Captive corporate governance and claims handling

Corporate governance issues should be considered before the decision to set up a captive is made, according to Isaac E Druker of Anderson Kill & Olick

Governance issues should be factored into the initial decision to establish a captive and should be revisited systematically and periodically once the decision to go ahead is made. Similar issues arise in both the public company and privately owned context, but the response to those issues will vary as a function of the different contexts. In the broadest sense, the governance issues relate to director- and officer-responsibility for appropriate due diligence and balanced risk-management decisions, at both parent and captive insurance company level. When the captive is organised, a significant component of those decisions relates to the selection and scope of coverages. Thereafter, monitoring of claims handling under those coverages is crucial, with a view to the impact on the affected constituency, employees, customers, and affiliates, for example. The question then becomes: within the established cost parameters, is the captive appropriately fulfilling its duties to the insureds?

When formation of a captive is put on the agenda

The provision of adequate and appropriate insurance coverages for the parent company and the corporate group should ultimately be a matter for serious review by the board of directors of the entity which is evaluated in the market. From a 'best-practices' perspective, for publicly traded companies, inclusion of insurance matters in the portfolio of a specific director with responsibility for review and regular reporting to the entire board over a lengthy time period would be advisable. This would assure that key decisions, such as whether to establish a captive, substitute existing or add new coverages as a primary, or to act as a reinsurer, receive proper scrutiny, along with operations. In fact, a similar process, if a less formal one, should be followed in the closely held company as well.

Particularly in the public company context, the process at some point should be guided by legal counsel, presumably outside counsel, expert in captive formation, tax planning and implementation, working in concert with accountants, actuaries, insurance brokers and captive management consultants. Wide-ranging and open discussion is to be encouraged. Preserving its confidentiality by way of attorney-client privilege can in principle be achieved by having counsel engage certain of the advisors; this can be crucial in the event of subsequent litigation, or tax or regulatory proceedings. The entire process should be carefully documented, to demonstrate scope of due diligence, questions raised and dealt with, and, finally, exercise of prudent judgment by the parent's directors.

There is a lengthy checklist of items to consider, including: provision of coverages either unobtainable or too costly in the commercial markets; financing of retained risk resulting from high deductibles; the proper role of tax planning in choice of coverages and in operation; group volume discounts in purchase of coverage; group-wide risk-management programmes; deferral of current taxes; impact on union relations caused by conversion of benefit plans to apparently self-insured status; customer response to utilisation of the captive for service and warranty programmes, for example, now dependent on the company's solvency; cost of initial capital and reserves required by the regulators; and the annual cost of operation, including that of out-sourced services, and regulatory charges. These, and other items, would all be factors in the comprehensive cost-benefit analysis.

The decision to go forward is followed by the selection of jurisdiction of incorporation and of appropriate directors and senior management of the captive. Next comes the design of

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upstream reporting systems as to both operational and financial matters, which for publicly traded companies should comply, as necessary, with disclosure and internal control requirements of the 1933 and 1934 Securities Acts, as well as the Sarbanes-Oxley Act of 2002.

Governance issues at captive level

The governance issues facing the captive board are different from those of the parent board, although they are to some extent overlapping ones. The scope of director oversight at captive level will vary in relation to the publicly held or closely held context, and also as a function of size of operation, and sophistication and elaboration of parent-management structure. Existing management and staff in a parent's insurance department or its CFO's office, or even experienced new hires, could be engaged as employees of the captive to perform tasks with which they already have substantive familiarity: reviewing or implementing captive operation, and/or interfacing with outside advisors and third-party administrations (TPAs) for areas not conducted in-house. On the other hand, TPAs might be engaged by the captive to conduct all management and claims handling functions. However the captive is staffed and supported, its operations must be kept separate from that of its owners, and particularly where an offshore captive is involved, tax planning must be a focus.

Whatever those choices, it is vitally important to distinguish clearly the separate lines of reporting and accountability. From a governance perspective, the board and senior management of the captive may be viewed as having to perform a somewhat difficult balancing act, for several masters. As part of the corporate family, the captive is not immune from parental pressures to meet both financial and operational targets. When claims are made, it must respond to affiliated or unrelated insureds as well as third-party reinsurers. It is accountable for investment and management of captive assets. It is subject to the laws and supervision of the insurance regulators of its state or country of incorporation.

All of this is, in practice, less perplexing for captive boards than may first appear, similar to the role played by the board of an operating subsidiary in an industry subject to pervasive regulation.

The tasks before the captive board comprise of at least the following:

1. Provide coverage comparable to that already in place or new coverage that at least meets industry standard.
2. If services are to be outsourced, review the credentials and performance history of proposed TPAs.
3. If the captive board is free to choose its own investment management services, perform a similar review.
4. Assure full disclosure and transparency for upstream reporting, internally and up the ladder to the parent, with systematic, periodic operational and financial reporting.
5. Routinely evaluate loss exposures, loss reserves, nature and rate of claims, handling of claims, and utilisation of stop-loss, tail and reinsurance coverages.
6. Engage an audit of the captive by an outside advisor, such as legal counsel, at one to two year intervals, for an update on the adequacy of policies and procedures for operations and systems.

Governance and claims handling issues

The quality of claims disposition should be a central concern of the captive board, as well as that of the ultimate parent. Arguably, the captive board is faced with an incipient conflict: On the one hand, as steward of a provider of either or both primary insurance and reinsurance, it must be concerned with the care and professionalism exhibited in examining and processing claims, whether from insureds or fronters/primaries. There may, however, be an institutional or experiential tendency toward overly strict policy interpretation, to enhance profitability and preserve capital. On the other hand, particularly where the captive is the primary, the parent and affiliates may strongly desire adequate responsiveness and suppleness vis-à-vis the insureds, which may include, in addition to themselves, a number of other valued constituencies both within and outside of the corporate group, such as employees, sub-contractors or customers.

The board of the captive, and later also that of the parent, may be involved in the question whether to settle or litigate, particularly when a claimant contests the outcome reached either in-house or by the TPA. Where the captive is the primary and its solvency or that of its parent might at some point be in question, the board may be concerned with the reaction of the third-party reinsurer, against whom recourse could be sought: will it require additional capital, letters of credit, guaranties or supporting trusts to collateralise the captive's claims obligations? In general, the manner of disposition of claims – not merely losses paid, in relation to value of claims made – must be a crucial area within the captive board's purview. Although responsibilities of the captive and parent boards are exercised from differing perspectives, as a consequence of their different locations on the corporate ladder, instituting sound governance standards at the time of captive formation, and maintaining them, pays obvious dividends. CR

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