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INSIGHT: Denied Business Interruption Claims Could Spur Boom in Captive Insurance

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The insurance industry is built on a foundation of actuarial certainty.

Individuals and businesses pay significant premiums—$1.22 trillion in 2018—to have something they hope they never will need. The Covid-19 pandemic has put that certainty in jeopardy.

As government mandated lockdowns began to wreak havoc on revenues in early March, business owners scrambled to review property and casualty policies for what they thought might be their saving grace—business interruption policies believed to be the buffer that would insulate businesses from the pandemic-induced trauma. As many articles have discussed; however, their hopes were short lived. Insurance underwriters had learned from past experience and added exclusions to limit or exclude coverage for unpredictable events, such as pandemics following the SARs outbreak in the early 2000s.

The realization among businesses that policy payouts were not forthcoming was met with a harsh reaction directed at the insurance industry, including a slew of negative media reaction and, in some cases, litigation. The plight of policyholders has even become a bipartisan talking point as politicians discuss ways to force insurers to cover business losses. Yet, practical hurdles stand in the way, including at its most basic level, whether insurance companies can afford to pay out an estimated $255-$431 billion in monthly small business losses just in the U.S.

As this pervasive uncertainty continues to grip business owners, those that manage to emerge from the Covid-19 crisis likely will be left with a jaded view of traditional insurance options. As a result, will this experience diminish interest in business interruption policies as business owners question the large sums of money annually spent on a product that left them without help when they needed it?

Perhaps the answer may lie with an overlooked and sometimes misunderstood alternative to traditional insurance: captive insurance.

While the history of the insurance industry dates back centuries to Lloyd's of London's coverage of shipping cargo, the captive insurance segment represents a much more recent development with a complicated history. Originally pioneered by Fred Reiss in 1957 with Youngstown Sheet and Tube Co., the idea was to allow a company to own and operate its own insurance company. With large enough scale, a company could create a subsidiary allowing for the company to pay premiums to itself while either reinsuring risk or providing coverage for previously uninsured risks. Although radical at the time, this idea since has been adopted by a majority of Fortune 500 companies.

The proliferation of captives was not initially welcomed by the Internal Revenue Service due to skepticism regarding the related entity structure and concern that captive insurance companies were functioning as tax shelters. The IRS pursued taxpayers through a number of cases and revenue rulings. Other issues, including that all captives were initially forced to domicile in Bermuda and the Cayman Islands, did not aid in taxpayer's arguments of legitimacy. Eventually, individual states allowed captives to move on shore. Moreover, other early issues subsided as a result of the Tax Reform Act of 1986, which altered the definition of controlled foreign corporations and introduced a new code section expanding the utility of a captive for smaller businesses.

The introduction of tax code Section 831(b) was critical as this provision encouraged the creation of so-called "micro-captives" which were permitted to receive up to $1.2 million—a number that has increased to $2.2 million—in annual premiums tax-free while simultaneously allowing the 100% deductibility of such premiums paid by the operating business. Accordingly, a business with a micro-captive subsidiary could utilize the entity to insure against risks that were previously uninsured or were prohibitively expensive in the traditional marketplace while only being taxed on the income earned from invested premiums.

Given the potential of such a tool for businesses, bad actors seized on opportunities for abuse in light of those changes. Throughout the last three decades, the IRS has continued to pursue less-than-legitimate structures in which either a captive was utilized to insure unlikely risks or simply as a tax shelter. While those cases stand out, the IRS has lost a number of cases when taxpayers can demonstrate a shifting of risk and a proportional distribution of said risk among captive insurance companies in a given reinsurance pool. Time and again the case history has proven that well-run captives operating for legitimate purposes can be an effective and efficient tool for businesses seeking to lower insurance costs.

Considering the current environment, it now seems imperative that businesses recognize the opportunity captives may offer, especially to those businesses denied interruption claims as a result of the pandemic. One of the greatest benefits of a captive insurance company is the ability of the owners to tailor insurance coverage to the needs of an organization—or group of organizations. While many large businesses routinely expend enough in premiums for a wholly-owned captive to make fiscal sense, flexibility in structure can allow for multiple businesses to come together to pool their insurance expenditures in a group captive for those in similar industries or who face similar types of risk. Moreover, association captives are another popular option for professional service companies seeking to manage practice-specific risks.

While there are a number of industries that could benefit, the restaurant industry in particular may be predisposed to accept such a change given the widescale pain felt as a result of forced closures. A group captive tailored to restaurants may be especially marketable if it can provide some semblance of certainty and coverage for those that survive.

Admittedly, captive insurance companies are not the singular answer to the pain and disruption caused by the Covid-19 pandemic. The unpredictability and wide scale effects of our current situation means that even a hypothetical, perfectly run captive would still struggle to cover the entirety of losses of a business or industry group. Yet, certainly there is value in the peace of mind associated with ownership in the insurance company and knowing that a policy does not contain surreptitious exclusions that will leave the insured out to dry when the next claim comes around.

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