

# Best Practices in Alternative Risk Financing

By Greg Nowakowski and Jenna Simon

**F**or several decades, traditional methods of protecting against risk have shifted from the purchase of commercial insurance to new means of covering risks. These other methods are sometimes referred to as *alternative risk financing*, or *alternatives*, and typically include using a legal entity that assumes insurance risk from one or more entities.<sup>1</sup> These entities can take many different forms (e.g., captives, risk retention/purchasing groups, reciprocal companies, etc.). Understanding how these entities can be used for your clients to reduce the cost of insurance and better control their insurance programs can be a significant asset not currently utilized or even known by your clients.

## Use of alternatives

Alternatives first became popular in the healthcare industry but have expanded into a variety of other industries, including financial, construction, storage, agriculture, real estate, and technology. Regardless of industry and based on our experience, many different types of risk may be covered through alternatives, including builders, property, intellectual property, professional liability, general liability, workers compensation, directors' and officers' liability, products liability,

specialized risk (such as environmental) liability, and cyber liability, one of the newest and more complicated types of liabilities included in alternatives programs.<sup>2</sup>

Two primary advantages that alternatives provide are competitive premium rates and control over the insurance program. In addition, these programs can provide greater flexibility in how excess funds are ultimately used. Alternatives that bear risk, like captive insurance companies, also provide access to reinsurance markets, allow insureds to focus on the causes of their losses, and provide the freedom to make internal decisions about what and who is covered, just to name a few.

## Captive insurance companies

Captive insurance companies are the most known alternatives and have been around since the late 1970s. By definition, a captive is an insurance company created and wholly owned by one (or more) parent(s) to insure the risks of its owner(s) and, often, a group of affiliated companies.<sup>3</sup> The most basic captive arrangement is a *single-parent* or *pure* captive, where the owner/insured pays a premium to its captive in exchange for insurance coverage for certain risks.<sup>4</sup> Other more complicated captive structures exist, including multi-owner captives and *cell* or *protected cell* captives.<sup>5</sup>

## Is a captive right for a client?

How does a client decide if a captive is right? The short answer is simple: if the benefits outweigh the costs. However, the detailed analysis is more complicated, encompassing recommendations from experts in tax, claims and coverage, operations man-

agement, and captive legal consultants in a feasibility study that attempts to answer that question based on the client's specific needs. The feasibility study is the backbone underlying a captive's formation. It is essentially the measure that a company's owners and industry consultants will use to determine whether the benefits of a captive outweigh the costs, e.g., state and federal tax costs, domicile selection (more on that below), and program structure best designed for a client.

## Selecting a domicile

Domicile selection is a significant factor driving much of a captive's future operations, and one should always compare various aspects of possible domiciles in making an informed choice. Captives can be domiciled either in the U.S. (onshore) or in a foreign country (offshore). A domicile is the captive's place of licensure and the state or country that will have primary regulatory oversight over the captive.<sup>6</sup> Of the onshore domiciles, Vermont leads with 505 captives as of September 2018.<sup>7</sup> Vermont is often viewed as one of the most stable onshore domiciles with a long history of healthcare captives and reasonable regulatory flexibility. It was recently awarded the top U.S. Domicile for "excellence in captive insurance services" by *Captive Review Magazine*.<sup>8</sup>

Bermuda and the Cayman Islands are the leaders of offshore domiciles, reported to have approximately 739 captives at the end of 2017<sup>9</sup> and 699 captives at the end of September 2018,<sup>10</sup> respectively. Both Bermuda and the Cayman Islands passed captive legislation in the 1970s; in our experience and despite any potentially negative public perceptions associated with forming offshore,

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they are longstanding domiciles with flexible regulatory environments (although perhaps becoming less flexible).

Michigan enacted its own captive legislation in 2008 and currently has 23 licensed captives.<sup>11</sup> While still new, interest in forming Michigan captives continues to increase, in large part because of the expertise of the regulators. Michigan-based entities exploring alternatives that include a captive should make sure to include the state as a possible domicile.

### Captive formation and operation

In the ongoing operation phase, owners and industry service providers have other responsibilities to address, including the handling of claims and coverage issues; continued policy review; updates to organizational documents; domicile changes and changes in company structure (as needed); board and shareholder meetings; legal, regulatory, and tax updates; tax filings; regulatory and tax compliance; contracting in the reinsurance market; and operational disputes. The services and cooperation of these experts are essential to the captive's success. And in the event of a captive closure or merger, these same experts can help facilitate the transaction to protect the company's best interests. A number of factors should be considered, including:

- The overall goals of the program
- The industry segment
- Whether the entity/insureds conduct business in one state, multiple states, or internationally
- The current insurance program structure and desired changes
- The claim reserves and loss ratio histories
- The current and desired tax position
- Ease of program inception and ongoing maintenance
- Available initial funding (including funds available for service provider fees)
- Tolerance for various regulatory approaches

### Conclusion

Captives are not for everyone, and the decision to form one should not be made lightly or without careful consultation with the assistance of experts who can provide input from an actuarial, financial, and insurance brokerage/coverage perspective. ■



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### ENDNOTES

1. IRMI, *Glossary: Alternative Risk Financing Mechanism* <<https://www.irmi.com/term/insurance-definitions/alternative-risk-financing-mechanism>>. All websites cited in this article were accessed December 9, 2018.
2. For example, MCL 500.4603 allows a captive insurance company licensed in Michigan to "do any and all insurance authorized by [the] chapter except worker's compensation insurance, long-term care insurance, critical care insurance, personal automobile insurance, or homeowners insurance [...]." The permitted lines of coverage vary by state, and some states include a broader scope of permitted coverages (such as worker's compensation).
3. NAIC, *Captive Insurance Companies* (November 9, 2018) <[https://www.naic.org/cipr\\_topics/topic\\_captives.htm](https://www.naic.org/cipr_topics/topic_captives.htm)>.
4. IRMI, *What is Captive Insurance?* (August 8, 2018) <<https://www.captive.com/news/2018/08/08/what-is-captive-insurance>>.
5. IRMI, *What Is a Protected or Segregated Cell Captive?* <<https://www.captive.com/resources/captive-insurance-basic-information-index/protected-segregated-cell-rental-captives>>.
6. IRMI, *Captive Insurance Domiciles* <<https://www.captive.com/domiciles>>.
7. Vermont Dep't of Financial Regulation, *Directory of Captive Insurance Companies* (September 2018) <<http://www.dfr.vermont.gov/sites/default/files/List%20of%20Captive.pdf>>.
8. Vermont Dep't of Financial Regulation, *Vermont named top domicile for captive insurance services* <<http://www.dfr.vermont.gov/vermont-named-top-domicile-captive-insurance-services>>.
9. The Royal Gazette, *Bermuda signed up 17 new captives last year* (December 2018) <<http://www.royalgazette.com/re-insurance/article/20180207/bermuda-signed-up-17-new-captives-last-year>>.
10. Cayman Islands Monetary Auth, *Insurance Statistics Overview* <<https://www.cima.ky/insurance-statistics>>.
11. MCL 500.4601 *et seq.*; see also Michigan Dep't of Insurance and Financial Servs, *Michigan Domiciled Captive Insurance Companies* (June 2018) <[https://www.michigan.gov/difs/0,5269,7-303-13044\\_13199-403210--00.html](https://www.michigan.gov/difs/0,5269,7-303-13044_13199-403210--00.html)>.