

Is a Captive Right for You?

Case Studies

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Is a Captive Right For You?

The decision to use a captive is unique to each business, business owner and their circumstances and objectives. In order to determine if a captive is right for you, you need to decide:

What do you want to achieve from the captive?

1. Stabilize Insurance Premiums – If you are looking to stabilize insurance premiums by shifting existing covered risks from a 3rd party insurer; you have to have sufficient premiums (usually over \$1 million annually) to realize sufficient savings to justify the cost, as well as have a low or manageable loss experience rate so that excessive claims will not erode the benefits.

An example of this is a Home Builders Association. They were experiencing rapid expansion and growth in their industry with a lot of new builders coming into the market. The new builders were not experienced and were increasing the amount of Homeowner's Warranty Claims being submitted to the carriers. As a result of the increased claims the carriers were raising the premiums to all builders. A group of experienced quality builders established a captive to provide Homeowner Warranty Coverage to the buyers of their homes. By utilizing a captive they stabilized the Homeowner Warranty Premium Cost in their operations and gave themselves a competitive advantage over the rest of their market.

2. Negotiation Tool for Lower Insurance Cost – Your current insurance policies are probably written by a single carrier, however a part of that risk is generally reinsured to a second insurance company. Risks are underwritten in layers. First there is a deductible that you bear. Second there is the risk that is covered by the company issuing your policy. The third layer is covered by the reinsurance company. The lower the layer of risk the greater likelihood of a claim (i.e. you pay up to your deductible first, then the issuing company, then only the claims in excess of these layers is covered by the reinsurance company. Since the risk of the lower layers is greater, their premium cost to you is greater. By utilizing a captive you can increase your deductible on covered risks and thereby reduce the premiums you pay to a 3rd party carrier.

An example of this is a sports equipment company, Equipco. Equipco is a family owned business with annual sales of about \$11m. The company designs sports equipment, outsources its manufacture and then sells and distributes the product.

Equipco has primary product liability coverage of \$1m/\$2m. Premium for this coverage was \$275,000 representing 2.5% of sales (up from 0.5% of sales just 5 years ago). The policy deductible had also risen to \$75k/\$450k. The company was also buying an umbrella policy.

The owners of Equipco are vibrant entrepreneurs, prepared to accept a certain level of risk. Indeed, their reasons for buying insurance are based, at least in part, on the requirements of resellers of their product. Frustrated by the increasing cost of insurance, Equipco's owners considered retaining significantly more risk. After review it was determined that it would make sense to establish a captive to insure that retention.

In 10 years the company had only experienced 12 minor claims mostly caused by customer misuse or misassembly. The total amount settled for these cases was \$70,000. A recent claim was more serious having resulted in severe injury after a fall. Although no product defect has

been found, a settlement for \$1m is expected. Equipco was facing a significant premium increase at its next renewal.

Working with Equipco and its existing insurance broker it was determined that:

A self-insured retention of \$500k was Equipco's preferred solution;

At renewal Equipco (after rate increases) would pay \$125k less in premium on this basis than if it did nothing;

Based on past experience, the premium saving for taking the self-insured retention and the cost of financing the existing \$75k deductible, a reasonable premium to insure the self insured retention would be approximately \$195k.

To derive greater value from the captive, we considered the potential benefits of insuring other risks not currently covered. Having experienced a product recall 5 years ago, the company was surprised to learn that product recall is an insurable risk and that it could also insure consequential losses such as business interruption, cost of re-establishing quality and recovering market share.

3. **Customize Coverage and Underwrite Exposed Risks** – Coverage with your captive can be customized to cover exactly what your business needs rather than what the outside insurance companies think all businesses need. Commercial insurance companies rarely offer highly customized insurance policies. You get what they want you to have. Some risks in your business may be so unique to your business that they are nearly impossible to underwrite in a mass market or to do so would be cost prohibitive.

An example of this is a medical laboratory business that had developed new and unique tests and reports that had become approved for payment by insurance payers and Medicare. Because of the new and innovative service and the lack of providers capable of such technology in the market place the reimbursement for their services was very good. The company was smart and realized that an advantage in technology only lasts a short time. In order to maximize their benefit from that technological advantage they had to expand rapidly and capture market share. One of the risks of rapid expansion in the health care industry is the potential change in allowable reimbursement for the service rendered. Insurance companies can unilaterally change their reimbursement for a service from \$100 to say \$60. If your business model for expansion is based on \$100 payment to cover the service and cost of expansion this drop in payment could be devastating. By utilizing a captive they were able to craft a policy that would cover this risk if their reimbursement went below the level needed to sustain the expansion and their operating cost in the period covered. Having this policy in place allows them to proceed with their expansion while minimizing the potential effect of regulatory change.

4. **Liability and Wealth Transfer** – Captives can be used to shift specific liabilities out of an operating business so they may be distributed and spread among multiple parties. Additionally, captives can be used to transfer wealth out of an operating business. If no claim occurs during the policy period the wealth is cleared of exposure and transferred to the owner of the captive via the surplus of the captive. This offers some potentially great advantages to the business owner, financial planner or estate planner.

An example of this is an industrial services company owner that had a very profitable business providing services to the petro-chemical industry. This business operated in an environment

that was ripe for many risks. If an event occurred the damages could be substantial and cost the business owner everything. Because of the potential size of some risks economical coverage was not possible from 3rd parties; however the owner wanted some degree of risk shifting and coverage. Additionally, the business owner had a substantial taxable estate and needed to start transferring some estate value to the next generation. A trust was formed and capitalized for the benefit of his children. The trust formed and capitalized a captive that contracted to cover some of the desired risks. The operating company paid tax deductible premiums to the captive for the risks transferred. The captive sat liable for those risks during the contract period. If no claims are made during the contract period the captives risk and exposure to those policies ceased and the premiums received became surplus for the captive. Since the captive is owned by the trust that wealth has been transferred out of the business owner’s estate and to the next generation in a protected environment.

5. Turning Risk into Profit – When used and managed properly, captives can be a means by which the business owner can turn risk management into a profit center. An example is a real estate brokerage, Cresco.

Cresco is a commercial real estate brokerage. Over a number of years it has built a network of approximately 600 broker/agents. Each of these broker/agents is an independent contractor that earns a commission on each property sold or leased.

For some time. Cresco has been retaining errors and omissions risks on these independent broker/agents. Each broker/agent retains a deductible of \$1,000 per year. Cresco charges each of them an annual E&O fee to provide coverage for the year. This fee is \$1,000 per agent. Cresco itself buys E&O insurance in the traditional market. Under the terms of this policy it retains a deductible of \$25,000 per occurrence with no aggregate cap. The premium paid for the policy is approximately \$60,000 per year.

Cresco formed a captive insurance company in order to formalize the underwriting program within the \$25,000 deductible. This captive has issued a deductible reimbursement policy to Cresco, citing each of the independent broker/agents as additional named insureds.

\$1,000,000/\$3,000,000 Traditional E&O Policy
\$25,000 per Occurrence Captive – Deductible Reimbursement
\$1,000 per Occurrence Agents’ Deductible

Regular actuarial reviews are done to establish the appropriate levels of pricing and reserves. Claims administration is handled by the commercial insurer within the terms of the traditional policy. A portion of the annual E&O charge made to each broker/agent is allocated between the captive and the commercial insurer. With approximately \$600,000 in E&O charges, the captive receives a premium of approximately \$500,000.

Annual claims to the captive have averaged \$66,000 apart from one year in which claims were 105% of premium. Having made an election to be taxed as a US domestic insurer and qualifying under §831(b) of the Internal Revenue Code, the captive pays no tax on its underwriting profit but is taxed on investment returns. The following table shows Net Income and Capital & Surplus in the first 5 years of operation.

	Year 1	Year 2	Year 3	Year 4	Year 5
Net Income	396,356.25	420,369.38	-47,702.08	472,121.20	499,531.35
Capital & Surplus	646,356.25	1,066,725.63	1,019,023.54	1,491,144.74	1,990,676.09

This captive program has allowed Cresco the following benefits:

- Combining all broker/agents' E&O coverage into one program with considerable administrative and cost efficiencies;
 - Building a fund for profit or future claims;
 - Providing a vehicle that gives Cresco flexibility in meeting future changes in the market.
6. Managing and Budget Operating Costs – All businesses have risks. The ability to plan for and budget them such that margins are maintained and operations uninterrupted are paramount to the success of a business. An example is a farming supply manufacturer, Farmco.

Farmco provides a range of essential products to farmers across the USA. Delivery is made by a number of independent operator/contractor drivers who haul Farmco's trailers around the country. To offset the costs of one-way hauls, the independent contractors arrange for return loads using Farmco's trailers. In return for the use of the trailer, Farmco receives a share of the return haul fee. Also, as part of the program, Farmco agrees to provide service for maintenance and breakdown on the operator's trucks.

In order to meet its obligations under this arrangement, Farmco had been buying mechanical breakdown contracts from a truck manufacturer for a number of years. The premiums paid for this coverage were significantly greater than the actual cost of repairs, which tended to be relatively stable, albeit subject to unusually expensive years particularly in very bad winters.

Farmco decided to establish a captive to insure this risk. It negotiated new costs of repair contracts with truck manufacturers to ensure the costs of certain common repairs. The premium that had previously been paid out for the mechanical breakdown contracts was now paid to the captive for a mechanical breakdown reimbursement policy. Now Farmco arranges and pays for vehicle repairs and submits reimbursement claims to the captive. The independent operator/contractors who had always contributed to the cost of the original mechanical breakdown program continue to contribute to the captive program on unchanged terms.

Premiums, at about \$275,000 annually are sufficient to cover the running costs of this simple captive and still produce an annual underwriting profit that has averaged \$50,000 over the 5 years during which this program has operated. The captive is exempt from taxes under §831(b) of the Internal Revenue Code. The initial capital required to establish this captive was \$100,000 and Farmco has no additional internal administering costs in insuring with the captive as opposed to insuring with the truck manufacturer.

Benefits to Farmco:

- Participation in underwriting profit;
- Investment of underwriting profit;
- Meet obligation to independent operator/contractors;
- Build fund to retain other risks in future or to reduce premium costs to preferred operator/contractors.