Earlier this year the IRS released a list of “dirty dozen” tax scams for the 2015 filing season. The list includes captive insurance transactions that involve “unscrupulous promoters” who form and create an “abusive [captive] structure.” One way that the IRS defined an “abusive structure” was to state that any such structure will involve “poorly drafted ‘insurance’ binders and policies to cover ordinary business risks or esoteric, implausible risks for exorbitant ‘premiums’.”

Clearly, an evaluation of a captive’s insurance practices is key to any determination of whether that captive’s operations have legitimacy and are not in any way “abusive.” Perhaps it’s even fair to say that such an evaluation is of greater import than merely looking to who owns the captive if the question is one of whether a small captive is a “real” insurer partaking in legitimate insurance business. Captives that have policies that use “cookie cutter” forms with over-generalized, poorly drafted language are not following best practices for policy drafting. Following best practices is simply the best - and only - way to run an insurance company. This article summarizes some captive best practices in writing policies.

Prior to beginning any discussion of what are best drafting practices let us first address the question: **what is an insurance policy?** While policies are indeed contracts, they are a particular kind of contract unique unto themselves. Insurance policies are “contracts of adhesion,” where the insurer drafts the contract and the insured has little or no ability to make changes to it.

**An Insurance Policy Defined**

An insurance contract is an agreement where the insured agrees to pay premium to the insurer in exchange for the insurer agreeing to cover claims that are within the terms and provisions of the insurance policy.

A fundamental tenet of insurance contract law is that any losses covered under any insurance policy must be fortuitous, unknown and contingent, at the time that the policy is entered into by the parties. The insurer’s obligation to perform (i.e., cover claims) is dependent on the occurrence of a fortuitous loss event. The act of purchasing coverage for an unknown risk is the vehicle through which that risk is transferred from the insured to the insurance company that is being paid premium to assume the risk.

**Rules of Policy Interpretation**

There is a significant body of United States case law that has developed over the years setting forth the rules in various jurisdictions governing policy interpretation and the rules can vary from jurisdiction to jurisdiction.
jurisdiction. Most United States courts have held that the terms and provisions of any policy must be given their ordinary and popular meaning. When interpreting provisions of a policy, courts generally look to dictionary definitions to establish meaning. Unless there is some technical meaning attributable to the policy provision at issue, most often just an ordinary, non-technical or non-legal dictionary definition will suffice to guide a fact-finder in interpretation of the provision at issue.

Courts generally also give all policy provisions effect so even if the court is charged with looking at only one provision or clause in the policy, the way a court (or fact-finder) would look at this provision or clause is in the context of the contract as a whole. This means that the language in a policy is always read in context, where each policy term and provision can be used to help interpret any other.

As a result, if an insurance company writes any particular clause or provision in a certain way, that clause or provision can and should be interpreted in all similar policies it writes in exactly the same way. Identical policy terms cannot be malleable from claim to claim. The proper interpretation of a policy provision in the context of one claim is quite often also the proper interpretation of the same provision in another. In the end, it is the individual facts and circumstances that determine whether or not a policy responds to a loss.

Another fundamental principle of policy interpretation that is widely recognized in United States insurance case law is that because insurance policies are “contracts of adhesion,” ambiguities in policy language are strictly construed in favor of the insured because the insured is presumed to have little to no expertise in insurance or insurance contract law (that said, the rule of strict construction is not typically applied in insurer versus insurer disputes relative to policy interpretation).

So, how is policy ambiguity evaluated? There are many different case law promulgated tests of whether policy language is ambiguous. A complete recitation of these tests is beyond the scope of this article. In general, however, most courts would agree that a policy is not ambiguous just because the parties to it disagree as to the meaning of any term or provision. Moreover, in most cases, courts will apply an “objective” test in determining policy ambiguity so that a court will find an ambiguity if the language at issue is subject to two or more fair and reasonable interpretations. Policy ambiguity may also be evaluated by an analysis of the premium.

While it’s true that the end result will be that if a policy ambiguity is found, the policy gets construed in favor of the insured’s reasonable expectation of coverage, the goal of any exercise in policy interpretation is to determine what was the parties’ mutual intent in contracting for the coverage. In this regard, policy interpretation is like any other type of contract interpretation, where the insurance contract is examined in its entirety to arrive at the parties’ intent and the terms and provisions of the contract are given wide berth as the most objective source of evidence of that intent.

**Features of the Captive Insurance Policy**

The key features of any insurance policy that make it different from any other contract are generally:

1. **insurable interest** by the insured in whatever is being insured under the policy;
2. a **possibility of fortuitous loss** associated with a claim;
3. that the insurer has been transferred the risk and that it assumes that risk as defined by the policy contract; and,
4. the **consideration for the policy contract is premium payment.**

All four elements of a policy contract must be present for the contract to be valid.

**Insurable Interest Defined:**

The insured must have an insurable interest in whatever is being insured. An insurable interest is basically a lawful interest, which means that the insured has some form of a substantial interest in seeking to protect the subject of insurance from loss, harm, damage or destruction.

The insured’s substantial interest need not be an ownership interest per se. Interest can be manifest through the insured receiving or being entitled to any kind of benefit or gain relative to the subject of the insurance (the property, location, business or whatever...
is being insured). Insurable interest is related to the idea of risk transfer. An insured needs to have an insurable interest in the subject of insurance so it can transfer risk to the captive.

From a captive best practices standpoint, any captive policy should adequately describe the risk transferred in a way that insurable interest could be substantiated in the contract terms itself.

**Standard Policy Provisions:**
There are many different types of risk that qualify for coverage under a policy and there are many different policy types. For example, property, general liability, E&O, and D&O lines of coverage. Policies are all different and the differences between the policy lines necessarily depends on what is the type of the coverage.

Prolific use of over-generalized boilerplate policy language where the policy contract does not follow the flow of a traditional insurance policy format could be suggestive of a problematic policy contract. In general, all “real” insurance contracts contain the following:

- The policy starts with a declarations page which identifies the policy number, named insured, the insurer, the type of policy, the policy limit, any applicable deductible or self-insured retention, the period of the coverage, whether or not there is any retroactive date, and the premium.
- A key component to any insurance policy is the insuring agreement. The provisions that make up a policy’s insuring agreement

are used to describe the nature of the coverage and what is the covered peril, location or risk.

- The definitions section of a policy provides definitions of key terms and phrases used throughout the policy. Defined terms are typically in bold or are highlighted in some other manner in the policy itself so that anyone reading the policy will know that the term has been defined in the coverage.
- Exclusions to a policy reduce or eliminate coverage. They describe risk, locations, perils, property, or a type of claim, injury or damage that would not be covered under the policy.
- Policy conditions are those terms and provisions that govern conduct. They detail the duties and obligations required of the insured in order to qualify for coverage. These provisions include notice provisions and cooperation provisions.
- Endorsements are additional documents that are attached to a policy form that alter or modify the coverage provided in the form. They can delete or modify terms and provisions that exist in the form, and can expand or contract provisions in the policy form. Or, they can add new clauses to the policy altogether.

**Documents That Are Incorporated Into the Policy**
The complete policy contract includes not just the terms and provisions as outlined in the policy form itself. The whole of the contract is also extended to include riders, endorsements, or anything physically attached to the policy form or incorporated by specific reference to the policy. For example, it has become commonplace for application documents to contain a statement that the application and all information contained in the application is specifically incorporated by reference into the policy. This is particularly important in the traditional world because it gives commercial carriers the vehicle through which to incorporate insured representations in the application into the coverage so that if there is any material misrepresentation made by the insured such misrepresentation is more easily made the basis for a denial of coverage.

In the captive context, a material misrepresentation as a defense to coverage might be a bit more unlikely to be made, but the idea of incorporating application information into the policy form is still useful in that it might help, down the line, in assisting with policy interpretation and establishing intent of the coverage or an insured’s expectations of coverage.

In the case of an endorsement, many courts have held that if the endorsement is in conflict with a term or provision in the policy form itself, the endorsement will control. What this tells us is that any policy is but the sum total of all its moving parts, but some parts do indeed have more weight when interpreting the contract as a whole and it’s important to look to all parts of the policy, even those parts of the coverage that do not necessarily exist in the policy form itself, even if the question only centers around one specific provision in that form.

A related point is that case law in some states holds that
a Certificate of Insurance is not the policy or the coverage itself. In these jurisdictions, the Certificate of Insurance can only be evidence of a policy – proof that coverage exists – but it cannot establish the terms and provisions of the policy. Conversely, other states have allowed information stated in the Certificate to become part of the policy or have allowed statements in the Certificate to be the basis for interpretation of something in the policy form itself.

The Art of Writing Captive Insurance Policies
In the United States, property and casualty insurers use what are called standardized policies which are drafted by advisory entities like the Insurance Services Office. The standardized, or specimen forms, to any given coverage can be altered by endorsement but the effect of a standardized system of forms is that the coverage can readily become, in many ways, one size fits all.

Artful policy drafting happens when it’s possible to hand craft policies tailored specifically to the risk, which is why captive policies can present an ideal policy drafting scenario. It’s not always possible for the commercial market to hand tailor a line for a single insured, or a single series of related insureds, or for the nuanced risk of a particular type of industry. Rather, the best a commercial carrier can do is alter specimen form coverage via a series of manuscript endorsements where the endorsements hone or replace language in the globally-used specimen contract to tailor the risk to the insured purchasing the line.

In a captive context, the policy form of coverage itself is easily tailored; in other words, captive underwriters need not rely solely on manuscript endorsements to change any policy form, they can make changes to the standard form of the coverage itself. This isn’t to say that specimen forms aren’t used in the captive context. Of course they are. The point is that the option to actually change a policy form to craft precisely tailored coverage that perfectly fits the risk of a single insured exists more liberally in the captive world than it might in the world of the traditional carrier.

All that said, small captive best practices dictate that a captive insurer not deviate too far from the traditional course when it comes to policy drafting. In other words, captives should follow policy drafting rules and convention that applies to their traditional brethren.

Captive owners should make it a best practice of their own to always review and evaluate captive policies to ensure that they have all the key terms, provisions and elements described in this article and to make sure that the policies themselves match the expectations of the insureds. Captive owners should also review all endorsements that are manuscripted onto any policy to ensure that the endorsements do not create a coverage result that is the opposite of what was actually intended.

The IRS is right to look to the policies in an effort to determine what may or may not be a legitimate captive insurance structure, where a legitimate captive is one that does real insurance business for the risk management benefit of the insureds and the captive owner. A legitimate non-abusive captive is one that has well-drafted insurance policies that are written following best practices and that transfer real risk to the captive for an appropriate amount of premium.

When it comes to an evaluation of any captive structure, the proof is in the policies.

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