of the early to mid 1980s have long ago passed! In contrast, a captive can operate with a much lower operating overhead and therefore has the ability to pay out losses of more than 100 percent of the premiums paid to it through capital calls on its shareholders if necessary.

It is clear that the selection of risks to be insured by a captive is critically important in that the decision of which risks will be insured will directly affect the future financial health of both the insured operating business and the captive. In addition, the captive, especially in its early years, needs to be mindful to balance the net risks assumed against limited capital available to fund any deficits. Absent reinsurance obtained by the captive, the captive is a terminal risk-bearing entity absorbing and paying for its own losses. For example, it would not make sense for a business to transfer 100 percent of its $20 million in property insurance risk to a newly formed captive with only $2 million in capital when a major fire loss would bring down both the captive and possibly the operating business as well. Policies need to be designed and the risks need to be carved up in a manner that will give the captive the ability to reasonably respond to all risks it bears, including non-performance of counterparties and investment losses.

By contrast, it very well might make sense for the operating business to transfer the first $1 million of property loss risk to a captive and buy $19 million in commercial insurance. Often, it makes sense for a captive to buy reinsurance protection to ensure that the potential loss exposure to the captive risk remains at a manageable level and does not threaten the future solvency of the captive insurer. The decisions regarding the specific risks to be insured by a captive must be made with the advice and counsel of persons who are knowledgeable in the areas of both risk management and risk analysis.

III. SPECIFIC TYPES OF RISKS POTENTIALLY SUITABLE FOR A CAPTIVE

Discussed below are several different types of risks that warrant consideration for potentially being insured by a captive. Although the risks described below are not an exhaustive list of risks appropriate to be insured by a captive, in working with over 200 captives and many thousands of policies over the years, we have found the risks discussed below to be good examples of the types of coverages that are appropriately insured in some manner by a captive.

A. DEDUCTIBLES RISK AND SELF-INSURED RETENTIONS

A self-insured retention is the amount that must be paid out-of-pocket by the insured before a conventional insurance company is required to pay any claims made by the insured or a claimant. A deductible is the amount that an insured must reimburse an insurer as part of the claim settlement. Many conventional insurance policies should have high deductibles in furtherance of the concept that insurance is there for the exception loss and not simply for
operating expenses (e.g., small losses), which are likely to continue to occur on an ongoing basis. In the context of a commercial policy, a $500 water damage to a significant commercial building should be under the deductible. This type of cost is more in the nature of a routine expense than a loss that should be the subject of insurance.

Commercial insurance should be designed in a manner to avoid simply “trading dollars” which are paid to the insurer for dollars which are basically returned as reimbursements for claims. Insurance should be there for the more significant commercial loss, leaving the insured to retain predictable losses that are easy to fund. As mentioned earlier, smaller predictable losses could fail the test of being considered a fortuitous loss.

A captive insurance company can be used to insure the layer of risk comprising the deductible or retention with respect to any claims made under a conventional insurance policy. More typically, the captive has a deductible with the captive’s insured risk being the layer that exceeds the captive’s deductible amount up to the commercial insurance deductible amount.

See Figure 6.1, which illustrates how a captive can be used to insure the layer of risk that consists of commercial insurance deductible amount.

**Figure 6.1**

*Example of Using a Captive to Insure the “Commercial Deductible Layer” of Risk*

- **EXCESS UNINSURED LAYER OF RISK**
  - Self-Insured by Operating Business for Amount of any Loss that Exceeds the Commercial Policy Limit

- **COMMERCIAL INSURANCE LAYER**
  - Insured by Commercial Insurance in Amount of the Policy Limit Established by the Commercial Insurance Policy

- **BUFFER LAYER/DEDUCTIBLE BUYDOWN/CAPTIVE INSURANCE LAYER**
  - Insured by Captive in Amount that Exceeds Captive’s Deductible Amount but is not in Excess of the Commercial Insurance Deductible Amount

- **PRIMARY RETAINED LAYER OF RISK**
  - Self-Insured by Operating Business in Amount of Deductible or Self-Insured Retention that Must be Met to Trigger Coverage by the Captive for Claims Exceeding Captive Deductible Layer

**Assumptions:**
- Captive Deductible Amount = $25,000
- Commercial Insurance Deductible Amount = $500,000
- Commercial Policy Limit Amount = $5,000,000
The captive receives a premium from the operating company in exchange for insuring the layer of risk consisting of the commercial insurance deductible amount, which effectively lowers the amount of the deductible for the operating company and concurrently enables the captive to build up a substantial surplus if the claims of the operating company made against the captive do not exceed the amount of premiums collected by the captive for insuring this layer of risk. At the same time, the cost of commercial insurance is significantly reduced because of its increased deductible.

B. CONTRACTORS RISK

Many operating businesses (e.g., builders) rely heavily on contracts with unrelated third-party contractors or subcontractors to complete the work necessary to provide services or products to their clients. If a contractor has financial issues, is unreliable, or causes accidental damage to property in the course of performing the contractor’s work, the operating business has potential loss exposure for this risk. The operating business can pay a commercially reasonable premium to a captive in exchange for “broad form” coverage of these risks.

C. CREDIT DEFAULT RISK

Credit default risk is the risk that a company or individual will be unable to make the required payments on their debt obligations. Many operating businesses have significant credit default risk with respect to major customers or other third parties who have agreed to buy products or services from them. Credit default insurance can be purchased by an operating business via its captive to insure against this risk.

D. FIDELITY RISK

A fidelity is a form of insurance protection that covers policyholders for losses that they incur as a result of fraudulent acts by specified individuals. A fidelity form can insur a business for losses caused by the dishonest acts of its employees. While sometimes called “fidelity bonds”, these obligations to protect an employer from “employee-dishonesty” losses are in fact insurance policies. These insurance policies protect a company from losses of company monies, securities, and other property due to an employee who has the requisite or manifest intent to cause the company loss. This type of risk is often excluded by conventional insurance policies. As such, fidelity risk exposure is an ideal candidate to be insured via a captive.

E. PRODUCT LIABILITY RISK

Product liability is the area of law in which manufacturers, distributors, suppliers, retailers, and others who make products available to the public are held responsible for the injuries that those products cause to the public. All companies that put products into the stream of commerce face these risks. Often, in addition to restricting capacity, conventional insurance companies will attempt to restrict their coverage for products liability risk through various exclusions in a commercial policy. For example, a conventional insurance company might exclude or limit coverage for pharmaceutical products or limit coverage for “off-label” usage. In any event, the coverage available from the conventional markets may be insufficient given the scope of a company’s operations. That is, the amount of product liability insurance available in
the market may not be available or practically affordable. By way of further example, the recent headlines about New England Compounding Pharmacy’s defective and harmful products and the resulting multiple deaths and Takata’s 70 million airbag recall raises the question as to how much product liability insurance is sufficient at whatever price. In the instance of these two businesses, whatever amount obtained would likely have been insufficient. In addition, the cost of product liability insurance, if such insurance was even available in the conventional insurance markets, would have caused these businesses to suffer an even earlier demise.

In manufacturing, product recall is a serious business risk. Yet the scope of the costs of the recall are often beyond the coverage provided. A manufacturing business might incur a variety of expenses, including costs for examination, transportation, destruction, analysis, decontamination of plant sites, storage space and cancellation charges, notification to customers and end users, and advertising measures. Future business might be permanently lost. The company’s reputation may need to be rehabilitated in the marketplace at considerable expense. Conventional insurance rarely covers these types of risks.

Potential lawsuits related to products liability cases can cause a company heavy litigation exposure for both the cost of fighting such lawsuits and the liability that results from an adverse outcome. Even a favorable outcome may cause reputational harm to the business. A captive can insure some layer of product liability risk (or serve as a co-insurer) and can cover the losses which the conventional carrier doesn’t. As a practical matter, the captive will only be able to insure a lower layer or a percentage share of the total coverage. The captive then has the opportunity to access the reinsurance marketplace, so the risk can be shopped against the insurance market to maximize the overall value.

F. EXTENDED WARRANTY RISK

An extended warranty is an extension of the coverage period on a standard warranty. The typical standard or “base” product warranty is not recognized as “insurance” for federal income tax purposes (see Chapter XX). However, an extended warranty, which provides coverage beyond the standard warranty, is treated as an insurable event. The company may offer the end user the ability to extend the time or the scope of the liability of the seller/producer of a product. End users are often given the option to include the additional extended warranty coverage either at the time of purchase, or they are solicited when the standard warranty is approaching its end date. A captive can be used to insure the risk of loss that is related to extended warranties that an operating business extends to its customers.

The majority of franchised car dealerships own captives, and many use them to insure this risk. Captives are also commonly used to insure losses related to extended warranties issued by distributors of (i) “white goods” (i.e., major appliances such as refrigerators, washers, dryers, etc.); (ii) “brown goods” (i.e., television sets, stereos, and audio or video recorders); and (iii) big iron (i.e., off road, untitled heavy equipment).

The extended warranty coverage through a captive provides other benefits. From a tax standpoint, the warranty revenue is earned when received by the distributor/manufacturer, with no deductions allowed until the loss is paid out. From a financial reporting standpoint, the warranty revenue is amortized over time, along with the loss reserve for future losses. This leads to an acceleration of taxable income and a deferral of reported financial income, despite the certainty of future losses. The captive allows financial and tax accounting treatment to be brought back into line.
G. BUSINESS INTERRUPTION RISK AND HAZARD/SEVERE WEATHER RISK

Most conventional property insurance policies provide coverage for loss of business income due to a covered peril by adding an endorsement to the insured’s property policy. This endorsement is designed to protect the insured for losses of business income sustained as a result of direct loss, damage, or destruction to insured property by a covered peril, which then adversely affects its business operations. A case in point is a tree falling on a manufacturing facility affecting its operations.

Although business interruption insurance can be purchased in the conventional insurance market, the coverage is often tightly worded, which makes it difficult for an insured to collect under the terms of a commercial business interruption policy. Businesses that have experienced a business interruption claim usually come away unhappy with the insurance result. A captive’s business interruption policy is typically broader than the restrictive coverage found in commercial policies. The coverage provided by a captive often provides for an “all perils” type of coverage with respect to business interruption losses, regardless of the peril causing the loss.

Under the typical commercial business interruption policy, the lack of manifestation of physical losses to the insured property itself precludes coverage. Thus, if a road leading to a business is inaccessible because a bridge is washed out or if there is a lack of electricity at the business because the area transformer is down, coverage does not generally exist. Generalized flooding would be excluded. This often leads to an absurd result in that, regardless of where the problem originates, the business can’t continue to operate. Thus, the captive policy often is better attuned to providing business interruption coverage for all contingencies or “all perils”, or at least supplementing the conventional coverages with a rider from the captive.

Hazard risks stem from severe weather that can cause damage to properties, equipment, vehicles, and more. These hazard risks can be a significant threat to many different businesses. Weather-related business interruption insurance would provide funding to cover business interruption losses and the extra expenses resulting from catastrophic events such as earthquake, tsunami, flood, hurricane, windstorm, tornado, excessive rain, unexpected drought, heat or cold weather, or snow/hail storms. One of the main features of the typical captive’s “all perils” policy is that this coverage does not require a direct physical loss to the insured’s property. These types of hazard risks can be covered by a captive and tailored to meet the specific needs of the insured operating business.

H. EMPLOYEE BENEFITS

Although captives have historically been used primarily to insure their owners’ property and casualty (liability) risks, captives can provide a broader range of coverage, provided that the coverage is permitted under the regulations of the selected domicile. In the case of a captive insuring employee benefits, the regulatory structure is quite different in that third parties (e.g., employees) are now being insured. Further, ERISA and U.S. Department of Labor regulations control these plans offered through captives. Typically, only the largest companies utilize some form of captive insurance to fund employee benefits.

A much wider range of companies use their captive to supplement employee medical insurance, with the captive bearing a layer of risk or participating in an employee deductible buy-down. Similarly, an employer may offer some kind of uninsured short-term salary continuation for their employees which can be written through the captive wherein the captive reimburses the employer for losses, generally outside of the ERISA and DOL regulations.
As to employee benefit plans within a captive, wherein the captive insurers the employees, the unique ERISA, Department of Labor, and domicile licensing requirements makes these type coverages beyond the scope of this book.

I. LIABILITY RISK

Operating businesses always bear the risk of being sued by another party in connection with the operation of the business, whether the theory is based on tort law, breach of contract, or another theory of litigation. This risk is rarely self-insured by the operating business. However, as is the case with each of the risks discussed in this chapter, litigation risk can be priced by a qualified actuary and be insured by a captive.

J. MERGERS AND ACQUISITIONS LIABILITY RISK

No matter how thorough the due diligence is prior to a merger or acquisition, sometimes deals go awry and, from both the buyer’s or seller’s perspective, liabilities or lack of revenue commonly appear post-closing. The HP acquisition of Autonomy is among the recent cases in point among many. A buyer can face liabilities when post-acquisition revenue falls short of projections because of product defects or unexpected merchandise returns or when the buyer unknowingly incurs successor liability exposures such as for unpaid income taxes, unidentified accounting issues, or undetected environmental contamination. In the case of the seller, the selling group represents and warrants a wide range of matters to buyers, which the captive can backstop through insurance coverage. Often, sellers find this coverage attractive relative to holdbacks and earnouts, allowing the selling owners to more quickly distribute the sales proceeds. A captive can be beneficial as a tool to insure losses that may result from a contemplated merger or acquisition.

K. DIRECTORS’ AND OFFICERS’ LIABILITY

Directors’ and officers’ liability insurance (often called “D&O” insurance) is liability insurance payable to the directors and officers of a company, or to the organization(s) itself, as indemnification (or reimbursement) for losses or advancement of defense costs in the event that an insured suffers such a loss as a result of a legal action brought for alleged wrongful acts in their capacity as directors and officers. Such coverage can extend to defense costs arising out of civil and criminal matters and regulatory investigations. A captive can be used as an alternative to provide supplemental protection to insure all D&O liability risks and provide full indemnification to the officers and directors of the operating company. There are special issues that arise in the case of a captive providing D&O coverage. Directors and officers have a vested interest in ensuring that the captive is well funded, fully able to meet its obligations when called upon, and that coverage not be hindered.

L. PROFESSIONAL LIABILITY/ERRORS AND OMISSIONS COVERAGE

Professional liability insurance is a form of liability insurance that helps protect professionals who provide advice and other professional services to clients from bearing the full cost of defending against a negligence claim made by a client, and damages awarded in such a civil lawsuit. Errors and omissions (“E&O”) insurance, which may exclude negligent acts other than errors and omissions (“mistakes”), is most often used by consultants and brokers and agents of various sorts, including notaries public, real estate brokers, insurance agents, appraisers, management consultants and information technology service providers (there are specific E&O policies for software developers, home inspectors, website developers, etc.),
architects, landscape architects, engineers, attorneys, third-party business administrators, quality control specialists, nondestructive testing analysts, and many others. A mistake which causes financial harm to another party can occur in almost any transaction across a variety of professions. A captive can be used to provide full or supplemental professional liability or E&O coverage to an operating business that is engaged in any of the above-mentioned professions.

M. CYBER RISK

Cyber risk is typically thought of as the risk connected to activity online, internet trading, electronic systems, network operations, as well as storage of personal data from customers, vendors, and employees.

Potential losses that can result from “cyber risks” include losses related to each of the following:

- Hacker attacks
- Data breaches
- Virus Transmission
- Cyber Extortion
- Employee Sabotage
- Network Downtime
- Multimedia Liability
- Human Error

These types of “cyber-attacks” have dramatically increased in frequency and can be humbling. Denial of service attacks have widened into viruses whose perpetrators demand monies or bitcoin payments to unlock a company’s key computer systems. Witness the data breaches at Target, Home Depot, Anthem, Yahoo, and Equifax, each of which resulted in costs being incurred in the tens (and some hundreds) of millions of dollars. Although losses related to cyber risk are usually considered to be “low-frequency/high severity risks,” this type of risk can be insured by a captive insurance company coupled with a “stop-loss strategy” established through reinsurance or layered coverage so that the captive will not be liable for risk beyond the amount that the captive retains before the reinsurance agreement comes into play.

N. SUPPLY AND CUSTOMER CHAIN DISRUPTION RISK

Many different events can occur that can potentially disrupt a company’s global supply chain or its global sales, including the events listed below:

- Natural disasters, such as an earthquake, flood, or storm
- Fire and explosion
- Machinery breakdown
- Faulty design/material/manufacturing
Supply chain disruption risk is a function of the likelihood of an event’s occurrence and its impact on the operating business. Recent examples have been the restrictions on U.S. companies doing business with Russia, Iran, and Venezuela. Exxon was stopped in its tracks on exploring for oil in Russia’s northern territories. BP saw its operations essentially nationalized or expropriated in Russia. In earlier years, Patriot Act regulations greatly increased the difficulty of doing business internationally. Disruptions can be caused by natural catastrophes like the Fukushima tsunami or can be caused by manmade events like the Chinese port explosion in Tianjin.

It is important to engage a qualified actuary in connection with quantifying supply and customer chain disruption risk and determining the appropriate amount of premiums that a captive should charge an operating company in exchange for insuring this risk. However, obtaining pricing data and articulating the range of risks that a business faces is the ultimate difficulty. Policy design is also critical to limit the captive's exposure to a level that it is capable of absorbing. In addition, a stop-loss strategy using reinsurance will most likely be necessary due to the potential magnitude of risk exposure related to a captive insuring supply chain disruption risk.

O. RISK OF LOSS OF KEY RELATIONSHIPS (EMPLOYEES, SERVICE PROVIDERS, CUSTOMERS, SUPPLIERS, AND FRANCHISEES)

All businesses are heavily dependent on key employees, key service providers, key customers, key suppliers, or certain franchisees in the case of a franchise business. A captive can underwrite a policy to compensate the operating business for any losses that the business may suffer as a result of losing any of these types of key relationships. Having coverage for these types of key relationships is important since, without such coverage, an operating business can suffer unexpected and potentially crippling losses if the business finds itself in a position of having to rely on one particular relationship that is important to the continued success of the business.

P. CONSTRUCTION DEFECT RISK

In the construction industry, a builder or construction contractor may well be liable for a “construction defect,” which could result from any of the following:

- Defective building material or components (i.e., Chinese Drywall issues);
- A violation of building codes at the time of construction;
- Failure to meet professional standards for design at the time construction plans were approved; or
• Failure to build according to accepted trade standards for good and workmanlike construction.

A captive can be used to provide coverage for any potential construction defect claim that may be brought against a construction or development company based on any of the above theories of liability.

Q. WORKERS’ COMPENSATION COVERAGE

Workers’ compensation is a form of commercial insurance that is typically state-regulated that helps people with work-related injuries and illnesses. Employees covered by workers’ compensation insurance are entitled to receive medical care necessary to treat their injuries and illnesses arising out of employment. In addition, depending on the type and severity of the injury, workers’ compensation coverage may also provide:

• Payments to replace some of an injured employee’s lost income, up to time and dollar limits set by law;
• Fixed benefits for specific injuries (e.g., $10,000 for the loss of a finger)
• Compensation for burial expenses for employees killed on the job; and
• Death benefits for dependents of employees killed on the job.

Workers’ compensation insurance is typically required to be maintained under a state’s workers’ compensation laws, although certain states such as Texas require both the employer and the employee to opt-in by purchasing workers’ compensation insurance and in the employees’ case agreeing to be covered by the policy that is purchased. Other states have a single statutory provider; still other states allow for a broader range of providers.

Sophisticated employers, which gage their risk profile as being lower than the average, often purchase a workers’ compensation policy with a high deductible to keep the premiums paid for such coverage down to an affordable level, funding the first tier of losses themselves. For this reason, a captive can be used as part of a deductible reimbursement program for certain businesses to insure a layer of workers’ compensation coverage provided by a fronting carrier which may only be absorbing a portion of the losses. In this instance, the captive issues an insurance policy to the operating business that insures the operating company for claims incurred up to the commercial deductible threshold.

For example: Acme Construction Company (“Acme”) purchases a workers’ compensation insurance policy with a $400,000 deductible from Commercial Insurance Company (“Commercial”). Acme decides to have its captive, ABC Casualty Corp., issue an insurance policy to Acme that insures Acme over $10,000 up to the $400,000 deductible threshold per claim. Acme incurs a workers’ compensation claim (for one of Acme’s employees) that settles for $800,000. Commercial is required to pay the injured worker $800,000. Commercial also bills Acme for the $400,000 deductible and Acme in turn files a claim with ABC Casualty Corp. for the $390,000 deductible reimbursement coverage.

This arrangement provides Acme with a significant reduction to its premium for implementing the large deductible plan, with Acme presumably instituting an aggressive safety program. Acme maintains the claims handling expertise of its carrier, Commercial, which finances large claims made by Acme that are predicted to occur less frequently. The premiums
charged by ABC Casualty Corp. to Acme (being those that are within the deductible layer of Acme’s workers’ compensation policy) are determined by an underwriter and actuary based on Acme’s previous loss history, relevant industry data, and the statutory premiums being charged to Acme by Commercial. The premiums paid by Acme to Casualty Corp., assuming that there is favorable loss experience, build up over time and are tax deductible to Acme. The premiums received by ABC Casualty Corp. may or may not be taxable to Casualty Corp. depending on its tax filing status and tax reporting position.

R. LABOR DISPUTES RISK

Labor disputes risk refers to the risk of a controversy developing between an employer and its employees regarding the terms of employment (e.g., conditions of employment, fringe benefits, hours of work, tenure, or wages) to be negotiated during collective bargaining or the implementation of already agreed upon terms. Commercial coverage is typically unavailable with respect to labor disputes risk since having coverage brings the “moral hazard” risk into play. Customized coverage can be had through a captive to buffer the insured’s operations in the case of a work stoppage.

S. TAX LIABILITY

Tax liability insurance can be implemented as part of a transaction, as stand-alone coverage for a specific tax liability, or on an overall basis for the insured. An example scenario would be where a tax issue resides within a target company that is being acquired and the seller is unable, or unwilling, to provide the buyer with a contractual indemnity equal the level of recourse required.

Tax liability insurance is usually of a “claims-made” nature with the policy period typically matching the general statute of limitations period that is applicable to the risk. Each tax liability insurance policy is bespoke and tailored to fit around the specific underlying tax issue. Tax liability insurance can be underwritten by a captive and tailored to insure specific tax liabilities of the operating business for which uncertainty may exist regarding either the existence or the magnitude of the tax liability with respect to past events or previous transactions. In all cases, “fortuity” or the uncertainty of a loss occurring should be an underlying premise to the coverage. Where a tax challenge is existing and the extent of the “loss” or IRS claim is being challenged, the requirement of “commonly-accepted notions of insurance” is less likely to be met.

T. EMPLOYMENT PRACTICES LIABILITY INSURANCE (“EPLI”)

Employment Practices Liability Insurance (“EPLI”) is insurance that deals with wrongful termination, sexual harassment, discrimination, invasion of privacy, false imprisonment, breach of contract, emotional distress, and wage and hour law violations. EPLI risks are typically excluded from commercial general liability policies and must be purchased on a stand-alone basis. Where it is included in a “package” of coverages, the scope of coverage or the policy limits are usually narrow.

Most commonly, employment practices liability deals with laws and protections brought under Title VII of the Civil Rights Act of 1964, the Americans with Disabilities Act) of 1990, the Civil Rights Act of 1991, the Age Discrimination in Employment Act of 1967, and the Family and Medical Leave Act. The Equal Employment Opportunity Commission (EEOC) through the
Department of Labor interprets and enforces these laws. Federal wage and hours claims where the purported offense is ambiguous or uncertain are a recognized area for captive coverage.

U. LEGAL DEFENSE

An operating business usually maintains liability insurance coverage to protect it from damages that may be awarded to a plaintiff in a potential lawsuit and also to cover the legal defense costs that will be necessary to defend against any potential lawsuit. Costs can mount quickly in the event of a lawsuit, even if the insured operating company is not found by a court to be liable for the wrongful conduct being alleged by the plaintiff. In cases where a commercial insurer issues a reservation of rights or in cases where the insured has uncovered risks, a captive can be used as a tool to provide coverage for all costs that may be necessary to provide a robust legal defense, including the cost of hiring legal counsel, court costs, and any other costs that may be incurred in connection with defending a potential lawsuit.

V. SUBSIDENCE RISK

Subsidence is the motion of a surface (usually, the earth’s surface) as it shifts downward relative to a fixed point such as sea level. Ground subsidence is of concern to geologists, geotechnical engineers and surveyors. Operations on or near an earthquake-prone fault line are of a similar nature. If an operating business is located in an area that is deemed to be a subsidence risk, the business is likely to experience problems in obtaining conventional insurance on the building where the business is located. Subsidence or the threat thereof can also lead to massively increased premiums from certain conventional insurers or, more likely, exclusions from conventional insurance policies. As such, subsidence risk can potentially be an ideal risk for a captive to consider insuring.

In the case of homebuilders and commercial real estate developers, insuring for losses associated with subsidence or damages resulting from buildings on or near faults can be especially difficult. Where available, it is often unattractively priced, which is partially a reflection of a non-competitive market for this type of coverage. The captive can step in and mitigate at least a certain layer of losses.

W. REGULATORY CHANGE

For many businesses, the possibility that the regulatory environment could change in a way that negatively affects an industry or a particular business is a real risk. For example, financial institutions were significantly impacted by the Dodd-Frank Act, which was passed in 2010. This Act was one of the most sweeping changes in financial regulation seen since the Great Depression, increasing compliance costs for all U.S. financial institutions. A significant increase in compliance costs resulted from the passage of this legislation. These costs included hiring new compliance personnel, increased reliance on outside compliance experts, additional resources allocated to compliance, and training many noncompliance employees on how to maintain in compliance with the Act moving forward.

A regulatory change policy might be issued by a captive to indemnify the insured business for losses resulting from the impact of a regulatory change. For instance, a captive could provide coverage for “all losses resulting from or caused by an adverse regulatory change that occur during the policy period.” The total calculation of losses to be insured could be defined to include loss of income, remedial measures, and legal representation resulting from a regulatory change. The regulatory change policy might define a regulatory change as, “an
alteration, amendment, creation of, or elimination of a statute, administrative code, or similar legal code such that the insured's gross income will be impacted.” This type of policy would help defray costs incurred by a business that are associated with compliance with a regulatory change. For example, any remedial measures that a business might have to take due to a regulatory change would be covered. This could include any changes that may be required to be made to the business’s internal policies, the cost of obtaining any necessary additional licenses or other professional approvals, or the cost of making any alterations to a business’s premises to achieve compliance with a regulatory change.

X. ADMINISTRATIVE ACTIONS

Typically, businesses are governed by a number of regulatory agencies. For instance, in the financial services industry, professionals are regulated by agencies such as the Federal Reserve, the Comptroller of the Currency, the Securities and Exchange Commission, the Federal Deposit Insurance Commission, and the Commodities Futures Trading Commission. There are also numerous state-level organizations having similar authority. Each of these regulatory agencies promulgates and enforces its own code of laws. This practice is referred to as “administrative law.” The effect that administrative law can have on a business can be significant and potentially cause the business to be required to incur expenses to comply with numerous rules and regulations. Such expenses can include the cost of filing applications with regulatory agencies, the cost of obtaining necessary licenses and permits, and the cost of attending administrative hearings and pursuing appeals if necessary.

Captives commonly issue administrative actions policies, which typically provide coverage for “all losses resulting from or caused by an administrative action.” An administrative actions policy could provide coverage for “loss of income, remedial measures, legal representation, and public relations expenses” that are caused by an administrative action or even that may be caused by negative publicity associated with an administrative action. An administrative actions policy can be tailored by a captive to define an “administrative action” very broadly so that coverage will be triggered in the case of any potential cost of compliance.

IV. CONCLUSION

As this chapter demonstrates, there are many different types of property and casualty risks to which an operating business may have exposure for which it may make sense to have such risks be insured by a captive insurance company. It is important for any client who may be interested in forming a captive to have an experienced captive professional team evaluate the risks of the relevant operating business so that the coverages to be provided by a captive can be identified and properly designed in a manner that will enable the captive to add significant value to the operating business based on its unique risk management needs. The process of evaluating a business’s unique risk management needs should begin with a feasibility study – typically performed on-site – that is conducted by an experienced underwriting team. The feasibility study enables the operating business to identify each of the relevant risks to which it has exposure. The feasibility study identifies and evaluates areas of potential coverage which leads to the designing and customizing of manuscripted policies to meet the specific risk management needs of the operating business. In designing the coverages, due consideration is given to existing commercial insurance coverages and any additional risks that may have previously been self-insured that can be funded in a more efficient manner through a captive insurance arrangement.
About Capstone

Capstone Associated Services, Ltd., offers the most comprehensive and sophisticated captive insurance planning services in the U.S. for privately-held mid-market businesses. Recognized globally for its award-winning turnkey approach, Capstone has in-house expertise to assist business owners in combatting risk and gaining greater financial efficiency through alternative risk planning.

Attorney-Led Captive Planning

For over 19 years, Capstone has supported mid-market businesses in the legal and regulatory processes associated with forming their own captive insurance companies in collaboration with lawyers, insurance professionals and certified accountants. Unlike many captive insurance management companies in the industry, our turnkey service providers do not disclaim tax and legal support. We have a proven track record for standing with our clients.

We work in alignment with our affiliated law firm, The Feldman Law Firm LLP, which employs experienced attorneys who specialize in corporate and business planning. Capstone leverages an award-winning, multi-disciplinary team approach. For one turnkey fee, we will retain and directly compensate all the players needed to analyze, design and implement an appropriate alternative risk strategy for your business.

Unmatched in the Industry

We're dedicated to providing comprehensive mid-market captive planning. Capstone and The Feldman Law Firm LLP have the expertise to carry out critical aspects of the planning, including insurance, tax, and legal. For over 19 years, no other captive service provider has offered the same level of support throughout the life of the captive.

The pitfalls of working with a captive insurance manager who doesn’t have the right experience can be disheartening for any business owner who has invested time and money into a captive planning strategy.
Many self-proclaimed captive managers have had only clerical and administrative experience. They may work at home, with a P.O. Box listed as his or her office address. Although they may have graduated from law school, they take a bold, apathetic stand against helping clients work through tax and legal issues.

Their true market focus might be to gain commission on the sale of an insurance policy or to simply grow their assets. Often, their backgrounds are difficult to gauge online.

The benefits of managing business risks through a captive are fully realized when you’re working with a captive planning firm offering true turnkey solutions. Capstone’s reputation precedes it, with over 200 successful captives formed since 1998. Our attorney-led team goes beyond risk management—we’re your partners in finance, tax planning, captive formation and management.

- Expertise in forming captives under IRC 831(a), 831(b), and 501(c)(15) for mid-market companies
- Expertise in risk management for mid-market manufacturing, construction, healthcare and other industries

Capstone provides captive insurance services to mid-market businesses across an array of industries. It is the most comprehensive alternative risk planning solution available.

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Quick Facts About Capstone and The Feldman Law Firm LLP

Capstone is a standout with:
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- 200+ captives formed
- Expertise in navigating existing and new captive legislation and regulatory changes
- Recognition as a Top 20 Captive Industry Pioneer by Captive Review (2015, 2016)
- Recognition on the Power 50 List of Industry Experts by Captive Review (2014)

The Feldman Law Firm LLP has:
- 55+ tax controversies successfully resolved, including Tax Court cases
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- 150+ years of combined legal experience
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