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## A solution to the insurance crisis?

**Fed up with soaring premiums, canceled coverage, and random underwriting rules, small companies are banding together to self-insure**

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(FSB Magazine) -- As Louisiana insurance commissioner, Jim Donelon has heard it all - the stories of quadrupling premiums, abrupt cancellations, disappearing carriers, denied claims. Consumers and business owners in this hurricane-battered region can recite all the reasons they want him to make property coverage more affordable, more available, and more effective. Donelon favors solutions that encourage competition, including adding Louisiana to the growing list of states that permit businesses to band together to create their own locally based "captive" insurance companies. Louisiana's enabling legislation is scheduled to be introduced next spring.



Across the nation, small-business owners are already finding captive insurance an attractive alternative to the commercial market. You don't have to run a company in Hurricane Alley to understand why: For manufacturers, contractors, and professional-service firms, property and liability insurance has become a pricey and uncontrollable variable - a wild card that can break a small business. Since 2000, when the captive business was mostly geared to self-insuring Fortune 500 companies, the industry has expanded to 27 states and the District of Columbia, and the number of captive insurance companies has more than doubled, to nearly 1,100.

Dudley Miles is among the converts. Miles, 61, is CEO of J.D. Miles & Sons ([jdmilesroofing.com](#)) in Chesapeake, Va., a firm founded by his grandfather in 1910. Wildly fluctuating premiums were throwing off his ability to cost his bids. "Once we quote a job, it may not start for six or nine months," he says. "If a carrier decided they'd had a bad year and had to raise rates, we lost money - we had no control." Miles also was finding it difficult to obtain coverage for mold and pollution claims resulting from harmful fumes.

Miles turned to Roof Connect ([roofconnect.com](#)), an alliance of about 75 firms with annual revenues ranging from \$2 million to \$90 million. By banding together and creating their own insurance company, these business owners hoped to bring predictability back to their profit statements, secure special coverage, and make certain that their insurance would not suddenly disappear.

How does it work? A group creates an insurance company, providing enough capital to cover a set amount of risk. The company then purchases reinsurance to cover losses beyond that amount. Day-to-day management is usually outsourced to a specialized company, called a captive manager. Over time, if there are no large losses, excess reserves can come back to the owners as dividends. "When you take in more premiums than your maximum loss, the profits go back to your own company," explains Walter Bell, Alabama's insurance commissioner.

[Small insurers to the rescue?](#)

The roofing contractors started by auditioning captive managers, listening to their pitches to get a handle on capital requirements

and other details. Once it was selected, the manager hired an actuary to perform a feasibility study. Next the contractors consulted lawyers on the structure of the captive and where it should be located: Captives can be domiciled in offshore locations such as the Bahamas or Cayman Islands, which can offer tax advantages, and in 28 U.S. jurisdictions that regulate captives. Of those, 19 have active captive markets. A business operating in a place without the enabling legislation can join a group captive established in another jurisdiction. A company can establish a "single-parent captive" in any of the 28 jurisdictions that permit it. And captive managers can cross state lines to offer their services.

For the contractors, the best solution seemed to be a "rent-a-captive," which appeals to businesses trying to conserve capital. In this setup a financial institution funds the captive, so members don't have to. They pay a fee to join plus annual premiums, and they must provide some form of collateral, such as a letter of credit.

A group of 25 Roof Connect contractors signed with a rent-a-captive in 2004. In the first year the plan took in more money than it paid out, so it enjoyed a net profit. But the contractors did not like the lack of direct control and thought the rent-a-captive had selected an investment advisor that charged too much (like all insurance companies, captives try to generate returns on invested premiums). The contractors terminated the rent-a-captive in 2006 and formed their own company, funding it largely with capital that had accumulated in the rent-a-captive account. They self-insured the first \$500,000 of risk and bought reinsurance to cover larger losses.

To control premiums, members agreed to adopt practices to limit claims, such as quarterly safety inspections and employee drug testing. Big insurers typically offer those services to business customers, but there's a key difference: When it's your own insurance company, the results tend to be better. "It's getting employees to understand that if there's an accident, it's us that's paying, not the insurance company," says Miles. Thanks to improved safety records and lower claims, the captive has been able to reduce premiums. If that continues, the members can expect a dividend - prorated partly according to each firm's loss record.

When should a business consider a captive? Generally, when its risks are not properly understood by commercial carriers. That's why Landscape Structures of Delano, Minn. (playlsi.com), a \$50-million-a-year manufacturer of playground equipment, sought an alternative, says CFO Fred Caslavka. While playground spills prompt a predictable number of product-liability claims every year, serious injuries have been rare, Caslavka says. The commercial insurer overlooked that in setting rates, then caused premiums to swell by racing to settle routine small claims, offering excessive payouts, he says.

After setting up a captive to self-insure the first \$500,000 of claims, a process that cost about \$60,000, Caslavka says he is saving money by taking a harder line on payouts. "Now we manage claims the way we want to," he says. "We decide whether to defend them vigorously or not."

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Superior risk management is a key advantage for captives - and the path to lower rates, says Henry Witmer, assistant vice president of A.M. Best, an insurance rating agency (ambest.com). "Captives offer much stronger risk management, because they can really focus on issues of the group," he says. "That leads to reduced losses and reduced costs and therefore lower rates."

The question remains how well captives perform when risks can't be controlled, such as with hurricanes. "Captives are used when coverage is hard to find or unavailable or too costly," says Leonard D. Crouse, deputy commissioner of captive insurance in Vermont (vermontcaptive.com), the state with the largest captive industry. That certainly describes the situation along the Gulf Coast. But he is skeptical that captives will be a big factor there. Because of the nature of the risks involved, he says, businesses will have to pay in large amounts of capital to get started and will face high reinsurance rates. That may limit the appeal.

Louisiana's Donelon says the biggest benefits of captives may come indirectly. By encouraging self-insurers - and welcoming other new entrants - Louisiana hopes to create an alternative market for businesses that can't find adequate coverage from traditional commercial carriers. Eventually that should help make insurance more available and affordable across the state.

Captives are not for every business. In many ways they're like buying rather than renting, says Dennis Harwick, president of the Captive Insurance Companies Association (cicaworld.com), a captive trade association. "You have to put money down, you have the headaches of maintenance, but if it goes right, you have the benefits of equity," he says.

Clearly the captive phenomenon is gaining momentum - from South Carolina, where captives are a popular alternative to traditional property and casualty insurance, to Arizona, where doctors are self-insuring for medical malpractice. "Small companies are going to be driving this market," predicts Crouse. ■

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