Captive Insurance

Explained In Plain English

CAPSTONE ASSOCIATED
CAPTIVE INSURANCE PLANNING
FOR THE MIDDLE MARKET

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If you're at all familiar with captive insurance, you know that it is often described as a robust, sophisticated alternative risk planning strategy. Industry experts rely on terms like affiliated, insured, earned surplus, loss ratio, domicile, and trigger to describe captives, betting that anyone in the corporate sphere would know how these terms relate to one another. They assume, often incorrectly, that captive insurance and their many benefits have been discussed at the dinner table or in the boardroom. The truth is, even if CPAs, conventional insurance brokers, and business owners have heard of captive insurance, they're often understandably hazy on the details.

Simply put, industry jargon has gotten in the way of true understanding. Over the years, we've spoken directly with C-level executives about the financial tools they use to streamline their businesses. Many haven't considered forming a captive because the nuts and bolts of captive planning have not been fully explained.

In this article, we've set out to bring some clarity to the industry and explain the fundamentals of captive insurance in clear, simple terms. For those who are interested, or even just curious about forming a captive insurance company, please keep reading. Let's cut out the jargon and explain what captives can really do. Let's do it in plain English.

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The Definition of a Captive Insurance Company, the Industry Jargon

A captive insurance company is an insurance company that insures or reinsures the risks of its parent, affiliates, or certain unrelated entities. These small property and casualty insurers receive premiums in return for issuing insurance often designed to supplement conventional coverages.

In Plain English

When you're a business owner and you need to cover risks, you're likely going to purchase a policy from a commercial insurance company like Travelers, AIG, or Liberty Mutual. Problem is, these policies may not cover all risks and they don't provide any other business-related benefits. To boot, if no losses occur in a given year, you will not see that money again. It's how insurance works, right? You pay someone to take on risks just in case something happens. A fire. A burglary. A supply chain breakdown. An interruption in business operations because a hurricane has blown the roof right off your office building. It is an accepted consequence that if these or any number of other losses do not occur, your money will go straight into the insurance company's coffers. Presumably, these monies will go to others with insurance policies who DO have claims.

Captive insurance companies are different. A business owner can opt to form his or her own insurance company (called a captive) to supplement their insurance coverage. The business owner will pay premiums to the captive just as they would to any other insurance company, but the broader policies written by the captive can cover losses not covered by their existing, commercial policy. Plus, the business owner has more control over the claims process, which drastically reduces the chance of getting denied. Captive owners don't have to worry about fraud (why would you be fraudulent against yourself?) and the custom-designed policies written by the captive cover risks that are specific to the company it is insuring. Essentially, these coverages fit like a glove! As an added perk, captives with premiums under $2.3 million may be Federal income tax exempt. Other business planning benefits come with owning a captive too…

Group and Association Captives, the Industry Jargon

In a group captive, the Law of Large Numbers, the variation around the mean observation declines. In other words, the average value gains predictive power.

Overall claim experience can be predicted with a higher degree of confidence for a group captive insurer than if a single organization's exposures were being covered. Reduced variation in loss levels allows group captives to assume greater retentions, a fact that will ultimately lower the long-run cost of insuring the group's risks.

In Plain English

What we described in our captive definition is that of a "single-parent." In the simplest terms, a single-parent captive refers to one business forming its own captive insurance company to cover its unique risks. But there are other types of captives too; one of which is called a "group captive." Group captives are formed when a group of people (or companies) come together to form a captive that each can own a little piece of. Some industry associations will form a group captive so that their members can benefit from the risk coverage.

A licensed insurance company owned by a group or an association, which participates in the risks of its members by reinsuring an admitted insurer offers the members considerable advantages including:

- The ongoing availability of coverages,
- Coverage flexibility,
- Pricing Stability,
- Risk Management and Loss Control Emphasis, and
- Support in Coverage Disputes.

There's one other perk to group captives that's really important to mention: businesses that share a particular high-risk can cover that risk with captive coverages. These are insurance coverages that are often hard to come by in the commercial marketplace. High-risk industries, like oil & gas, healthcare, coal mining, electrical, and construction could form a captive, and be covered if the unthinkable were to occur. Associations, including industry associations that have unique risks can also form a captive – If one member of the association has a claim, the funds inside the captive can cover their claim.

Favorable Loss Conditions, the Industry Jargon

When properly employed, the use of a captive insurance strategy can help businesses better manage insurance costs, control claims, and use the retained earnings in the captive to strengthen the risk financing mechanism. Favorable loss conditions solidify the captive's position as not only a risk management tool, but as a vehicle for better business efficiency.

In Plain English

When a business owner (or owners) pays their premiums to the captive and premium dollars exceed the cost of losses in a given year, the earnings are considered "earned surplus." It's considered a "favorable loss condition," as the money can be used as investment income and for various business expenses, such as equipment. It could also be paid to the operating company in the form of a secured loan, or as dividends.

Captive Domiciles, the Industry Jargon

For a captive to be economically feasible, it must operate in a domicile with an efficient and accessible regulatory environment. Legislation must be in place which facilitates captives as distinct from the regulations imposed on standard insurers. Each domicile has licensing and regulatory regimes that may or may not be focused on providing cost-effective services to its regulated entities.

In Plain English

Captives are highly regulated—and like most companies, have to operate under certain rules. The domicile, or jurisdiction where the captive has been formed, provides the regulatory oversight needed for the captive to be compliant. Whether they are onshore or offshore, issues like taxes, risk levels, claims, etc. are regulated by the domicile. Each offers its own set of requirements, making some domiciles more attractive for mid-market businesses than others. For example, Vermont requires companies to enlist the services of a Vermont-based captive manager. The state also requires that captive owners appear in-person for annual meetings.

On the contrary, Delaware has become a premier captive domicile, as it is continually creating a captive-friendly environment. Steve Kinion, Director, Bureau of Captive and Financial Insurance Products, said that "One of the attributes of domiciling in Delaware is that captive insurers can take advantage of Delaware's premier entity laws. No other jurisdiction integrates business and corporate laws with alternative risk transfer like Delaware." Delaware.gov reported that the state's sophisticated corporate laws, judiciary and financial infrastructure make it the preeminent jurisdiction for business. The captives that are formed there reap the benefits of better costs and administration of their insurance coverage. In fact, the Delaware General Assembly passed House Bill 218, modernizing Delaware law regarding the formation of captive insurance companies back in 2005.

The plain truth is that domiciles are springing up across the U.S. to take advantage of captives' surging popularity.

Reinsurance, the Industry Jargon

Reinsurance is a process whereby one entity takes on all or part of the risk covered under a policy issued by an insurance company in consideration of a premium payment.

In Plain English

Reinsurance is contract that allows for a transfer of risk. In laymen's terms, it is when an insurance company (an insurer) transfers all or some risks to another firm (the reinsurer) for a premium. Policy holders (insureds) needn't worry that some risks are being transferred from their insurance company to a 3rd party reinsurance firm. If, for any reason the reinsurer doesn't cover their part of a claim, your insurance company will still be on the hook for the entire amount.

Speculative vs. Pure Risk, the Industry Jargon

Speculative risk refers to the uncertainty about an event under consideration that could produce either a profit or a loss. The risk involved in situations that present the opportunity for loss but no opportunity for gain is referred to as pure risk.

In Plain English

Gambling. A not-so-tried-and-true business venture. These are considered speculative risks because the outcome could be either positive or negative. These types of risks are typically considered business risks and they're uninsurable. But, in the case of a pure risk, like the chances of having fire damage to your building, there is no opportunity for gain. These are generally insurable by an insurance company.

Turnkey Services, the Industry Jargon

A captive manager may promote turnkey service--the ability to offer a comprehensive package of captive planning services, typically provided on an a la carte basis via an outsourced firm. They may state in the fine print that: "Hiring an attorney is in the best interest of the business owner as we cannot provide legal or tax services."

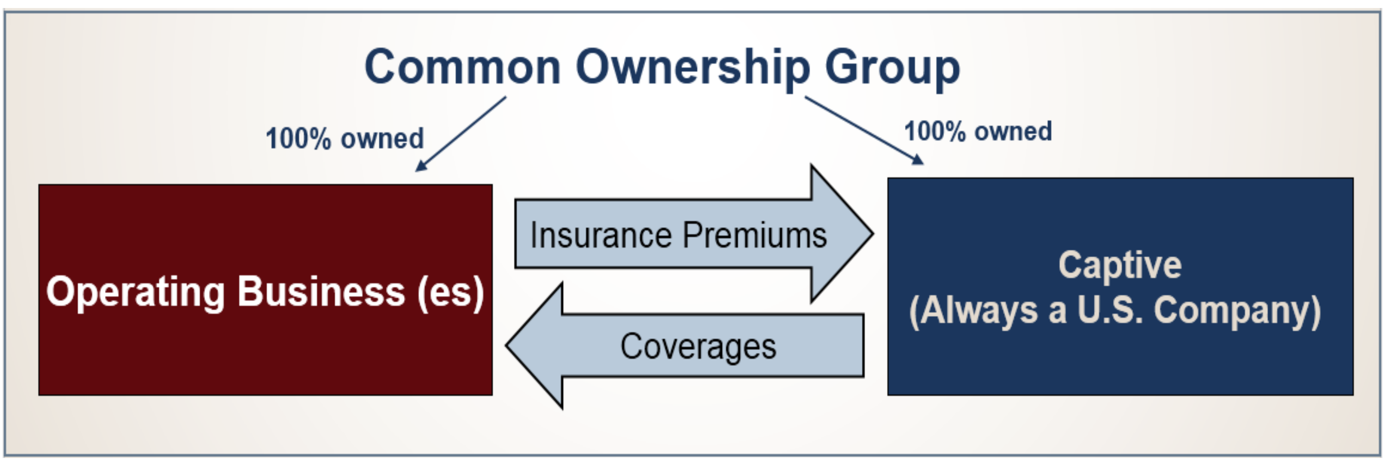
In Plain English

When a business owner decides to form a captive insurance company, he or she may be informed that they are receiving a turnkey service, aka, an all-in-one solution. If the insurance, tax, legal, and regulatory services are provided a la carte, then it is not a true turnkey service.

Operating a captive is complex and requires specialized skills spread over a number of disciplines. Captive managers shouldn’t draft insurance policies. This is generally the function of a senior insurance or corporate lawyer. They shouldn’t price policies, which is done by a property & casualty underwriter, having designations like ARM or CPCU. They shouldn’t act as the actuary (the person who provides industry risk information in the aggregate). Finally, they don’t purport to be responsible for state or federal tax issues, which is what a tax lawyer does. The formation and ongoing management of a captive must be overseen by experienced professionals that understand the insurance, financial, tax and legal aspects of the captive. A true turnkey service will have these services available for one flat fee and the proverbial “bait and switch” tactic will never enter into the equation.

Capstone Associated Services, Ltd. in affiliation with The Feldman Law Firm LLP offers a sophisticated captive planning solution which includes the tax, insurance, and legal professional services required to form and maintain a compliant captive insurance company. Tacking on hidden charges has never been part of our business practices. It is what was led Capstone to become the premier captive planning management firm for midmarket companies since 1998. It is what we stand for…in plain English.

Diagram: Ownership Structure of a Captive



About Capstone

Capstone Associated Services, Ltd. is the most integrated and comprehensive outsourced provider of captive insurance services for the middle market. Recognized globally for its award-winning turnkey approach, Capstone has in-house expertise to assist business owners in combatting risk and gaining greater financial efficiency through alternative risk planning.

Attorney-Led Captive Planning

For over 23 years, Capstone has supported mid-market businesses in the legal and regulatory processes associated with forming their own captive insurance companies in collaboration with lawyers, insurance professionals and certified accountants. Unlike many captive insurance management companies in the industry, our turnkey service providers **do not disclaim** tax and legal support. We have a proven track record for standing with our clients.

We work in alignment with our affiliated law firm, The Feldman Law Firm LLP, which employs experienced attorneys who specialize in corporate and business planning. Capstone leverages an award-winning, multi-disciplinary team approach. For one turnkey fee, we will retain and directly compensate all the players needed to analyze, design and implement an appropriate alternative risk strategy for your business.

Unmatched in the Industry

We're dedicated to providing comprehensive mid-market captive planning. Capstone and The Feldman Law Firm LLP have the expertise to carry out critical aspects of the planning, including insurance, tax, and legal. For over 23 years, no other captive service provider has offered the same level of support throughout the life of the captive.

The pitfalls of working with a captive insurance manager who doesn't have the right experience can be disheartening for any business owner who has invested time and money into a captive planning strategy.

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Many self-proclaimed captive managers have had only clerical and administrative experience.

They may work at home, with a P.O. Box listed as his or her office address. Although they may have graduated from law school, they take a bold, apathetic stand against helping clients work through tax and legal issues.

Their true market focus might be to gain commission on the sale of an insurance policy or to simply grow their assets. Often, their backgrounds are difficult to gauge online.

The benefits of managing business risks through a captive are fully realized when you're working with a captive planning firm offering true turnkey solutions. Capstone's reputation precedes it, with over 200 successful captives formed since 1998. Our attorney-led team goes beyond risk management—we're your partners in finance, tax planning, captive formation and management.

- Expertise in forming captives under IRC 831(a), 831(b), and 501(c)(15) for mid-market companies
- Expertise in risk management for mid-market manufacturing, construction, healthcare and other industries

Capstone provides captive insurance services to mid-market businesses across an array of industries. It is the **most comprehensive** alternative risk planning solution available.

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What's Included in Capstone's Attorney-Led Planning

- Feasibility study with independent, professional sign off
- Tax – design, structuring and ongoing monitoring of the planning
- Accounting
- CPA - independent audit
- Insurance & regulatory
- IRS tax controversy
- Policy drafting & coverage pricing
- Ongoing management
- And much more

Quick Facts About Capstone and The Feldman Law Firm LLP

Capstone is a standout with:

- 23+ years in business
- 200+ captives formed
- Expertise in navigating existing and new captive legislation and regulatory changes
- Recognition as a Top 20 Captive Industry Pioneer by *Captive Review* (2015, 2016)
- Recognition on the Power 50 List of Industry Experts by *Captive Review* (2014)

The Feldman Law Firm LLP has:

- 55+ tax controversies successfully resolved, including Tax Court cases
- 30+ years in business
- 200+ years of combined legal experience
- 115+ years tax law experience
- 7 attorneys on staff

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Industry Awards:

TOP CAPTIVE INDUSTRY PIONEER
2016 AWARD WINNER
Capstone CEO, Stewart Feldman

TOP 20 - CAPTIVE REVIEW RECOGNIZING
KEY PIONEERS IN THE CAPTIVE INDUSTRY

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