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INSURANCE SPECIAL

## Companies increasingly look to captive insurance

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Companies seeking an alternative to traditional risk management approaches are increasingly turning to the captive insurance market, especially for recurring and foreseeable losses.

As most commonly understood, the captive operates as a private in-house insurer that is wholly owned by a parent company. The parent pays the captive premiums, just as it would to a conventional insurance company, and the captive assumes the risk for certain defined losses. This structure is known as the “single-parent captive.”

Unlike traditional insurance, the parent company keeps its capital if claims are less than the premiums. The parent, of course, also bears the risk if the opposite happens — though most sophisticated entities will purchase re-insurance for larger, less predictable risks.

The potential cost savings of using captives drove the emergence of this market in the 1950s primarily among large multinational and international companies that could afford such an undertaking. But captives aren't just for the behemoths anymore. The captive self-insurance mechanism now comes in a variety of forms, such as trade association and group captives, that allow small and mid-sized companies to combine and insure the risks of their members.

In addition, companies can buy into so-called “rent-a-captives,” which are created and managed by outside organizations. The rent-a-captive can be an attractive program for a company with a relatively small risk management program that might otherwise find prohibitive the costs and administrative challenges of forming a single-parent captive.

Estimates vary as to how many companies have tapped into the captive market for their insurance needs. Most industry experts report that approximately 90 percent of Fortune 1000 companies now transfer risk through a captive, while nearly 60 percent of mid-sized companies, meaning those with annual revenues of between \$100 million and \$1 billion, now take advantage of some form of captive structure. These numbers have increased significantly over

the last 20 years.

A captive is technically a form of self insurance — though captives differ from traditional self insurance in an important respect. In its simplest form, a self-insuring company generally creates a savings account to cover claims that arise on an as-needed basis. The captive, by contrast, is a bone fide insurance company that receives premiums in exchange for accepting defined risks.

The types of insurance most conducive to a captive arrangement for companies of all sizes include general liability, workers compensation, professional liability and auto insurance. Over the past few years employers across a variety of industries have expressed interest in establishing health insurance captives to minimize the financial impacts of the Affordable Care Act, aka Obamacare. Recent experience, however, shows that, though appealing at the outset, the cost and complexity of such an endeavor has rendered these efforts a nonstarter, at least at this point.

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The rise in alternative risk transfer activity has been accompanied by a movement onshore of captive companies. Until recently, the most popular domiciles for captive formations have been Bermuda, the Cayman Islands, Barbados, primarily because these locations offered tax advantages and favorable capitalization requirements.

A majority of U.S. states now to allow for the licensing of captive insurers under equally advantageous conditions, resulting in a trend of companies forming onshore. The leader in this movement is Vermont, which this year licensed its 1,000th captive insurance company. The state of Vermont reports that its captive insurance industry generates millions of dollars in licensing fees and premium taxes and supports more than 1,400 full- and part-time jobs.

Other active states in the industry include Delaware, Hawaii, South Carolina, Nevada, Arizona, Utah and New York. Texas adopted captive insurance legislation this year. We are anxiously waiting for California to get onboard. To be clear, California companies can still participate in the captive market — but captives of California companies must be domiciled in other jurisdictions.

Recognizing this onshore movement, the National Association of Insurance Commissioners is adopting model rules, which may offer California leaders a blueprint on how to move forward and make the domestic captive insurance market even more prevalent throughout the U.S.

In addition to complying with state regulations, domestic captives are subject to numerous federal laws. For example, captives established by publicly held companies must comply with the Sarbanes Oxley Act of 2002, which established financial reporting requirements for corporations to prevent accounting fraud.

The advantages of forming a captive are first and foremost increased control over the risk management process and reduced costs. On the front end, companies have greater underwriting flexibility, allowing them to establish programs that more specifically meet the needs of both the employer and employees. Once a claim arises, all parties involved can benefit from having claims handled by individuals who both know an industry inside and out and also have risk management expertise. Our clients often find that, because of their intimate knowledge with the risk characteristics of their particular industry, they can process claims more efficiently and effectively than traditional insurers — and get to the “end zone” in a fraction of the time. This greater control over every stage of the risk management process gives our employer clients peace of mind and can improve their relationships with employees and unions.

The impact on a company's cash flow can also be significant in the appropriate situation. By retaining the premiums not spent on claims and paying lower deductibles, companies can create both underwriting and investment income that would not be

available through traditional insurance. Moreover, in certain instances companies can receive a tax deduction for the insurance premium paid to a captive. Another important benefit is that captives allow companies direct access to the reinsurance market which can increase their bargaining leverage and reduce costs. The captives may also provide companies with an affordable vehicle to insure risks that would otherwise be costly to cover in the broader insurance market.

It is important to understand, however, that captives are not for everyone. A company must carefully assess its unique risk management characteristics before plunging into the captive market. Captives, for example, can be costly to maintain and may be more complicated than the standard insurance contract. Also, captives are generally more appropriate for businesses with recurring, predictable risks, such as slip and falls, construction accidents and auto claims. A business with more varied, unpredictable risks may want to stick with the more predictable insurance model.

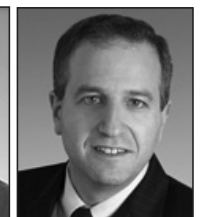
Exploring these considerations with the client through a preliminary feasibility study is essential in today's evolving risk management environment. Captives, as well as risk retention groups and other self insurance mechanisms, have gained a foothold in the market. These alternatives present both opportunities and potential pitfalls for clients.

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