Introduction

Defining Insurance

One of the biggest surprises in the U.S. Internal Revenue Code is that the federal government does not define insurance. To the government's credit, this is an example of good legislating because insurance transcends narrow definitions. Insurance is a sophisticated financial vehicle with infinite variations malleable to the world's evolving economy. It is best understood through the lens of risk management, as insurance is only one form of managing risk.

Classical risk management theory outlines five broad ways through which to manage risk:

1. Avoid the risk.
2. Mitigate the risk.
3. Retain the risk and deal with consequences later.
4. Transfer the risk.
5. Finance the risk in whole or in part.

Risk financing consists of a blend of transferring the risk to a third party to pay for the consequences of perils and retaining the risk by keeping funds on hand to manage losses. Various third parties provide risk financing, such as bondsmen, sureties, and insurance carriers.

There are two types of risks:

1. Speculative risks—risks with possibility of gain or loss
2. Pure risks—risks that only have downside

Insurance companies may only insure pure risks. Gambling and investing are risks, but because they have the potential for gain they are speculative and are not insurable. Consequently, insurance concerns the financing of pure risks.

The courts frequently opine on what transactions constitute insurance. In particular, the U.S. Tax Court spends a lot of time deliberating the definition. The Tax Court defined commercial insurance as "a mechanism for transferring (or shifting) the financial uncertainty arising from specific pure risks faced by one firm to another firm in exchange for an insurance premium."[1] The court's definition was based largely on a pair of expert witnesses who generally defined insurance in the following manner:

A) Insurance exists when the following elements are present: (1) economically independent decision makers who enter into contracts to reduce the economic consequences of pure risk; (2) the transfer of risk to an insurance pool that reduces uncertainty through the operation of the law of large numbers; and (3) equity capital committed to the pool to smooth out the consequences of adverse loss fluctuations.
B) An arrangement whereby individuals or firms transfer their exposures to loss, and premiums, into a common pool. Losses suffered by the individual participants are paid from the common resources of the pool.[2]

Central to both experts' testimony is that the concept of insurance is not just a contract. Rather, insurance is stated to exist upon the finding of certain elements. Essentially, insurance is an arrangement consisting of certain central practices. Further, each definition focuses on pooling risks. Insurance requires stakeholders to transfer risks to a pool of other risks, which reduces the exposure to any particular risk.

Given the ephemeral nature of insurance as a financial vehicle, U.S. courts have consistently declined to narrowly define insurance. Rather, federal courts, including the Tax Court, ultimately view an insurance transaction as (1) the existence of an actual insurance risk, (2) the presence of risk shifting, and (3) the presence of risk distribution and that the transaction should involve the notion of insurance

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1 AMERCO & Subsidiaries v. Comm'r, 96 T.C. 18 (1991).
2 *Id.*

in the commonly accepted sense.[3] Past and current courts opine that these criteria do not define insurance; rather, they provide the framework for testing whether a transaction qualifies as insurance for federal income purposes. Federal income tax is a paramount issue with insurance because insurance premiums are deductible under § 162 of the Internal Revenue Code. Each element of insurance constitutes a deeply litigated line of case law in the courts and these are explored in more detail in Chapter 2.

Insurance escapes a simple definition. It is tempting to blame our legal system for this mess. Were the difficulties of defining insurance only a function of Americans' overly litigious nature, we would suggest Shakespeare's solution to the problem.[4] Fortunately for the bar, the reason that insurance escapes an easy definition is due to its fungibility. Insurance policies are drafted to cover unusual, new, and exotic risks every day. As the capital markets develop new products so, too, will the insurance professionals adapt their risk management practices. This flexibility is the golden goose. The concept of insurance is limited only by our imagination. The courts and politicians are as ill equipped to define insurance as they are to dictate the wants and desires of the free market.

How Insurance Works

What is the price of risk? Insurance provides financial coverage for exposures. Carriers set premium rates based on the expected value of the risks covered by an insurance policy. Expected value is generally defined as the predicted difference between anticipated revenues and anticipated expenses.

Expected Value = Expected Revenues – Expected Expenses

The expected value of risk estimates the probability of a loss. This measurement represents a reasonable estimation concerning the threat of a peril to an entity.

Imagine a landlord with a $1 million property. The probability of a catastrophic tornado in northwest Georgia is 0.1% (one catastrophic

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3 Harper Grp. v. Comm'r, 96 T.C. 45, 58 (1991), *aff'd*, 979 F.2d 1341 (9th Cir. 1992). *See also* AMERCO & Subsidiaries and Republic Western Ins. Co. v. Comm'r, 96 T.C. at 38 (1991).

4 "The first thing we do, let's kill all the lawyers." William Shakespeare, The Second part of Henry VI act 4, sc. 2.

event per 1,000 years). The landlord has several ways to finance this \$1 million risk. He can secure a loan for \$1 million (let's assume at 2% interest), he can save \$1 million, or he can purchase insurance. Saving \$1 million takes a long time for most companies, and the interest payments on a \$1 million loan at 2% amount to \$20,000 annually. The landlord decides to call an insurance broker.

The landlord purchases a property insurance policy for \$1,000 per year. The insurance company collects total premiums from 100,000 other parties amounting to \$100,000,000 per year. Given the 0.1% probability of a tornado, the insurance carrier expects that 100 properties will file an insurance claim during the policy period. Assuming 100 companies file a \$1 million claim, the insurance carrier pays out \$100 million in claims while each individual company paid only \$1,000 in premiums. Everyone wins. The insureds win because they can finance the risk collectively for much less than retaining the risk. The insurance carrier wins because it can invest the premiums and earn interest on the reserves until claims are paid. In this perfect world, all profits are returned to the insureds in the form of claims.

Of course, this is not how the real world operates. Insurance is almost always mispriced. Carriers charge clients with good claims histories more premiums to make up for losses from bad insureds. Sometimes losses never manifest because of good luck or proper business management. And some carriers' transaction costs inflate premiums just to cover overhead costs. This is where captive insurance shines.

Assume now that the carrier is charging \$2,000 per policy instead of \$1,000. Assuming the same facts as before and a 0.1% probability of loss, the carrier is sitting on \$100 million of premium at the end of the year. The landlords could decide that they would prefer to keep that profit for themselves and create their own insurance company. They pool their capital and pay monthly premiums into the captive insurance company. At the end of the year, profits in the company are distributed to the owners of the company instead of the commercial carrier. This is the basic model of captive insurance.

This model can be bent in any number of ways. Perhaps one landlord owns enough properties and has enough capital to create a captive for his property coverage without any other landlords. Or perhaps the landlord decides that he wants to put general and professional liability into a captive insurance company to self-insure his property managers. Or perhaps he decides to reinsure a portion of his workers' compensation insurance premiums through his own company. Each of these variations will be covered in this book because they are common, profitable variations on the captive insurance model.

The History of Captive Insurance

If defining insurance is a challenge, then defining captive insurance is no easier. *Black's Law Dictionary* provides that a "captive insurance company is defined as a company that insures the liabilities of its owner. The insured is usually the sole shareholder and only customer of the insurer."[5] This description generally describes "single parent" or "pure" captive insurance companies but sheds little value on the vehicle itself. Captive insurance companies are financial vehicles that create economic efficiencies through the formalization of self-insurance within an affiliated group. Although the majority of captives are pure captives, as described in *Black's Law Dictionary*, there are also group captives, association captives, rent-a-captives, risk retention groups, agency captives, industrial insured captives, and more. Variations on captive structures grow as the alternative risk financing market adapts to the needs of the capital markets.

The earliest known usage of the term "captive insurance" dates to 1953 when the Steel Insurance Company of America was founded for the benefit of its parent.[6] The term arose out of the use of "captive" mines, which were mines owned by the parent company that sold their ore entirely to the parent.[7] Frederic M. Reiss, a property engineer, is credited with coining the term.[8] Because U.S. regulations made it difficult to set up captive insurance companies within the United States, the first captives were set up in alien domiciles. This largely explains why the captive insurance industry maintains such a large presence in smaller Caribbean domiciles as well as Bermuda.[9]

The Value of Captive Insurance

Captive insurance is the zenith of risk financing. Captives provide businesses the ultimate flexibility regarding coverage, claims, premium, and control, while further offering a bevy of valuable attributes such as lucrative dividends and innovative financing

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5 Black's Law Dictionary 926 (10th ed. 2010).

6 *See* Hugh Rosenbaum, *The Early Days of Captives (through 1984)*, Captive.com (2018), https://www.captive.com/resources/captive-insurance-history/before-1985 (last visited May 9, 2018).

7 *Id.*

8 *Id.*

9 *See* Shanique Hall, *Recent Developments in the Captive Insurance Industry*, comment to The Center for Insurance Policy and Research Newsletter (January 2012), https:www.naic.org/cipr_newsletter_archive/vol2.htm (last visited May 9, 2018).

techniques, and including but not limited to what is covered in the following sections.

Profit

The only reason to start a business is to make money. Properly run captive insurance companies earn profits. By underwriting risks and paying reasonable amounts of claims (through smart underwriting), captives can earn profit on their premiums. The first lesson of captive insurance profitability is to remember that captives generally provide coverage for risks that are already financed by a commercial carrier. By internalizing all or some of that risk, the premiums paid to the commercial carrier are reduced, while the captive retains the profits. In addition, the captive can secure excess and reinsurance to finance risk deemed unacceptable to the stakeholders.[10] In that sense, the captive retains the most profitable risk layer of the insured's risk profile.

In addition to pure profits, captives have been demonstrated to increase shareholder value.[11] A seminal study on captive insurance value concluded that well-managed captives "have an extremely high probability of generating value for their shareholders—even without favorable tax treatment."[12] The study occurred in 2007, before the tax deductibility of insurance premiums was wholly accepted by the Internal Revenue Service (IRS).[13] Regardless, the study's findings demonstrated that captive insurers operate with lower expense ratios than do commercial insurers and provide a new profit to the stakeholders. This confirms the axiom that captives result in lower and fewer claims with fewer expenses related to risk management in addition to adding shareholder value to the parent company.

Custom Insurance

Captive insurance companies can insure exotic risks. Traditionally, unique risks are presented to a Lloyd's of London syndicate for underwriting. The classic example is the athlete who takes out an insurance policy on his knees or fingers. These risks are commonly unavailable through commercial carriers and require specialized

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[10] Excess and reinsurance are covered later in other chapters of this book.

[11] Nicos Scordis, James Barrese, & Masakazu Yokoyama, *Conditions for Captive Insurer Value: A Monte Carlo Simulation*, 30 J. Insurance Issues 79-101 (2007).

[12] *Id.*

[13] *Id.*

expertise to craft the proper policy. With captive insurance, an athlete, sports agency, or sports franchise can create a unique policy insuring athletes' body parts. This flexibility is not limited to sports. Entertainers frequently insure legs, buttocks, or breasts, as they are valuable parts of the entertainer's persona and ability to generate income. Agencies, movie studios, or the entertainers themselves can self-insure against these exotic risks using a captive.

Obviously, sports stars and entertainers are not the only exotic risks in the market. New companies in unexplored industries, such as human commercial space travel or blockchain technology, may find a lack of qualified underwriters who can understand the risks of the company. Again, captives can insure that.

Entry Point to Insurance Industry

Captives can also provide a launch pad into the insurance industry. An association captive or risk retention group can create a viable competitor to the commercial insurance carriers and attract quality third parties to purchase the insurance. This means that entrepreneurs who are generally interested in founding an insurance company can safely enter the field without the risk of a traditional start-up.

Control

Executives want more control. Nothing gives more control over risk management than a captive. Many captive insurance programs provide stakeholders with absolute authority relating to the hiring and firing of defense counsel, settlement funding, and authority, as well as the final say regarding when to take cases to trial. Few things anger leaders more than watching insurance premiums rise because a commercial carrier settled a winnable case in lieu of trial. Captives can stop that from ever happening.

Reinsurance Markets

Direct access to reinsurance markets means that captives can act as large deductibles, with excess and reinsurance providing cover above a certain threshold. While there are many advantages to negotiating directly with reinsurance carriers, the fact that a captive provides the ability to create larger deductibles creates the possibility of cheaper overall insurance programs. This is because there are fewer commissions to be paid and because the third-party carriers assume less risk than with a traditional program.

New Revenue Streams

Captives open innovative business practices. For example, most airline carriers allow customers to purchase tickets online. Almost every carrier offers trip insurance at the end of the booking experience. That insurance is generally offered through a captive insurance company. Given the historically low incidents of trip insurance claims, this is basically a whole new line of profit for the airline carriers. Similar strategies exist with automobile dealers and producer-owned reinsurance companies, and many commercial warranties frequently follow this model.

Interest Income

Insurance companies are required to hold assets in reserve to have liquidity to pay claims. These reserves are invested. These investments earn income. A conservatively invested reserve portfolio creates an income stream on top of the captive's underwriting profit. These investment profits create another layer of profitability for the captive.

Access to Capital

Finally, well-managed captives accumulate significant assets. As long as solvency issues are satisfied, the captive may extend loans to affiliated companies or provide distributions of capital to finance new business ventures. There are any number of reasons why a business may need an infusion of capital. The captive provides an ability to look internally, rather than to investment bankers and the marketplace, to secure funding at favorable rates.