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Legal Considerations for Captive Claims

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While captive insurance companies can serve very useful purposes, the benefits can be difficult to realize in certain situations, especially when companies expect them to function as "plug-and-play" solutions. Much of the preliminary interest in captives comes from the prospect of decreased insurance costs and tax benefits. However, the dual requirements of "risk shifting" and "risk distribution" can, depending on the structure envisioned, eliminate the possibility of tax savings. Further, the initial savings on insurance premiums can be diminished by transaction and claims administration costs. While deterrents to some, many companies find workable solutions to these issues and move forward to run successful captive programs.

There are, however, other issues to consider, many of which do not arise until a company faces a large loss. For example, when the time comes for a captive to pay a large loss claim, there may not be an established procedure for how to account for and handle the mechanics of claims payments, adjust future premiums to reflect the loss or re-capitalize the captive. While these types of issues might be unlikely to cause significant, long-term problems, there can be internal disruptions if the company expects a captive to, in effect, take care of the claim in a manner similar to that of a commercial insurer.

Additional issues can arise if there is any interaction between the captive and commercial insurers, which often work jointly with captives to fulfill specific roles in a company's overall risk management structure. And, even when commercial insurance is not purchased by the policyholder, other insurance can become involved through pre-existing policies or contracts containing indemnification and insurance provisions. The interaction between a captive and this commercial insurance can lead to unintended or unexpected results in certain loss situations, exposing the captive—and therefore the company—to greater risk.

Financial Objectives

After a significant loss, other issues can arise that will influence the payment obligations of the captive. For many corporate policyholders, insurance is not purchased to cover losses the company could not pay in the absence of insurance. Rather, in addition to compliance purposes, insurance is primarily used to reduce the risk that losses will unduly impact budgets, earnings or cash management. While a captive can ensure compliance with contractual or regulatory insurance requirements,

it is much more difficult to get a pure captive to actually meet the financial objectives that commercial insurance can provide.

More specifically, if a captive arrangement does not involve any aspect of risk transfer (loss is merely passed from the balance sheet of one entity to another with no net effect on the consolidated enterprise), it is likely that the captive arrangement will do little or nothing to blunt the financial detriment of a large loss on a consolidated basis. If this is not considered at the time the captive is arranged, a company's expectations about the financial benefits provided by a captive might not be met.

Independent of whether a captive arrangement involves risk transfer, financial objectives for captives also can be frustrated by unexpected costs. Aside from tax benefits and investment income earned on the "float," captives are often touted as saving policyholders the portion of premium that covers a commercial insurer's overhead, claims administration costs and underwriting profit.

Those savings, however, are dependent on the insured actually being able to operate more efficiently than a commercial insurer. The savings further depend on the captive policy functioning as intended, which may not always be the case. Moreover, these two risks are often realized together, as the revelation of an issue that might lead to the captive not functioning as intended usually causes a spike in administrative costs. In-house legal and financial professionals are forced to dedicate time to the issues and, in many cases, retain outside service providers.

The mere possibility that a captive arrangement might not yield the anticipated savings is, of course, not a reason to dismiss the possible benefits of a captive, especially when one that is properly structured and managed can mitigate the risks that could result in unmet financial objectives. However, these are real issues that need to be considered when assessing the potential benefits of creating or keeping a captive.

Inter-Insurer Issues

From the company perspective, even separately managed captives can be viewed as more akin to a "friendly" corporate subsidiary than a truly independent commercial insurance company. Running counter to this view, commercial insurers often formulate positions adverse to the company/policyholder that rest on the notion that the captive is "true insurance." And, while insurers have a deserved or undeserved reputation for not always playing fair with policyholders, there is no lack of aggressive positions being asserted in inter-insurer disputes.

Problems between commercial insurers and captives can arise when captives issue primary coverage below several layers of excess insurance issued by commercial insurers or when the captive is reinsured by a commercial insurer. For example, an insurer excess to a captive policy might attempt to defer attachment pending "proof" that the underlying captive policy has been properly exhausted, claiming that defense costs were reimbursed unreasonably or claims within the captive layer were settled improvidently. Or, if the captive refuses to settle a claim within its limits and the jury returns a verdict in excess of the captive insurance limits, the excess insurers might very well attempt to pursue a subrogation claim against the captive (in the policyholder's name) for a bad faith failure to settle.

In both of these situations, the other insurer would be pursuing the captive as though it were a regular commercial insurer, disregarding the captive's purpose within the insurance structure, the economic reality of many captive arrangements and/or the adverse impact such action would have on the commercial insurer's own policyholder.

The potential for these types of "insurer v. insurer" disputes also can arise between a captive and commercial insurers that had no relationship with the captive, such as the policyholder's own insurers from other years and insurers for third-parties with which the policyholder does business. For example, if a loss involves allegations implicating multiple policy years, occurrence-based insurers that pre-dated a claims-made captive policy may take the position that the captive needs to cover 100% of the loss, or at a minimum, participate in the loss under an allocation scheme. Or, as another example, if an insured requires a third-party vendor to provide it with indemnification and "additional insured" coverage, the insured might believe that its captive would not be required to contribute to a loss until the vendor's coverage has been exhausted.

In both of these situations, however, the commercial insurer might feel more justified trying to treat the captive as a "real" insurer under an equitable contribution or subrogation theory than it would in a direct

dispute with the policyholder, notwithstanding that the economic result for the policyholder might be the same irrespective of the theory advanced by the insurer.

The relative merits of a commercial insurer's claim that a captive should be treated as another "insurer" likely would depend on various factors, including the contract language at issue and whether the captive provides, in fact, actual insurance. In order to be considered "true insurance," there must be a transfer of the impact of a potential loss from the insured to the insurer. But captives can be structured in such a way that there is no actual transfer of risk. If losses on the books of the captive reduce the value of the captive to the parent, for example, it has been held that the risk of loss has not been effectively transferred and the arrangement is therefore not "insurance."

While most courts have looked to the economic substance of the transaction, however, some might be unwilling to move beyond the captive's characterization as "insurance." And independent of whether that is the right result when the captive is providing actual insurance, a company with a simple captive that provides few if any of the benefits that can exist when risk is actually transferred (such as tax and financial benefits) almost certainly will be left with the impression that it ended up on the wrong side of the deal.

Maintenance Required

As anyone involved with captive programs knows, success requires a large and continuing investment of resources in its set-up and maintenance. Therefore, it is wise to be cautious if a company is told to expect a captive to provide an inexpensive, maintenance-free alternative to what many perceive as the hassles of dealing with commercial insurers.

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