FEATURE

Adding Value to Captive Boards with Independent Directors

In a recent report from the National Association of Corporate Directors (NACD), the association cited a 2019 survey they conducted which found that "73% of directors reported that board leadership is more challenging than it was three years ago, and 84% reported that performance expectations had gone up for all board members." The report, titled "Fit for the Future: An Urgent Imperative for Board Leadership" also indicated that "a much deeper board understanding of business operations will become critical as … new trends start to transform how businesses are financed, run, and controlled, and how they deliver value to customers."

This is where independent directors come in. Adding an independent director can make an enormous difference in board governance. A qualified independent director can bring skills and experience that can help to educate fellow board members, while bringing a unique point-of-view.

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WHAT IS AN INDEPENDENT DIRECTOR?

An independent director is a board appointee who provides "creative contribution to the board by providing independent oversight and constructive challenge to the executive directors," according to the 2019 "Captive Governance" guide issued by AIRMIC, a UK-based association for risk managers and insurance professionals.

"An independent director will provide independent thought, question the decisions of the captive and challenge the quality of service provision. They can also be used to fill essential skills gaps or provide broader insight into the sector the company is active in."

An independent director is someone who has not been an employee of the captive's owning companies in the last five years or been a third-party service provider to the captive in the last three years. Additionally, the independent director won't have ties to with the captive's senior management, company advisors, or owners; the director doesn't represent a shareholder; the director receives no compensation outside their director's fee; or will have served on the board for more than nine years.

The person serving as an independent director should meet the "Fit and Proper Person Test," in that they should be a person with some type of insurance background, insurance knowledge, or other relevant experience. At its most basic, the director should be "fit"—someone who understands insurance—and "proper"—someone who is ethical and of good character.

An independent director brings to the captive board expertise that the owners likely will not have. According to Jeffrey Simpson, partner with Womble Bond Dickinson (US) LLP, "When the owner of the captive doesn't have a lot of background in insurance, an independent director can help to educate them. When you have a public company, the captive owner is going to be the risk management professionals in the public company. They're going to know what they need to know about captive insurance. When you get down into the middle market and the privately held enterprises that are forming ERCs, for example, they're not going to have the applicable experience and they're going to need the help."

For most group captives and ERCs, the board of their captive is usually made up of owners who are not well-informed about insurance, insurance regulation, or key functions like reserves and reinsurance. While a captive manager or general counsel can help to educate the board in the matters of insurance, having a director on the team that is knowledgeable about the industry helps to broaden the range of discussion and helps to increase the board's ability to make decisions. An active independent director will bridge the gap between management and board.

THE INDEPENDENT PART

It's the "independent" part of an independent director that adds value to a board by the expertise and skills they bring to the table, as well as a contrarian voice. If a board is only made up of the captive owners and the captive manager's people, the captive is only going to have two voices providing input into the company's governance. By including directors outside of those two primary voices, the captive board will get a more complete view of the issues with a closer eye to good governance.

Simpson said, "When you find somebody who is independent—who is not tied up in the politics of the organization, the issues within the organization—they can just focus on how the captive works… They can add a lot of value. They can show you ways to use your captive that you wouldn't otherwise have thought about. They can identify regulatory issues that you might not think about or that you might overlook. They can keep you on the straight and narrow when maybe not everyone is paying attention to that."

According to the AIRMIC report, "A truly independent and proactive [independent director] will also assist the company in demonstrating to the local regulator that the captive takes its governance requirements and role as a regulated entity seriously."

Independent Directors

While independent directors are not required in most U.S. captive domiciles, many states do require a captive board to have a resident director—a board member who lives in the domicile state. In the early days of captives, resident directors were often appointed through the captive manager which operated in the state of domicile. With the proliferation of domiciles, it's not expedient for captive managers to have offices in every state, so the requirement for a resident director on the captive's board is a chance to seek out a qualified independent director.

"A resident director needs to be a resident of the domicile state and work on the captive's board. That's an invitation to bring someone onto the board that you wouldn't otherwise have," said Simpson. "Now you have the opportunity to bring in somebody who can add value to the transaction and to me that is a big opportunity to bring on an independent director to help you. You get folks in who can show you things you didn't know, can see things from a different perspective, and who can help you avoid regulatory pitfalls."

If independent directors are so valuable to a captive board, why don't they all have independent directors? "If there was going to be a practical reason that they weren't going to do it, it would be cost," said Simpson.

"I think that's a narrow view—a legitimate view, a reasonable view—but it's not an ambitious view and I don't think it's an open-minded view."

Independent directors can add extra costs in terms of a director's fee or stipend, extra travel costs, and additional Directors and Officers (D&O) insurance policies. Independent directors will expect some kind of renumeration as any type of expertise does not come free. They will also expect to be offered D&O coverage or to be compensated for procuring their own to cover the cost of their risks in taking on that responsibility. It's not that independent directors are terribly expensive, but if a captive is operating on a tight budget, the difference of an extra thousand dollars per year for an independent director could be a deal breaker.

However, if it is in a captive's budget to bring on an independent director, then it should be a priority. In fact, Simpson recommends bringing on more than one independent director if possible. This is a widespread view and is endorsed by AIRMIC as well, "The captive may want to counter 'group think' and increase diversity by ensuring the [independent directors] outnumber the parent's representatives and captive manager on the board. If the shareholder of the captive has a number of directors representing them on the board, it may be important to have more [independent directors] involvement to support and demonstrate independent mind and management for regulatory and tax residence purposes."

FINDING THE RIGHT INDEPENDENT DIRECTOR

Another reason that captives may not bring on an independent director is that qualified independent directors can be hard to find. According to Simpson, "I think there are a fair number of people out there who are willing to offer their services as independent directors. There aren't enough, in my view, who know what they're doing. That's not just independent directors, that's also in the captive space. There aren't enough people in the captive space who have the right kind of experience to do the job right now because there is such a huge need in the industry for experienced people. There aren't enough people to fill all those roles."

As with the whole of the captive sector, identifying and recruiting people on all levels is a well-known problem. The captive industry is growing faster than qualified professionals can be trained. That's not to say that there aren't insurance and captive professionals that aren't available to be independent directors. Independent directors can often be found among retired insurance professionals who still want to keep their hand "in the game," who want to make a difference who are not necessarily in it for financial gain.

Simpson hopes that as captive professionals begin retiring, they will want to stay involved in the industry by providing their services as board directors. "I have this idea that we ought to, within the senior ranks of the industry, begin a tradition of not retiring but instead providing some service to the industry," said Simpson.

"Instead of ending your career, maybe take your foot off the gas a little and continue to serve the industry by being a resident director or independent director, putting yourself in a position where you can work less, maybe not earning what you were, but contribute to training and developing new people who are coming along. This would help the industry to have the capacity to absorb all the new business by making sure that people with sufficient expertise stick around for a while." ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: www.karriehyatt.com.