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Captive Insurance Companies:
Going to Oz—The Culture Shock

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An American business that self-insures by forming a captive insurance company is in for a culture shock like Dorothy experienced in Oz, but without a happy ending. The tornado will hit when claims-paying time comes.

There is a big difference between being a policyholder dealing with insurance companies and owning or renting a captive. Putting a captive between the policyholder and real insurance transforms the policyholder into an insurance company. The treatment the former policyholder—now insurance company—receives from insurance companies and reinsurance companies is entirely different.

Unabated Growth of Captives

The growth of captives has continued unabated. Two hundred new captives were formed in 1996, and more states are allowing businesses to set up captives. Legislation signed into law in New York in August 1997, authorized captive insurance companies providing property and casualty insurance company for a parent company and its subsidiaries. Maine allowed captive insurance companies to set up shop beginning on September 1, 1997. Vermont is already the home of 297 captives with Hawaii, Colorado, Tennessee, Georgia, Delaware, and Illinois each having less than 50 captives.

Forming a captive can have peculiar consequences when disputes arise. Recently, when a deputy sheriff served papers on a defendant captive insurance company, he drove to the captive's address, which was also the address of the plaintiff! To reach the defendant on the telephone, one must dial the plaintiff's main switchboard! The case, *General Mills Inc. v. Gold Medal Insurance Company*, pits the huge food processor and manufacturer against its captive insurance company in what has been called the first case by a parent company suing its single-parent captive insurance company for insurance coverage.

A Shocking Scenario

As a warning to those who do not buy real insurance from a real insurance company, consider the following scenario:

Barney and Barney (B & B), an insurance broker, advises the risk manager for electric switch maker, Jones Electric Co. (Jones) of Germany and New Jersey, to self-insure. Jones' biggest customer, Sears, requires Jones to have insurance for products liability to protect Sears. B & B tells Jones to set up a captive insurance company in Bermuda, "Jones Electric Insurance Co.,"that will "issue"an insurance policy for Jones to satisfy Sears.

Sears is not pleased, because Jones Electric Insurance Co. has little capital. B & B assures Sears that this is no problem, because Jones Electric Insurance Co., the captive, will buy reinsurance from Friendly Reinsurance Co., which is well known and well capitalized.

An electrician is killed, and his family brings a $10 million lawsuit against Sears. Sears turns the claim over to Jones Electric Insurance Co., which stalls by saying, "Wait until we get the money from Friendly Reinsurance."Friendly, it turns out, is not so friendly: it will not pay. Jones Electric Insurance Co. brings a claim against Friendly.

Friendly will contend that Jones Electric Insurance Co. did not disclose to Friendly Reinsurance the nature of its business nor the significant risks in the electric switch business. Every risk manager knows this is absolute nonsense. Not so in the reinsurance context. The duty to make the reinsurance company aware of the risks is on the captive. The roles have been reversed.

Friendly Reinsurance Co. never asked Jones Electric Insurance Co. about the risks involved. Accordingly, Jones Electric Insurance Co. never disclosed the risks to Friendly. Jones Electric Insurance Co. did not reveal the risks to Friendly. Since the risk manager is accustomed to being a policyholder, there was no realization that the utmost good faith standard governs when the transaction involves reinsurance. The risk manager had a duty to tell even if Friendly did not ask. Friendly seizes on this nondisclosure to avoid paying the claim, and United States Supreme Court precedent supports Friendly's denial of coverage.

The Duty to Disclose

A century ago, the United States Supreme Court held that a ceding company, the company purchasing the reinsurance, had an absolute, unqualified duty to disclose all material facts to the companies from which it brought reinsurance and that a violation of that duty, even if unintentional, voids the reinsurance. The original insurance company, in this case Jones Electric Insurance Co., owes a duty of utmost good faith to the reinsurance company.

To illustrate, as an ordinary policyholder, Jones Electric does not need to disclose anything to an insurance company if it is not asked. The duty is on the insurance company to ask. The situation changes dramatically when Jones becomes an insurance company. As an insurance company, Jones Electric Insurance Co. must disclose everything to the reinsurer, Friendly, even if it is not asked. In effect, the captive is the guarantor of the knowledge of the reinsurance company. The established law regarding reinsurance companies and ceding insurance companies is countercultural to those who are not accustomed to being insurance companies. The role reversal results in a massive shift in legal obligations which creates confusion that leads to litigation.

If a reinsurance company rightly or wrongly concludes that a ceding captive insurance company has not met its duty to disclose, it can deny the claim. The end result is that the reinsurance is nullified. The litigation system is structured so that by denying a claim, the reinsurance company gains the time-value of money and the likelihood that the claim will be settled for less than its full value. The policyholder must contend with the reinsurance company's lawyers, and simultaneously defend endless allegations of fraud by the claims adjuster. Whether in negotiation or litigation, reinsurance companies win by saying "no."

Confusing Holdings

Litigating is especially risky because the courts are just as confused as the policyholders about the disclosure standard in reinsurance dealings. The inconsistent holdings in an insurance company versus insurance company case, *Compagnie de Reassurance D'Ile de France v. New England Reinsurance Corp.*, 57 F. 3d 56 (1st Cir. 1995), exemplify this judicial confusion.

In *Compagnie*, the reinsurance companies agreed to reinsure New England Reinsurance Corp. (NERCO). NERCO claimed that heavy losses were covered by the reinsurance treaties. The reinsurance companies disagreed and sued NERCO. The reinsurance companies claimed that the insurance treaties were procured by fraud. A federal trial court in Boston agreed with the reinsurance companies and found that NERCO had not disclosed material facts to the reinsurance companies. A United States Court of Appeals vacated that finding in a decision that should give some comfort to policyholders who decide to become insurance companies.

How much comfort remains to be seen because the opinion in *Compagnie* is wrong. The court noted, "Without first being asked by the other party, one would not expect defendants to volunteer a plethora of details on their proposed underwriting practices."*Id.* at 80. The law of reinsurance is contrary and captive participants must be warned of and aware of the fact that the utmost good faith standard applies, and that nondisclosed facts will result in the nullification of the reinsurance. Since self-insurance (non-insurance) frequently involves captives and reinsurance, *Compagnie* is good news for policyholders such as Jones Electric.

Buy Real Insurance

Policyholders can avoid travelling to Oz if they continue to buy real insurance from real insurance companies. Paying more for real insurance is better than paying less for non-insurance. Those who do take a chance and try to self-insure using a captive and reinsurance to provide real insurance coverage will realize they should have stayed home in Kansas. ■

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