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CAPTIVE MANAGERS

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Charles R. Cohen, Esq.
(602) 648-4040

Captive Managers

Most state laws authorizing the formation of captive insurers require the captive insurer to engage and utilize a Captive Manager. This article will discuss the reasons for this requirement, the role and responsibilities of the Captive Manager, qualifications and approval of Captive Managers, and conflict of interest and dual agent issues inherent in the role of Captive Manager.

Captive insurers are not permitted to market and provide insurance at large, but are restricted to providing insurance to their affiliates and certain other parties who have a relation to the captive insurer that fosters an incentive for the insured to actively manage risk and control loss. Thus, most regulators regard most captive insurance programs as a form of self-insurance. Licensing and regulation of captives is therefore not motivated by the same primary consumer protection concerns that underlie the regulation of "traditional" insurers. The primary public interests in regulating captive insurers are usually the generation of public revenue, the economic development of the captive insurance service industry within the state, and enabling business enterprises to address their own insurance needs through alternatives to commercially available insurance from third party insurers. Captive insurer owners, directors and officers commonly lack experience and expertise in operating an insurance company. The Captive Manager is a private sector insurance consultant and service provider the regulator relies upon to: (i) serve as a knowledgeable intermediary between the regulator and the captive insurer's owners (whose expertise lies in some other industry); (ii) monitor the affairs of the captive insurer on behalf of the regulator; (iii) educate and orient the captive insurer's owners, directors and officers with respect to owning and operating an insurance company; (iv) justify a more relaxed and flexible regulatory regime for captive insurers; and (v) promote the development of the state's captive insurance industry.

Role

Most captive laws provide only a very general description of the responsibilities of a Captive Manager. To the extent addressed at all in the law itself, most captive laws specify that the Captive Manager is required to maintain the captive insurer's books and records at a location in the state of domicile and is required to promptly notify the Commissioner of any failure of the captive insurer to comply with the applicable captive law. Regulators' more specific expectations of the Captive Manager are often expressed in general reference materials, websites, application forms and instructions, and bulletins or even more informal statements of policy.¹ South Carolina and Washington, D.C. have issued regulatory bulletins that describe a Captive Manager's responsibilities in some detail, summarized as follows:

- Maintain a place of business for the captive insurer in the state
- Maintain and make available for inspection by the Commissioner copies of the books and records of the captive insurer
- File statutorily required reports on behalf of the captive insurer
- Obtain prior approval from the regulator prior to implementing material changes to the captive insurer's plan of operations
- Notify the regulator promptly if the captive insurer is out of compliance with financial requirements or evidences another adverse financial condition

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See Government of the District of Columbia, Department of Insurance and Securities Regulation, Captive Insurance Bulletin 2002-01; South Carolina Department of Insurance, Bulletin 2008-03.

Additionally, some states require the Captive Manager to approve material expenditures by the captive insurer, or even be a signatory on the captive insurer's checking account.²

Beyond these "formal" responsibilities, Captive Managers commonly fulfill the following functions:

- To actively promote the captive domicile and attract captive insurer applicants
- To consult with prospective captive owners in the development of their business plans
- To serve as broker for the purpose of obtaining fronting and reinsuring carriers
- To formulate and shepherd the captive insurer's application for certificate of authority
- To recommend other professional service providers, such as attorneys, auditors/accountants, actuaries, underwriters/administrators, risk managers, adjusters, investment managers, bankers and others
- To coordinate the captive insurer's use of professional service providers
- To provide administrative support to the captive's board of directors or other governing body
- To actively monitor the captive insurer's ongoing regulatory compliance

It is not unusual for captive managers to be affiliated with substantial insurers, reinsurers or insurance brokers and to offer "bundled" services that include basic captive management together with some of the other above-described professional services that captive insurers may require.

Qualifications

Most state captive insurance laws commonly describe the required qualifications to serve as Captive Manager in broad terms of possessing sufficient "competence," "experience," "character," and "reputation." Some states specifically require or request that Captive Managers have applicable E&O coverage. *See e.g.*, Arizona Captive Insurance Division Reference Guide, p.11 (5/09).³ *See, e.g.*, S.C. Code Ann. § 38-90-60, 8 V.S.A. § 6002, A.R.S. § 20-1098.01, U.C.A. § 31A-37-202, N.R.S. §§ 694C.180, 694C.210 and 694C.310, and DC ST §§ 31-3931.09 and 31-3931.11. Though some states provide additional guidance amplifying upon one or more of these standards, they are usually not specifically defined. Thus, consistent with general principles of statutory construction, these qualification standards should be afforded their ordinary meanings. Presumably, the regulator's assessment of a proposed Captive Manager's qualifications will be made in the context of the duties the Captive Manager is obligated to perform after approval.

The International Center for Captive Insurance Education (ICCIE) is a 501(c)(3) organization with the purpose of developing and certifying qualified captive insurance professionals. It provides a comprehensive education program leading to the certification of Associate in Captive Insurance (ACI), and also allows course enrollment on a modular basis. The ACI designation requires the completion of five "core" courses, two elective courses, participation in three topic-specific teleconferences, and twelve continuing education credits within three years after obtaining the ACI designation. This is a credible program supported by many reputable participants in the captive insurance industry. However, this author is unaware of any state insurance regulatory agency that relies upon the ACI designation to approve a Captive Manager.

Some domestic captive domiciles "pre-approve" Captive Managers through a quasi-licensing process.⁴ Typically, these domiciles require a prospective Captive Manager to submit a prescribed application form and supporting materials with the objective to be added to that regulator's published list of pre-approved Captive Managers. An applicant for a captive insurer certificate of authority in that domicile must then indicate in its application that it has engaged, or will engage, a Captive Manager from the regulator's pre-approved list. Other domiciles do not publish a list of pre-approved Captive Managers but instead require each applicant for a captive insurer certificate of authority to indicate its choice for Captive Manager, which the regulator must

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then find acceptable in the context of that particular application.⁵ In such case, the captive insurer's application must include certain information about the proposed Captive Manager, often on a prescribed form. The content of the prescribed Captive Manager application forms, under either approval system, effectively constitutes the regulator's articulation of the information it considers relevant for purposes of assessing whether a proposed Captive Manager is sufficiently "competent," "experienced," "reputable," etc.

Any process for approval of Captive Managers creates the possibility of denial and termination of approved status. In fact, the captive insurance laws of many domiciles grant the regulator express authority to withdraw or terminate the approval of a Captive Manager. For example, Arizona law provides that "[t]he director may require a captive insurer to discharge a captive manager for failure to substantively fulfill the captive manager's duties under this article." A.R.S. § 20-1098.16. The South Carolina bulletin provides that the regulator may withdraw or suspend approval of a Captive Manager if:

- "The captive manager knew or should have known the officers or directors of the company were engaged in any conduct that...violated state or federal laws or engaged in any conduct that would otherwise threaten the solvency of the captive insurer and failed to report such conduct to the Department in a timely manner."
- "The captive manager knew or should have known and failed to inform in a timely manner, the captive board of directors and the director of insurance of actions...leading to revocation or suspension of the certificate of authority..."
- "The manager failed to perform the basic manager responsibilities or reporting requirements..."
- "The captive manager engaged in conduct detrimental to the interests of the captive insurer, including but not limited to, conduct that constitutes a breach of the fiduciary duty owed to the captive insurer or a conflict of interest."

South Carolina Department of Insurance, Bulletin 2008-03, pp. 6-7.

Under general principles of administrative law, codified in the Administrative Procedures Acts of most states, the disapproval of a Captive Manager's, or captive insurer's, application for approval of a Captive Manager, and the subsequent withdrawal or termination of approval, constitute agency actions that should be subject to appeal on the grounds of being unauthorized, arbitrary, capricious, or an abuse of discretion.

In determining whether to disapprove a proposed Captive Manager, the regulator obviously enjoys great subjectivity and latitude. In fact, the regulator is likely not to even make any affirmative findings regarding disapproval of a proposed Captive Manager. From both a practical and legal perspective, it would be difficult for either the applying Captive Manager or the applying captive insurer to successfully challenge the regulator's decision that a proposed Captive Manager is not sufficiently "competent," "experienced," "reputable," etc. However, after the regulator has approved a Captive Manager, or licensed a captive insurer without rejecting its proposed Captive Manager, the regulator's withdrawal or termination of that approval should be more susceptible to administrative challenge.⁶ The regulator may be acting arbitrarily and capriciously if it takes the position that a Captive Manager it previously approved or declined to disapprove is now not sufficiently "competent," "experienced," "reputable," etc., unless there is some new evidence that would justify a different conclusion as to the qualifications of the same manager. Thus, it appears that the most likely scenario for the regulator to withdraw or terminate its prior approval of a Captive Manager is the allegation that in its conduct as Captive Manager after initial approval, the Captive Manager failed to perform in accordance with the requirements set forth in the applicable captive insurance law or other guidance.

Dual Agency

A Captive Manager is obviously an agent of its principal, the captive insurer, to the extent it acts on the captive insurer's behalf in dealing with the regulator and other third parties. Generally, an agent has a duty of

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loyalty to its principal to act solely for the benefit of the principal in all matters connected with the agency. Restatement (Second) of Agency § 387 (1958-2009). This duty of loyalty encompasses duties not to act or speak disloyally in matters connected with the agency and not to use or communicate, for its own benefit or that of a third party, confidential information acquired by the agent in the course of its agency. *Id.*; Restatement (Second) of Agency § 395 (1958-2009). However, these general principles of agency do not fully describe the relation of a Captive Manager to a captive insurer because, as discussed above, captive insurance laws generally require the Captive Manager to serve as agent to both the captive insurer and the regulator. In other words, the function of a Captive Manager under most captive insurance laws is one of dual agency.⁷

As in the case of any agency, the exact nature and scope of the duties and authority of an agent as to dual principals must be determined from the particular facts and circumstances. Restatement (Second) of Agency § 376 (2009). However, there are guiding principles. The dual agent must make full disclosure to the principals of all relevant facts regarding its position so that they have full knowledge of the agent's position as dual agent, and the principals must assent to or acquiesce in the dual agency. Restatement (Second) of Agency § 237 (2009). The dual agent has a duty to act with fairness to each principal. *Id.* The dual agent must act with consideration for the interests of each principal and must provide impartial advice to each. Restatement (Second) of Agency § 392 (2009). Unless otherwise agreed, a dual agent has a duty not to disclose to one principal confidential information given to it by the other. *Id.* However, an agent is privileged to reveal information confidentially acquired by it in the course of its agency to protect a superior interest, such as the public interest in preventing the commission of a crime. Restatement (Second) of Agency § 395 (2009).

Suffice it to say, a Captive Manager's legal relations with the captive insurer that employs it and the regulator is a complex dual agency. It is a consultant and service provider to the captive insurer, and at the same time it is a quasi-regulator for the benefit of the regulator.⁸ To properly effectuate this dual agency the Captive Manager must (i) make full disclosure of all relevant facts regarding its position with respect to both principals; (ii) obtain the consent or acquiescence of the principals to the dual agency; and (iii) carry out the dual agency with consideration for the interests of each principal.⁹ It is therefore important that a Captive Manager's service agreement with a captive insurer adequately makes the required disclosures and obtains the insurer's express assent to the dual role. To the extent the Captive Manager fails to make full disclosure to the insurer and to obtain its consent, it may be exposed to liability to the insurer should the performance of its duties for the benefit of the regulator allegedly result in some damage to the insurer.

Conflicts of Interest

The inherent conflict of interest in the Captive Manager's responsibilities to the captive insurer and the regulator is not nearly the only potential conflict of interest scenario for the Captive Manager.

It is not uncommon for a representative of the Captive Manager to serve as an officer and/or director of the captive insurer. Most state's captive insurance laws require that the governing board of a captive insurer have at least one member who is a resident of the state of domicile. Because a captive insurer's owners, and the situs of the activity it insures, often reside outside the state of the captive insurer's domicile, Captive Managers are commonly requested to provide a representative who resides in the state of domicile to serve on the captive insurer's board, either for a full term or until a state resident without such affiliations can be secured to serve as director. Further, representatives of Captive Managers are commonly requested to serve as Secretary and/or Treasurer of a captive insurer. The role of the Captive Manager under the captive law is often functionally similar to the role of a Secretary (i.e., maintaining records) or Treasurer (i.e., approving expenditures) of a company, and it may seem redundant to the captive owners and affiliated directors to put a different person in those offices. Because the captive owners and affiliated directors often lack insurance industry experience and expertise, they may be comforted by having a representative of the Captive Manager in a formal director or officer role with the company.

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Another conflict of interest scenario for a Captive Manager may arise from its role as a provider of services other than services technically associated with the Captive Manager role. As discussed above, a captive management firm may offer its captive insurer clients bundled services that combine services such as brokerage, actuarial consulting, underwriting, policy or claim administration, risk management, and investment management, with the services technically regarded as Captive Manager services. In such cases, the Captive Manager may have a conflict of interest within its own service obligations to the captive insurer. For example, a Captive Manager affiliated with a fronting or reinsuring carrier must be sensitive to the potential to be perceived as "steering" the captive insurer's business toward its affiliates. Or, the Captive Manager may have duties to the captive insurer and/or regulator to report and/or recommend discharge of a service provider not properly performing critical services, such as policy administration. If the same firm is providing captive management and policy administration services, a conflict of interest is likely present. Even if the Captive Manager is not engaged to provide any such additional services to the captive insurer, it may have a conflict of interest arising out of the fact that it is a competitor of the firm that is engaged to provide such services to the captive insurer. This article is not to be regarded as an exhaustive listing of the various scenarios under which a Captive Manager may have an actual or potential conflict of interest as to its client captive insurer.

The general principles of managing conflicts of interest are full disclosure, express consent, and formal recusal from certain deliberations and actions that implicate the conflict of interest. To avoid undue liability exposure to other outside directors/officers of the captive insurer, insureds, claimants, and creditors, among others, a Captive Manager is well advised to be highly informed and sensitive as to conflict of interest issues and expert in their management.

With assistance from DeeAnn Barnes, Esq., Low & Cohen, PLLC.

Endnotes

1. For example, much of the Arizona Department of Insurance regulatory policy with respect to Captive Managers is set forth in its informational "Arizona Captive Insurance Division Reference Guide."
2. Arizona is an example of a state that requires the Captive Manager to approve all disbursements by the captive insurer.
3. Some states specifically require or request that Captive Managers have applicable E&O coverage. See e.g., Arizona Captive Insurance Division Reference Guide, p.11 (5/09).
4. Such domiciles include Washington D.C., Nevada, South Carolina, Delaware, Utah and Vermont.
5. Such domiciles include Arizona, Hawaii, Montana and Kentucky.
6. There may be an issue whether the appropriate appellant is the terminated Captive Manager or the affected captive insurer. The determination may rest upon whether that particular state has a pre- approval process for Captive Managers separate and apart from the certificate of authority application process for captive insurers.
7. Though a Captive Manager is required to function as the agent of both the regulator and the captive insurer, the manager is employed and compensated only by the captive insurer.

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8. One must assume that a court would regard the duties of the Captive Manager to the regulator under the applicable enabling captive insurance law as legally superior to the duties of the captive manager to the captive insurer under its private contract with the captive insurer, to the extent of any conflict.

9. As a practical matter, the requirement of full disclosure and consent concerns the Captive Manager's contractual relationship with the captive insurer rather than its relationship with the regulator. The Captive Manager's duties to the regulator are set forth in the applicable captive law and in the guidance provided by the regulator pursuant thereto. Its dual role is known and understood by the regulator as a given for any captive insurer to which the regulator issues a certificate of authority. However, if not expressly disclosed by the Captive Manager in connection with its written service agreement, the owners, directors or officers of a captive insurer may not be aware of the Captive Manager's various roles and relations under the captive law.