Breaking Ground

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Captive Insurance as a Risk Management Tool

By Sandra L. Fenters

Consider the following hypothetical situation: BJF Contracting was the low bid winner on a North Shore area project for the City of Pittsburgh. The project consisted of building a retaining wall to stop a steep hill from washing onto a local road. Closure of the road was necessary during construction. In order to ensure the road was reopened on schedule, the City had a $2,500 per day liquidated damage clause (LDC) in the contract.

The specifications for the concrete retaining wall called for a special type of cathodic protection to prevent rebar corrosion. There were only two suppliers of this protection system, one in Canada and one in Oregon. BJF subcontracted with the Canadian company, and included the LDC in the subcontract.

Two months later the road was closed, the forms were ready, and the Canadian subcontractor arrived on site with the wrong type of material for the protection system. The inspector would not permit installation of anything but the specified product. Unfortunately the Canadian subcontractor did not have the specified product in stock. To mitigate damages, BJF hired the Oregon subcontractor to complete the work. BJF had to pay an additional $4,800 to the Oregon subcontractor, 12 days of liquidated damages, as well as other jobsite costs incurred during the delay.

BJF is out $54,000 and files suit against the Canadian company for breach of contract. The court ruled that the LDC was in fact a penalty clause and unenforceable, since the subcontract value with the Canadian company was only worth $13,000. The only damage BJF could collect was the $4,800 for their reliance interest.

Unfortunately this is not an uncommon occurrence in the day to day life of a contractor. Unforeseen exposures rear their ugly head on job sites every day which is why managing and mitigating risk factors, including safety issues, is so critical to the health of a contractor's balance sheet.

Have you ever taken an inventory of the risks you inherently absorb in your business everyday as a contractor? Some of the risks you already mitigate by way of paying premiums to the traditional insurance marketplace include workers compensation, auto liability, and general liability.

But what about the risks you assume every day in contracting that are not insured by the traditional marketplace? Possibly risks such as job-site pollution, extensive punch lists, subcontractor disputes, engineering defects and unforeseen conditions the owner will not recognize, and liquidated damages as seen with BJF Contracting? These hazards are often the events directly affecting the profit margin on a project versus a well-thought out estimate. The estimators probably calculate some of the costs associated with these unforeseeable challenges, but if weighted too much in the estimate, you lose the bid.

What could they have done to help prevent or offset the liquidated damages with the City? Typically it is the operational managers of a construction company who try preventing the type of loss incurred by BJF Contracting. While the operational staff works to mitigate these risks, the CEO or CFO can also work to protect the company from these unexpected losses, beyond the utilization of the traditional insurance marketplace.

The construction field is an industry class that has historically been rated by the traditional insurance market as "high risk." The demand for the use of alternative risk finance mechanisms, known as captives*, by contractors began to increase with the advent of the hard insurance market cycle in the early 2000's. As the soft market quickly dissipated during this time, traditional carriers were restricting coverage and increasing rates industry-wide. The result was the best-in-class companies began subsidizing the worst-in-class, forcing contractors to seek alternative forms of procuring insurance. Today a majority of mid-to-large size contractors are participating as members of a group captive arrangement, either

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homogeneous (i.e. National Roofers Association) or heterogeneous (multiple trades) in nature.

Joining a group insurance arrangement with like-minded companies is not uncommon in the construction industry. If structured properly, these group captives can provide protection for traditional statutory coverage such as workers compensation and auto liability, and at the same time return investment income and an underwriting profit as a result of good loss experience to the members of the group. While group captives harness these important aforementioned benefits for its members, they are an extension of the traditional market place, not a replacement thereof. In other words, in a group captive environment, coverage may not have been afforded for the loss experienced by BJF Contracting.

In addition to group captives, there are many types of captive arrangements available to assist contractors with strategic planning and if your trusted advisors are not talking to you about these, they should be. Specifically, have you ever entertained the idea of owning your very own insurance company?

It is often a misconception that owning your own insurance company, referred to as a pure single parent captive, is an option not afforded the closely held businesses and their respective owners. While it was once believed that only the publicly traded companies and large well-capitalized private companies could take advantage of the numerous benefits afforded by owning your own insurance company, it is no longer the case.

Actively participating in a group captive arrangement does not preclude a business and its owner from creating its own separate profit center by way of a single parent captive that would underwrite the risks endemic to the construction industry that are inherently and historically self-insured by the owner. By converting the characteristics of a self-insured arrangement (i.e. liquidated damages) to a captive insurance company arrangement, the business may be able to accelerate the deductions of the premiums as an insurance expense to the operating company and the captive may be able to build up reserves and policy holder surplus in a tax advantageous manner.

Harnessing all of the benefits of owning your own captive insurance company, including the tax benefits, is simply prudent strategic planning. As long as the proverbial tail (tax) is not wagging the dog (insurance and business purpose), you should have a solid foundation for your captive to build upon. "Tax litigation has taught that a captive, in order to justify its tax benefits, must demonstrate economic substance and business purpose independent of such tax benefits. This does not mean that a captive cannot openly pursue the tax advantages that ensue from qualifying as an insurance company. Instead it means that the simple pursuit of federal tax advantages is not enough to sustain the decision to create a captive." [1]

What if BJF Contracting had implemented its own single parent captive? First, the contractor would have paid premiums over the course of the year, creating a deductible expense for the contractor in year one and all subsequent annual renewals. Those premiums would have then accrued within the captive, earning investing income, free from third party creditors and liability. At the time of a claim, BJF Contracting would seek reimbursement from its captive for the total loss amount of $54,000 plus legal fees.

In the absence of the captive, BJF incurs those expenses within the contracting business however, the deduction is not allowable until the amount is actually paid, referred to as an "economic performance," which might not occur until future accounting and/or tax periods. By implementing a captive the contractor smoothes out the affects of losses on cashflow, builds up reserves to be utilized for potential future claim activity that may be excluded by other sources of insurance, builds up surplus to be utilized to negotiate with bankers or sureties, and may also experience certain tax and asset protection advantages as well.

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* The term "captive" comes from Frederic M. Reiss, who coined the term while he was bringing his concept into practice for an industrial client in Ohio in the 1950's, Youngstown Sheet & Tube Company. They had a series of mines where the ore was used solely for the company's operation and its management referred to them as captive mines. When Reiss helped the company incorporate its own insurance subsidiaries, they were referred to as captive insurance companies because they wrote insurance exclusively for the captive mines. Reiss continued to use the term for his concept and both the captive and the term have adopted a far wider context.

[1] November 2008 Captive Review "When the tail wags the dog" Randy Beckie and Phil England of Anderson Kill & Olick.

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