

Captive consolidation in the era of health care M&A

By: Bruce C. Whitmore, Senior Consultant



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With health care M&A activity creating larger organizations, consolidated captives can retain more risk and generate more efficiencies. However, developing the optimal risk retention versus transfer structure to substantively drive down the net cost of risk may involve strategic thinking beyond simply consolidating captives.

Introduction

The health care industry has evolved over the last 10 years due to merger and acquisition activity, spurred on by the goal of the Affordable Care Act to reduce the costs of delivering medical care. While intuitively this has resulted in the consolidation and closure of some captive insurance companies, it has also driven new formations to respond to new needs. Regardless, consolidations and divestitures in the health care industry mean one thing when it comes to managing the cost of risk: The need to adjust risk retention and transfer mechanisms.

Due diligence of existing captives during M&A

It can be easy to overlook in the M&A process, but existing captives should be subject to proper due diligence prior to any merger since every captive is a separate, subsidiary business of the parent organization. While we find that the existence or condition of a captive rarely derails a transaction, its financial structural and operational health can have a substantive effect on the negotiated terms and conditions.

Such due diligence should include:

- Gaining a thorough understanding of the role the captive historically and currently fulfills in financing the target organization's risks
- Closely reading the captive's board meeting books, business plan and key documents to determine the captive's operational consistency and regulatory compliance
- Performing an in-depth review of the captive's audited financial statements and actuarial studies to determine the financial health and surplus of the captive
- Comparing the historic and current primary policies and captive reinsurance agreements across multiple underwriting years to determine if any coverage gaps exist
- Evaluating reinstatement provisions to determine if any coverages may be exhausted
- Determining if any coverage conflicts exist or are likely to arise in the future
- Obtaining an understanding of the loss reserving protocols and the adequacy of prior loss reserves and how any insufficiencies were accounted for in the captive's actuarial studies
- Quantification of post-merger strategic captive utilizations and expected gains in efficiencies and funding requirements that would result from captive consolidation

Reconsidering the role of the captive for the consolidated entity

As entities merge, they not only become larger, but their risk retention appetites change. If the organization became highly leveraged to accomplish the acquisition, their risk retention appetite may actually constrict rather than expand. For example, the organization may become much more focused on enhancing cash flows and reducing expenses rather than strategically enhancing the utilization of their captive.

However, the more common issue for the captive to address will be the need to underwrite risk in expanding geographies and for additional types of subsidiaries (for-profit ventures, independent physicians, clinics, etc.). Such new risk financing needs may require a restructuring of the acquirer's captive, thus enhancing its capabilities.

For example, the acquirer's captive may need to satisfy certain regulatory issues, such as qualifying for Patient Compensation Fund (PCF) participation. Or, if the acquired entity has both tax-exempt and for-profit subsidiaries, a segregated cell structure might be required to allow for greater flexibility in income tax elections and to avoid generating Unrelated Business Taxable Income (UBTI). Further, if the organization will want to underwrite voluntary benefits sometime in the future, the captive should likely be domiciled in the U.S. (or have a U.S. branch) to allow for the application of an ERISA exemption.

In the end, the acquiring entity will likely want to engage in a risk optimization project to determine the most efficient way to retain and transfer risk prospectively. For more information, see the additional Willis Towers Watson white paper entitled "Risk optimization in the era of health care M&A".

Consolidating existing captives

Commonly, risk and finance executives presume that multiple captives can simply be consolidated, resulting in captive management, audit and actuarial cost savings. While generally these assumptions are correct, the process usually isn't quite as simple as it sounds.

We find that captive consolidation usually occurs 12 – 24 months post-merger because it takes a while for the dust to settle and new roles and responsibilities to be established. At a high level, the consolidation process generally involves:

- Engaging with the captive manager, qualified captive legal counsel and the captive's regulators
- Quantifying any potential self-procurement and U.S. income tax implications
- Deciding whether recent changes affecting captive domiciles would favor redomiciling the captive
- Selecting the optimal process for disposing of liabilities and ultimately closing the captive, including:
 - Closing out existing policies
 - Running off existing liabilities
 - Commuting direct-issue policies with the parent
 - Commuting fronted policies
 - Closing pooled reinsurance arrangements
 - Negotiating commercial loss portfolio transfers/novations
 - Obtaining reinsurance to close
 - Performing a novation to a segregated cell of the acquirer's captive
 - Merging (amalgamating) the captive with the acquirer's captive
 - Selling the captive or RRG to a third party
- Obtaining the release of any necessary third-party reliances
- Identifying the best method for using or distributing captive surplus
- Drafting and submitting the necessary captive documents for approval by the captive regulator to effectuate the closing of the captive and the surrender of its license

In closing...

Consolidating captive insurance companies and transforming the risk retention/transfer structure of large organizations post-merger can be a daunting on the surface, but when addressed in bite-sized portions, can be accomplished relatively quickly. Ultimately, however, the organization should not simply rush to judgement that consolidating captives will automatically result in substantive cost savings. Doing so may saddle the parent with a captive that has limited capabilities, reducing its risk financing efficiency. Instead, we recommend clients engage their captive managers and consultants to thoroughly think through the potential structural and operational options.

For more information, please contact:

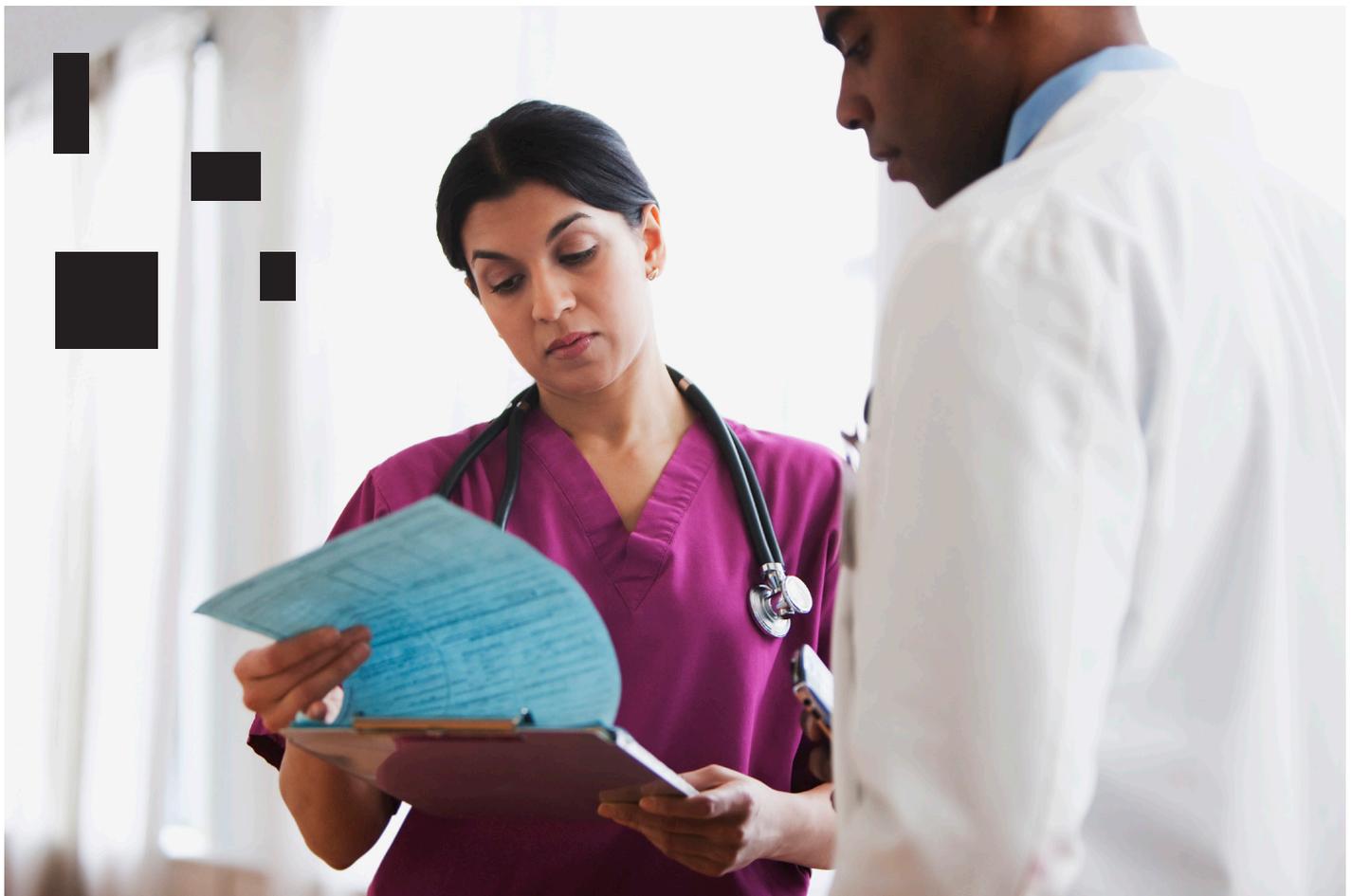
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