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Captive Insurance Companies for the Transportation Industry: A Quick Q&A with Those in the Know

AUGUST 29, 2019

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Captive insurance companies are an elusive risk management strategy that, for many, is so poorly understood it is difficult to even begin consideration. Those who happen to fall into discussions of captives often bounce between painting quaint images of financial right-sizing and flexibility with antiquated jargon and reference to regulation. It is time to set the record straight by gaining actionable feedback from those who know.

The value and pitfalls of captive insurance companies look different from any angle. The legal perspective lends observations of global risk and administrative burden. The accounting perspective sheds light on financial advantages and models for structuring programs. The insurance market perspective indicates the relative benefit as compared to other risk management strategies and paths forward.

As the old joke goes, an attorney (Matt Selby), an accountant (Phil Denny), and an insurance broker (Jeremy Speckman) walk into a bar to discuss captive insurance in the transportation industry. What follows is the best summary of captive insurance strategies we have heard in quite some time.

It is often said that captive insurance programs are not for every motor carrier-what is the "sweet spot" for determining whether captives are a good fit?

Matt Selby: Captives are neither for everyone nor a suitable substitute for every type of insurance that a transportation company may need in its portfolio. However, a captive can be an attractive option for a company that is looking for more stability in rates or to maximize the lawful potential and creativity of tax planning. A key challenge when considering captives can be the on-hand cash and cash flow required to absorb the ongoing collateral requirements.

How is it that forming a captive insurance company is so financially attractive to some motor carriers?

Philip Denny: A captive insurance company can be an effective way to help motor carriers self-insure certain risk. Captives also offer a creative solution for addressing a range of risks for which coverage may not be available in the commercial insurance market. These risks may include items such as:

Deductible Reimbursement for (1) Vehicle Liability, (2) Vehicle Physical Damage, and (3) Cargo - Reimbursements for losses that are considered to be within the deductible or self-insured retention of the insured's commercially purchased insurance policies of these types.

(4) Collection Risk

- Accounts receivable that are unable to be collected, including interest and expenses arising from the inability to collect after exhaustion of all remedies, such as use of a collection agency and litigation.

What are the key factors to consider when a motor carrier considers risk and reward based on total insurance spend and the availability of captive insurance programs?

Jeremy Speckman: The purchasing decision can turn on a wide range of factors including suitability of the captive model, total spend, and total potential recovery in the event of a claim. A member-owned group captive insurance company is particularly ideal for organizations that share such qualities as: (1) long-term financial strength and stability; (2) management teams committed to safety, with solid safety programs in place; (3) loss histories that are better than average for their respective industries; and (4) minimum casualty premiums in excess of $100,000.

Perhaps the most important threshold consideration, however, is that group captive members are often subject to premiums in a range that can be prohibitive for certain motor carriers. Annual premiums of at least $250,000 are the norm. It is not uncommon to see $1-$5 million in annual premiums, and those can even reach or exceed $25 million.

What types of captives are available and what are their basic characteristics?

Philip Denny: There are essentially two types of captives available, A and B. All property and casualty insurance companies are either taxed under IRC 831(a) or IRC 831(b). IRC 831(a) captives are taxed on taxable income after a deduction for reserves. Qualifying IRC 831(b) captives are taxed only on their taxable investment income.

We see a great deal of interest in “B” captives due their tax advantages. The basic requirements to qualify as an IRC 831(b) captive are: (1) the insurer must distribute risk among its policyholders; (2) the arrangement must involve insurable risk; (3) the arrangement must shift risk to the insurer; and (4) the arrangement must be insurance in the commonly accepted sense.

Technical requirements also apply when qualifying for “B” captive status: (1) premiums for the taxable year 2019 cannot exceed $2,300,000; (2) such company meets the applicable diversification requirements; and (3) such company elects the application for IRC 831(b) for the taxable year.

Is there any meaningful difference between captive insurance and traditional insurance in the event of high-exposure casualty incidents?

Matt Selby: One key difference in the event of a major catastrophic loss is that the captive will have reinsurance to cover a large of portion of the loss. These types of ‘one-time’ events do not usually ‘count’ against a member for the full amount of the loss and the amount that is covered by reinsurance (commonly an amount in excess of $250K) is not typically shared among the members. Just as with traditional insurance, the captive will still only cover the amount of the policy as decided by the members (for example, $2 million).

How does captive insurance perform differently compared to traditional insurance?

Jeremy Speckman: It is important to bear in mind that conventional insurance pricing rarely reflects the actual cost of the protection you are purchasing as the insured. This cost often includes markups to cover the insurer's acquisition costs, marketing expenses, high commissions, administration and overhead. This cost structure is specifically designed to deliver profit to the insurer's bottom line. In a captive, the goal is to minimize those costs and enhance your bottom line. It is possible to build or identify captive solutions that are closely tailored to your risk needs and thereby eliminate unnecessary cost.

What additional accounting and financial requirements are required to maintain a captive insurance company?

Philip Denny: The specific location of a company can have the greatest impact on other specific requirements for maintaining a captive insurance company. The location of domicile will dictate all applicable financial and tax filing requirements, which can differ by location. These variances can include financial filings for insurance regulations, tax returns, and potentially the frequency of a financial audit.

What creative options are available for those looking to enter the captive insurance market?

Jeremy Speckman: As a member of a group captive, you are far less susceptible to the ever-increasing and unpredictable costs imposed by conventional insurance providers year after year. Some of the other benefits enjoyed by group captive members include:

(1) Better services and better management. A captive can purchase strategic insurance products, such as specific and aggregate excess reinsurance coverage, that allow each captive member to manage predictable losses while transferring potential catastrophic losses. For captives supported by third-party service companies, such as Captive Resources, this leads to improved loss control and greater awareness of the factors that commonly give rise to losses, so that they may be reduced and often prevented in the future.

(2) Enhanced profit potential. As a member of a group captive, safety pays. You are rewarded for effective risk management by receiving dividends that are directly related to loss performance, while investment income accumulates to your benefit. That's more money in your pocket to invest in whatever way your business needs it most.

(3) Long-term control of your insurance outlook. Group captives overseen by third-party servicers afford their members the ability to customize insurance programs that meet their specific needs, so that you're not paying for coverage you don't require. Also, as a captive grows, so does its risk tolerance and ability to negotiate favorably with reinsurers.

What are the administrative burdens and other potential pain points associated with managing a captive insurance company

Matt Selby: One of the major pitfalls of the captive structure is the potential for an unintended stranglehold on collateral (whether cash or a Letter of Credit). Most captives will require a certain percentage of a member's frequency fund for three rolling years. Although this helps to minimize the risk of nonpayment by another member, it can certainly strain a business where margins are already tight-as is often the case in the transportation and logistics sector. Sometimes the practical effect of this unintended consequence can offset the benefit of a lower rate than you would receive in the traditional insurance market.

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