Is a Captive Right for Me?

Owning a Captive is the Creation of a New Business
Many business owners who form captives think of it for what it does, but they do not realize that they have just created a new business – an insurance company – and thereby cast themselves into the business of insurance.

The captive thus acts not just as an enterprise risk management tool, but also as a segue into a whole new business opportunity.

An existing captive with sufficient capital can be converted to a full insurance company that offers insurance to the general public by changing its license and business plan and meeting certain other state requirements.

This usually does not mean that the new insurance company owner will throw open the doors to the general public, but instead often limits business to the same business that the owner is familiar with – offering insurance to similar businesses where the insurance company owner can get a good feel as to their claims exposure, and accordingly, price premiums appropriately.

The business of insurance can be a great business, and more than a few business owners find insurance an even better business than the successful business they are already in.

We have had clients go from their captive being just another affiliate in their overall business organization, to running an insurance company and conducting the business of insurance as their primary business.

Running Your Own Claims Forces the Business to Focus on Risk Management
When a business is buying insurance from a commercial carrier, the concept of claims is only loosely attached to the economic cost to the business in terms of increased premiums. But when claims are being paid from a captive – effectively, from the business owner's pocket – the focus on claims can become intense, and consequently, the business becomes focused (often for the first time) on enterprise risk management.

The benefits of enterprise risk management, while sometimes hard to exactly quantify, are enormous. The focus shifts to analyzing the business so as to spot potential risks. Claims are thus prevented instead of administered. In the end, the business owner gains a better understanding of the business and its limitations, and that is priceless.

Saving Money on Insurance
The primary purpose of a captive is to save money on insurance, and in this, captives have no equal. There are three main aspects to this:

First, by underwriting the insurance needs of the business, the captive can capture and retain the underwriting profits that would ordinarily be lost to the commercial carrier.

Additionally, considering that commercial carriers have enormous costs that must be priced into their policies, such as the expense of compensating agents, marketing and advertising expenses, and high executive compensation, there is a great deal of fluff having nothing to do with true risk in commercial policies that can be saved through the use of a captive.

Second, even where the business decides to keep commercial insurance in place against particular risks, the captive can be used to reduce costs by raising deductibles, lowering coverage limits, or increasing exclusions – the idea being for the business to find the sweet spot where the commercial insurance is most economical, and then use the captive to insure around that area.

Since the greatest expense of most insurance policies is the "first dollar" expense, simply increasing deductibles can result in dramatic premium decreases with commercial policies.

Third, the mere existence of the captive and its ability to underwrite risks can save money even if the captive is never used for that purpose at all.

This is because the insurance broker knows that if the premium prices offered to the operating business for insurance are not efficient, the operating business may decide to cover them in the captive instead – and once that particular book of business is lost, it may be forever lost to the broker.

Thus, the threat of a captive can be used to significantly barter down the commercial carrier into offering insurance to the operating business at rock-bottom prices.

The combination of all three of these factors can result in very substantial savings to the business enterprise, but the benefits of a captive can extend well beyond the immediate savings of insurance dollars.

Administer Claims on Your Own Terms
A problem with commercial carriers is that they can allow a small claim to fester, either by not taking care of the claim early or by allowing it to drag on without resolution.

Or the insurance company may settle a frivolous claim just to save defense costs, thus encouraging more such frivolous claims against the business.

With a captive, the business owners can administer their own claims on their own terms and get on top of claims quickly before they spin into something much larger.

The business owners can also choose to not settle frivolous claims, forcing the plaintiff's attorneys to incur time and expense litigating the claims before dismissal, and by doing so, deter future lawsuits.

A captive's ability to draft its own policies, choose its own attorneys, and administer its own claims are all important cost-saving benefits of a captive.

Choose Your Own Legal Counsel
When you buy insurance from a commercial carrier, they typically retain the right to hire an attorney for you.

Theoretically, the attorney that your insurance company hires will be your attorney and only look out for your interests even to the detriment of the insurance company – but will he or she really do so?

Insurance defense counsel may be assigned approximately 200 cases from a particular insurance company in a year, only one of which is yours. Who do you think they will genuinely owe their allegiance to?

Additionally, insurance companies are notoriously cheap when it comes to hiring counsel – you may get someone whose primary qualification to handle your defense is that he or she bid lower than any other insurance defense attorney for the work.

My opinion has long been that if you are ever sued and your insurance company appoints counsel for you, get your own counsel to ride herd on your insurance company's lawyers; i.e., make sure that they competently represent your interests first and foremost, and if possible, settle the claim within policy limits.

With a captive, a business does not have these problems at all. Since the business owners control the captive, they can select the counsel of their choice to handle particular claims. They have the option of not opting for the cheapest insurance defense counsel, but the best. Or, on the flipside, they can retain a good insurance defense attorney to handle most matters at a discount. All this usually has the effect of a better defense at a lower cost to the business.

Draft Your Own Policies
Captives can (and should) draft carefully custom-tailored policies to fit the exact needs of the business. This not only means covering areas of exposure and eliminating exclusions, but also drafting the policy in ways that make it nearly impossible for a third-party claimant against the business to assert a claim directly against the policy (unlike most commercial policies).

Because policies can be custom-tailored, they can be much more efficient. With commercial policies, a business might be stuck with $2 million in coverage of some risk, even though as to that particular risk, the business might only need a more precisely-calculated $1.45 million in coverage – so the business need not pay for what it does not need, and instead allot those same premium dollars to other risks for which the business is exposed.

Cover Risks Otherwise Exposed
Businesses are often forced to effectively self-insure risks (whether they realize it or not) because either the risk is so unusual that insurance cannot be purchased for it at any price, or because the insurance to cover the risk is exorbitantly expensive.

These are ideal risks to be covered by a captive, and indeed, this is one of the primary purposes of captive insurance.

Moreover, even where a business has insurance against certain types of risks, the business will still be exposed to deductibles and exclusions. While in the past, general liability insurance (known in the industry as "GL") covered an extremely broad range of risks, typical modern exclusions give such a policy more holes than Swiss cheese.

These days, the typical GL policy may have exclusions for things like employment practices liability, which exposes the business to claims of sexual harassment, age discrimination, wage and hourly claims, and the like. The insurance provided by captives can fill these gaps.

Enterprise Asset Protection
A collateral benefit to a captive is that each dollar paid by the operating business to the captive reduces the assets of the operating business by that same dollar.

Accordingly, if something goes dreadfully wrong for the business, those dollars are no longer available to creditors of the business.

Indeed, captive insurance must rank as one of the best enterprise asset protection strategies ever created. Note that it would be exceedingly difficult for creditors of a business to prove that payments to a captive for bona fide insurance coverage would be a fraudulent transfer, since the business received back a substantial economic benefit in the insurance coverage from the captive.

Also, the captive may (and usually is) structured to be remote from the underlying business for purposes of bankruptcy, so even if the operating business is forced into bankruptcy, the odds are low that the captive will be swept into the bankruptcy vortex.

Retain Key Employees
Occasionally, business owners will award a key employee or two by giving them equity in the captive as part of an overall strategy to retain those employees for the benefit of the business.

Giving key employees stock in the captive is sometimes less messy and troublesome than giving them equity in the business itself and can avoid the animosity that can sometimes materialize when other employees are not given a stake in the business.

While this situation is rare, it works swimmingly.

While ownership in the operating business is difficult to conceal, particularly for businesses with significant accounting staffs, often no one in the business except the owners knows what is going on with the captive, allowing great flexibility in creating key employee arrangements.

Create a Giant War Chest for the Business
Like any insurance company, captives tend to accumulate a considerable amount of assets in reserves and surplus. While these assets back the policies issued by the insurance company, a portion of those assets may be available to the business owner in a worst-case scenario where the business owner needs the funds to cover a larger catastrophe.

While there may be significant tax ramifications to "cashing out the captive" to meet some emergency not covered by a policy, at least the business owner has the option of so doing and can then weigh the cost/benefit analysis at the time the money is needed.

Certainly, getting money out of a captive is easier and more expedient than obtaining a business loan from a bank at a time when the business is in deep distress.

During the 2008 crash, more than a few business owners did exactly that. And while their captives became empty shells for a while, they were able to use the money to save their businesses.

While one who is setting up a captive certainly hopes their business never will have such a need, it is nice to know that safety net is there.