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Information, guidance, and resources from the nation's leading testifying, financial experts.

UPCOMING APPEARANCES

by Members of the Editorial Board

P. Dermot O'Neill

PICPA Business Valuation Conference
IRS Business Valuation Guidelines
Holiday Inn East
November 10, 2008, , Harrisburg, PA

PICPA Forensic and Litigation Services Conference
Damages in Personal Injury Litigation
Crowne Plaza Valley Forge
November 20, 2008, King of Prussia, PA

INSIDE THIS ISSUE

FEATURE ARTICLE

The Boom in The Crunch

BY EDWARD B. CORDES

While this title may sound like a byline for a new breakfast cereal, I am referring to something that should keep us fed for some period of time – the bowl chock full of work resulting from the credit crunch.

The excesses of the easy credit era led to extensions of credit that were fundamentally unsound. These poor credit decisions went far beyond the home mortgages that have caught the attention of the press, and encompassed both commercial real estate and business lending. Much of this debt was sold in securitized pools, which incented the originators to get deals done without regard to the underwriting parameters.

The problem, however, extends well beyond the poorly underwritten loans. Because of the volume of defaults, capital providers have abandoned the market, and bankers are tightening underwriting standards amid rising losses and pressure from regulators. As a result, access to credit has contracted, negatively affecting financings that might otherwise have been consummated in a more stable credit environment. As cash flow is the lifeblood of any business, it is inevitable many businesses will suffer, or fail, as the credit spigot tightens.

Where there are business failures, you will find plenty of forensic accounting, damage calculation, and expert witness work. There will be battles between and among partners and shareholders, battles between lenders and owners and battles among creditors. Regardless of status, parties want to know where the money went, and if there is a path to recovery.

This nutritious array provides sustenance not only for the insolvency and

(continued on page 2)

BV FOR THE LITIGATION PRACTITIONER

Commercial Liability and Captive Insurance – How Does the Choice Affect Value?

BY LARI B MASTEN, MSA, CPA, ABV, CVA

When was the last time you asked a client what type of liability insurance they carried?

As professionals, we know the insurance policies carried by the businesses we value are not all alike. It is not uncommon to see life insurance, property and casualty insurance, liability insurance, workers' compensation insurance, and health insurance all as expense line items on the income statement of a business. As the provisions of the above vary greatly depending on the nature of the business,

(continued on page 4)

COMMERCIAL LIABILITY

(continued from page 1)

age of the insured, number of employees and claims made for workers' compensation, so fluctuate the magnitude of the expense to net income.

Outside the treatment of life insurance proceeds, most books written about the process of valuing a business contain very little discussion of insurance. Most business valuation normalizing adjustments relative to insurance are for

- Excess life insurance;
- key man insurance;
- excess health insurance carried on non-employees; and/or
- excess property insurance on non-operating or non-business owned assets.

Typical normalizing adjustments made by valuation analysts do not include adjustments of commercial liability insurance. I've not come across any examples of adjustments for commercial insurance premiums in business valuation books or articles. In addition, I've not observed practitioners making such an adjustment when reviewing their work.

I am increasingly uneasy with this observation for the following reason: there is a new 'old' game in town – captive insurance. If the owners of a business have elected to use a captive insurance model instead of a traditional commercial liability insurance model, proper recognition can dramatically alter an opinion of value of a business. I'll briefly describe the insurance models, and then address the potential impact on the discount rate, benefit stream, and balance sheet of a Company from a valuation perspective.

Background

Traditional Commercial Liability Model

Insurance is defined as the equitable transfer of the risk of a loss, from one entity to another, in exchange for a premium. An **insurer** is a company selling the insurance. Liability insurance, therefore, is a part of the general insurance system of risk transference, and relies on dedicated carriers **- insurers -** to offer protection against specified perils in consideration of a premium.

Captive Insurance Model

In its simplest form, captive insurance can be defined as a limited purpose wholly owned insurance subsidiary of an organization not in the insurance business, whose primary function is to insure some or all of the risks of its parent. The two most germane types of captive models are:

- Single-parent captives, which underwrite only the risks of related group companies.
- Rent-a-captives, which provide 'captive' facilities to others for a fee, without the user needing to capitalize his own captive. This vehicle is often used by companies that are too small to justify establishing their own captive.

It is popularly thought that a captive is primarily a tax minimization device. In fact, captives are usually formed for other economic reasons with the main drivers being risk management and risk financing. Some of these reasons include:

- **Lower insurance costs.** Commercial insurers set premium amounts to cover the cost of claims, plus their own overhead and to provide a profit. <u>The portion of the premium for overhead and profit can represent as much as 35% or 40% of the whole</u>. In establishing a captive, a Company not only retains the portion of the premium that would have been the insurer's profit, but it may also be able to reduce insurance costs by charging a premium that more accurately reflects the Company's loss experience.
- **Cash flow.** Apart from pure underwriting profit, insurers rely heavily on investment income. Premiums are typically paid in advance while claims are paid out over a longer period. Until claims become payable, the premium is available for investment. For a captive, premiums and investment income are retained within the group. Additionally the captive may be able to offer a more flexible premium payment plan thereby <u>offering a direct cash flow advantage to the Company</u>.
- **Risk retention.** A Company's willingness to retain more of its own risk, particularly by <u>increasing deductible levels</u>, may be frustrated by the inadequate discount offered by insurers to take account of the increased deductible and by the fact that the Company is unable to establish reserves to pay future claims. Establishment of a captive can help address both these problems.
- **Unavailability of coverage.** Where the <u>commercial market is unable or unwilling to provide coverage</u> for certain risks or where the price quoted is seen to be unreasonable, a captive may provide the coverage required.
- **Risk management.** A captive can act as a focus for the risk management and risk financing activities of its parent organization. An effective risk management program will result in recognizable profits for the captive. <u>Risk management can be a potentially profitable part of the Company's activities, rather than a cost center</u>.

(continued on page 5)

COMMERCIAL LIABILITY

(continued from page 4)

Captive insurance has historically been fairly controversial from the standpoint of the potential abuse of the vehicle. Using captives to hide income from the IRS has resulted in very strict rules regarding transference of risk and the need to comply with all the regulatory issues surrounding insurance.

Because of the controversy and added compliance requirements, captives have been relatively uncommon in smaller, closely held companies. With the advent of the rent-a-captive, however, the cost of owning one's own insurance company for the sake of self-insurance has become attainable via 'renting' the captive insurance vehicle, resulting in phenomenal growth in the number of captive insurance companies over the last 5 to 10 years.

What's the Difference for Business Valuation Purposes?

Traditional commercial liability insurance is pretty straight forward. The Company pays the premium, and absent any error on the quotation for the premium, no valuation adjustment is necessary to adjust the expense. The rationale is the expense exists, and likely the Company has taken all precautions necessary to minimize this expense line item.

Single-parent captives will likely be obvious to the valuation analyst, as the analyst will likely uncover the fact that a subsidiary of the business is an insurance subsidiary. Addressing the value of the single-parent captive can be guided by the valuation issues discussed in this article.

The *rent-a-captive* is the model that is hardest to detect when simply looking at the expense line items on an income statement of a Company, and the model most likely to cause over/under valuation of a Company if the analyst makes no adjustments.

Normalizing Adjustments for the Discount Rate, Benefit Stream, and Balance Sheet

Benchmarking: When comparing a Company that uses a rent-a-captive versus traditional commercial liability insurance to its peer group, it may appear that the Company is more efficient, has less risk, or is very good at negotiating their premiums. Assuming all other factors remain equal, an analyst might conclude that specific Company risk for their discount rate is somewhat lower than the Company's peers based on this comparison. In reality, there may in fact be additional risk that the Company is taking on, in order to reduce its premiums paid to the rent-a-captive, and the analyst should be applying a higher specific Company risk adjustment rather than reducing it.

Expenses: A Company may be motivated to minimize or maximize premium expenses, depending on its objective for electing to use a captive insurance plan.

Scenario One – minimizing expenses. The premium expense line for commercial insurance can be lower for the Company using a rent-a-captive versus a traditional third party insurer, and may need to be normalized, for two reasons. First, there is a cost savings on the rent-a-captive premium rate because the Company does not have to pay for the overhead and profit of a third party insurer. Second, the Company can tailor deductibles to suit its risk needs (e.g., make the deductible much higher), thereby reducing its premium rate paid to the rent-a-captive.

Scenario Two – maximizing expenses. As previously mentioned, one of the driving factors in creating captives in the 1970's was to enable a Company to take the tax deduction (expense) at the time of the premium payment to the captive, while sheltering value for a later period. The motivation for the Company is to have as high of a premium rate as reasonably allowable. In other words – the Company has the flexibility to defer income to a later period. In doing so, the Company may be undervalued based on a net-of-expense benefit stream that is lower than the actual risk would justify.

Long-term unrecorded liabilities: If the Company is reducing its premiums via a captive insurance model, there may be some long-term unrecorded liabilities not reflected on the balance sheet. These unrecorded liabilities will need to be recognized.

Long-term unrecorded assets: Finally, there is the ultimate winding down of the captive. In the event the 'premiums' paid into the captive exceed the total costs of claims, then there is a tidy asset that the Company created – with pre-tax dollars – that will be realized.

In summary, what do you do when the business you are valuing uses captive insurance rather than standard insurance to insure against risk?

Pay attention to risk, both from an unrecorded liability standpoint and from your assessment of specific company adjustments in your discount rate.

Find out the motivating factor for the Company. Is the Company in an industry that it makes sense to create the captive because there are hundreds of small claims that have low payouts (reduces deductible expense)? Is the Company under regulatory mandates that require coverage over long periods of time (construction defects, medical malpractice tail insurance)? Or, does the Company need to defer income for cash flow management purposes?

(continued on page 6)

COMMERCIAL LIABILITY

(continued from page 5)

Do the deductible, premium, and contract for the captive make sense/are they in line with its industry peers? It may be that the industry as a whole makes a practice of using captives. It also may be that the insurance contract with the captive allows the Company to manipulate the claims process.

ASK what type of insurance the Company carries.

I know, it sounds simple and straight forward. But, when was the last time you asked a client what type of commercial insurance they carried?

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TECHNOLOGY TIPS

Got OLW?

BY KATHLEEN C. ATKINS, CMMOS

In today's business environment, our workday rarely ends while we are still at the office. Increasingly, we find ourselves either working at home or in a collaborative environment with individuals located across the country. But, how do you easily gain access to the necessary data? Stop emailing files to yourself! Mothball your flash drives! Use *Microsoft Office Live Workspace* (OLW) beta for easy remote access to your documents.

Microsoft Office Live Workspace beta is a web-based, ad free online productivity tool that allows people to access their documents online from any internet connected computer. Microsoft offers this free hosted service of 500 MB of storage space in a password protected environment. Based on average file sizes, this enables you to store approximately 1,000 documents online.

One can view Word, Excel, PowerPoint or PDF documents online, even if the Microsoft Office suite is not installed on your computer. Editing a document uses a check-in/check-out procedure where changes are made locally and synced back to the OLW service. Although OLW is primarily for the sharing and collaborating of Office documents, other file types are also accepted.

Microsoft Office Live Workspace beta enables either an individual or a group to share a single document, or a collection of file types known as a workspace. This stored information can be accessed from any web-based browser, at anytime. OLW offers valuable support for individuals that work from more than one location, or a group that provides input from across the country.

Using your Windows Live ID and password, establish your free *Office Live Workspace* beta account at www.workspace.OfficeLive.com. Virus protection for your uploaded documents will be provided through Microsoft Forefront Security for SharePoint. You choose the access permissions of either "view", "edit"

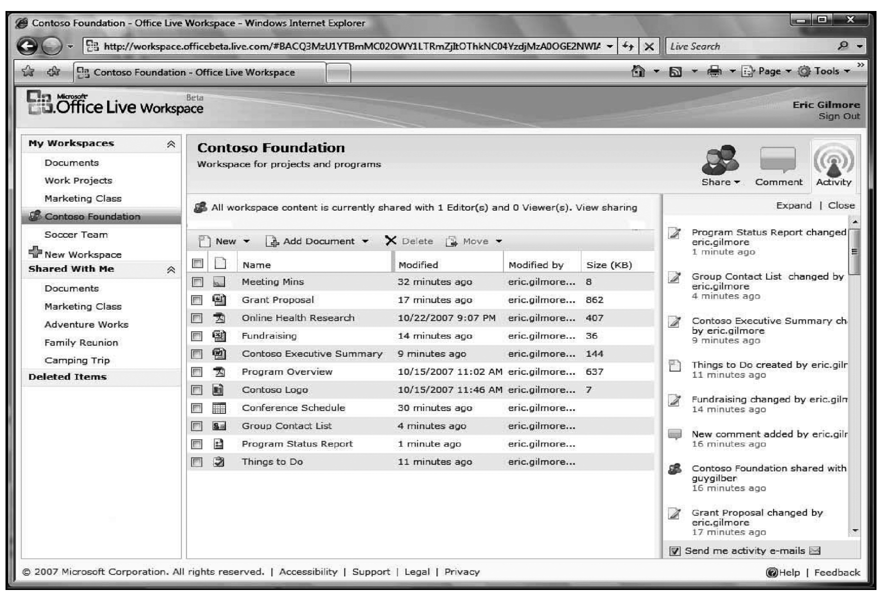

Figure 1 Office Live Main Screen and Activity Panel

(continued on page 7)

