National Network of Accountants

Re-Imagining Business Insurance

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National Network of Accountants, 6900 Jericho Turnpike, Syosset, NY 11791
www.nnaplan.com E-mail address Daniel@nnaplan.com
Offices located in Connecticut, Florida, New York, and North Carolina

IS IT NECESSARY TO CREATE AN OPERATING AGREEMENT?

By William York, VP of Marketing
National Network of Accountants

Forming a captive insurance company can be a very attractive option to many businesses on many levels. As every day goes by, the value of a newly created, *well managed* captive insurance company should continue to grow in value. Risk management controls added to supplement a well-managed commercial insurance program, should result in the development of a profitable captive insurance company. This is the goal of every captive. The captive must plan for this now and into the future!

THIS BEGS THE QUESTION: How many captive insurance companies are guided by a functioning operating agreement?

Captive owners face increasing financial risk on many levels when not creating a transition/operating plan. An operating agreement is one of the most important documents any business can create, and every captive should carefully consider implementing one. The captive operating agreement governs the internal workings of each captive in a way that suits the specific needs of the owners. Due to the uniqueness of a captive, this document must be filed and accepted in the captive domicile.

REASONS CAPTIVES NEED AN OPERATING AGREEMENT?

1. An operating agreement protects your captive in the eyes of the state of domicile. This document memorializes specific events, and helps each domicile in its oversight function whether redeeming shares, making distributions, or adding additional shareholders.

2. An operating agreement assists a captive insurance company in the event of a possible IRS audit as the captive must prove that it operates as a true insurance company. Most commercial insurance companies create operating agreements. If a captive is a true operating business, it should have a current operating agreement. As it is a separate incorporated business, and is a true insurance company … a captive must operate like a real business.

3. An operating agreement can clarify verbal agreements. Even if members have orally agreed to certain terms, misunderstandings can still arise. It is always best to have the operating conditions in writing so they can be referred to in the event of any conflicts.

Established businesses normally have standing operating agreements. Consequently, it is essential that captives create, recognize, and work in concert with these existing agreements.

ISSUES THAT SHOULD BE ADDRESSED IN A CAPTIVE OPERATING AGREEMENT

1. **Deadlock among members:** Utilizing captive assets, and the future business purpose the captive might consider; the specific duties and role of the managing member when using an LLC structure rather than a "C" corporate structure.

2. **Determination of value:** Considering the timing of claims against direct and indirect claims as well as reserves, surplus, and capital.

3. **Departure of a shareholder:** Caused by a change of employment in the sponsoring company as well as the normal retirement of a shareholder.

4. **Determining the methodology for the inclusion of a new shareholder**: Method of buy-in, changes in existing shareholder ownership.

5. **Divorce of a shareholder**: This may result in a spouse ending up with half the stock of a shareholder. The agreement must contain a provision for a forced buy back of shares.

6. **Death of a shareholder:** Method and timing of payout needs to be considered.

7. **Disagreement among owners**: Especially when there are unequal or multiple owners.

8. **Disability of a shareholder:** If extended, how and when will the shareholder's equity be purchased? Moreover, if there are multiple members – how will the remaining equity be adjusted?

9. **Dissolution of the captive**: Changes in the core sponsoring business, sale or merging of the core sponsoring business, and/or changes in the commercial insurance coverage of the core sponsoring business.

Each of the above issues must be addressed as soon as possible in order to properly control the orderly operation of each captive. Moreover, these issues must be coordinated with the sponsoring company's operating agreement to avoid possible conflicts.

PRACTICAL ISSUES AND REAL-LIFE EXPERIENCE

In order to provide expertise to each captive insurance company, we have researched over 300 captives over a one-year period. At the NNA we believe captives represent one of the strongest risk management tools for mid-market businesses. Our review has shown that every captive should immediately institute an operating agreement. This is particularly important when the ownership is complex.

Recently we reviewed a captive owned by an LLC which had five members. It had been operating for three years and they were looking to bring in an additional member. Questions raised – At what price? How would the other owners' shares be affected?

Another extremely complicated situation occurred with captive ownership when one partner was going through a divorce and the captive ownership was brought in as a marital asset. The captive was owned by one individual and his two sons. This situation required a valuation of the captive and an acceptance by the State of Domicile of the possible new shareholder.

Our job is to relieve your stress, assist in making sound decisions and assisting in the protection of your business so you can sleep at night and not be held "captive" by possible events that could upset your planning. An operating agreement for your captive is one of the tools essential for the success and profitability of your captive.

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Daniel Mauclaire
Phone: 203.650.7357
E-mail: daniel@nnaplan.com
National Network of Accountants
15 N Main St, Suite 100
West Hartford, CT 06107
www.nnaplan.com

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