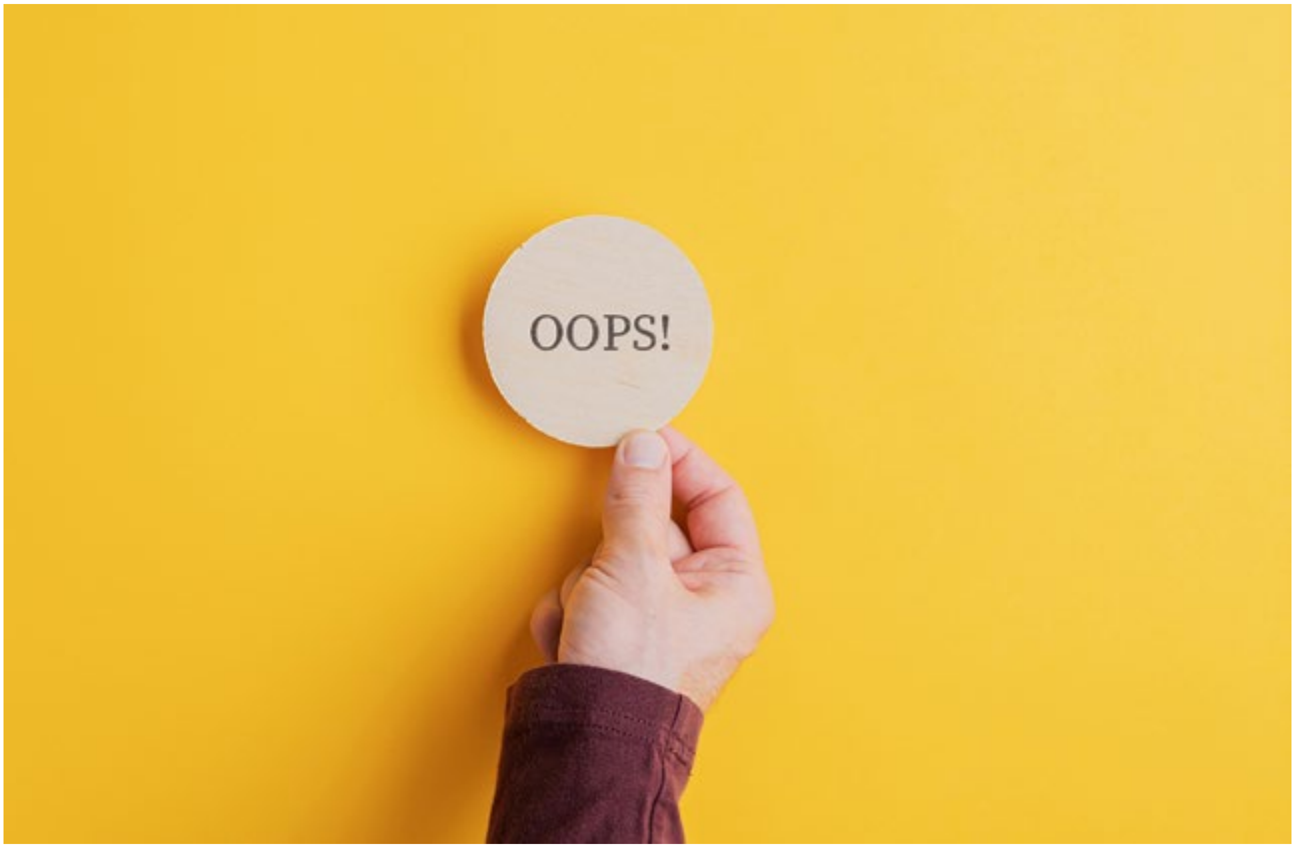


COMMON MISTAKES PROSPECTIVE CAPTIVE OWNERS MAKE

Written by Karrie Hyatt

As there would be entering any new type of business, prospective captive owners have a lot to learn. Even with guidance from their service providers, new captive owners still take missteps. The most common mistakes they make are not understanding that a captive is an insurance company, that good governance takes work, that not every domicile is the same, and that a captive investment is for the long-term.

However, with instruction provided by experienced service providers, prospective captive owners can avoid the pitfalls these mistakes and misconceptions entail.

CAPTIVES ARE INSURANCE COMPANIES

Many prospective owners begin the process of starting a captive with both misleading information and little knowledge about owning an insurance company. The most common mistakes that prospective owners make at the very first stage of starting a captive are that they are interested in forming a captive for the wrong reasons, they don't understand that they will be owning an actual insurance company, and they aren't knowledgeable about insurance business models, practices, and processes.

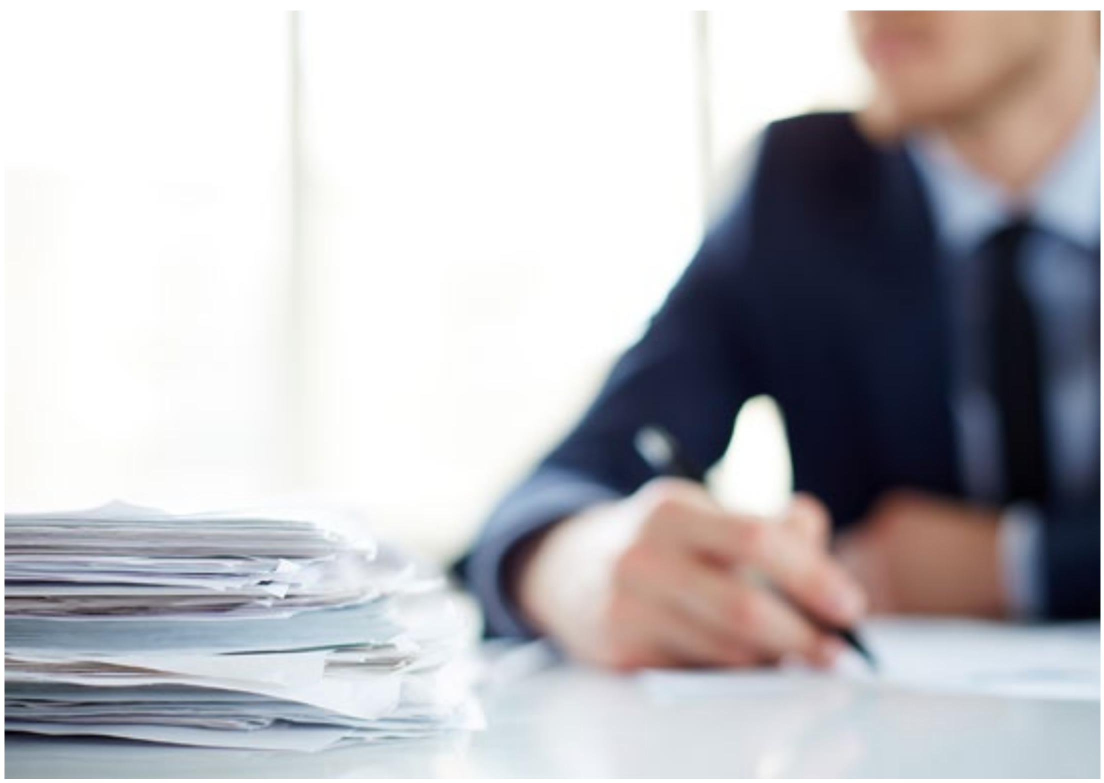
When a company comes to a captive manager to start a captive, Les Boughner, chairman of Business Insurance at Advantage Insurance Inc., finds that "[We provide] a very thorough education for all sizes of captives … and there is a steep learning curve in some cases."

For any start-up captive, there will be a lot to learn to understand the in-and-outs of managing an insurance company—regulatory requirements, risk management, coverage available for different types of risk, and other minutia that a consumer of traditional insurance doesn't have to know. This holds true particularly for Enterprise Risk Captive (ERC) start-ups whose owners may not have any experience with self-insurance.

Managing expectations is a key issue when captive managers begin working with companies wishing to start a captive using the 831(b) tax designation. They come to the table with the idea that forming an ERC is going to save them money on taxes or other business dealings, but they don't understand how or why.

According to Boughner, "The majority of people forming [ERCs] have been given false expectations by people that promote them. It ranges from flagrant tax abuse to just ignorance. It's very easy to form a captive, the challenge is structuring it properly for tax purposes. [ERC] owners need to understand, it's not just forming an insurance company, it's owning an insurance company."

He continued, "Whereas if you're dealing with a traditional captive, generally they have been self-insured—particularly for workers' compensation—and they now want to put an insurance wrapper around their reserves because it's financially a lot more efficient to do it that way."



According to Stephanie J. Mapes, director with Paul Frank + Collins P.C., "From the legal perspective, our education role surrounds the formation and structure of the captive, including the tax position the captive may take, which differs of course depending on many factors, including whether or not the parent is a non-profit entity. Most of our captives have sorted this out before even hiring their local law firm. Others have not, and that can be a learning curve that requires some lead time."

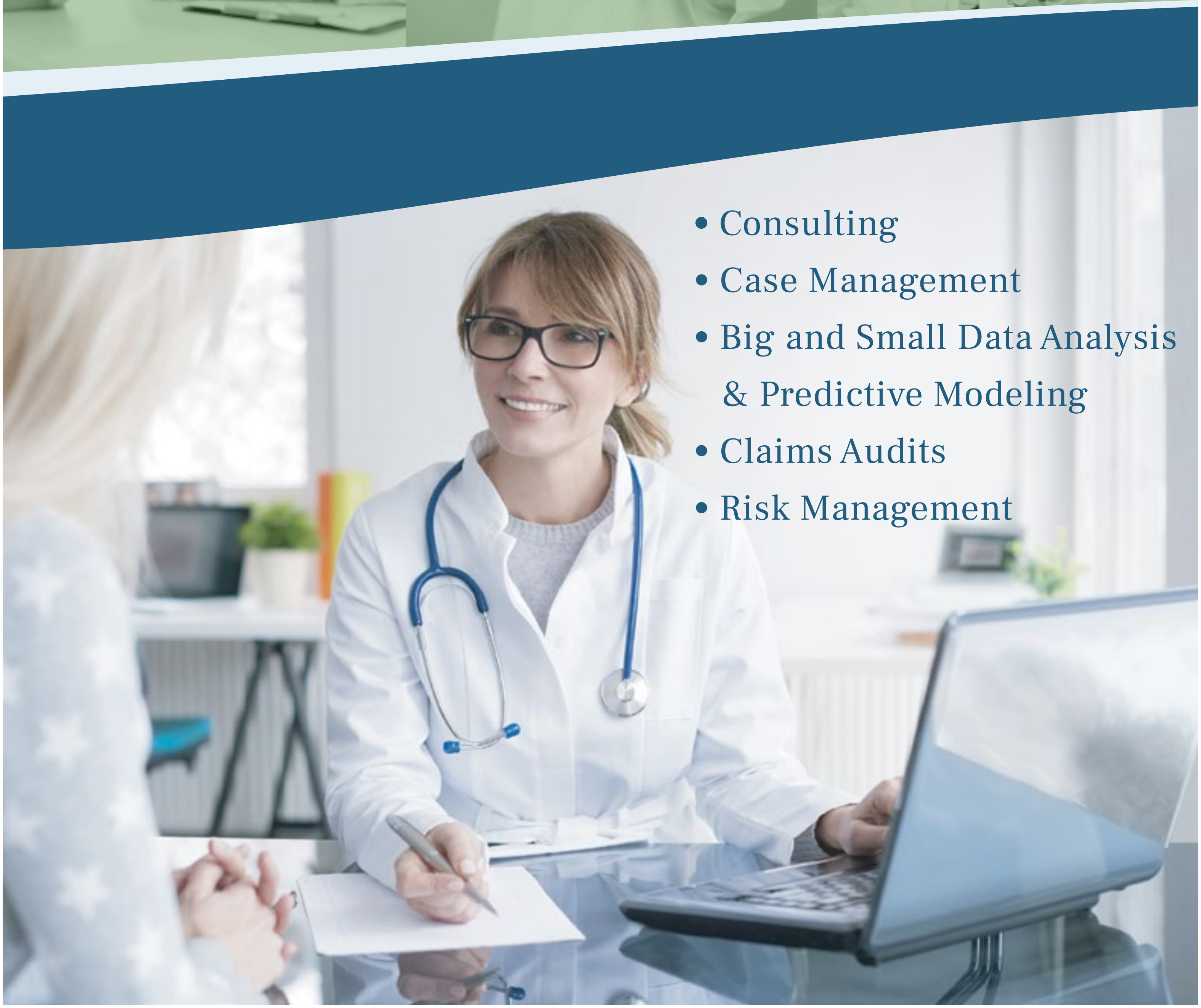
"For some of our smaller and less experienced captives and cells, it can be difficult to get them to remember that their captive or cell belongs to them," said Mapes. "The decisions they make about funding the captive are all about where their money resides. Either at 'home' where it can be readily deployed by the parent, or in the captive to fund for that rainy day."

"We also educate on board governance, which often involves gentle reminders as to 'which hat' a board member is wearing at any particular time," Mapes continued. "The parent/insured hat? Or their captive hat."

As ERCs are the fastest growing segment of the captive sector, captive managers and attorneys specializing in captives find they have to explain that owning a captive means owning an insurance company. Which means making risk financing decisions about funding, capital, risks, and allocation—things that many business owners are not familiar with.

DOMICILES ARE NOT ALL THE SAME

With so many captive domiciles to choose from, prospective captive owners can be overwhelmed with choices. It may seem to them that one domicile is the same as another, so they choose a domicile that is conveniently located or has the least expensive terms, but this leaves out many considerations that new captive owners should be looking into.



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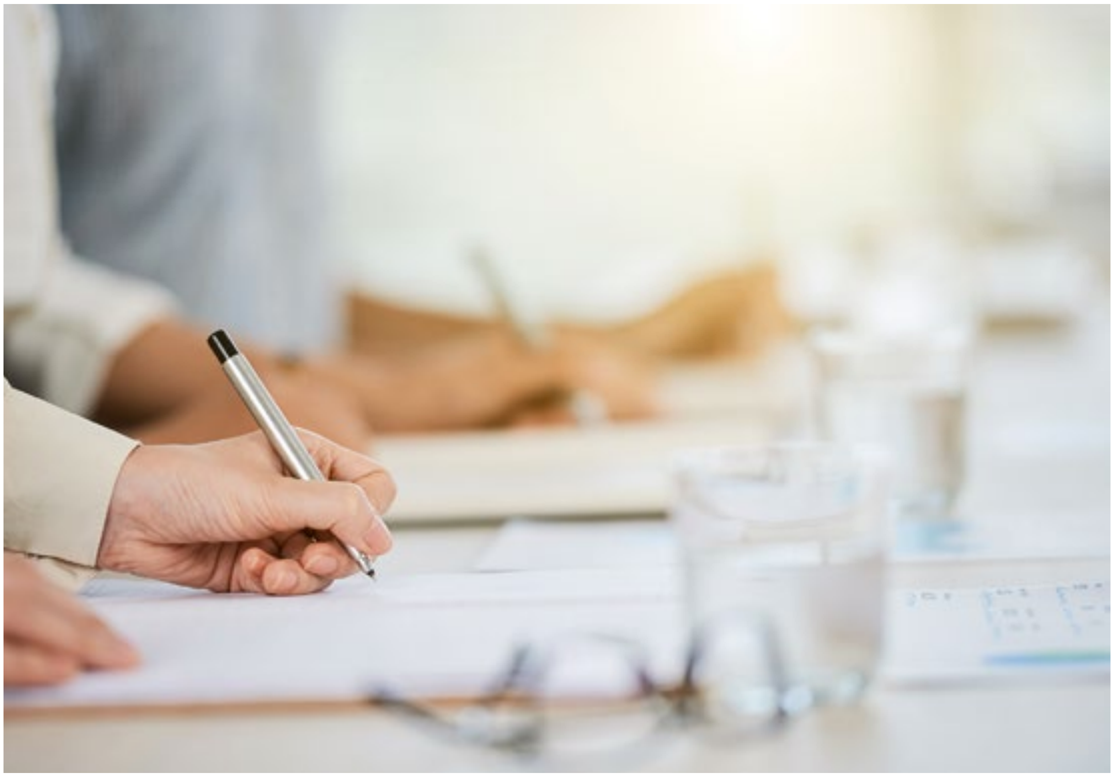

"They have to understand that they are getting into something serious and that it's a long-term commitment," said Boughner. "I wouldn't say they are not willing to invest for the long-term, I just think they don't realize that they will be investing for the long-term."

The benefits—other than saving money—are not always readily apparent to new captive owners. This is why education plays such a large part of getting a captive up and running. "Once you've completed the education and the captive has been operating for a while, they become extremely engaged in it and they look forward to the annual meeting and look at it as a very positive experience. I would say that once new captive owners understand and are committed to getting the proper structure, they become enthusiastic supporters of the captive," said Boughner.

"My best advice is to choose a well-established and well-respected domicile for your new captive," said Mapes. "The folks in these domiciles, including Vermont of course, are the best.... They are experts in their field, accessible, and they know how to walk that fine line between being a good regulator and allowing the captive to serve the objectives and interests of the parent company."

For Boughner, as a captive manager, he urges new captive owners to look into three or four different domiciles. "We encourage them to actually visit with the regulators because then they get can get a feeling about how the regulator works and can be confident that that domicile can handle their business. I can tell you, even if a regulator says they understand the business, you will quickly get a sense that they are not comfortable with the business your bringing to them. If they are very comfortable with that business, you'll see that through their enthusiasm."

CAPTIVES ARE FOR THE LONG HAUL

Just as some prospective owners have trouble grasping that a captive is an insurance company, they also have trouble understanding that captives are not an investment that they can easily divest in a few years. Common mistakes that companies looking to form a captive is that they don't understand that it's a long-term investment, they don't define multi-year objectives and goals, and they don't see risk management as an on-going venture.

Another question Boughner often gets in the initial stages of opening a captive is how will the owner be able to close the captive—indicating that they are not thinking of a captive as a long-term investment. Bougher said, "The thing that I find is that you routinely get the question of 'how do I shut it down or when do I close it,' but once they understand and begin to use it, they never shut it down unless they sell the business."

What it comes down to, according to Mapes, is that once "Insureds own their own risk, the incentives are clearly there to understand loss trends and loop these back to risk management and quality control." Prospective captive owners may come to the table with little understanding of using captives as a risk financing mechanism and have a lot to learn. However, that's where experienced service providers can help.

"Many [captive professionals], like me, have been in this industry for over 30 years," said Mapes. "We don't let that experience go to waste. We make sure all of our clients benefit from that and we often keep them from making mistakes. In fact, that is part of our job. We lead and educate our captive owners, and if a new client comes along that is forming a captive for all of the wrong reasons, we let them know."

After many years working with captives, Boughner still enjoys working with new clients. "Captives are a fun business, once new captive owners understand what the captive is doing, they really enjoy getting involved." ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: www.karriehyatt.com.