A TAILORED FIT

Matthew Howard and Ernest Achtien discuss the main considerations for businesses when forming an individualised micro-captive

The flurry of 831(b) micro-captive insurance company formations in recent years may lead some interested parties to "jump on the bandwagon" and speedily start up their own. While imitation may be the highest form of flattery, a prudent business owner will take a step back and conduct a reasonable level of due diligence prior to becoming an insurance company owner, regardless of what everyone else may be doing. Given recent discussions regarding the potential misuse of these captives, it's a good time to revisit the fundamentals.

When a business forms a micro-captive, the owners of the business commit to operating a legitimate insurance company that will provide unique or specialised coverage which may be unavailable in the traditional insurance market, or perhaps coverage that is cost prohibitive. From the outset, a responsible captive manager will ensure that its client understands that in order to create the best micro-captive possible, the captive manager will require the client's active involvement throughout the evaluation and start-up process. While there is no officially prescribed methodology for the formation process, this article will briefly describe specific steps that incorporate sound, captive insurance fundamentals, which help to ensure a micro-captive that will provide individualised risk protection.

Bringing everyone to the table

Forming a micro-captive can impact a business in multiple ways, including effecting changes in the company's risk management programme and its cash flow. Because of this, it can be very beneficial to involve all of the business's risk and financial advisers in the formation process from the very beginning. In particular, it's helpful to have the risk manager and insurance agent/broker involved in creating the captive risk management programme. When developing the structure of the micro-captive, it's key to keep in mind its limitations – it's a micro captive – a small insurance company limited to $1.2m premium and, as such, it will have limited capital and, therefore, limited use initially. The insured business should not necessarily expect to wholly replace its current commercial insurance policies. After the captive has been operating for a time and reserves are built up, it may then be utilised to insure a greater portion of the risk currently insured in the commercial market. By working with the risk manager and advisers from the outset of the formation process, a captive manager can recommend lines of coverage for the micro-captive that will supplement or support the business's current risk financing programme.

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Collecting the necessary information

In order to create a micro-captive that will provide individualised risk protection, the captive manager requires a comprehensive understanding of the insured business. Naturally, this means that the captive manager must gather substantial information about the business, including but not limited to:

- A detailed description of the business's operations;
- Number, type and location of employees;
- The business's current financial position;
- The business's corporate structure; and,
- Complete copies of all commercial insurance policies and other details of the existing risk financing programme.

Creating the captive risk management programme

Of course, the overriding premise for selecting the right risks for the micro-captive is that the captive meets the tax definition of an insurance company, i.e., there is sufficient risk shifting and risk distribution. The process of identifying lines of coverage for the micro-captive might begin by asking: "What does this business do and what would I want to protect if I owned this business?" Of course, most businesses

have already asked and answered this very question, resulting in many risks being addressed by commercial and/or self-insurance. However, there are some risks that are considered too expensive to commercially insure, and also risks that are simply too unique to find a suitable commercial insurance option to satisfactorily cover them. A micro-captive can provide the ideal foundation of a risk management programme to address such risks, and continual communication will often identify additional unique risks for future policy years.

Recently, after presenting a captive risk management programme option to a food distribution business, we engaged the business owner in discussion about its operations, focusing on any activities that expose the business to financial loss, in particular, those that appeared "uninsurable." The owner explained that whenever there is a power outage at its storage facility, a back-up power generation system must be run to prevent the food stock from spoiling, which is very costly for the business. We ultimately worked with this business to create an insurance policy that would cover the specific costs of running the back-up power generation system resulting from a power outage.

A micro-captive also allows businesses to insure large and small deductibles or self-insured retentions. One of our clients purchased a comprehensive commercial sub-contractor default policy. The policy had a $500,000 per occurrence deductible and a $1.5m aggregate deductible. We worked with the business to insure these deductibles in its micro-captive. Also, there will always be risks that are common to virtually any business, such as employment practices liability or perhaps directors & officers liability for example, and it may make sense to insure these risks, or a portion of them, in a micro-captive. Examples of other types of coverage that may be suitable for a micro-captive include:

- Product recall;
- Cyber liability;
- Terrorism;
- Pollution;
- Defence costs;
- Loss of key employee.

The actuary

Once lines of coverage are identified for the micro-captive it's imperative that an experienced and independent actuary be engaged to determine the price of premi-

ums for each line of coverage. Impartiality and independence are important because the actuary will be better positioned to calculate the premiums at arm's length using generally accepted actuarial principles. An actuary that is familiar with multiple industries is also invaluable, since micro-captives have widespread applicability. It's also helpful to work with an actuary that has experience working in various domiciles so that they can assist the captive manager to efficiently navigate a particular state's regulatory environment.

Domicile selection

Choosing an appropriate domicile provides yet another opportunity to ensure that all aspects of the client's micro-captive supplement and support its business. There are multiple factors that should be considered when choosing an appropriate domicile:

- **Reputation:** First and perhaps most important, is the domicile's general reputation. It should promulgate a fair and well-run regulatory environment and demonstrate a true willingness to work with its captive community;
- **Legislation:** Specifics of the legislation itself including capitalisation requirements, level of and maximum premium taxes, investment restrictions, discounting of reserves, and reporting and meeting requirements, should be closely reviewed;
- **Captive industry infrastructure:** Service providers including captive managers, accountants, actuaries and lawyers with captive expertise, and adequate regulatory resources should be dedicated to the captive industry;
- **Geographic location:** Geographic proximity to the captive owner can help to control travel costs to the domicile for meetings, etc.

Another critical consideration regarding choice of domicile surrounds domestic versus offshore. There are both onshore and offshore domiciles which lend themselves to relaxed business operations by the captive. However, generally, domiciling micro-captives offshore adds a layer of complexity.

Issues relating to the Internal Revenue Service (IRS) must be considered. It's certainly no secret that the US Government tends to view many offshore business operations as potentially suspect. This, and the unfavourable press generated by the few that have allegedly misused micro-captives, mean that it's quite possible that the audit rate for offshore captives making the 831(b) election will be higher than similar domestically domiciled captives. This, by itself is not an issue if the captive is formed and operated correctly, as there should be no issues from a tax standpoint. However, the inconvenience and cost of a federal income tax audit is an added friction.

Another issue involves the election of a captive to be taxed as a US corporation under IRC Sec. 953(d), which involves a closing agreement that commits the captive to a letter of credit or certain assets being made available to the IRS. This election is required in order for an offshore entity to be viewed as a domestic captive and be able to be taxed under Section 831(b).

Many future captive owners are enticed by the relatively low capitalisation requirements when forming a captive offshore. However, the IRS is of the opinion that there should be adequate capital, regardless of the domicile's minimum requirements, relative to the amount of premium paid into the captive. An acceptable ratio appears to be 4:1, premium to capital.

In conclusion, by adhering to the fundamentals of captive insurance and tailoring the micro-captive to the client's specific needs, captive managers and other financial advisers can create a micro-captive insurance company that is an integral part of the overall risk management programme, and will provide multiple benefits to the client's business.