The Right Prescription? Should Your Company's Medical Benefits Be Insured Through a Captive Insurance Company?

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A wave of industry commentators has recently advocated that companies insure their employee medical benefits through a captive insurance company. Caveat emptor. While there are certain situations in which it is advisable for employee benefits to be insured through a captive, covering all medical benefits through a captive may result in higher costs and larger administrative burdens.

This article will first describe captive insurance companies generally and focus on the benefits and drawbacks associated with captives. We will then introduce some legal requirements of placing employee benefits in captives and identify the types of employee benefits that have been insured through captives. The second part of this article will analyze the efficacy of providing medical benefits of U.S. employees as an employee benefit,[1] either for full coverage or stop loss coverage.

Background on Using Captive Insurance Companies for Employee Benefits

What is a Captive Insurance Company? A captive insurance company is simply an insurer owned by its insureds. A captive is one of several alternative market vehicles[2] that have developed in response to "hard market" conditions.[3] While captives developed in the mid-1800s as mutual insurers, the incredible growth in the number of captive formations has occurred in the last 30 years.[4] It is estimated that more than 60 percent of Fortune 500 companies utilize a captive insurer,[5] and the use has been rapidly expanding for mid-sized companies.[6]

There are different types of captives. The most popular, the **single parent** (or pure) captive, only insures risks of its parent company and affiliates in its corporate family. An *industrial insured* (or group) captive insures risks of several insureds in a similar industry sharing joint/group ownership. The **association** captive insures an association of related members, which may be outside of one corporate family, such as member companies of a trade organization. More recently, jurisdictions have allowed for the development of **sponsored** captives. Sponsored captives are typically sponsored by an insurer and may have individual segregated cells that may be "rented" in order to implement an insurance program.

Many domestic and offshore jurisdictions compete to attract captive formations by offering low fees and taxes. Bermuda, the Cayman Islands and Guernsey have the most captive insurers for offshore jurisdictions,[7] while Vermont, Utah, Hawaii and South Carolina have the most for domestic jurisdictions.[8]

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Potential Benefits Associated with Captives. Insuring through a captive may offer a number of benefits unavailable to a company purchasing insurance through a traditional carrier. Many of these benefits may lead to cost savings.

Some captive benefits are those that are available to all insurers, including investment income on float and possible underwriting profits, which are also benefits of self-insurance.

Investment Income on Float. Warren Buffett defined float as "money [the insurer] temporarily hold[s] . . . that does not belong to [the insurer]."[9] Insurers receive premiums at the beginning of the policy or periodically over the life of a policy. Typically, claims are paid later (and in some cases, much later) than when premiums are received. The insurer can invest these funds in its custody to earn investment income, which contributes to profits.

Possible Underwriting Profits. Underwriting profits result when the total amount of premiums received exceed the total expenditures associated with paying claims, underwriting and servicing the policy, including administrative expenses associated with marketing the policy. A captive can have underwriting profits if it has better than expected loss experience. More importantly, perhaps, a company may achieve a benefit from a captive if it actively manages the risk that it insures through a captive. For example, a corporation that places an emphasis on reducing workplace losses may achieve savings directly if it insured the workers' compensation through a captive. In contrast, if the company insured its workers' compensation through a traditional carrier, the company could expect, at most, to benefit indirectly through future premium decreases (or lower premium increases).

Other benefits, however, are captive-specific:

Deductibility of Insurance Premiums. Captives, if properly structured, may permit the corporation to deduct insurance premiums when paid, which can be a substantial benefit if claim payments are long term. In comparison, with self-insurance, there is no tax deduction until losses are actually paid.

Access to the Reinsurance Market. After providing insurance coverage to its insureds/owners, captives may cede a certain amount of risk to a reinsurer. Purchasing reinsurance via a captive and insuring the underlying benefit through the captive may be cheaper than purchasing insurance in the commercial market for a variety of reasons. First, reinsurance is more akin to the wholesale market, whereas primary insurance is more like the retail market. For many insurance lines, there often is more capacity in the reinsurance market than in the direct market, making the cost of reinsurance lower. In addition, the amount of reinsurance coverage purchased is typically much less than the amount of direct insurance that would be purchased by the corporate family collectively, since the captive normally retains a substantial portion of the risk.

Customized Program Design. A corporation can design and implement the captive as it chooses and for its specific risks.

Potential Drawbacks Associated with Captives. Insuring through a captive offers drawbacks and difficulties that do not occur with the purchase of insurance through a traditional carrier, including possible underwriting losses, less diversification of risk, capitalization requirements, and developing competencies in running the captive. (Possible underwriting losses and less diversification of risk are also drawbacks associated with self-insurance.)

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Possible Underwriting Losses. With potential underwriting profits comes potential underwriting losses. With a traditional insurance policy, the company's total losses are limited to the premium payments and any deductible or co-insurance requirements. Thus, by using a captive, a company may be more exposed to insurance risk.

Less Diversification of Risk. Less diversification in a particular coverage exists in a captive than in a traditional commercial insurance program. Still, using a captive to insure multiple risks as part of a corporate enterprise risk management strategy can help increase risk diversification in the captive, especially if the covered risks are unrelated.

Initial Capitalization Requirements. Captives are regulated by insurance laws. These laws require the captive to meet certain initial capital requirements and subsequent requirements if capital (or surplus) become too low. The company would need to provide this funding, which is not necessary if insurance is bought from a traditional carrier. While the capital requirements for a captive are generally lower than for a traditional carrier, it remains the obligation of the captive owner to provide such capitalization.

Competencies in Running the Captive. Insurers specialize in the management and operations of insurance. Although corporations have human resources personnel and risk managers, these employees are usually not familiar with the competencies needed to run a captive insurance program. Thus, the company either needs to train these people in these competencies or outsource some of these roles to third-party advisors, including attorneys, actuaries, and captive managers.

Legal Requirements Applying to Insuring Employee Benefits Through Captives. The Employee Retirement Income Security Act of 1974 (ERISA) is a federal law designed to protect employees and beneficiaries by setting minimum standards for health and pension plans in the private market.[10] ERISA plans are exempt from many of the requirements of state insurance laws. Without an exemption, the prohibited transaction rules in ERISA generally prohibit employers from insuring employee benefits through captives. In 1979, the U.S. Department of Labor (DOL) created a class exemption that set out numerous restrictions on using a captive to insure employee benefits.[11]

Since 1979, however, the restrictions have been eased and simplified. The DOL permits an individual exemption with the fulfillment of 10 requirements.[12] Two important requirements for this discussion are: (1) that the captive is licensed to sell insurance or conduct reinsurance operations in at least one State, which is defined to include *inter alia* U.S. territories; and (2) that the plan contracts with a "fronting insurer" with an A.M. Best Company rating of A or better.[13] A fronting insurer writes the policy and then cedes most, if not all, of the risk to the captive. The fronting insurer is fully subject to state insurance laws, so any policy written must meet the minimum requirements imposed by those laws, even if such requirements are different or more onerous than those imposed under ERISA. The plan sponsor must also engage an independent fiduciary (normally a qualified actuarial consultant) to review the initial transaction, and perform annual evaluations to confirm that the plan continues to follow the exemption requirements.

Employee Benefits That Have Been Insured by Captives. A recent survey by Business Insurance lists the 20 companies that have used captives to insure employee benefits to date.[14] Approximately one-third have either used the captive to insure long term disability benefits or life insurance. Approximately two-thirds have used the captive to insure more than one coverage, including life, long term

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disability, or accidental death and dismemberment coverage.

Medical Benefits in Captives – Full Coverage or Stop Loss Only?

Should Medical Benefits Be Insured by Captives? Unlike certain liability and workers' compensation coverages typically covered in captives, most medical insurance coverage is short term. That is, claims are made shortly after premiums are received. For this reason, there is less opportunity for investment income or accelerated deductions. In addition, to gain the individual exemption from the DOL as described above, a fronting insurer must be used to offer the insurance; thus, the medical insurance policies are subject to state insurance laws, which vary greatly by jurisdiction. These minimum requirements mandated by state insurance laws may be more robust, and more costly, than the employer intended in its ERISA plan. In addition, if the employer has locations in more than one state, this fronting requirement may also cause a patchwork of different plans as each state may have different requirements as to what must be covered. Thus, most companies will need to closely analyze these factors to be sure there will be a demonstrable benefit provided by insuring medical benefits through a captive.

Captive start-up costs must be weighed against any potential future benefits. New captive formations are strictly regulated; thus, gaining the individual exemption will take some time. In general, captive start-up costs tend to negate most of the financial savings from reinsuring the employee benefits. A more cost-effective and common approach may be to work through an existing captive where the company's property and casualty risks (e.g., workers' compensation) reside. This may also allow tax advantages by having more tax deductible business (i.e., medical benefits) in the captive to strengthen the argument to the Internal Revenue Service (IRS) to rule that all coverages in the captive are tax deductible, even if the existing coverages were not deductible on a stand-alone basis.

While using a captive for full coverage of medical benefits is uncommon, using a captive (especially an existing captive) to insure the stop-loss portion of medical benefits is gaining more popularity for employers, particularly in light of the potential upward cost pressures due to the imposition of new benefit requirements and the elimination of old risk selection techniques under the Patient Protection and Affordable Care Act (PPACA).[15] New interest is emerging in self-insured plans now, because they are not subject to many of the provisions imposed by the PPACA, most notably the pricing restrictions, some benefit design requirements, and risk adjustment mechanisms.

Given pressure on fully insured premiums, brokers, associations, and plan sponsors (among others) are considering self-insurance even for groups smaller than those that are traditionally self-insured.[16] For example, when PPACA eliminates medical underwriting and limits on age rating beginning in 2014, employers in the small group market (i.e., under 51-100 employees, depending on the state) covering predominantly young and healthy individuals may face upward cost pressures. Self-insurance is one way to try and mitigate these cost pressures.

Despite their benefits, self-insured plans are vulnerable to catastrophic claim risk. Plans will be exposed to more catastrophic risk going forward because PPACA prohibits annual and lifetime benefit limits. One way to mitigate this increasing risk is for the self-insured plan to purchase stop loss insurance (albeit at a higher price or with less exposure than pre-PPACA when annual and lifetime limits were in place). Stop loss insurance generally comes in two forms:

> ***Specific***, where losses are covered on a per-person basis beyond some catastrophic amount to mitigate the risk of an individual having very high claims.

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Aggregate, where losses are covered in aggregate for the employer beyond an attachment point that is some percentage of expected claims across all covered members.

Employers often combine these stop loss protections or have other innovative approaches for managing catastrophic risk while remaining primarily self-insured, such as through minimum premium products or "spaggregate" coverage. For smaller employers, stop loss coverages are particularly important as they are subject to far greater claims fluctuations than larger employers, which can rely on their greater number of covered members to spread risk. For example, consider that without catastrophic risk protection, a $60,000 covered health expense under a 50 member self-insured plan costs $100 per member per month (PMPM) in aggregate (= $60,000 / 50 / 12), while it only costs $1 PMPM in aggregate (= $60,000 / 5,000 / 12) for a 5,000 member plan.

If the employer purchases the stop loss coverage for the self-insured plan from its general assets and not employee funds, purchasing the insurance coverage from a captive would not trigger the prohibited transaction rules under ERISA and the restrictions necessary for an exemption discussed above would not apply.[17] The employer (or group of employers if they are smaller employers) would then take advantage of many of the benefits of captives outlined above.

In addition, using an established captive to provide the self-insured plan with stop loss insurance brings other benefits. First, because a corporation would have already committed to the fairly substantial capitalization requirements, adding medical benefits coverage would not significantly increase these amounts. Second, because the captive already contains other coverages that are not perfectly correlated with medical coverage, medical stop loss exposure enables employers to diversify their captive's coverages across different types of risks, which can reduce variability in the insurance pool. Such coverages may include workers' compensation, product liability, property damage, and other liability related coverages. Third, including medical coverage, which the IRS considers to be "third party business," may allow for deductibility of these over coverages that would not otherwise be allowable.

Conclusion

Many factors must be considered before a corporation chooses to use a captive to insure its employee medical benefits. In some situations, it may be better to choose alternative structures. But in the right situation, especially when the captive insurer provides stop loss coverage to a self-insured ERISA plan, the use of the captive can provide demonstrable benefits.

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1 The authors have elected to focus on the U.S. employee population. The analysis for non-U.S. employee populations may be different. This article also focuses on ERISA plans. It does not address benefit programs that do not fall under ERISA jurisdiction, such as executive nonqualified deferred compensation plans and workers' compensation.

2 Other alternative market vehicles include retrospectively rated programs, high deductible programs,

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and self-insurance. For this article, self-insurance exists when a company retains its insurance risk without using a captive or other risk transfer vehicle.

3 Hard markets occur when insurers are less willing to write insurance, which results in higher prices for policies. In contrast, soft markets occur when insurers are more willing to write insurance, resulting in lower prices for policies.

4 *See, e.g.,* International Association of Insurance Supervisors, Issues Paper on the Regulation and Supervision of Captive Insurance Companies (Oct. 2006).

5 Dennis R. Childs, *Captive Insurance Industry – What Is It? Where Is It? Why Is It Important?*, CPCU eJournal, May 2007, at 7.

6 Jerry Geisel, *Smaller Firms Turning to Captives*, Business Insurance (March 8, 2010).

7 Business Insurance Survey, *Leading Captive Jurisdictions, 2009-2010*, Business Insurance, Mar. 14, 2010 (excludes credit life insurers).

8 *Id*.

9 Berkshire Hathaway Inc., *Shareholder Letter 2010*, at 5.

10 29 U.S.C. § 1001 *et seq.*

11 U.S. Department of Labor, *Class Exemption to Permit Sales of Employee Benefit Funding Contracts by Insurance Companies That are Substantially Affiliated With Employers Maintaining the Plans*, Prohibited Transaction Class Exemption 79-41, 44 Fed. Reg. 46,365 (Aug. 7, 1979).

12 U.S. Department of Labor, *Grant of Individual Exemptions Columbia Energy Group*, Prohibited Transaction Exemption 2000-48, 65 Fed. Reg. 60,452 (Oct. 11, 2000).

13 Captive insurers cannot sell insurance. In addition to fronting arrangements, insurance may be able to be independently procured by the insureds in some states or available to the insureds through a risk retention group.

14 Business Insurance Survey, *The Drive to Fund Employee Benefit Risks Through Captives*, Business Insurance (Dec. 20, 2010).

15 Pub. L. 111–148, 124 Stat. 119 (2010).

16 Association captives composed of similarly-situated employers with small numbers of insured employees to provide stop loss coverage are also being considered. In this manner, the employers receive the benefits of the captive while simultaneously avoiding some of the requirements of PPACA.

17 U.S. Department of Labor, PWBA Advisory Opinion 92-2A (Jan. 17, 1992).

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