

## Innovation at Work: Employers Creating Their Own Captive Insurers

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In today's crippled economic and changing healthcare environment, businesses (both publicly-held and privately-owned) face critical challenges. They must preserve, manage and grow their precious capital and, at the same time, effectively manage their business risks, including, for example, the risks associated with their employer-provided health insurance plan and other benefits. These needs conventionally have been handled separately: capital planning and management typically have been conducted as a financial function separate from the risk management and human resources ("RM/HR") functions. In other words, capital solutions and RM/HR solutions typically have enjoyed a "siloed" existence. Moreover, RM/HR solutions traditionally have involved a combination of purchased insurance in the marketplace and retained risk or self-insurance (for example, the deductible liability on an employer-provided health insurance plan).

Some businesses, though, have taken a nontraditional, innovative approach to meeting these critical capital and RM/HR needs, especially in the current environment. This innovative approach is interdisciplinary. It taps the unique synergy of developing a captive risk management strategy in the healthcare and employee benefits space – a strategy which utilizes many of the exportable captive insurance, governance, business entity, asset protection, tax, trust, capital management, regulatory, financial and risk management benefits that the State of Delaware offers (and which are collectively called "the Delaware advantages"). It is a customizable strategy which helps to preserve, manage and grow financial capital and to manage effectively business risks in a cost-effective and often tax-advantaged manner. Businesses across the country are increasingly turning to this innovative approach to develop their capital and RM/HR solutions.

Let's examine how this innovative best practice works. Assume an employer is interested in pursuing a less expensive strategy for its employer-provided health insurance plan and its errors and omissions liability. The employer and its consultant carefully analyze the available options, testing the metrics and feasibility of different alternatives, and finally determine what would be an optimal solution. That optimal solution involves the employer's establishment of its own captive insurance company which will cover (a) the employer's deductible liability on its employer-provided health insurance plan and (b) the

employer's errors and omissions liability. The captive insurance company will be organized and licensed in Delaware and will be "serialized" (which will be explained below) for the two types of transferred risk.

In this strategy, the employer and consultant decide to increase the level of the employer's deductible under the plan, thereby having the plan's coverage attach at a higher level and lowering the employer's cost of the plan. By doing so, and having the new captive insurance company cover the risks of the higher deductible, the employer will save substantial costs – and preserve significant capital – as demonstrated by the independent feasibility study as part of the due diligence analysis.

The other leg of this strategy involves the employer's replacing its commercially purchased errors and omissions ("E&O") insurance with coverage by its new captive insurance company. This similarly will result in substantial cost savings for the business, preserving (rather than permanently expending to a third-party insurer) additional capital. The feasibility study, which recognized the employer's excellent record of no claim having been made under its existing E&O insurance policy, demonstrated that the employer can expect to achieve substantial savings in both the short-term and long-term by implementing this captive risk management solution.

What is this captive insurance company? And how does it benefit this employer?

**Nature of a Captive Insurance Company.** Captive insurance is a form of private risk transfer and coverage. Captive insurance essentially involves the transfer of specified business risks from an enterprise (here, the employer) to a separate, typically private, legal entity, the captive insurance company (the "captive" or "captive insurer"). The captive economically assumes those risks and is financially responsible for any losses resulting from the realization of those risks. The captive insurer, not the captively insured enterprise, therefore is responsible for payment of claims on those losses.

**Customizability for the Employer.** In our hypothetical, the employer transfers its high deductible liability risks and its E&O liability risks to its newly established Delaware captive insurance company. Just as most Fortune 500 companies are incorporated in Delaware but conduct their business operations in other states, so too can an employer organize and license its captive in Delaware to cover the selected risks of its business conducted outside Delaware.

The employer organizes its captive insurance company as a Delaware limited liability company ("LLC") and places its selected health plan deductible liability and E&O risks, respectively, in Series A and Series B of its new Delaware LLC. Series A and B are segregated divisions (called "series business units" or "SBUs") within the Delaware LLC captive. They are not separately incorporated subsidiaries of the LLC. This structural flexibility allows the employer to establish one or more series within its new Delaware LLC captive insurer without the need or expense of creating multiple standalone entities or subsidiaries. (Note that while this employer chose a serializable Delaware LLC for its new captive, the same serializability is available through Delaware statutory trusts and limited partnerships. In fact, Delaware is the only state which offers serializability for all three structures – the LLC, statutory trust and limited

partnership.) By utilizing this simple Delaware-advantaged structure for its new captive, the employer can establish simply one centralized governance (management) for the captive – which will be more cost-effective and efficient than having to establish two separate governance structures for two incorporated subsidiaries. The employer has the further option to engage an outside manager(s) to perform some or all of the administrative responsibilities for the captive, such as, for example, accounting, asset management, claims processing, regulatory reporting and reinsurance procurement and coordination.

**Business Flexibility.** The serialized Delaware LLC captive also gives the employer business expansion flexibility. If the employer wishes to captively insure additional types of enterprise risk (for example, risks for which it traditionally has purchased commercial insurance, such as property and casualty risk, or selected risks associated with a newly launched business line), it will have the option of using its Delaware LLC captive. In that case, the employer simply could create an additional series business unit within its existing Delaware LLC captive. That SBU would captively insure those additional risks.

**Tax Advantages.** The serialized Delaware LLC captive also provides state and potential federal tax advantages. As a licensed Delaware captive, the employer's new captive will be exempt from Delaware business income tax. As a serialized Delaware LLC captive, the employer's new captive will enjoy favorable state premium tax treatment. For Delaware premium tax purposes, this serialized captive (including all its distinct series) will be treated as one enterprise and, therefore, will be subject to only one \$5,000 minimum annual premium tax requirement (rather than subjecting each series to a separate \$5,000 annual minimum). Furthermore, Delaware caps the amount of payable annual premium tax for a Delaware-licensed captive, regardless of premium income growth.

Delaware also provides other state tax benefits to Delaware-domiciled captives. These include, for example, a cap on a captive's annual premium tax where the captive (which is not otherwise required to do so) employs a certain number of workers in Delaware. The world's largest captive, which is operationally headquartered and licensed in Delaware, enjoys this tax benefit.

The employer's serialized Delaware LLC captive also has the opportunity to benefit from various federal income tax advantages. Although the serialized Delaware LLC is a single legal entity, for federal income tax purposes each series (in our employer hypothetical, Series A and Series B) can be treated as a separate federal taxpayer, allowing each SBU to possibly qualify for favorable federal income tax treatment. For example, if Series A in our example (covering the employer's health plan deductible liability) is expected to receive not more than \$1.2 million in annual captive insurance premium, that SBU possibly may qualify for favorable federal income tax treatment under section 831(b) of the Internal Revenue Code. If it does, that Series A's premium income would be exempt from federal income taxation, thereby potentially saving that Series A up to \$420,000 in federal income tax (assuming an otherwise applicable 35% federal rate) – a preservation of substantial business capital.

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Finally, the employer paying the premium to its captive receives an income tax deduction for those paid premiums.

**Capital Benefits.** This captive risk management strategy allows the employer to cost-effectively access, preserve and grow its financial capital, while providing a desired RM/HR solution. Rather than permanently expend its capital to a third-party commercial insurer, the employer in effect recycles that capital to itself (and its owners) by utilizing its own, and less costly, captive insurer. If that captive's capital is managed well, and if the transferred risks and claims are managed well, that capital in effect can be returned to the employer over time in the forms of dividend distributions and claims payments. In addition, the employer's captive can directly access the reinsurance market, should it decide to reinsure any of its risks, at lower rates – another means of saving additional capital.

**Conclusion.** In short, a properly organized and well-managed serialized Delaware captive typically is more cost-effective, less expensive and potentially more tax-advantageous than purchased third-party commercial insurance and bare self-insurance. Through a customized captive, an employer can design a strategy which addresses both its capital and risk management objectives, including its RM/HR targets.

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