# Should You Form a Captive?

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*My book **U.S. Captive Insurance Law** is the leading legal text in the area of captive insurance. All of the information in this document is derived from it. If you'd like to learn more, it's available through Amazon.com*

## What Is A Captive Insurance Company?

A captive insurance company is an insurance company owned by the insured. The practice started in the 1950s as certain industries either couldn't find insurance or could only find insurance at incredibly expensive rates. As such, the only way these companies could mitigate their risk was through a captive program.

**Who should form a captive?** Any company with an above average risk profile should consider forming a captive. Some of the companies that regularly form captives are

- oil and gas concerns
- transportation companies
- commercial property owners
- construction companies
- manufacturers
- professionals with malpractice insurance and
- hospitals

This list is hardly exclusive.

**Are there any revenue requirements?** At minimum, a company should have gross income of at least $600,000 and insurance premiums of at least $300,000. But, gross revenue figures can be lower if there is the requisite amount of risk – doctors are a classic example of this fact. Additionally, *most businesses are underinsured* – in some cases vastly so. This means there are probably fairly large sums of risk for the captive to insure.

## The 10 Questions

Here is a list of "10 questions" every prospective captive owner should answer when thinking about forming a captive insurance company. You can find out more at our website, **www.captiveinsuranceinfo.com**

1.) **Do I need tax deferral and conversion strategies?** Tax deferral is simply changing the time when a taxpayer recognizes income (and therefore has to pay tax on it). Conversion is changing income from ordinary income to capital gain. With a captive, the taxpayer lowers his taxable income, places it into a captive and, if he has a good loss record, takes the income out of the captive in the form of capital gain in 15-20 years.

2.) **Have I started an asset protection or estate plan?** A captive insurance plan is often part of a larger asset protection or estate plan. If you haven't begun either of these, you should, and then fit the captive into one or the other. If you have started either (or both), the captive can still play an integral part in either.

3.) **Has there been a problem with one of my existing property and casualty insurance plans** -- that is, have I had a difficult time getting a claim paid, or have I have a hard time reaching my agent, or have I found the service to be lacking? With a captive program, you can tailor your coverage to fit your needs

4.) **Do my current policies adequately cover all my risks?** Even if you have an insurance policy, it's likely big gaps exist. For example – do your current policies have cyber risk coverage? This is a fairly common exemption. Or, how much insurance do you really have for big areas of risk? These are critical questions you need to ask when thinking about a captive program.

5.) **Am I able to actually negotiate the coverage terms with my current insurance carrier, or, do they hand me a policy to sign?** Writing your own insurance contract is a tremendous advantage, as it allows you to add the policy provisions you want.

*There are many different points to consider when analyzing the possibility of forming a captive insurance company.*

# The 10 Questions

*Doctors and other medical professionals are the perfect candidates for a captive insurance company. They have a large amount of risk to underwrite and the stable cash flow to provide the original capital and ongoing funding.*

6.) **Have I seen my insurance prices increase?** Captives can provide stable pricing – meaning when the market for a particular line of insurance increases, a captive's may not, depending on the experience of the parent company. This, in turn, gives the parent increased visibility in its earnings and expenses.

7.) **Am I willing to add another set of corporate responsibilities to my schedule?** Remember – by forming a captive, you're starting another business. That means you now have additional corporate responsibilities to undertake – more reports to read, another set of corporate meetings to hold, etc.. Are you willing to engage in this?

8.) **Am I comfortable placing money into a business enterprise for an extended period of time?** All captives require original capital and surplus to pay claims. These payments are placed into the captive by the insured. In addition, the captive can't do anything to jeopardize its financial position. So, after placing capital into the captive, you have to leave it there. Are you financially able to do this?

9.) **Am I committed to lowering the cost of my risk?** Central to the idea of forming a captive insurance company is the understanding the insured is going into the insurance business. As such, are you ready to undertake risk minimization strategies? For example, if your captive underwrites a cyber risk policy, are you willing to purchase anti-hacking services from third party venders?

10.) **Am I committed to a long-term business plan?** That is, am I willing to see this through for at least 3-5 years? Captives require a long-term commitment; you can't simply start one and then end it a year later. At minimum, you need to commit to a 3-5 year time period to get the full benefit of a captive.

# What Are the Benefits Of A Captive?

**Stable insurance premiums**: a captive underwrites a limited number of insureds. This means it operates in an exclusive economic enclave, removed from the general market forces that determine premiums. As such, a captive will typically not have the same degree of premium variability as third party insurance providers.

**Using a company's individual loss profile:** while insurers used to look at each insured's loss profile to arrive at rates, premiums are now dictated to the insured without any individual analysis. Part of the captive underwriting process involves an actuary looking at each company to develop premiums that account for that company's risk profile.

**The ability to insure previously uninsured risks**: captive insurance typically fills gaps in third party coverage, eventually providing the insured with an "insurance tapestry" combining standard insurance and captive insurance. For example, doctors often use a captive to reinsure part of their medical malpractice coverage.

**Asset protection:** by placing assets into a stand-alone insurance company, the insured is also engaging in asset protection, meaning he is placing assets into a company that may not be the target of a creditor or a judgment in the event of a default or loss.

**Estate planning benefits:** captive insurance companies can be structured in the exact same manner as family limited partnerships. The children are given highly restricted interests in the captive, which increase in value as the insured pays premiums. However, there are no estate tax implications because no one has died and there are no gift tax implications because the insured is purchasing a product for fair market value.

*There are numerous benefits to a captive. In addition to risk mitigation, the owner can achieve asset protection, increased insurance coverage, stable insurance premiums and – if desired – estate planning benefits.*

# What Kind of Policies Can a Captive Write?

*One of the main purposes of a captive is to underwrite "small print" risk; these are risks typically excluded from traditional third party insurance policies. For example, employee theft and cyber-risk are usually underwritten by a captive insurance program*

**Deductible Reimbursement:** some insureds need a nationally recognized third party insurer. For example -- doctors typically need such coverage in order to obtain hospital privileges. In this situation, we form a captive to underwrite a deductible reimbursement policy for their third party malpractice insurance, thereby allowing the insured to still have nationally recognized coverage but also giving them the benefits of a captive insurance company.

**Cyber Risk:** Since most companies store customer information in electronic form, they are exposed to this risk, which is typically excluded from many policies.

**Employment practices:** Lawsuits for employment related practices -- such as wrongful termination and discrimination -- are on the rise. The cost of this litigation – and the final settlements thereof – can be very expensive.

**Employee malfeasance:** The cost of employee theft – especially when they engage in wide-ranging and deeply entrenched fraud – can be staggering. This policy helps to protect the business owner against this risk.

**Product liability/product recall:** this is very popular for manufacturers, as these risks are typically excluded from a standard commercial general liability policy.

**Intellectual Property Infringement:** Many companies use intellectual property as part of their business model. What happens when another company infringes on your IP? This policy helps to mitigate the costs of this expensive problem.

## How Do You Form a Captive?

There are several stages to the captive formation process.

**First, some states want to meet the captive applicant** – usually by phone – in order to get a better idea of his business goals for the captive.

**Second, a feasibility study has to be prepared.** This is the captive's business plan. It includes an actuarial study of the candidate's business, an analysis of his current insurance policies, accounting projections and an overall business plan for the captive.

*On average, a captive can be formed in about 60-90 days.*

**Third, the candidate must pass a background check for the state.** This includes an examination of the applicant's residential and business history. Also included are questions regarding the candidate's financial viability and ethical character. In asking these questions, the state wants to make sure the captive owner won't be tempted to mismanage the captive for personal gain.

Fourth, if the regulator feels the captive is in the state's best interest, he will issue a license.

## Who Will I Need to Run the Captive?

You will need to following professionals to help administer the captive program, which typically contract with the captive manager:

*You'll need several professionals to help run the captive.*

- **A captive manager**
- **An attorney**
- **An accountant and auditor**
- **An investment manager**