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Structure, Benefits, and Potential Pitfalls of Captive Insurance

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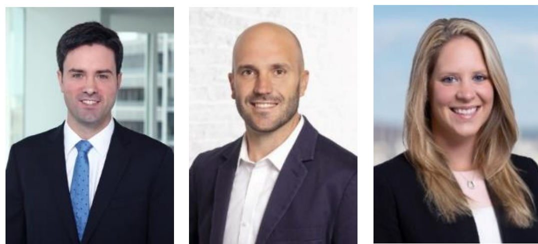

Over the last several years, traditional insurance has become increasingly expensive as insurers use risks and claims associated with the COVID-19 pandemic, geopolitical risk, supply-chain disruption, inflation and intensifying severe weather events to justify premium raises and coverage reductions. While premiums hikes may have fallen from the height of the hard market in 2020, recent reports have found consistent, rising average pricing rates as the difficult market continues across most product lines.

In response, some policyholders have turned to non-traditional solutions to mitigate risk, such as captive insurance, self-insurance and risk retention groups. In particular, the number of captive insurance companies registered in the United States has risen steadily, with the Insurance Information Institute recording a 14% increase in captive registrations in 2021. State regulators have also taken notice. Earlier this year, the Delaware legislature passed an amendment to the statute governing Delaware corporation's ability to indemnify directors and officers, clarifying that "insurance" purchased to insure company directors, officers, employees and agents includes captive insurance. While captive insurance companies represent an alternative to traditional insurance, recent legal activity reveals the importance of structuring and implementing captives correctly.

Captives 101

Generally speaking, a captive insurance company is an insurance company that issues insurance to an entity that also owns and controls the captive. In that set up, the captive insurer's primary purpose is to insure the risks of its owner and use its underwriting profits for the benefit of that owner. Captives can be formed and tailored to address the goals, needs, finances and risk appetites of its owners. Like a traditional insurer, a captive is subject to jurisdiction-specific regulations, like those pertaining to financial reporting, solvency and reserve requirements, and annual actuarial opinions. Each jurisdiction also regulates the formation of captives.

There are various ways to structure a captive.

- **Single-owner captives**, as the name suggests, are set up and operated by a single owner to insure the owner's risks and the risks of its subsidiaries and affiliates. Single-owner captives insure the risks of the owner—sometimes referred to as a "pure captive"—or they may be able to provide coverage to other entities as well.

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- **Group captives**, in contrast, are owned by multiple, non-related entities. Typically, group captives insure similar types of risk (think energy or health companies operating in the same industries). Group captives may also be able to provide coverage for entities other than those affiliated with theowners.

- **A rental captive**, or rent-a-captive, is a captive insurer that is not owned by a policyholder but rather by a broker, reinsurer or fronting insurance company. Essentially, in a rental captive structure, the captive insurer creates a separate set of books for each insured to account for the insured's individual risks and contributions. While rental captives can require less initial capital than a single-owner or group captive, they may offer less flexibility.

- **Protected cell companies** are a special kind of rental captives. Also known as segregated portfolio companies or segregated account companies, protected cell companies allow for the segregation of accounts so that each account may be legally protected from the liabilities of other accounts within the captive. Each protected cell operates as an independent cell within the captive's larger structure.

Benefits and Drawbacks of Using Captives

While each type of captive has its own advantages and disadvantages, all captives share some common advantages.

- **Insuring the uninsurable.** Captives can provide policyholders with alternative coverage options and limits that are unavailable or too expensive in the traditional insurance market.

- **Customized coverage.** Compared to traditional insurance markets, captives may also provide policyholders more flexibility to customize coverage, eliminating the need to pay for a package of additional coverages that the insured does not need or want.

- **Tax benefits.** In addition, premiums paid to the captive may be tax deductible, and surplus premiums not used to pay claims stay with the company, rather than flowing to third-party insurers. Moreover, captives can invest money set aside to pay claims, and the profits of those investments can flow back to the owner of the captive.

Although the advantages discussed above make captives attractive in some situations, there are also disadvantages that must be considered.

- **Upfront costs.** As an initial matter, captives can require significant effort, time and expense to setup. Set up costs include conducting a feasibility study, selecting the captive's domicile, securing state regulatory approval, assessing risk exposure of the insured(s), forming a corporate structure and agreeing upon the terms of insurance, among other things. Additionally, the captive must be adequately funded to handle claims once coverage begins.

- **Disputed claims.** Despite the alignment between captives and the companies that own them,captive arrangements may not eliminate disputes with traditional insurance companies because some programs involving captive insurance still use traditional insurance. For instance, the captive may purchase reinsurance from traditional insurers. Also, a captive may issue the

primaryinsurance policy and the policyholder may purchase excess insurance from traditional insurers.

- **Claim frequency and severity.** Captives are often used for high-frequency, low-severity risks thatprovide fulsome data and are more predictable. This allows actuarial modeling to more accurately predict future losses (and corresponding funding requirements) with higher degrees of certainty. Predictability is critical for captives and their owners because the captive needs to be funded with adequate capital to respond to potential losses should a claim arise.

The kinds of coverages that typically fit into this model are workers' compensation, general liability or products liability. Directors and officers liability claims, in contrast, are usually low-frequency and high-severity, which may complicate modeling and predictability in creating and funding a captive for D&O risks. Companies evaluating captive arrangements should take these factors into account in deciding whether to depart from traditional insurance markets.

Interested in a Captive, What's Next?

Once a company decides to pursue a captive arrangement, one of the first steps is to conduct a feasibility study. A feasibility study involves using data to help determine whether a captive is a viable option, and if so, what type of captive makes the most sense.

Many jurisdictions require prospective captives to submit a feasibility study as part of the formation and licensing process, but even where a study is not required, it is often in the prospective captive owner's interest to engage in this process. The feasibility study can serve not only as a business plan with actuarial support for loss assumptions and capitalization requirements, but also a documented risk assessment.

Typically, the study will focus on three categories: control, cost, and capacity. A feasibility study should beginby addressing whether a captive program can improve risk management control, including identification of the risks facing the insured.

The next step is to analyze costs associated with the captive, including changes in risk financing expenses and the long-term financial impact of the program. Typically, this analysis involves modeling after-tax cashflows under various loss scenarios. Finally, most feasibility studies examine the retention ability of the captive, i.e., the amount of aggregate incurred losses the captive can retain in any financial reporting period without creating and adverse impact on cash flow or earnings.

The feasibility study may be performed by insurance brokers, captive managers, independent risk management consultants or some combination of each.

In addition to the myriad economic considerations that inform captive formation, it is also critical to consider the legal risks captives pose. As noted above, one of the advantages captives offer is the possibility that companies can deduct premiums as business expenses just as they would for premium payments to a traditional insurer. However, recent litigation shows that the use of captives can engender IRS scrutiny.

For example, in June 2022, the IRS petitioned a federal court to enforce an administrative summons related to its examination of tax liabilities for two entities involved in a captive insurance transaction. Across two tax years, affiliated entities using the captive insurance arrangement took business expense deductions of more than $425,000 for captive insurance premium payments, all of which the captive reported on its returns as exempt from taxation. If the IRS determines that the sums were improperly deducted, the entities may facecivil and criminal penalties.

Moreover, unscrupulous actors may use captive insurance arrangements to defraud policyholders. For example, a complaint filed recently in Maryland federal court alleges that a policyholder was swindled out of almost $19 million dollars when its captive insurer unilaterally cancelled its policy. The policyholder's attorney, who purportedly failed to disclose his ties to the captive, allegedly effectuated an assignment of the policyholder's rights that triggered the captive's ability to cancel the policy. As a result, the policyholder contends that it lost all benefits under the policy, including its right to receive a return of premiums paid.

These examples show that engaging competent counsel in all stages of captive development and administration—from regulatory compliance and manuscripting of coverage to proper tax treatment and claims administration—can benefit prospective captive owners. Failure to comply with both state and regulatory guidance, as well as failure to understand the consequences of certain decisions, may create new and expensive risks for owners that could undermine the efficiencies and protections captives afford.

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