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How are law firms using captives?

Aon expert David Christensen discusses how law firms are using different types of captives as a risk management solution.

Captive usage is evolving. Since early 2018, several law firms have developed their use of single parent captives for PI risk programs, and these trends are gaining momentum across the sector.

What are captives?

Captive insurance companies are specialty vehicles designed to assist organizations manage self-insurance of all or a portion of their own risk. Captives fall into three main categories:

- Single parent captives (also known as “pure” captives) are captive insurance companies owned by a single organization and whose principle role is to insure that organization’s risks
- Group captives are insurers which underwrite the pooled risks of their owners. Group captives have played a significant role in large law firm professional liability insurance and continue to do so today
- Protected cell captives, sometimes called “rent-a-captives,” are a specialty form of captive used for special purposes and for organizations not willing to make a commitment to their own insurance captive.

How are law firms using captives?

Group captives for law firms have been operational since the late 1970s. Historically, single parent captives have not seen the same levels of popularity with law firms. This may be changing now for several reasons:

- Due to the structure of law firms, achieving the US tax deductibility of premiums has been very difficult for single parent captives. In recent years, tax deductibility has become less important than other strategic uses of captives such as reducing volatility, coverage availability, control of program and participation in underwriting profit. As a result, tax issues are not seen as a disadvantage as much as in the past.
- From approximately 2007 to 2017, professional liability insurance capacity was relatively cost-effective and plentiful, so there was limited demand for new self-insurance vehicles. However, professional liability insurance market conditions began to shift in 2018 and accelerated through 2019. Insurers began to reduce capacity, impose higher retentions on law firms and increase premiums for firms even with clean loss histories. Firms with losses have seen significantly higher retentions and premiums.

- Law firms are increasingly acting like private corporations and have hired specialized resources such as Chief Financial Officers and even dedicated risk managers. Many firms have also grown their General Counsel office to take on risk and insurance issues. This brings with it the need for new financial management techniques, including understanding the benefits of self-insurance and how captives might be used. Furthermore, with the growth of the lateral market, firms are paying more attention to maintaining a stable environment for their partners, and captives may be one additional tool to do so.

We appear to be in the early stages of this trend, but there is clearly interest in exploring captives in various ways.

> *"Over the last 12 months, several law firms have asked us about potentially using a single parent captive for risk financing their professional liability exposure."*
>
> David Christensen, Aon

Approach 1: a single parent captive to self-insure a larger retention, thus pushing up the primary layer attachment.

For example, a law firm willing to take a USD 500,000 per claim retention might create a captive insurance company that will be capitalized enough to retain USD 500,000, excess of USD 500,000. In some cases, there may be premium savings made from this move. In other cases, the captive may be a structure that facilitates a higher retention being forced upon the firm. The captive's role in this structure helps to moderate the volatility caused by the additional retention on the firm's year-to-year financial results.

Approach 2: a captive insurance company shares in the risk in the primary layer (or layers) of a placement alongside commercial insurers.

This is known as a "quota share" structure and can play a strategic role in a professional liability insurance program placement, sharing in the premium and loss of the layer and very visibly demonstrating the firm's willingness to participate with the insurance marketplace. This can positively impact the negotiation process and the firm can increase its participation depending on its view of the risk/reward balance in the insurance transaction.

As the global business environment continues to change, existing and emerging risks will continue to demand innovative solutions. Captives can enable firms to take a dynamic approach to risk management, but engaging with a specialist consultancy and management service will ensure your risk management strategy remains effective and efficient.

If you'd like to discuss any of the issues raised in this article, please contact **David Christensen**.