# WOULD YOUR CAPTIVE BENFIT FROM AN INDEPENDENT DIRECTOR?

The Model Audit rule promulgated by the National Association of Insurance Commissioners has been adopted by most states. It established independence requirements that became effective January 1, 2010. Independence requirements were intended by the NAIC to apply to audit committees appointed by the Board of Directors to oversee the accounting and financial reporting processes, and the audit of financial statements of captives and other insurers. To the extent that many insurers have not appointed an Audit Committee, the entire Board is deemed to be the Audit Committee.

These rules are now in place for insurers or groups of insurers who have more than $300 million of direct written premium. But how about the many insurers who are smaller than that? The vast majority of captive insurers, including risk retention groups, are not that big. Good corporate governance should not be limited to compliance with statues and regulations. Rather, captives should adopt best practices based on common sense.

It has often been said, “If you have seen one captive, you have seen one captive”. More so than traditional carriers, each captive insurer is unique. No two captives have the same objectives, the same ownership structure, the same business model, and the same skill sets on their management team.

Here are some of the key factors to consider in determining the corporate governance needs of your captive:

- Who owns your captive? After all, the shareholders are the ones who elect the Board of Directors to best represent their interests.
- Is your captive taking risk solely on behalf of a parent company and its affiliates or does it represent groups of insureds? All other things equal, a risk retention group or an association captive has a greater need for independent directors to represent the interests of its customers than does a pure captive that does not write any unrelated business.
- Who manages the daily operations of your captive? Do you have full time employees dedicated to the management of your captive, or have you outsourced critical functions to professional service providers? Your board needs to independently evaluate the performance of management, and this process becomes problematical if the board and the managers are the same people.
- What is the current makeup of your Board? Do you have sufficient expertise on the board to address strategic risk management issues, investment policy matters, and the business acumen required to objectively evaluate vendor selection decisions?

What can regulators (and legislators, if necessary) do to encourage best practices in the arena of corporate governance? One small, but important step, is to re- examine the requirement common to many states for a “resident director”. Many captive domiciles require that each captive board of directors include a resident of the state in which the captive is domiciled. Historically, this might have been a well-intended attempt to insert representation on the board that is independent of the management. In practice, it frequently accomplishes just the opposite.

The most common starting place to find a resident director is a captive management firm representative who lives and works in the captive's domicile state. While this individual may be well qualified to advise the board, this advisory role is best served in a non-voting capacity. Captive managers should attend all board meetings and play an active role in the agenda setting. However, allowing them to vote on the vendor contracts for critical services, including their own, creates a potential conflict of interest. Additionally, many captive managers (and regulators) consider the role of the captive manager to be a quasi- regulator. The first and foremost obligation of the board of directors is the fiduciary duty of care and loyalty to the people who elect them – the shareholders. In the unlikely event that the interests of shareholders come into conflict with those of a regulator, the captive manager is caught in the middle.

Captive domiciles would be well served by providing the option of an independent director in lieu of a resident director. The independence standard is a far better measure of the potential value of a board member than the location of his or her home. Enabled by legislation or regulations that permit independence requirements as an alternative to residence requirements, captive shareholders have more inducement to select value added members to their boards.

Will this add another cost to the captive's expense structure? Probably so. Many captives do not pay director fees to their inside directors, who are already compensated by their respective employers for their efforts on the captive's board. Finding well-qualified independent directors to serve on the captive's board of directors will be the first challenge. When you find the right person, you will discover that they are not willing to serve at no cost – nor should they!

The cost will be influenced by your expectations of the independent director's contribution. How frequently does your board meet in person or telephonically? Are there board committees on which the independent board member should serve? How smoothly does your independent audit process work? Do the auditors communicate well on the front end planning of the audit and the tail end wrap up stage? You just might discover that having an independent director on your board results in better planning and documentation for all your board members. If the additional benefits of having an independent director do not justify the additional costs over the long haul, do not continue the practice.

Insurers who write more that $300 million of premium have a very specific minimum requirement for outside directors. Insurers writing more than $500 million of premium have an even higher quota. Captives and other smaller insurers have a choice to make. Would your captive benefit by adding one or more independent directors to your board?

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