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Captive Governance in a Post-Enron World

Editor's Note: Corporate governance has finally made it into the lexicon of American captive owners and risk managers, despite being an international concern for nearly a decade. **Monte D. Jahnke**, senior member with the law firm of Kerr, Russell, and Weber, PLC, in Detroit, presented this subject at the June International Captives Congress (ICAP).

Captive owners are facing an emergence of corporate governance standards because of the political visibility arising from several recent events: the current interaction of globalization and its attendant economic forces, corporate attempts to locate offshore for tax purposes, and the avowed crisis in American corporate governance. This powerful mix will impact captives licensed onshore or offshore, single parent or group programs, and heterogeneous or homogeneous writers.

The most likely initial impact may be on single parent programs, as their publicly traded parents grapple with intensified regulation and stakeholder scrutiny. This theme will cross over to group programs as well, and could prove even more intense for that sector due to the often disparate and varied interests, locations, and markets group programs routinely serve. The common, transcending theme will be fair and equitable treatment of stakeholders and accountability to increasingly attentive regulators and market monitors.

Globalization

Globalization has overtaken the provincial. Dominant control of markets by a few major players (even the United States) is a fond memory in most respects. Given globalization, it is no wonder that the Organization for Economic Cooperation and Development (OECD) and its Financial Action Task Force aggressively pursued their 1998 agenda, attacking perceived tax havens and other allegedly abusive practices of certain governments worldwide (see *CICR* September 2002). By June 2002, 32 governments, including the principal is-

land insurance venues, had signed compliance undertakings, and many had initiated legal and regulatory reforms to avoid blacklisting by the OECD.

Such reforms and the ongoing dialogue all emphasize a form of transparency: the openness of information from one government to another and to other interested parties showing legitimate needs to know. Transparency is one of the common globalization themes many scholars and pundits argue must be embraced by governments to survive. Mature systems depend on it. The example of the historical and growing efforts of the U.S. Securities and Exchange Commission (SEC) are often held

out as examples, as evidenced by current U.S. reforms which rely greatly on the role of the SEC.

Many well-known American companies have considered moving their legal situs offshore for tax reasons. At the same time, insurance buyers have continued to pursue captive insurance alternatives in some of the same offshore domiciles. Together, they raise the unwanted specter that these domiciles need further regulatory oversight for transparency.

In addition, corporate America's wrenching loss of credibility from the Enron and other corporate scandals is raising further concerns. The growing importance of deployed captive assets in a world of transparency and disclosure will not allow captive owners and their managers, their domicile regulators, or their boards to continue comfortably as before.

Emerging Concepts

Anticipating these developments, captives must be prepared to step up their governance and operating standards. Remedial legislation and regulation will continue to push these central concepts:

- Increased board awareness and responsibility.
- Greater emphasis on internal audit and financial reporting, chiefly through the functions of audit committees or their equivalent.
- Heightened sensitivity to related party issues, such as actual or potential conflicts of interest, self-dealing, and excessive compensation.

Techniques to address these issues will continue to scrutinize financial reporting while emphasizing accountability for asset deployment.

Recent actions of the U.S. Congress and its regulatory agencies should dispel any doubts. The Auditing Accountability Transparency Act of 2002, hurriedly signed into law on July 31, puts the onus for balance sheet honesty squarely on executive and audit committee leadership. The SEC's moves to accelerate the filing of key quarterly reports (10-Ks) and expand the list of material events to require expedited public disclosure on forms 8-K demonstrate the imperative of real time transparency. That agency's requirement of CEO and CFO endorse-



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ment of financial disclosures and statements, and accompanying requirements of corporate procedure codes to enhance significant event awareness and financial reporting, are just a few examples of the level of scrutiny which will become the norm in U.S. corporate governance and regulation. Other bills of similar ilk remain before the U.S. Congress on shareholder rights.

Perhaps the vanguard law will prove to be the U.S.A. Patriot Act passed in the aftermath of September 11, 2001 (see *CICR* September 2002). At first glance, given the origin of the law and its title, this might not seem to be a concern for captive owners. Nevertheless, the Act portends regulations now in draft at the Treasury Department that will interpret the law's application to include offshore insurance companies. Anti-money laundering and customer disclosure purposes are the two key issues addressed by the Act. Island governments serving the captive community are already taking steps to comply with this and similar U.S. legal policies now present in tax treaties and other protocols.

The current sea change in governance and market trends worldwide and particularly in the United States could in fact enhance captives as a reasonable and market sensitive alternative to traditional insurance programs. More than passive acceptance will be needed. Deliberate prudent action with a long-term view of improving governance will be the best and most effective approach.

Recommended Initiatives

Everyone involved with captives can play an important role in improving governance of captives. Captive managers, their boards, officers, and service providers should work with regulators to improve captive governance techniques while preserving the efficiencies and flexibility of the captive model. Commitment to approach the issues, monitor the trends, and anticipate a constantly changing environment will be imperative. Following are some initiatives to consider.

Monitor International Trends. Keep track of the international regulatory and policy trends. The OECD's efforts (www.oecd.org) do not exist in isolation. Anticipate and learn how they are being supplemented and consider how they might impact captive regulators and your program. Some other voices in regard to general governance in-

clude the U.K.'s Turnbull Report and Germany's KonTraG (see *CICR* December 2000).

Track U.S. Trends. Understand and evaluate the increasing scrutiny of onshore stakeholders, such as publicly traded captive parents, overseen by the Securities and Exchange Commission (www.sec.gov). Rely on knowledgeable legal counsel to advise on this and U.S. taxation issues. Group captives serving publicly traded shareholder insureds should also do this as the issues may become more complex in a group model. Even where the stakeholders are private companies, the trends will be instructive as such regulation often trickles down to action by state and local regulators.

Coordinate with Parent Companies. Understand the implications of these governance changes for the entities with which captive results may be consolidated or reported. This can be as simple as coordinating your annual captive corporate calendar with the parent's earning release and securities reporting requirements. Generally, the captive should become part of an annual "forward agenda" of the parent or of the captive's principal owner companies.

Revisit and Revise Captive Mission Statements. This idea can be borrowed from the not-for-profit world and should not be regarded as so much window dressing or "feel good" writing. Particularly important for group captives with previously unaffiliated shareholder insureds, such a statement can provide focus and will generally help keep programs on target with appropriate flexibility.

Draft Governance Principles. Write down the captive board's "way of doing things." This should go beyond the usual generally worded articles of incorporation/association/bylaws typical in captive formations. Typical topics include director compensation; the use/development of agendas; how/when board committees are formed, charged, and heard from; and how board member performance is assessed. Governance principles can prove helpful to U.S. board members of companies formed and licensed under the British models so typical in offshore venues.

Establish Codes of Ethics. As the captive grows, consider the appropriateness of a code of ethics. Do related party transaction/conflict of interest situations need to be anticipated up-front in your program? What will the captive's policy be about

information requests of a sensitive nature? How should loans to shareholders or officers be handled? Will the determination of financial materiality of a given event be left only to auditors and counsel?

Clarify Reporting Lines. Assure that the captive project has a pipeline to the top of the involved stakeholder organizations. The size of assets deployed to captives is growing, and the ability to have key policy questions and vital information shared with senior owner management should be confirmed.

Strengthen Your Board. Consider the talents needed to make the captive successful. Assure that those talents are represented on or at least available to the captive's board. Captive board membership should not be chosen by default or just because the meetings might occur in an exotic place. These are increasingly important business programs: the independence, objectivity, and probative skills of their boards cannot be ignored. Non-executive board members are a must for captives now more than ever before.

Redefine the Risk Manager. Become a corporate advocate within the parent if you have not done so already. See below in this regard.

Know the Stakeholder's Office of Corporate Secretary or Equivalent. Large companies, particularly those that are publicly traded, have established secretarial functions that are very attentive to good governance trends and practices. Much can be learned from such sources. You might also see: www.ascs.org, the Web site of the American Society of Corporate Secretaries.

Know the Parent's Internal Audit and Investor Relations Departments or Equivalent. These offices deal with shareholder relations in large companies. As such, they are a good source of information about single parent situations and how to deal with the type of issues which, by analogy, might become relevant in group captive settings.

Stay Current. Captives are usually licensed and regulated by a jurisdiction other than that where the parent or shareholders are domiciled. Take time to monitor its pronouncements and news:

- Bermuda: www.biba.org; www.roc.bdagov.bm; www.bma.bm

- Barbados: www.lowtax.net
- Cayman: www.cimoney.com.ky
- Hawaii: www.hawaiicaptives.com
- Vermont: www.bishca.state.vt.us
- Any number of publications from government and commercial sources, including *CICR*

Establish Meeting and Other Governance Mechanics. Work with the captive's managers and other service providers to plan effective meetings. Board and committee agendas and support material should be published in advance. To the extent possible, substantive resolutions on material points should be predrafted. Group captives in particular should rely on careful shareholder disclosures and documentation in light of anti-fraud laws, and all of this should be periodically updated.

Be Prepared and Timely. Demand timely reporting and preparation for conducting captive business. This should specifically apply to support from service providers, but is equally import for board members themselves. Captives often make decisions related to millions of dollars. A jumbled and untimely approach to such matters must be avoided.

Develop Key Committee Charters. To augment the standard governing documents created at licensure of the captive, articulate with specificity the function and responsibilities of each standing committee. For example, the authority and operation of risk management, underwriting, and finance committees will be important. Their efficient operation can make the captive more successful and its annual meetings and board meetings more efficient and meaningful.

Assure Continuity. Core board functions—such as underwriting, risk control, investment, and executive committee leadership—benefit from continuity. Seek board members willing to serve for meaningful time periods, yet preserve the ability to keep these groups fresh and probative.

Buy Directors and Officers (D&O) Coverage. Single parent and group captives alike can benefit from solid D&O liability coverage. This may not be as critical for single parent programs as the fi-

nancial risks are, generally speaking, consolidated with the parent. But it might provide a comfort level to the onshore parent and a source of funds if liabilities arise. Group captives should seek such coverage because the interests of shareholders may differ and can create disputes about their relative rights that can implicate board and officer liability to the shareholders.

Backstop Your D&O Coverage. Once coverage is in place, assure that the governing documents of the captive allow indemnification of officers and directors for liabilities related to their roles as such. This can also be done by board resolution, but having it in the governing documents is preferred.

Enable Responsiveness. Functioning in an atmosphere of transparency does not mean that all confidential information about a program is suddenly public knowledge. Managers should, however, work with counsel to know the boundaries in a

given domicile and to anticipate responding when/if relevant information is requested.

Plan Ahead/Propose and Dispose. Being a director means just that—a fact often lost in today’s world of celebrity CEOs. Captive boards, like other corporate boards, must avoid the pattern of being updated on an after-the-fact basis about critical decisions made by a few or without consultation. Boards should be regularly updated on the proposed initiatives of the captive and its strategic direction. Key policy directions and changes, material expenditures, budgets, and trends should be standing topics on board agendas. Executives and managers will then be in a position to do best that which is their inherent role: execute.

CICR comment: We first addressed corporate governance in our lead article in December 2000. That article reviewed many of the corporate standards initiatives undertaken around the world over the past decade. ■