Captive Insurance Companies
Role of Independent Director

by
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The current captive insurance company climate is gravitating toward pushing captives—including single-parent captives, association captives, and agent-owned captives—to appointing experienced, independent directors to their boards. Regulators (National Association of Insurance Commissioners, Bermuda Monetary Authority) and rating organizations (A.M. Best and Standard & Poor's) have all come out in favor of the movement toward the appointment of independent directors. They believe that independent directors add value, by providing independent, experienced guidance to captive owners that is separate and distinct from a captive's other advisers, such as managers, lawyers, and accountants.

Independents do not have conflicts of interest, present a wealth of experience different from others on the board, and usually have a broad captive insurance perspective rarely matched by others. However, when working with other directors that have complementary expertise, an independent director presents a valuable perspective that few captive would not benefit from. Too often, however, captive owners overly focus on fees that an independent director may require.

And, as might be pointed out by some captive managers who prefer to keep independents out of their hair, captive managers maoy have other fingers in the captive pie, such as brokerages, reinsurance brokerabes, actuarial, claims, investments, and even providing leads for a possible fee for premium financing.

Furthermore, too often captive owners believe they get all the advice they need from their current advisers.

What is too often overlooked is the value added independents offer. Here is a partial list of services normally expected of experienced independent directors:

- ✓ Help in selecting the reinsurance intermediary. They provide an independent perspective separate from the reinsurance broker or risk manager.

- ✓ Advise on acquisition opportunities of the captive, if any, such as buying a third-party administrator, a licensed admitted insurance company, or an investment in a new start-up retail brokerage firm. These sophisticated ideas are an expansion of most captives' business plans and need to be considered carefully given the risks they present.

The captive landscape from the 1970s is littered with the carcasses of captives that ventured ill-advisedly into such businesses, often on the encouragement of their advisers.

- ✓ Help in evaluating a reinsurance program structure.
- ✓ Attend and advise on the rating process with outside rating agencies, such as A.M. Best.
- ✓ Attend meetings with insurance regulators,especially if there is a regulatory concern.

Independent directors are also asked to vote on many issues, such as:

- ✓ Should the captive change "fronts"?
- ✓ Should the captive make a large dividend payment. to the parent corporation, or should the captive return capital to its owners?
- ✓ Should the captive write direct procurement policies for the parent corporation?
- ✓ What law firm should handle uncollectible reinsurance?
- ✓ Should the captive litigate or arbitrate certain claims?
- ✓ Should it change asset investment managers?
- ✓ Should the captive expand into other lines of business, such as writing third-party reinsurance business?
- ✓ Should it move from an offshore tax haven domicile to a domestic domicile?
- ✓ How can the captive reduce the cost of its reinsurance program?
- ✓ How does a captive evaluate its various service providers?

Independent directors, because of their very nature of having experience, may cause "constructive friction" with the captive manager, and even the front company. The inexperience of captive owners shows through when they have executed reinsurance agreements or fronting agreements and do not understand the consequences of these agreements until litigation occurs. Here are some examples where I feel I have added value in my role as an independent director:

- ✓ **Advisory director in the interviewing and selection process for the reinsurance intermediary to be retained by the captive insurance company.** In this case, the captive wanted to evaluate if it should participate in a new reinsurance opportunity being offered; namely, becoming a profit center. Understanding the agenda of a reinsurance intermediary, i.e., brokerage income, selection of reinsurance company markets, and structure of the reinsurance program for the captive are complex issues to be understood.

- ✓ **Advisory director in the entire negotiating process with the rating agencies: A.M. Best, Standard & Poor's, Moody's.** Sometimes, a captive wants a rating. The director actually attends the meetings with the rating agency and explains capitalization, operational plan, and strategy of the captive to the rating agency to secure a good rating.

- ✓ **Advisory director forming part of the taskforce to select an insurance litigation attorney to represent the captive owner against the fronting insurance company.** Independent directors have had experience in testifying at trials in insurance coverage disputes.

- ✓ **Experienced, independent director negotiating with regulatory authority in the state of domicile regarding direct procurement policies being issued by the captive insurance company**. The approval process with the regulatory authority requires an experienced, independent director who is familiar with regulatory personnel and understands their perspectives.

- ✓ **Experienced, independent director as an insurance industry expert at the board level.** Though the other directors are usually employed by the parent corporation with the risk manager as the acting president, none have deep insurance industry expertise, especially in insurer operations.

Independents on the Horizon. In the coming months, expect to see the captive owners reaching out to secure independent directors, both because of their value-added consulting expertise and because regulators and possibly rating agencies will require it. It already exists in some overseas jurisdictions, and with Solvency II, it may become more important; it may ultimately apply here.

The Messy Matter of Fees. Finally, captive owners need to be familiar with providing compensation for independent directors. Allocation of time and hourly rates varies with each individual directorship, all of which is spelled out in the retainer agreements. Director fees are negotiated on a time basis so that captive owners receive value for their expenditures. The costs for such services are highly negotiable, but no different than the costs for actuarial reports, audit fees, and captive management fees. Most captive owners need to establish a plan and a budget for the independent director so there are no surprises.