The coverage tower

With a profusion of service provider contracts and policy documents, sometimes captive perils sit alongside the rewards. Josh Gold of Anderson Kill examines the thornier issues around captive ownership

For just about every risk manager these days, captive insurance is an option that is being considered if not already utilised. But with the options offered by captive structures come risks that many of those selling captive insurance products and services rarely broach with customers until a problem is at hand.

The problems can vary, ranging from fronting insurance companies over-reserving claims to captive manager conflicts of interest to regulators seizing collateral accounts of captive insurance companies when fronting insurance companies go belly-up. While none of these risks can ever be entirely eliminated, there are steps policyholders and their captive insurance companies can take to mitigate these perils.

Observing business formalities

Having the captive operate more like a traditional insurance company may minimise certain problems later under certain captive scenarios. Some policyholders, for instance, use captives to fill lines or layers (or pieces of layers) of coverage where underwriting capacity is either scarce or cost-prohibitive.

When this happens, policyholders would be wise to have their captive insurance companies duly prepare and deliver insurance policies, even where the primary or lead underwriter has yet to accomplish this task. Some insurance companies and insurance markets are notoriously poor at delivering (accurate) insurance policies in a timely fashion.

Policyholders who have captives participating in a tower of coverage at an excess layer should not wait around for the primary to prepare and deliver the policy. If the primary fails to deliver the policy in a timely manner and an insurance claim hits, the captive is put in an awkward position of figuring out the final terms of coverage after the claim. Some insurance companies, both below and above the captive's position in the tower, may try to exploit this situation to the policyholder's detriment.

Not only would it seem advisable to observe formalities by actually preparing captive insurance policies, it also makes sense to handle and pay claims in the ordinary course (even when the net effect is to transfer money between related entities) under a delineated procedure whereby the captive receives and settles claims from the policyholder.

Such niceties not only help support the notion of a separate legal entity, but it may also be necessary to actually have the physical transfer of money to deal with arguments by excess and co-subscribing insurance companies that money actually be paid from the captive to exhaust the policy and trigger coverage at other layers within a programme.

Additionally, if there is reinsurance standing behind a captive insurance policy, then it may be required by the reinsurance company that the captive actually (physically) pay or transfer money to the policyholder in order to trigger the reinsurance company's coverage obligations.

On a related note, it is helpful to have a sound claims handling protocol that the captive can utilise. Reinsurance companies may try to argue that there is collusion between the captive and the policyholder in paying a claim (that is ultimately reinsured) since the captive insurance company is literally a 'captive'.

While these arguments may be unfounded, reinsurance companies may make them nonetheless – especially where there are no established claims handling practices and procedures that the captive can point to. As such, where possible, it may help address such accusations (warranted or not) by having in place a claims handling function that is somewhat insulated from the normal risk management and legal function of the policyholder that owns the captive.

Conflicts of interest

While policyholders and their captives may wish to establish some space between themselves for purposes of claims that are reinsured (in whole or in part), policyholders do have to be mindful of whom they select to manage their business.

There are many captive managers that may have independence from the actual policyholder which owns the captive, but have no (or only superficial) independence from the insurance industry. There are many captive management companies completely tethered to and therefore completely reliant upon insurance companies and reinsurance companies. When push comes to shove, these firms cannot take an adverse position against the insurance industry where a claim or transaction is disputed.

As such, policyholders and their captives must strike a careful balance between setting up the captive as a functioning insurance company but not handing over the reins to a manager or administrator beholden to adverse interests. Such a scenario can lead to a messy and expensive dispute where the policyholder and its captive create multiple adversaries. There are some very good and truly independent captive management firms. It is worth taking the time to find them. The rest should be avoided.

Fair contractual terms and recourse

Fights involving claim managers and administrators for insurance companies can manifest themselves in various forms, including disputes over the payment of claims and setting of reserves. For example, some captive insurance companies have found themselves embroiled where an administrator working for a fronting insurance company has set reserves in a manner that the policyholder views as imprudent and unreasonable.

If the administrator setting the reserves is not truly independent of the insurance company (or is otherwise is bounded by certain contractual provisions set forth in the fronting insurance company relationship), the policyholder and its captive can find themselves in a very problematic transaction that is difficult to untangle and resolve.

In fact, the inflation of claim reserves may 'coincidentally' arise at the very time the policyholder is considering using a new insurance company for its fronting needs or other business requirements. Setting inflated reserves may have the effect of either tying up existing collateral for several years or calling for the infusion of additional assets from the policyholder to collateralise its 'obligations'.

To guard against this risk, policyholders should seek some measure of protection in the underlying contracts that spell out the obligations and rights of the parties pertaining to claims handling, the setting of reserves and the resolution of disputes should the parties disagree on the reserving methodology. The administrators, TPAs and claims managers should be thoroughly vetted to best ensure they will be fair and even-handed in carrying out their tasks.

Many contacts drafted by insurance companies provide a one-sided formula for setting reserves and triggering collateral requirements. Policyholders should spend the time necessary to balance contracts with fair and reasonable terms that delineate the formula to be used and the manner in which actuarial disagreements over reserve setting and claims handling will be resolved.

While scrutinising the actual terms underpinning these obligations and rights at the point of purchase, the policyholder should make sure those terms provide the policyholder with some recourse if it believes that collateral is being locked-up improperly to secure inflated claim reserves or is otherwise being utilised and dissipated for the improper handling of claims.

Another problem is posed by some forms of collateral agreements circulated by insurance companies that fail to prescribe that funds or assets are 'collateral' posted by the policyholder. Further, some forms of agreements being circulated fail to recite when and for what purpose the collateral may be used or drawn-down upon.

This problem goes beyond just a fight with a fronting insurance company. For example, if a policyholder posts collateral in favour of an insurance company that later enters liquidation or (in the US) state insurance department rehabilitation, a state insurance commissioner or department may seek to seize the collateral as part of the insurance company's estate or general assets to satisfy other creditor claims.

Generally speaking, taking certain steps before a contract is signed or before a claim is received can avoid problems later or, at the least, position the policyholder and its captive to have stronger assertions should a dispute arise. CR

COLLATERAL DAMAGE

Last year, the New York Insurance Department in a published opinion from the Office of the General Counsel gave policyholders added incentive to identify their collateral clearly, concluding:

The view that collateral should not be included in the general assets of an insurer undergoing liquidation or rehabilitation is generally consistent with the practice of the New York Liquidation Bureau, which has indicated to the Department that, in situations where there is a bona fide agreement between a policyholder and an insurer that specifically characterises an asset as collateral and not part of the general assets of the insurer, such collateral will not be included in the general assets of the insurer's estate in liquidation or rehabilitation.