

Showing you the ropes

Phillip England of Anderson Kill & Olick and Randall Beckie of Frontrunner Captive Management outline the function of a captive insurance attorney for *Captive Review*

THE LEGAL process for forming a captive in the US generally can be broken down into the following four steps:

1. Form a legal entity (a corporation or, in some states, also possibly a non-corporate entity) in the state that has been selected as the captive's domicile.
2. Appoint officers; adopt articles of incorporation and by-laws; contribute minimum required capital; issue share certificates.
3. Submit captive insurance licence application, which generally includes a business plan, designations of a captive manager and other service providers, and biographical information about the captive's officers.
4. Following receipt of a captive insurance company licence, the captive will commence insurance business by issuing one or more policies of insurance or reinsurance in keeping with its business plan.

Steps 1 and 2 are routine matters for most law firms that would fall in the category of 'legal and corporate governance' costs in a captive's start-up budget. Although performing these steps does not require a licence to practice law, it is nevertheless prudent and common to rely on an attorney for steps 1 and 2.

Regarding steps 3 and 4, captive insurance company formation historically has been spearheaded by captive intermediaries or captive management companies

(whether owned by an insurance brokerage house, a commercial insurer or privately by the management company's principals). Amidst the advisory talents offered by risk management consultants and other types of captive insurance intermediaries, where do attorneys fit in with captives?

In a captive formation proposal, often there is a chart that portrays the captive management services company as the quarterback of team efforts provided by the tax adviser, the attorney, the actuary, the insurance broker, the auditor, and captive's officers (usually executives of the affiliated insureds). Practice varies (and so does perception) as to who actually governs the captive's business activity. Everyone wants the part he plays to be seen as important. However, mutual enthusiasm for the captive can fog an understanding of how its objectives should be ordered and its achievements evaluated.

Attorneys traditionally wear two hats: that of a technician (re: tax law and contract law) and also a business adviser (focusing on corporate governance). As business adviser, an attorney alerts management to the strengths and weaknesses of the captive's service team, its internal controls, and the suitability of its strategic agenda. He is a sounding board for management. At his best, an attorney helps motivate everyone on the captive's service team to excel and be recognised. In Italian there is a word – consiglieri – for an attorney in the role of a trusted general counsel; a voice of objectivity within the management's inner circle. In these various roles, an attorney's best use



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to a captive is to prevent or troubleshoot potential problems – to show the ropes to the captive's stakeholders.

Attorneys as tax advisers

US captive insurance taxation has become sufficiently common knowledge that captive intermediaries and captive managers who are not tax professionals may be able to give a captive's owners 99% of the insurance tax awareness that is needed. The problem is that the 1% of captive insurance tax understanding that is beyond common knowledge can make or break a



captive arrangement. In his capacity as tax adviser, an attorney should be equipped to point out that definitional requirements for captive insurance depend to a large extent on the forum of controversy resolution. Most taxpayers would opt not to go to court to settle a tax dispute. However, a taxpayer's right to go to court – and sometimes the threat of actually doing so – might be in some cases parlayed into a favourable resolution at the IRS examination or administrative appeals level.

There are wide gaps between the views of the IRS and the courts. For example, the notion that 'risk distribution' requires multiple insureds appears to be a firmly established IRS position, whereas Tax Court judges historically have been divided on that issue. At one point the Tax Court majority disagreed with the multiple policyholder requirement, and at no point has the Tax Court embraced the multiple policyholder requirement by its own reasoning. Instead, it is the 6th Circuit that seems to have adopted the idea that risk distribution requires at least a few insureds, based on precedent in a life insurance risk pooling case – where the multiplicity of insureds was simply a given, not an issue that sheds much light on the meaning of 'risk distribution'. Mindful of the diversity of opinion on whether multiple insureds (and how many) are required to comprise an insurance arrangement, many captive arrangements have been composed from fewer insureds than the IRS may call for. In such situations, addressing the potential for tax controversy is an endemic part of the taxpayer's strategy, like it or not.

Among different kinds of tax advisers, tax attorneys have the most tools for managing the potential for tax controversy. A tax attorney can rattle the saber about settling an issue in court and, if necessary, follow through. More fundamentally, tax advice from an attorney can be provided under attorney-client privilege, which can be useful to preserve a taxpayer's appearance of preparedness to defend an inter-

pretation in court even if as a practical matter the taxpayer would be more inclined to negotiate a settlement with the IRS.

A captive that is a member of a consolidated group generally needs a tax sharing agreement – especially if it is intended that the parent, not the captive, will bear tax interpretational risk; all aspects of the arrangement constitute insurance. Also, a tax sharing agreement can be one of the means by which a captive distributes a portion of its earnings to the parent. A tax sharing agreement is a contract, usually drafted by an attorney.

Policy contract pitfalls

Once a captive enters into a reinsurance contract (in contrast to a direct insurance contract with operating affiliates of the captive), the captive becomes exposed to the hazards of interpretation of reinsurance contract law. Reinsurance litigation involving captives is becoming more common as the captives proliferate. Most of the litigation stems from situations where a captive is trying to collect from reinsurers. Although litigation is less common between a captive and a ceding company (often called a fronting company), a fronting arrangement is a reinsurance contract with all the legal pitfalls that may pertain thereto.

A captive generally wants to control the cedant's decisions about whether to contest claims and how to settle claims. However, as the fronting company has primary liability for claims, it generally does not want to be beholden to the captive. A claims cooperation clause in the reinsurance contract may be an important tool for the captive, at least if the fronting company will accept it (not always the case). The right to control investigation and handling of a claim may become a point of contention where a fronted captive programme lays off risk to the reinsurance markets. The reinsurers may want to resist a claim that the fronting company wants to settle, leaving the captive in a quandary: if the captive fails to present the claim to its rein-

surers, it could be considered to exhibit a lack of good faith, which could cause the captive to lose reinsurance coverage if the claim is ultimately paid.

Where a captive assumes a book of business from a fronting company, the fronting company has an incentive to bias conservatively the valuation of losses borne by the captive, thereby increasing the captive's required collateral. In one recent controversy, a workers' comp captive in Vermont sued AIG on grounds that AIG forced the captive into rehabilitation for six years because AIG's loss estimates were in excess of the captive's estimates, thereby inflating the captive's collateral requirements.

Issues for a captive to consider in drafting a fronting agreement may include:

- Handle claims in such a way as not to prejudice the fronting company's or captive's ability to minimise the value of the claim or maximise recoveries through subrogation;
- Insert a claims cooperation clause to require the captive's acquiescence as a condition of admitting its reinsurance liability and, failing that, define a claims investigation procedure that would demonstrate good faith;
- Determine the manner of appointing loss adjusters;
- Choose jurisdiction of law and jurisdiction of dispute resolution (which may be different);
- Anticipate the selection of a reinsurance arbitrator or mediator.

Often the drafting of reinsurance contracts is left to an insurance broker, captive manager or commercial insurer. A prudent practice would be to involve the captive's attorney in contract drafting – not only for insurance contracts but for service contracts as well.