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The Captive Medical Malpractice Insurance Company Alternative

*James A. Christopherson**

INTRODUCTION

In recent years, health care providers, including hospitals, health maintenance organizations, and physician practice groups, have faced steadily rising medical malpractice premiums, which have led them to seek alternative sources apart from the traditional policies and services provided by large, independent, commercial insurance companies. One alternative of increasing popularity is the captive medical malpractice insurance company ("captive"). Rather than purchasing insurance from an independent insurance company, the insured can create a subsidiary or sister corporation, the captive, to act as a funding vehicle for the insured (the captive's owner(s) or its affiliate(s)) by assuming some or all of the owner's risk of financial liability for medical malpractice either through direct insurance or reinsurance.

The relationship between an insured and its captive is distinguished by the high degree of control the insured can exercise over its insurer. As the captive's owner, the insured can be directly involved in major decisions made by the captive regarding underwriting, investment policies, claims management, and quality improvement. Direct involvement with these issues as well as with the captive's ongoing performance often means that the insured can reduce its risk-funding costs. Indeed, reducing insurance costs by effectively managing risks and by eliminating much of the overhead carried by an independent insurance company is what makes forming a captive an attractive option for many health care providers.

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Beyond reducing premiums and providing protection from premium fluctuations, there are several other reasons health care providers may decide to form a captive:

- * the insured(s) can control the investment of premium income and capital, which can reduce premium costs;
- * the captive can design loss prevention and claims handling programs for medical malpractice claims, a highly specialized area (including a unified legal defense among multiple defendants);
- * the captive can provide broader coverage than may be available in the commercial insurance market (or for some risks the only coverage); and
- * the captive can access the reinsurance market.

A practitioner who attempts to form a captive for a health care provider must be aware of many issues.¹ An extremely significant issue is the tax treatment of the premiums the insured pays to its captive: a for-profit insured must be able to deduct as business expenses the premiums it pays its captive,² and not have them treated as nondeductible loss reserves. The recent Sixth Circuit Court of Appeals decision in *Malone & Hyde, Inc. v. Commissioner*³ highlights some of the tax traps that await the unwary practitioner when forming a captive. While it is beyond the scope of this article to describe in detail the tax advantages and disadvantages of a captive, it will discuss *Malone & Hyde* and, more generally, the Internal Revenue Code's treatment of corporate insurance, providing an overview in this area.

In addition, a practitioner must consider the tradeoffs involved in domiciling the captive. Offshore domiciles are extremely popular because of the greatly reduced regulatory

1. For more guidance, see Donald A. Winslow, *Tax Avoidance and the Definition of Insurance: The Continuing Examination of Captive Insurance Companies*, 40 CASE W. RES. L. REV. 79 (1990); Joseph C. Safar, *When Federal Tax Law Frustrates Policy: The Confused Rules Governing the Deductibility of Captive Insurance Premiums*, 34 DUQ. L. REV. 105 (1995); Julie A. Roin, *United They Stand, Divided They Fall: Public Choice Theory and the Tax Code*, 74 CORNELL L. REV. 62 (1988); Note, *Revenue Rule 77-316 and Carnation Co. v. Commissioner: An Analysis of the Attack on Captive Offshore Insurance Companies*, 2 VA. TAX REV. 111 (1982); Theodore D. Moskowitz & Walter A. Effross, *Turning Back the Tide of Director and Office Liability*, 23 SETON HALL L. REV. 897 (1993); Stuart R. Singer, *When the Internal Revenue Service Abuses the System: Captive Insurance Companies and the Delusion of the Economic Family*, 10 VA. TAX REV. 113 (1990); William B. Barker, *Federal Income Taxation and Captive Insurance*, 6 VA. TAX REV. 267 (1986).

2. See generally Winslow, *supra* note 1. This issue is not important to the tax-exempt organization.

3. 62 F.3d 835 (6th Cir. 1995).

burden, lower capitalization requirements, and certain federal tax advantages for tax-exempt organizations. This article will discuss the reasons for forming a captive medical malpractice insurance company, the different types of captives, and the due diligence considerations that the practitioner will face when forming a captive.

I. REASONS TO FORM A CAPTIVE MEDICAL MALPRACTICE INSURANCE COMPANY

Most entities looking at the possibility of forming a captive do so because they believe that they can reduce risk-funding costs. There are two primary ways a captive can reduce premiums. First, a captive should be able to minimize the administrative costs (including taxes) and eliminate the profit margins included in a commercial insurance company's premium. Second, a captive may be able to reduce loss exposures and manage claims more effectively than a commercial insurer. One single principle underlies the advantages a captive may afford its founders: by directly aligning the policyholders' economic interests with the economic interests of the captive's owners/decision makers, a more favorable financial outcome is likely. Further, in the health care context, it can be expected that these economic considerations will result in improved patient care.

The reduction of commercial insurance company overhead alone should result in some lowering of premiums. However, in order to reduce premiums further, the captive must become an effective vehicle for reducing loss exposures and managing claims. Therefore, any entity looking at the formation of a captive should closely examine its own loss history. For example, there can be wide swings in profits and losses from year to year because of the potential for large verdicts (and settlements) in medical malpractice lawsuits. Health care organizations considering whether to form a captive must look very closely at the amount of risk to be retained in the captive relative to obtaining commercial excess or reinsurance coverage for higher-exposure layers.

Another advantage to forming a captive is directing investments and retaining income on invested premium and capital until claims and loss adjustment expenses are actually paid. While captives often are formed with a relatively small amount of capital, loss reserves typically are quite large and are invested for the lengthy amount of time it takes to resolve the medical

malpractice claims. This investment income can be used to reduce future premiums.

While the low capitalization required for a captive may be seen as an advantage, in general a practitioner should advise a client against undercapitalizing the captive. An undercapitalized captive may not provide an adequate "cushion" should premiums fail to cover claims and adjustment expenses. A properly capitalized captive may avoid the drastic consequences of a court declaring the captive a sham corporation, as did the Sixth Circuit Court of Appeals in *Malone & Hyde, Inc. v. Commissioner*.⁴

Another reason a health care entity might consider forming a captive is to use its expertise in handling medical malpractice claims. Many commercial insurance companies writing medical malpractice insurance also write other lines of insurance. By having a captive formed expressly to provide medical malpractice insurance for its owners and perhaps other closely related and economically interested parties (such as medical staff physicians), the captive can handle its claims more efficiently, which can ultimately result in smaller or fewer claims being made. Smaller and fewer claims result in increased profits for the captive or, in the alternative, reduced premiums to the policyholders/owners.

Captives and their owners may also benefit from being able to access the reinsurance market. Many captives, when they are initially formed, do not have the financial ability to take on intermediate layers of risk, much less catastrophic layers of risk. So captives often contract with reinsurance companies to assume a portion of the risk. For example, a captive may determine that it cannot remain economically viable if it has to pay claims aggregating over \$500,000 in a particular year. The captive could then cede to a commercial reinsurer aggregate annual losses in excess of \$500,000 by entering into a reinsurance contract (often called a reinsurance treaty). The captive would then pay the reinsurer a portion of its gross written premium in exchange for the reinsurer's covering the specified portion of the risk.

By gaining all of these advantages, the captive can provide coverage to meet the insured's very particular needs. In some instances, the captive is the only means of coverage, as commer-

4. 62 F.3d at 841. See *infra* section II(B).

cial insurers may be unwilling to insure certain high-risk activities of the health care provider.

II. TAX CONSIDERATIONS

Most offshore domiciles do not impose income or other taxes on captives. While onshore or offshore captives or their for-profit owners generally will pay to the United States government a federal income tax on investment and underwriting income, the offshore captive itself can avoid federal income tax as long as it does not engage in United States trade or business.⁵ A tax-exempt organization, such as a not-for-profit hospital, however, will not be concerned with this issue.⁶ Currently, tax-exempt shareholders of an offshore captive are not taxable because "subpart F" income attributed to them is treated as a dividend excludible from "unrelated business taxable income."⁷ Depending on what version of tax legislation Congress passes in 1996, however, this latter benefit may be reduced or eliminated.

It is beyond the scope of this article to describe completely the tax advantages and disadvantages of a captive.⁸ As a general rule, taxable policyholders of a captive will attempt to have premiums treated as deductible business expenses.⁹ However, tax-exempt policyholders, such as many health care providers, are indifferent to tax deductibility, but can benefit in other ways. Two key issues facing captives with taxable owners are: (1) whether the owners can deduct the premiums paid to the captives as they would commercial insurance premiums, and (2)

5. See Roin, *supra* note 1.

6. In *Florida Hosp. Trust Fund v. Commissioner*, 71 F.3d 808 (11th Cir. 1996), the court held that a trust fund formed to pool the risk of tax-exempt health care entities is not itself tax exempt. "[T]he member hospitals are not 'self-insuring' themselves through these trusts. . . . Neither are they 'purchasing' insurance on a group basis through these trusts. What these member hospitals are doing is providing insurance to each other, on a reciprocal basis, using trust vehicles as their chosen method of operation. Each member insures—each is liable for the losses." *Id.* at 812. The court held the trust funds did not qualify for tax-exempt status under section 501(e)(1)(A). While the tax commissioner had also applied section 501(m) (denial of tax exemption for providing commercial-type insurance) to preclude exemption, the court of appeals never reached that alternative holding.

7. See Comm. on Foreign Activities of U.S. Taxpayers, Am. Bar Ass'n, *Annual Report: Important Developments During the Year*, 44 TAX LAW. 1287 (1991) (citing Priv. Ltr. Rul. 90-24-026 (Mar. 15, 1990)).

8. For taxable owners of a captive, however, most federal tax advantages of a captive were eliminated by the Tax Reform Act of 1986.

9. See generally Winslow, *supra* note 1.

whether they will in fact be treated as separate entities from their owners.

A. *The Definition of Insurance Under the Tax Law*

Businesses other than insurance companies cannot deduct business expenses until the expenses are actually paid or accrued. Under section 832 of the Internal Revenue Code, a reserve established for losses is deductible only if the taxpayer actually issues policies of "insurance" as that term is interpreted by the tax law. If a noninsurance business simply sets up a reserve for losses, it cannot deduct the reserve from income.¹⁰ Therefore, a taxable captive owner/policyholder can take advantage of this deduction only if the captive issues "policies of insurance." To the contrary, captives formed by tax-exempt organizations generally prefer *not* to be defined as "insurance companies" because (1) no federal excise tax will be due, (2) state insurance code regulatory violations may be avoided, and (3) tax-exempt organizations do not need to deduct premium payments. The Internal Revenue Service (IRS) often has taken aggressive positions against captives, claiming that they are not really issuing insurance and therefore are not insurance companies. Whether the courts accept the IRS's position is determined by the legal definition of "insurance" as the term has been defined by case law.

The test for defining an insurance transaction, as set forth by the United States Supreme Court in *Helvering v. Le Gierse*,¹¹ requires that the transaction involve both "risk shifting" and "risk distribution." In *Le Gierse*, the taxpayer concurrently purchased a life insurance policy and an annuity from a commercial insurance company. The "premiums" and annuity payments were structured as an offset so that the insured, and not the insurance company, retained all the risk upon her death. As a result, the insured did not shift risk to the insurer. The Supreme Court found that no insurance existed and, in the process, defined for the first time what constitutes insurance:

Historically and commonly insurance involves risk-shifting and risk-distributing. That life insurance is desirable from an economic and social standpoint as a device to shift and distribute risk of loss from premature death is unquestionable. That

10. See *Steere Tank Lines, Inc. v. United States*, 577 F.2d 279, 280 (5th Cir. 1978), cert. denied, 440 U.S. 946 (1979).

11. 312 U.S. 531 (1941).

these elements of risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators.¹²

Subsequently, courts have struggled with the issue of whether insurance premiums paid to a wholly owned subsidiary can be deducted, or whether they are more like payments made to a self-insurance reserve. To answer this question, courts have attempted to define insurance and determine how that definition applies to captives in a variety of factual situations.

1. The IRS Argues for the Economic Family Approach, but Courts Do Not Adopt It

The IRS, in support of its aggressive position against captives, advanced in 1977 the “economic family” approach: “[T]he insuring parent corporation and its domestic subsidiaries, and the wholly owned ‘insurance’ subsidiary, though separate corporate entities, represent one economic family with the result that those who bear the ultimate economic burden of loss are the same persons who suffer the loss.”¹³ In 1988, the IRS took the position that, based on its economic family theory, no amount of outside insurance business written by a captive creates risk shifting from the parent or its subsidiaries to the captive.¹⁴ The IRS’s position was explained in *Sears, Roebuck & Co. v. Commissioner*:

According to the Commissioner, “insurance” from a subsidiary is self-insurance by another name. Moving funds from one pocket to another does nothing, even if the pocket is separately incorporated. If Subsidiary pays out a dollar, Parent loses the same dollar. Nothing depends on whether Subsidiary has other customers; there is still a one-to-one correspondence between its payments and Parent’s wealth.¹⁵

The IRS’s economic family approach is hard to reconcile with the well-established doctrine that the tax law respects separate corporate forms and thereby treats a subsidiary and its parent as separate legal entities.¹⁶ The courts uniformly have rejected the IRS’s “economic family” approach.¹⁷ For example, in

12. *Id.* at 539.

13. Rev. Rul. 77-316, 1977-2 C.B. 53, 55. See Barker, *supra* note 1, at 282; Note, *Revenue Rule 77-316*, *supra* note 1, at 125-29. See generally Singer, *supra* note 1.

14. Rev. Rul. 88-72, 1988-2 C.B. 31, 32.

15. 972 F.2d 858, 861 (7th Cir. 1992).

16. See *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 439 (1943).

17. See Barker, *supra* note 1; Singer, *supra* note 1.

AMERCO, Inc. v. Commissioner, the Ninth Circuit stated: “[Other] courts have . . . noted [the economic family theory’s] difficulties and have not followed it. . . . We see no reason to follow it now.”¹⁸

2. Some Courts Agree With the IRS’s Position That Captives May Not Be Shifting Risk

While the economic family approach has been widely rejected, courts will look at the degree to which the captive does insurance business unrelated to the parent’s business to determine if the parent has in fact shifted or distributed risk. Thus, while the Tax Court and some courts of appeal have accepted the IRS’s position that single-parent captives are only providing self-insurance, captives with substantial outside business will be deemed in the insurance business for tax purposes. For example, in *Harper Group v. Commissioner*,¹⁹ the unrelated business of the captive varied between twenty-nine and thirty-three percent; the Ninth Circuit held that the Tax Court did not err in finding this amount of unrelated business as demonstrating the existence of true insurance. The *Harper* court relied on *AMERCO*,²⁰ where the Ninth Circuit affirmed the Tax Court’s finding that there was sufficient unrelated business (fifty-two to seventy-four percent) to create a true risk pool and to generate risk shifting. In *Sears, Roebuck & Co. v. Commissioner*,²¹ the Seventh Circuit allowed the deduction when 99.75% of the subsidiary’s business was outside insurance business. In *Beech Aircraft Corp. v. United States*,²² the Tenth Circuit held that only one-half of one percent of unrelated business did not involve risk shifting, and, therefore, the transactions did not create true insurance. It is obvious that the issue of whether there is true “risk shifting” must be closely examined by any health care entity that decides to establish a captive.

B. Premium Deductibility and the Sham Corporation

Counsel should be aware of a highly significant captive case in which the United States Court of Appeals for the Sixth Circuit

18. 979 F.2d 162, 166 (9th Cir. 1992) (citing *Sears, Roebuck & Co. v. Commissioner*, 972 F.2d 858, 861 (7th Cir. 1992). See also *Ocean Drilling & Exploration Co. v. United States*, 24 Cl. Ct. 714, 729 (1991).

19. 979 F.2d 1341, 1342 (9th Cir. 1992).

20. 979 F.2d at 168.

21. 972 F.2d 858, 863-64 (7th Cir. 1992).

22. 797 F.2d 920, 922 (10th Cir. 1986).

refused to recognize the captive as a distinct corporate entity.²³ Malone & Hyde established a wholly owned Bermuda insurance subsidiary, Eastland Insurance, Ltd. ("Eastland"), to provide workers' compensation and liability coverage for Malone & Hyde and its subsidiaries. Eastland's sole asset was its initial capital of \$120,000, which met the minimum requirements of Bermuda law. Northwestern National Insurance Company ("Northwestern") served as Malone & Hyde's primary insurer (sometimes referred to as its "fronting" company) to issue the workers' compensation policies. Northwestern and Eastland entered into a reinsurance agreement pursuant to which Eastland assumed the majority of the risks of Malone & Hyde and its subsidiaries, which was Eastland's sole activity. Specifically, Northwestern reinsured the first \$150,000 of coverage per claim with Eastland. Eastland provided Northwestern with an irrevocable standby letter of credit in the amount of \$250,000 to cover any amounts unpaid under the reinsurance agreement. Subsequently, Eastland increased its letter of credit to Northwestern to \$600,000. Malone & Hyde, as the parent of the captive, executed a hold harmless agreement in favor of Northwestern, agreeing to indemnify Northwestern against any liability to the extent Eastland defaulted on its obligations as Northwestern's reinsurer.

Malone & Hyde paid Northwestern \$2,613,354 in insurance premiums in 1979 and \$3,047,507 in 1980. Northwestern paid Eastland reinsurance premiums of \$1,982,369 in 1979 and \$2,343,648 in 1980. Malone & Hyde claimed federal income tax deductions for the entire insurance premium it paid to Northwestern. The IRS disallowed that portion of premiums paid by Malone & Hyde to Northwestern that Northwestern in turn paid to Eastland as reinsurance premiums.

The issue before the United States Tax Court was whether Malone & Hyde was entitled to deduct as an ordinary and necessary business expense under section 162 of the Internal Revenue Code²⁴ the portion of the premiums that Malone & Hyde paid to Northwestern that were in turn paid by Northwestern to Eastland as reinsurance premiums. The Tax Court ruled that

23. *Malone & Hyde, Inc. v. Commissioner*, 62 F.3d 835 (6th Cir. 1995).

24. I.R.C. § 162(a) (1994).

Malone & Hyde could deduct these portions,²⁵ and the IRS appealed.

The Sixth Circuit began its inquiry by noting that “premiums paid by a business for [commercial] insurance are considered deductible business expenses . . . [but] sums set aside for the payment of anticipated losses through reserves or . . . as a plan for self-insurance, are not deductible business expenses.”²⁶ The Sixth Circuit relied upon *Helvering v. Le Gierse*,²⁷ stating that “unless [a] transaction involves both ‘risk shifting’ and ‘risk distribution,’ it is not an insurance transaction for purposes of the Internal Revenue Code.”²⁸ Since the IRS did not contest the element of risk distribution, the issue before the Sixth Circuit was whether or not there was risk shifting.²⁹

The Sixth Circuit reversed the Tax Court, holding that the payments made by Malone & Hyde were not deductible.³⁰ Initially, the court found that the Tax Court should have first determined whether the premium Malone & Hyde paid to Eastland was “for a legitimate business purpose or whether the captive was in fact a sham corporation.”³¹ The Sixth Circuit found that Eastland was a sham corporation: “an undercapitalized foreign insurance captive that is propped-up by guarantees of the parent corporation.”³² Thus, “premiums” paid by the parent to the sham corporation are not deductible expenses under section 162(a).

The *Malone & Hyde* court extensively discussed and distinguished *Humana Inc. v. Commissioner*,³³ which, unlike *Malone & Hyde*, involved a captive organized to provide medical malpractice insurance. Humana and its numerous wholly owned subsidiaries operated for-profit hospitals in the United States and abroad. When insurance coverage for these hospitals had been canceled, Humana formed as its wholly owned subsidiary Healthcare Indemnity, Inc. (HCI), a Colorado captive capitalized with \$1,000,000 that provided insurance coverage exclusively to Humana and its subsidiaries. Humana claimed the

25. *Malone & Hyde, Inc. v. Commissioner*, 66 T.C.M. (CCH) 1551, 1562 (1993), *rev'd*, 62 F.3d 835 (6th Cir. 1995).

26. 62 F.3d at 838.

27. 312 U.S. 531 (1941).

28. 62 F.3d at 838 (citing *Helvering*, 312 U.S. at 539).

29. *Id.*

30. *Id.* at 843.

31. *Id.* at 840.

32. *Id.*

33. 881 F.2d 247 (6th Cir. 1989).

aggregate amounts paid to HCI as an ordinary and necessary business expense deduction. The IRS denied the deduction and Humana filed suit in the Tax Court, which upheld the IRS's determination.³⁴ The Sixth Circuit affirmed in part, finding (a) that payments made by Humana to HCI for Humana's own coverage did not constitute deductible insurance premiums,³⁵ but (b) that payments made to HCI for coverage provided to Humana's subsidiaries were deductible business expenses because "risk shifting" between and among Humana's numerous subsidiaries existed under the *Le Gierse* test.³⁶

The factual situation in *Humana* was distinguishable from that in *Malone & Hyde* for the following reasons. First, Humana was unable to replace its coverage when its insurance was canceled; *Malone & Hyde* had no problem obtaining insurance. Second, Humana formed HCI as a fully capitalized insurer under Colorado law subject to that state's regulatory control; Eastland was operating on the thin minimum capitalization requirements under Bermuda law. There was nothing in the record to show what regulation Bermuda exercised over captive insurers. Third, on two occasions, *Malone & Hyde* furnished Northwestern with hold harmless agreements; there were no parental guarantees in the *Humana* case.³⁷

The Sixth Circuit in *Malone & Hyde* concluded that

[i]f Humana's scheme had involved a thinly capitalized . . . insurance company that ended up with a large portion of the premiums paid to a commercial insurance company as primary insurer, and had included a hold harmless agreement from Humana indemnifying the unrelated insurer against all liability, we believe the result in *Humana* would have been different.³⁸

A practitioner considering forming a captive must be very careful when relying upon the *Humana* case. *Humana* adopted the approach used in *Clougherty Packing Co. v. Commissioner*,³⁹ where the Court of Appeals looked only to the effect of a claim on the insured's assets to determine whether the party shifted its risk.⁴⁰ However, courts reviewing this issue have not reached a

34. *Humana Inc. v. Commissioner*, 88 T.C. 197, 214 (1987), *aff'd in part, rev'd in part*, 881 F.2d 247 (6th Cir. 1989).

35. 881 F.2d at 251.

36. *Id.* at 252.

37. *Malone & Hyde*, 62 F.3d at 840-41.

38. *Id.* at 842.

39. 811 F.2d 1297 (9th Cir. 1987).

40. *Id.* at 1305.

consensus on any one approach.⁴¹ The *Humana* holding is premised on the theory that there is no direct connection between a loss sustained by a captive and the affiliates of a parent.⁴² The Sixth Circuit refused to look to the parent to determine whether a subsidiary shifted its risk of loss since this treats the parent and the subsidiary as one economic unit;⁴³ it relied upon the United States Supreme Court case of *Moline Properties, Inc. v. Commissioner*⁴⁴ for the proposition that a court should not disregard the separate legal status of a company where it has a valid business purpose and corporate formalities are observed. The Sixth Circuit in *Humana* found that *Humana's* use of a Colorado captive insurance company was not a sham and that it served a legitimate business purpose.⁴⁵

The dilemma facing a practitioner after the *Malone & Hyde* decision is what to do to eliminate the risk of having the IRS treat the captive as a sham and thereby disallow a tax deduction. The lessons of *Malone & Hyde* are as follows:

1. Counsel should advise the client to capitalize the captive with more than the minimum capitalization requirements of the offshore jurisdiction.

2. The parent company and the reinsurer should closely examine the issue of whether the parent should enter into a hold harmless or parental guaranty agreement.

3. The parent and captive should adhere to corporate "formalities" to substantiate that in fact the captive operates as a separate legal entity from the parent.

4. Counsel should be prepared to develop fully the court record with regard to the offshore jurisdiction's extensive regulatory scheme with regard to the captive.⁴⁶

III. PLACE OF DOMICILE

Captive medical malpractice insurance companies may be domiciled in the United States or offshore. Most captives are formed offshore because (1) many offshore domiciles require a

41. Safar, *supra* note 1, at 107-09; Winslow, *supra* note 1, at 81.

42. 881 F.2d 247, 252 (6th Cir. 1989).

43. *Id.* at 256.

44. 319 U.S. 436, 439 (1943).

45. 881 F.2d at 253.

46. In *Malone & Hyde*, the record was devoid of any reference to the degree of regulation that could have been exercised under Bermuda law. If the record had been fully developed so as to disclose Bermuda's extensive regulatory scheme, the Sixth Circuit might have reached a different result.

lower level of capitalization, (2) the captive can avoid the burdensome reporting requirements and regulations imposed by state insurance regulators, and (3) the tax-exempt organization under current law can avoid being taxed under federal law for unrelated business taxable income, while the taxable owner of the captive often can avoid state income taxation.⁴⁷

The following estimates for 1995 show the popularity of offshore captives. Nearly 1850 of the 3400 captives worldwide have a United States sponsor, approximately seventy percent of which are formed offshore.⁴⁸ Bermuda boasts the largest number of captives (1205 of a total 3400), followed by the Cayman Islands (360), Guernsey (280), and Vermont (263), the largest onshore domicile.⁴⁹

However, onshore domiciles are popular as well. For example, a 1995 survey of the fifty-seven insurers licensed under United States captive/Risk Retention Group⁵⁰ regulations shows thirty (over half) onshore medical malpractice insurance company captives domiciled in Vermont, with none of the other six states (Colorado, Delaware, Georgia, Hawaii, Illinois, and Tennessee) even reaching double digits.⁵¹

When forming a captive, the first question posed must be where the captive will be domiciled.

A. Onshore Domicile

There has been a recent trend in the United States to enact less restrictive statutes specifically for the formation of captives. State laws and regulations, however, are still much more onerous⁵² than the laws and regulations of offshore domiciles.

47. For an in-depth analysis of the tax benefits of offshore captives, see Note, *Revenue Rule 77-316*, *supra* note 1.

48. CAPTIVE INS. CO. REP., Jan. 1995, at 4 (Risk Management Publications, Towers Perrin Financial Services, Stanford, Ct.). *See also* TOWERS PERRIN FINANCIAL CENTER, CAPTIVE INSURANCE COMPANY DIRECTORY (1996).

49. CAPTIVE INS. CO. REP., *supra* note 48.

50. *See infra* section III(A) (discussion regarding risk retention group regulation).

51. CAPTIVE INS. CO. REP., July 1995, at 5 (Risk Management Publications, Towers Perrin Financial Services, Stanford, Ct.). *But see* Governor Howard Dean, *Vermont Governor Urges Reconsideration of Budget Proposals*, 10 INS. TAX REV. 2701 (1996) (asking President Clinton to reconsider federal measures that could decrease Vermont's appeal as a captive domicile).

52. *But see, e.g.*, N.Y. S.B. 7582, 219th Gen. Assembly, 2d Sess. (1996) (introduced on May 21, 1996, to exempt from insurance law requirements captives that are formed and licensed in New York).

The Liability Risk Retention Act of 1986⁵³ has encouraged associations and other groups to explore forming risk retention entities within the United States. The Act enables the creation of two different types of entities. The first is a Risk Retention Group (RRG), a risk-bearing captive organized under state law. The second is a Risk Purchasing Group (RPG), an entity that purchases insurance on behalf of the members of a group from an unrelated commercial insurance carrier. Unlike an RRG, an RPG does not require an initial capital investment. The Act does not permit companies based in offshore jurisdictions to qualify as either an RRG or an RPG.⁵⁴

Under the Liability Risk Retention Act, businesses or persons with similar types of risk may form an RRG to insure against their liability exposures. The RRG will be regulated primarily by the domiciliary state.⁵⁵ The Act in large part preempts the authority of nondomiciliary states to license and regulate RRGs.⁵⁶ Specifically, an RRG

is exempt from any State law, rule, regulation, or order to the extent that such a law, rule, regulation, or order would . . . make unlawful, or regulate, directly or indirectly, the operation of a risk retention group except that the jurisdiction in which it is chartered may regulate the formation and operation of such a group⁵⁷

There are exceptions to this broad preemptory language. Nondomiciliary states may, among other things:

1. Tax business written by an RRG in the domiciliary state.
2. Require that the RRG comply with the nondomiciliary state's unfair claims and deceptive trade practice laws.
3. Require that the policies issued by the RRG contain a notice to the insured that the nondomiciliary state's insurance laws do not apply and state insurance insolvency guarantee funds are not available.
4. Permit, under some circumstances, the state insurance commissioner to examine the RRG's financial condition.

53. 15 U.S.C. §§ 3901-3906 (1994).

54. 15 U.S.C. § 3901(a)(4)-(6).

55. See Maureen A. Sanders, *Risk Retention Groups: Who's Sorry Now?*, 17 S. ILL. U. L.J. 531, 535-36 (1993).

56. See Susanne Scalfane, *NRRA, La. Battle Over RRG Rules*, NAT'L UNDERWRITER, PROPERTY & CASUALTY/RISK & BENEFITS MGMT. ED., Mar. 19, 1996, at 4 (United States District Court for the Middle District of Louisiana granted a temporary restraining order prohibiting Louisiana Commissioner of Insurance from enforcing its new \$5 million minimum capital and surplus requirements on RRGs).

57. 15 U.S.C. § 3902(a)(1).

5. In federal court, assert that an RRG is in “hazardous financial condition.”⁵⁸

The cost of forming an RRG can be significantly higher than forming an offshore captive, depending on the minimum capitalization requirements, feasibility studies, legal fees, and disclosure requirements to avoid anti-fraud provisions of state securities laws. But if the captive wants to sell insurance in states other than the state in which it is domiciled, then the captive (unlike the RRG) may also have to comply with all the licensing and regulatory rules within each state in which it intends to do business.⁵⁹ There has been a substantial amount of litigation regarding the authority of a state, other than the state in which the RRG is domiciled, to regulate the RRG.⁶⁰ Although there are a number of ambiguities with respect to the Risk Retention Act of 1986, an RRG is far better suited for a national liability insurance program than an unfronted offshore captive.

The Liability Risk Retention Act also authorizes the formation of RPGs. Here the states have been given much greater authority to regulate RPGs. The Act allows states to enforce their laws that are not specifically exempted by the Act.⁶¹ In *Florida Department of Insurance v. National Amusement Purchasing Group, Inc.*, the Eleventh Circuit held that the Liability Risk Retention Act does not “exempt purchasing group insurers from being licensed or otherwise authorized in the state where a purchasing group member resides.”⁶² In *Swanco Insurance Co.-Arizona v. Hager*,⁶³ the Eighth Circuit held that the Iowa Commissioner of Insurance could impose its licensing requirements upon an Arizona insurance company providing coverage to an RPG domiciled in Arizona but having members in Iowa. In *Insurance Co. of Pennsylvania v. Corcoran*,⁶⁴ the Second Circuit held that Pennsylvania could apply its regulations relative to insurance policy forms and rates to RPGs. The bottom line is that an RPG provides some, but not complete, relief from state regulation.

58. 15 U.S.C. § 3902(a)(1)(E).

59. Sanders, *supra* note 55, at 536-37.

60. See, e.g., *National Home Ins. Co. v. Commonwealth*, 444 S.E.2d 711 (Va. 1994).

61. 15 U.S.C. § 3903(g).

62. 905 F.2d 361, 365 (11th Cir. 1990).

63. 879 F.2d 353, 359 (8th Cir. 1989).

64. 850 F.2d 88, 92 (2d Cir. 1988).

State insurance laws usually define the conduct of insurance business broadly in terms of acts that may be conducted in the state only by a company licensed to conduct insurance business within the state. Typically, the acts that can only be conducted by a licensed insurance company include underwriting, negotiating, and issuing policies within the state.

When an insured within a state contracts with a company that is licensed within that state, the premiums paid to the licensed company are subject to state premium taxes.⁶⁵ There are some exceptions that allow an insured within a state to contract with insurers that are not licensed in the state. For example, states allow exceptions for insurance companies not licensed within a state to transact "surplus lines" business.⁶⁶ The insured can only place insurance through a broker with an insurer not licensed within the state if, after due diligence, it is determined that the insured cannot obtain the particular coverage from a licensed insurer within the state. The surplus lines premium tax is usually paid by the insured and turned over to the state by the licensed surplus lines broker. A surplus lines company normally must meet minimum capitalization requirements and will be regulated to a limited extent by state law.

A second exception to the requirement that an insurance company cannot conduct business in the state (including underwriting and issuing policies) without being licensed within the state applies to self-procurement transactions. Self-procurement transaction exceptions often apply to single-parent (as opposed to group) captives. The captive will usually be considered an unlicensed company if it is not domiciled in the same state as the insured. The state laws in this area vary and should be closely examined. Generally, state laws require the following:

1. The transactions must be reported and the premium tax paid.
2. The negotiation and delivery of the policy and the payment of the premium must occur outside of the insured state.
3. The negotiations should not be conducted by mail or telephone from within the state, and insurance agents or brokers should not be involved in the transaction.

65. See, e.g., VT. STAT. ANN. tit. 32, § 8551 (1991 & Supp. 1995). Direct premiums of a captive insurance company are taxed at a higher rate than reinsurance premiums. VT. STAT. ANN. tit. 8, § 6014 (1993 & Supp. 1995).

66. See, e.g., VT. STAT. ANN. tit. 8, § 3368 (1993).

Depending on the state, the practitioner should look closely to the state law and the applicable statutes.⁶⁷ Historically, owners of captives have not usually reported or paid premium taxes for the following reasons:

1. Regulators, up to now, have not strictly enforced the statutes.

2. The rationale for a premium tax is to pay for regulation and protection. Captives generally are not regulated and do not need the protection.

3. Contributions to a self-insurance fund are not insurance premiums.

4. All activities of insurance take place outside of the state.

Certainly, some states make the formation of captives attractive. However, as stated above, offshore sites provide unique opportunities for those wishing to take advantage of the captive option.

B. Offshore Domicile

The most popular offshore jurisdictions for captives generally are Bermuda, the Cayman Islands, Barbados, the Bahamas, the Channel Islands, the Isle of Man, and Ireland. In addition to the less stringent regulations they impose, these domiciles have existed for a long time and have developed an infrastructure that leads to predictability.

A 1995 report of medical malpractice insurance company captives shows that the Cayman Islands maintains 132 of the 236 reported captives, followed by Bermuda with 67, and Barbados with 19. The other jurisdictions, Europe, the British Virgin Islands, British Columbia, Australia, and the Bahamas, rank only in the single digits.⁶⁸

In addition to the tax and regulatory benefits listed above, offshore domiciles do not limit the type of coverage that a captive can write. Nor do offshore domiciles regulate the amount of the premiums that can be charged to members. This can result in significant cost savings for the captive. Captives formed offshore, unlike RRGs and RPGs, are not limited to writing liabil-

67. For example, specific self-procurement taxes or industrial insured exemptions issues may arise. See, e.g., Ruling of R. Gary Clark, Tax Admin., R.I. Div. of Taxation, No. 94-21, Aug. 3, 1994, 1994 WL 415239.

68. Johnson & Higgins, Address at meeting held in the Cayman Islands (Dec. 1995) (on file with the *Annals of Health Law*). See also CAPTIVE INS. CO. REP., *supra* note 51.

ity insurance. They can write additional lines of coverage such as workers' compensation if the coverage is fronted by an admitted carrier.

In the two most popular offshore domiciles for captives, the Cayman Islands and Bermuda, the minimum capitalization requirement is \$120,000 in United States currency.⁶⁹ This minimum requirement can help overcome what may be the greatest obstacle to successfully forming or operating a captive: the inability to raise sufficient capital. However, captives normally should be formed with capitalization well in excess of the minimum requirements. In addition to the minimum capitalization requirements, most offshore domiciles also require a sufficient premium to surplus/capital ratio. For example, the insurance regulators in the Cayman Islands prefer that the captive calculate a capitalization figure that reflects the volume of the captive's business, its exposure to risks, its pay-out patterns, and its obligations under fronting and reinsurance agreements.⁷⁰ The regulators suggest that the premium-to-surplus (in other words, capital) ratio be at least three to one, and it is extremely unlikely that the Cayman Islands will license a captive with a premium-to-surplus ratio above five to one.⁷¹ Some offshore jurisdictions require that the capital be at least five times the exposure to any single retained risk. In contrast, most state statutes require that capitalization be at least ten times the exposure to any single retained risk.

The first health care captive—started by Harvard University in the 1970's—was originally to be domiciled in Bermuda. However, Bermuda regulators resisted the captive's formation because of a fear of physician malpractice risk. So the captive was domiciled in the Cayman Islands. Beginning with the Harvard captive, the Cayman Islands has been the domicile of choice for many other health care captives. While Bermuda has become more flexible and many health care captives are now

69. Michael Schachner, *Cayman Copes with Soft Market; Slow, Steady Growth is Target Until Insurance Rates Harden*, BUS. INS., Apr. 30, 1990, at 64 (Cayman Islands); Susanne Sclafane, Malone & Hyde *Dims Deduction Hopes*, NAT'L UNDERWRITER, PROPERTY & CASUALTY/RISK & BENEFITS MGMT. ED., Mar. 18, 1996, at 9 (Bermuda).

70. John E. Darwood, Head, Ins. Section, Cayman Islands Fin. Serv. Supervision Dep't, *Health Care Sponsored Captives: Cayman Keys to Successful Captive Operations*, at 6-7 (presented at the Cayman Islands on Nov. 30, 1995) (on file with the *Annals of Health Law*); Schachner, *supra* note 69.

71. Michael Bradford, *Cayman Fees for Captives Unchanged*, BUS. INS., Apr. 10, 1989, at 68.

domiciled there, the Cayman Islands regulators are quite receptive to captives insuring physicians.⁷²

IV. TYPES OF CAPTIVES

When deciding whether and how to form a captive, health care providers and their attorneys have several options, which provide different benefits depending on the particular characteristics of the provider.

A captive can be set up as a direct writing captive, or the captive can use a fronting company (an insurance company licensed to provide insurance in the United States). If a captive operates through a fronting company, the fronting company issues the malpractice insurance policy to the provider and the captive assumes a portion of the risk through its reinsurance agreement with the fronting company. Use of a fronting company will increase costs because the fronting company will receive a portion of the premiums in exchange for the use of its license and for accepting some of the risk. The captive will also be relinquishing some measure of control to the fronting company.

However, there are some cost advantages to using a fronting company. The federal excise tax is only one percent of the premium when a fronting company is involved,⁷³ while the federal excise tax is four percent of the premium when the offshore captive directly issues insurance.⁷⁴ Physicians often prefer fronting companies because (1) they feel secure knowing that the insurance company is regulated within the United States (and thus has a strong rating), and (2) if the insurance company fails, they will usually be protected by the state's guaranty fund.

Captives are often formed by large tax-exempt health systems. In today's rapidly changing health care environment, health care systems are looking at creative ways to gain an advantage. A captive can provide specialized coverage, such as managed care coverage, that may not always be available or affordable in the commercial marketplace. In addition, health care systems often attempt to find ways to add value to their health system by attracting affiliated physicians. Through captives, health care systems can often offer reduced premium rates for both employee and independent contractor physicians. A

72. See *Hospital Forms Captive for Malpractice Cover*, BUS. INS., Feb. 15, 1988, at 63.

73. 26 U.S.C. § 4371(3)(1994).

74. *Id.* at § 4371(1).

danger area for tax-exempt health care systems is unrelated business taxable income, which, if substantial, could jeopardize the system's tax-exempt status. Offshore captive income is not usually subject to unrelated business taxable income,⁷⁵ but changes currently proposed in the 1996 tax bill may change that.

Many health care systems are trying to find ways to develop affiliations with independent physicians. Some health care systems have discovered that they can reduce premiums for physicians as well as increase physician loyalty by using captives. If the physicians are employees of the health care system, coverage can be provided directly by the captive. If the physicians are not employees of the health care system, there are two legal problems to be addressed. First, physicians may have contractual obligations (perhaps with an outside hospital) that require them to carry professional liability insurance from a licensed or admitted carrier. Second, a captive generally cannot directly solicit business insurance in the United States without violating state insurance laws.

There are two possible solutions to these problems. The first is to use a fronting company to provide coverage to the physicians. The fronting company will reinsure some of the risk with the captive. However, as stated above, the use of the fronting company will increase the costs of providing insurance. The second possible solution is to form an RRG, discussed earlier, under the Liability Risk Retention Act of 1986. The health care system must carefully and closely consider these two alternatives when evaluating the feasibility of providing insurance to independent contractor physicians through the use of a captive.

VI. OTHER COVERAGE FOR THE HEALTH CARE PROVIDER

One of the principal advantages to setting up an offshore captive is that the captive can provide very flexible insurance coverage. A captive can handle risks throughout a health care system. Many health care systems are currently involved in physician hospital organizations (PHOs), managed care organizations (MCOs), management service organizations (MSOs), joint ventures, and other collaborations. Under certain circumstances, a captive may be able to write insurance to provide managed care "capitation" risk coverage, as well as traditional

75. Eric T. Laity, *Defining the Passive Income of Controlled Foreign Corporations*, 21 N.C. J. INT'L L. & COM. REG. 293 (1996). See, e.g., Priv. Ltr. Rul. 94-07-007 (Nov. 12, 1993).

malpractice insurance coverage, for these organizations. The legal structures now found in the health care industry, including PHOs, MSOs, and MCOs, present unique risks that may become uninsurable in the traditional insurance market. Even if these new health care structures can be insured in the commercial market, the premiums may be extremely high because the underwriters are uncertain about what they are insuring. In many of these ventures, the health care entity can be a provider, supplier, customer, and insurer all at the same time. Captives can usually manage the risk for these ventures and reduce costs far better than can commercial insurance companies.

In addition to managed care coverage, a captive can provide other traditional lines of insurance, including (1) provider stop-loss insurance; (2) workers' compensation insurance; (3) general liability insurance; (4) environmental liability insurance; (5) auto and property insurance; (6) directors and officers insurance; and (7) errors and omissions insurance.

VII. CAREFUL SELECTION OF A CAPTIVE MANAGEMENT CONSULTANT: DUE DILIGENCE

Normally an entity that is considering the captive alternative must hire an insurance management consultant to assist both with feasibility studies and, ultimately, in forming the captive. Enter the captive insurance company manager, a burgeoning field. A captive may hire an outside consultant, such as one of the five largest—Johnson & Higgins/Unison, Marsh & McLennan, Alexander & Alexander, ARM/IRM, or Sedgwick—or it may self manage, which is growing in popularity.⁷⁶ It is advisable to interview several managers prior to selecting a management consultant.

The management consultant will assist the entity wishing to form a captive and its legal representatives in preparing the application for licensing in the domicile, as well as the other administrative and legal needs. Often, the consultant will recommend a legal representative if the owner does not already have one. In conducting due diligence, the potential owner of the captive should address each of the following with the prospective consultant:

1. The expertise of the consultant in forming captive medical malpractice insurance companies.

76. *Largest Captive Managers*, CAPTIVE INS. CO. REP., Sept. 1995, at 6.

2. If the type of the potential captive is distinctive (such as a jointly owned physician and hospital entity), the specific experience of the consultant in that area.

3. Names and addresses of references that can be contacted.

4. Estimates of the cost to conduct a feasibility study. (Feasibility studies can be quite expensive, yet due diligence is important.)

5. Specific information regarding the consultant's accounting procedures, including its ability to maintain financial statements and management accounts, issue premium invoices, if applicable, provide for the payment of claims and reinsurance premiums, arrange for audits, prepare and file statutory returns, provide for the administration of investment procedures, and maintain accurate records of all financial transactions.

6. The actuarial expertise of the consultant in the area of claims, either in house or through the use of competent outside specialists.

7. The expertise of the consultant in the area of underwriting and arranging for reinsurance.

8. Specific pro forma financial information.

9. Specific information regarding the costs and fees paid to the consultant for setting up the captive as well as running it on an ongoing basis.

10. The consultant's willingness to allow the owner of the captive to sever the relationship with the manager, in whole or in part, after the captive is formed.

Once the captive is operational, the management company and the board of directors will govern the captive. Most captives are managed by professional management companies that employ a team of professionals (usually accountants) to provide expertise in insurance underwriting, claims, reinsurance, financing, accounting, and legal matters. Depending on the level of expertise of the entity forming the captive, some of these functions may, over time, be performed in house, although counsel must consider the various tax ramifications of an offshore manager versus an in-house staff located in the United States.

CONCLUSION

The captive alternative for coverage of medical liability may greatly benefit some health care providers. Pros and cons for forming a captive exist for both tax-exempt and taxable entities.

For tax-exempt health care entities, the advantages of a captive may, in many circumstances, outweigh the disadvantages. For taxable entities, there are no tax savings at the federal level, but forming a captive nevertheless may significantly reduce the cost of providing insurance. The practitioner must address many issues, which will differ with each sponsoring organization, and consider the various available jurisdictions for a domicile. In summary, any sizable health care entity should carefully consider the possibility of setting up a captive.