

Managing the middle ground

Stewart A Feldman, of The Feldman Law Firm and general counsel to Capstone Associated Services, reveals the Fortune 1000 planning techniques that are now available for the middle market

Decades ago, the largest US companies came to realise the benefits of captive insurance programmes. Today there are approximately 10,000 captive insurers worldwide, the majority of which are affiliated with American businesses. Some of the reasons for the migration to captive insurers by middle-market companies can be demonstrated through the following real business scenarios:

- **Acme Manufacturing** is a closely-held business, generally offering a one-year warranty on its products, which can be supplemented with a multi-year extended service warranty. The extended service contract can be structured as an insurance arrangement wherein a captive insurer assumes Acme's financial obligations in exchange for a premium. Structuring the contract as an insurance arrangement allows Acme to deduct the costs of its extended service warranty upfront (rather than deduct warranty-related service expenses as

they occur). Meanwhile, the captive's investment income can build up on a tax-advantaged basis to help fund future losses.

- **Federal Industrial Cooling LLC** provides industrial cooling equipment and services to commercial and industrial customers. It relies on its experienced heating, ventilating, and air conditioning engineers and salesmen to interface with architects and mechanical engineers who design projects. Its COO and CFO are also critical members of the executive management. The loss of any of the engineering or sales staff or the executive management would significantly impact Federal. While key man policies are widely available in the marketplace, it is more difficult to come by policies that insure against disability, retirement or quitting. Its captive can insure these risks.
- **Enviro Services Ltd** has developed, at great expense, certain processes and trade secrets used in containing and

cleaning up industrial waste. It wishes to insure these non-patentable processes against competitors' wrongful appropriation of these technologies. Its captive insures the integrity and exclusivity of these processes against devaluation caused by the misappropriation of these processes by competitors.

- **Plastic Surgery Associates, LLP** unknowingly self-insures serious exposures, including changes in reimbursement rates, the costs of Centers for Medicare and Medicaid Services (CMS) and insurance company audits, the risk of delisting by an insurer, malpractice deductibles, employment practices, accounts receivables exposure and disability. These significant exposures are not covered under the company's traditional professional liability coverage. The client finds that owning its own captive insurer helps control the rising cost of risk and provides added insurance protection by filling the holes and exclusions in its conventional coverages, while providing a more stable level of income for its owners.

Practically speaking, in none of these situations is insurance available from a conventional carrier to cover company-specific risks, at least not at a reasonable premium for a mid-market company.

Tens of thousands of businesses representing industries ranging from medical services to manufacturing to fabrication to distribution, finance and construction, are now participating in some type of alternative risk planning programme, whether it is a group captive, a cell captive, a single parent captive

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insurance arrangement or some other form of alternative risk financing. These companies do not necessarily cancel their conventional liability or property or auto/truck coverages. Rather, these businesses supplement their conventional coverages with tailored policies that pick up where conventional carriers fall short.

For years, the largest US companies have realised the benefits of alternative risk financing and captive planning. Principal among the reasons is the ability to customise coverages to the insureds' needs rather than simply relying on 'standard' conventional policies riddled with restrictive exclusions. Insureds have found the vexatious claims submission processes of conventional property and casualty carriers, especially when faced with substantial commercial claims, are often more cost-effectively handled through captive insurance arrangements. Traditional carriers only pay out a portion of premiums received for actual losses, with marketing costs, regulatory expenses, executive compensation, commissions, investment losses and litigation with insureds absorbing a disproportionately high amount of actual premium dollars. A well-designed and implemented captive arrangement can recoup these dollars for the insured.

Therefore, it is not surprising that captive insurance, as an alternative risk management strategy, has long been used by most Fortune 1000 corporations.

The past decade has seen an increasing demand for more targeted and cost-effective insurance coverages which quickly lead to captive insurance and other alternative risk financing techniques. For the past 10 years, Capstone has been translating sophisticated alternative risk financing techniques used by large corporations into techniques which can be used by the middle-market, privately held company and its principal owners. Turnkey outsourced providers such as Capstone, with legal, regulatory, risk management, statutory accounting, claims management and policy manuscripting skills, have reduced the complexity of captive planning for these businesses.

Growing confidence

One factor which continues to fuel the growth of captive insurers among middle market companies is the conventional carriers' recalcitrance in responding to claims. Conventional property and casualty insurers have a well-deserved reputation for not paying claims. Yet businesses sometimes depend on these same carriers for protection when they are sued. Middle-market companies are looking for more certainty from their



insurance company when filing claims. It is commonplace for many conventional insurers, especially on larger commercial claims, to deny bona fide claims as part of the 'negotiation process', especially when facing a significant loss. As a result, businesses have to sue their insurance companies to recover unpaid claims or face declaratory judgement actions where, in a classic role reversal, the insured can be liable for the insurer's legal fees. The certainty of payment from a captive is, for many, a better alternative.

Traditional insurers often rely on policy exclusions, which create uncertainty among insureds, regarding whether the claim will be paid. In contrast, policies issued by captive insurers can be custom-designed to more clearly delineate coverage and to eliminate holes in conventional insurers' policies. A captive can provide cost-effective coverages which are not readily available in conventional markets. In some cases, the captive's policies are designed to specifically take over when the conventional carrier denies coverage on the underlying policy.

A captive insurer offers considerable flexibility. It may provide primary coverages, or it may just insure the policies' exclusions. The client often keeps most of its conventional insurance in one place, using the captive to cover the 'expectation gap' where the items' exposures that were thought to be covered are not covered by the conventional carriers. Our middle-market clients throughout the US want to protect their significant businesses with comprehensive and tailored insurance

coverages. If the conventional markets are not providing the needed coverages, these are provided by the captives.

Capstone concentrates its efforts on the largest growing segment of alternative risk planning: captives for closely-held, non-public companies with substantial operations. Our clients' captives, generally speaking, retain appropriate risks through their captive and insure other risks through the conventional market.

It is no surprise that up to half of the total property and casualty premiums paid in the US are written through a captive or other alternative risk planning arrangement.

Since 1998, Capstone Associated Services, Ltd. and Capstone Insurance Management, LLC together with their affiliated law firm, structure, design, implement and operate captive insurance arrangements on behalf of more than 80 companies. Capstone is based in Houston, TX and has offices in Anguilla and Delaware where many of its captives are domiciled. ☪



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