MANAGING CAPTIVE CLAIMS

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The discussion below is a general summary of the issues and does not necessarily reflect the views of the authors or their clients.

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I. Forms of Risk Transfer

Insurance is, of course, a form of risk transfer. But as anyone familiar with enterprise risk management will advise, a policyholder may not be able to transfer the key risks it faces to an insurance carrier, at least not at commercially reasonable rates. What are the options available to large commercial enterprises for transferring risk?

A. Traditional Insurance

Traditional insurance policies transfer risk transfer from the insured to the insurance carrier in consideration of the payment of a premium.

B. Self-Insurance

Whereas commercial liability insurance typically applied on a "dollar one" basis, most large commercial enterprises will now layer their coverage beginning with a working primary layer that is self-insured and for which the insured itself controls the defense and adjustment of claims until the SIR is exhausted.

C. Going Partially Bare

Larger insureds who have the financial assets to absorb some risk may choose not to purchase primary coverage or will purchase no coverage at all except when required by contracts or regulations. In addition, insurance is, of course, not available to cover all risks that a business may face – whether because commercial insurers are not willing to write insurance policies that cover those risks (e.g., asbestos), or because they are contrary to law (e.g., insuring willful criminal behavior), or because of expense (e.g., a large pharmaceutical company that might try to purchase "dollar one" products liability insurance).

D. Alternative Premium Arrangements

Many larger insureds that are likely to experience frequent claims will want the expertise of an insurance carrier or third party administrator in managing claims but will not want to pay the premiums associated with “dollar one” risk transfer. Responding to that demand, some insurance policies are subject to “retrospective premium” arrangements under which the insured will pay a minimum advance premium, with possible additional premiums at the end of the policy period depending on claims experience. In addition, some insurance policies – such as contractor- or owner-controlled insurance programs for large construction projects – include “large risk rating plans,” that use retrospective premium adjustments to turn what looks at first glance to be risk transfer insurance into an insurance program largely funded by the named insured.

E. Fronting Policies

To satisfy regulatory or contractual requirements to have insurance policies in place, some larger insureds will purchase commercial insurance policies but the policies either will have retained limits equal to the policy limits or will be fully reinsured by the named insured’s captive insurer. As a result, there will be little or no net risk transfer.

F. Obtaining Protection from Business Partners: Contractual Indemnity and “Additional Insured” Coverage

A business may also obtain protection through its contractual arrangements with business partners. For instance, most construction projects include indemnity terms requiring subcontractors to hold the general contractor and owner harmless against any claims arising out of the subcontractor’s work. Such indemnity undertakings are typically backed up by contractual terms giving the indemnitee additional insured status under the indemnitor’s policies.

II. Captive Insurance Companies

All of the foregoing alternatives are variants on the traditional risk transfer model of insurance. One non-traditional model is the creation of a captive insurance program, wherein the insured insures itself.

Captive insurance programs can be attractive risk transfer alternative for numerous reasons, including the ability to manage the insured’s own risk, control cash flow, deduct insurance premiums and develop a coverage program that is better aligned with a corporation’s risk profile than conventional insurance allows. Whether for these reasons or others, captive programs have become a popular risk transfer option for large commercial enterprises. In the 55 years since the first captive program was created in Bermuda in 1962, 7000 captives have been created.

A. What is Captive Insurance?

"A captive insurance company is an insurance company formed by a business owner to insure the risks of the operating business. The operating business pays premiums to the captive, and the capture insures the risks of the operating business." Jay Adkisson, *Captive Insurance Companies* viii (2006). Some of the typical characteristics of captive insurers are that the captive:

1. Is owned by the named insured (or, in some instances, by a group of insureds or consists of a risk retention group or joint powers authority);

2. Is incorporated in a jurisdiction with a regulatory structure that supports captive insurers (such as Bermuda, the Channel Islands, or Vermont);

3. Can be limited to the types of insurance policies authorized by its license (*e.g.* general liability insurance may be authorized but not workers' compensation may not be);

4. Is run by a "captive manager" (usually by contract with a major brokerage or consulting firm);

5. Manages claims through an in-house group or a third party administrator; and

6. Limits its risk by purchasing reinsurance for the self-insured losses as well as conventional excess insurance for losses exceeding the limits of the captive program.

B. Why would a business set up a captive?

1. Obtain better control over costs of insurance.

2. Lower overhead than conventional insurance.

3. Can use the existence of the captive to obtain leverage in negotiations with commercial insurers over premiums and scope of coverage.

4. Because the named insured knows its own business better than any commercial insurer, it may be able to be more precise about premiums and limits than a commercial insurer.

5. Can spread premiums over a longer period so that the named insured does not have to pay up front.

6. Can have broader policy terms and scope of coverage, or more customized coverage than commercial insurers are willing to sell.

7. More control over the claims handling process.

8. More flexibility to use higher (or lower) deductibles.

9. Direct access to reinsurance.

10. Can cover risks that commercial insurers are unwilling to accept or that, in the jurisdictions whose laws would govern a commercial insurance policy, are uninsurable (*e.g.,* a Bermuda insurer can cover a punitive damages risk for a New York business whereas a New York insurer may not be able to cover that risk).

11. Gives the insured a greater incentive to prevent losses.

12. Control own defense and retain counsel of own choice.

13, May become a profit center for the named insured.

C. Deciding to Set Up a Captive

While these are significant advantages, a corporation should carefully assess its insurance needs before electing to set up a captive. Before making such a decision, a business should undertake a comprehensive and objective analysis of needs and exposures. Questions to be considered include (1) what lines of coverage should be included; (2) does the business have sufficient expertise to handle some or all of these risks in-house or should it hire a Third Party Administrator; (3) what jurisdiction has the most favorable regulatory environment for such a program and (4) how much risk is the insured willing to absorb and to what extent can this risk be mitigated by purchasing excess insurance layers and/or reinsurance to protect against adverse loss experience.

III. Reinsurance

A. What Is Reinsurance?

Reinsurance is not a new development in the insurance world. As one treatise explained nearly 250 years ago: “Re-assurance . . . may be said to be a contract, which the first insurer enters into, in order to relieve himself from those risks which he has incautiously undertaken, by throwing them upon other underwriters, who are called re-assurers." (J. Park, *A System of the Law of Marine Insurance* 315 (1789) (quoted in G. Staring & D. Hansell, *Law of Reinsurance* 1 (2017 ed.).)

B. Types of Reinsurance

Generally speaking, reinsurance is either written on a "treaty" or a "facultative" basis. Treaty reinsurance covers more than one insurance policy; facultative reinsurance is reinsurance written specially to cover a single insurance policy. Reinsurance of captive insurance is almost always facultative.

C. Formation of a contract of reinsurance

1. The party that purchases reinsurance is called the "cedent": It cedes part (or, sometimes, all) of the risk to the reinsurer.

2. Traditionally, the cedent has to comply with a duty of "utmost good faith" (*uberrima fides*) in purchasing a contract of reinsurance. Some states even require the communication to the reinsurer of privileged information relevant to the decision to bind coverage. More recently, the ceding insurer's duties to the reinsurer tend to mirror those of the policyholder's duties to the insurer, at least outside of the marine market.

3. Facultative reinsurance policies (often called "certificates") typically incorporate the terms and conditions of the insurance policy they are reinsuring, but also have standard form provisions and endorsements modifying either the cedent's insurance policy (when the reinsurer is not willing to back all of the risks the ceding insurer is insuring) or the terms of the reinsurer's standard form certificate of reinsurance.

4. Often, reinsurance of an insurance policy with large limits of liability will be written in layers, just as is the case with large insurance programs.

5. While a reinsurer's duty to pay generally does not arise until the cedent actually pays a judgment or settlement, reinsurance agreements uniformly require the ceding insurer to give notice of claims that are "likely" to implicate the reinsurance or otherwise meet certain specified objective criteria. Timely notice of serious claims affords the reinsurer the opportunity to exercise its rights under the agreement to associate or otherwise involve itself in the investigation, adjustment, defense or settlement of the underlying claim.

Reinsurance agreements contain various different clauses affording insurers these rights, including "right to associate," "claims cooperation" and "claims control" clauses.

A "right to associate" clause typically gives the reinsurer the right to participate "in the defense and control of any claim, suit or proceeding which may involve [the] reinsurance with the full cooperation of [the cedent]." Association clauses permit the reinsurer to consult with and advise the reinsured in its handling of the claim without imposing any affirmative obligation on the reinsurer to investigate or pay for the defense of the underlying claim. While the level of association varies from relationship to relationship, the right generally includes more than the contractual right of inspection and claims review, and allows reinsurers the right to have and timely express an opinion about the on-going handling of the underlying claim.

Some reinsurance agreements, particularly those emanating from the London Market, contain "claims cooperation" which give reinsurers greater input and control over the defense than a conventional "right to associate" clause and which may explicitly require the reinsurer's consent before the insurer can settle.

Finally, some agreements contain "claims control" clauses that permit the reinsurer to participate directly in negotiations, adjustment and settlement of underlying claims. In general, these clauses are more common when the ceding company retains little or no risk and may therefore have little financial incentive to aggressively contest the insured's claim against it. These clauses cede the most control to a reinsurer and may impose an affirmative obligation on the reinsurer to exercise actual control over all or a portion of the claims handling, including the obligation to investigate, adjust and resolve claims.

6. Most reinsurance certificates also contain "follow the fortunes" and "follow the settlements" provisions that limit the reinsurer's ability to challenge its obligation to reinsure losses paid by the cedent.

a. A follow-the-fortunes clause "binds a reinsurer to accept the cedent's good faith decisions on all things concerning the underlying insurance terms and claims against the underlying insured: coverage, tactics, lawsuits, compromise, resistance or capitulation." *N. River Ins. Co v. ACE Am. Reins. Co.*, 361 F.3d 134, 139-40 (2d Cir. 2004) (citation omitted). The clause further "obligates the reinsurer to indemnify the ceding insurer . . . for any payments the cedent makes for claims covered by the underlying insurance." *Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Am. Re-Ins. Co.*, 441 F. Supp. 2d 646, 650 (S.D.N.Y.

2006); *Christiania Gen. Ins. Corp. of N.Y. v. Great Am. Ins. Co.*, 979 F.2d 268, 280 (2d Cir. 1992) ("Under the 'follow the fortunes' doctrine, a reinsurer is required to indemnify for payments reasonably within the terms of the original policy, even if technically not covered by it."). A typical "follow the fortunes" clause is: "Except as otherwise agreed, the liability of the Reinsurer specified in the Declarations will follow that of the Company and will be subject in all respects to all terms and conditions of the [ceding insurer's] Policy . . . ."

b. "The purpose of the . . . 'follow the settlements' doctrine in reinsurance law is to prevent the reinsurer from 'second-guessing' the settlement decisions of the ceding company." *Granite State Ins. Co. v. ACE Am. Reinsurance Co.*, 849 N.Y.S.2d 201, 203 (App. Div. 2007). "[T]he follow the settlements doctrine imposes upon the reinsurer a contractual obligation to indemnify the ceding company for payments it makes pursuant to a loss settlement under its own policy, provided that such settlement is not fraudulent, collusive or otherwise made in bad faith, and provided further that the settlement is not an ex gratia payment." *Aetna Cas. & Sur. Co. v. Home Ins. Co.*, 882 F. Supp. 1328, 1346 (S.D.N.Y. 1995). Thus, when reinsurance certificates have follow-the-settlements clauses, "the reinsurers will be bound by the settlement or compromise agreed to by the cedent . . . ." *Excess Ins. Co. v. Factory Mut. Ins. Co.*, 822 N.E.2d 768, 771 n.3 (N.Y. 2004). A typical follow-the-settlements clause provides, in relevant part, that: "All loss settlements made by the Company, provided they are within the terms, conditions and limits of the [ceding insurer's] Policy, and within the terms, conditions and limits of this Certificate, will be binding on the Reinsurer."

c. Ceding insurers often argue that follow-the-fortunes and follow-the-settlements clauses are necessary parts of the reinsurance relationship because, otherwise, the process of adjusting and paying claims would be delayed and the ceding insurers could run afoul of both regulatory requirements to pay covered claims promptly and duties of good faith and faith dealing.

d. Often, reinsurers of captive insurance policies will omit or delete the follow-the-fortunes and follow-the-settlements provisions in their standard form certificates of reinsurance when they are reinsuring captive insurance policies, out of concern that the ceding captive insurer may decide to pay claims that a commercial insurer might decline. However, some authority exists for the proposition that a follow-the-fortunes clause applies when it is in a certificate of reinsurance that covers an insurance policy issued by a captive insurance company. *See Mentor Insurance Co. (U.K.) Ltd. v. Norges Brannkasse*, 996 F.2d 506 (2d Cir. 1993) (requiring reinsurer to follow the fortunes, albeit under the specific and somewhat unusual facts of the case).

6. Certificates of reinsurance often contain other standard provisions that apply to the ceding insurer, such as:

a. Most, but not all, reinsurance treaties have alternative dispute resolution clauses requiring arbitration in the event of a dispute, often with a New York, Delaware, or English choice-of-law and choice-of-forum clause.

b. The cedent typically must provide prompt notice of claim to the reinsurer. Courts are split as to whether a "notice prejudice" requirement applies if the reinsurer wishes to raise an "untimely notice" defense. *Compare Unigard Sec. Ins. Co. v. N. River Ins. Co.*, 79 N.Y.2d 576, 584 (1992) ("prejudice" required), *with Liberty Mut. Ins. Co. v. Gibbs*, 773 F.2d 15 (1st Cir. 1985) (no prejudice required; Massachusetts law).

c. The cedent must cooperate with the reinsurer's reasonable requests for information.

d. The cedent sometimes must obtain the reinsurer's consent before settling a claim that would trigger the reinsurer's payment obligation before settling a lawsuit or claim that exceeds the captive policy's deductible.

D. Presenting Captive Insurance Company Claims to Reinsurers:

1. Timely notice

2. Cooperation

3. Frequent exchanges of information and input when consistent with the defense of the underlying litigation

4. Share coverage opinions with reinsurer

5. Keep reinsurer informed in real time of settlement discussions

6. Many certificates of reinsurance are subject to unusual alternative dispute resolution requirements, such as binding arbitration before a panel comprised of current or former insurance company executives. Because of the prevalence of ADR requirements in reinsurance certificates, reinsurance litigation is rare.

IV. Claims Handling Under A Captive Insurance Program

A. Attachment Points

Captive insurance policies often apply in excess of a large deductible or retained limit. As a result, it often is the case that claims against the named insured are too small to reach the attachment point of a captive insurance policy.

B. Arm's Length Claim Handling

Although administered by the policyholder, a captive insurance program retains many of the hallmarks of traditional insurance including the possibility that some claims will not be covered. There is a certain tension, of course, in requiring the administrator of a captive insurance program to deny coverage to its business client. Such safeguards are essential to the actuarial viability of such programs, however, and are preconditioned to approval by state insurance regulators and the availability of reinsurance for such programs.

To the extent that claims reach the attachment point, it often is the practice of claims managers for captive insurers to handle claims at arm's length. That is, the captive insurer will pay claims only if the captive insurance policy covers them, and not as an accommodation to the named insured.

1. As a result, a claims manager or third party administrator should feel free to deny coverage or reserve rights if the claim is not, or may not be, covered. Sometimes, the claims manager or TPA will seek the advice of coverage counsel for problematic claims.

2. This is especially important when the captive insurer has purchased reinsurance, as reinsurance may not cover an *ex gratia* payment or a payment that is not made in good faith. Arm's length claims handling is also important because a captive insurer must maintain its capital and must pay out in claims roughly what it charges in premiums in order to remain in good standing with regulatory and tax authorities.

3. To the extent that the captive must obtain the reinsurer's consent to settle, a reinsurer is much more likely to consent to an arm's length acknowledgement of coverage.

4. In cases where claims are plainly not covered, the risk manager may choose to apply to the captive manager for retroactive coverage, which may or may not be granted subject to the approval of state regulators or reinsurers who may have concerns with respect to the impact of the claim on the viability of the program.

5. Some captive insurance policies provide that the captive will only indemnify the named insured to the extent that reinsurance provides coverage.

C. Maintaining Communication

A captive insurer typically does not have a duty to defend, so it does not need to manage the underlying claim. However, the captive is likely to insist that the in-house counsel and defense counsel keep the captive informed of developments in the litigation and seek the captive's consent. If there is a duty to defend, the captive files should be well documented regarding coverage determinations and ongoing communications.