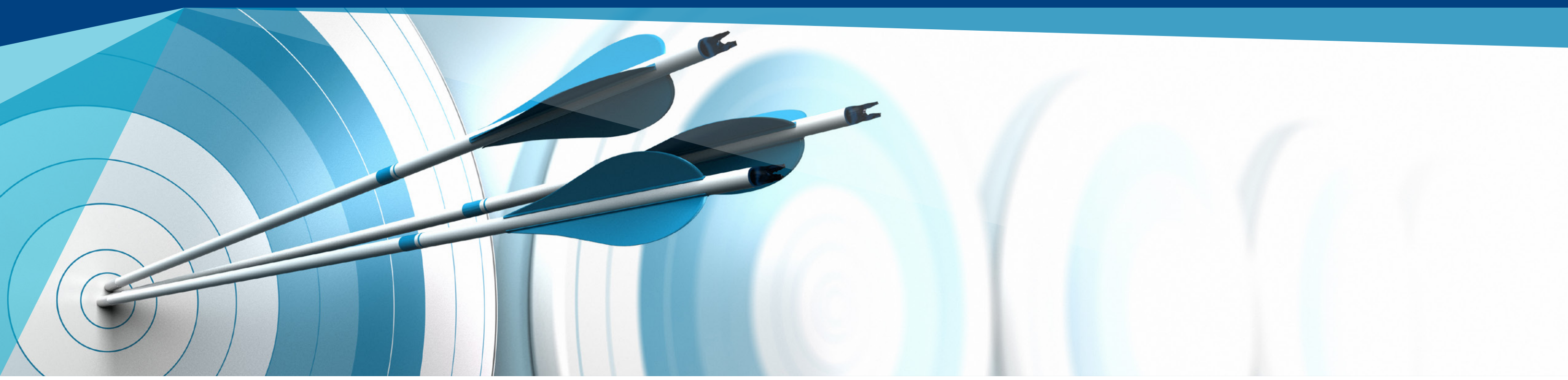
SMALL CAPTIVE CONCEPTS



Captive insurance companies have long been a risk management tool for large corporations. Increasingly, small-to-medium size firms are realizing the benefits of small captives to fund their insurable risks, while seeking the potential economic benefits available to qualifying structures.

SMALL CAPTIVE OVERVIEW

WHAT IS A CAPTIVE?

A captive insurer is a legal entity formed primarily to insure the risks of one corporate parent company, or a number of affiliates, thereby reducing the parent company's total cost of risk. Captives are usually domiciled in a specialized location, either onshore or offshore, and sometimes write business unrelated to their parent companies.

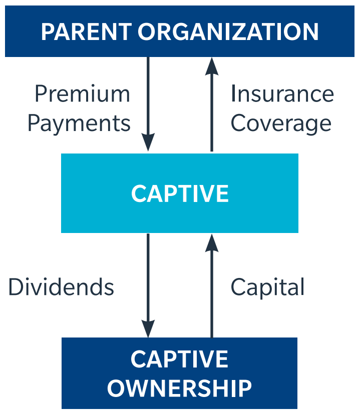
WHAT IS A SMALL CAPTIVE?

The term "small captive" refers to a captive insurance company typically created by mid size companies writing less than US$2.3 million in premium. Should the captive meet certain risk distribution and risk shifting elements and qualify as an insurance company for US federal tax purposes, they can then elect to be taxed only on investment income. Captives that make this election often insure risks that are characterized with historically high-severity and low-frequency losses.

Small Captive Facts

- Captives writing premiums of US$2.3 million or less annually represent the most common new captive formations over the past five years.
- Small captives have led to significant growth in various domiciles onshore and offshore.
- There are estimated to be more than 1,000 small captive formations by US companies.

Typical Captive Structure



ADVANTAGES OF A SMALL CAPTIVE

The major benefits that a parent company stands to realize through the formation of a captive can be divided into two main categories:

BUSINESS AND INSURANCE ADVANTAGES

- Coverage for risks not available in the commercial market.
- Improved negotiating position with insurance and reinsurance markets.
- Flexibility in program design.
- Broader and simpler insurance contracts.
- Better risk management discipline and central governance.
- Efficient way to begin a new captive program - small and simple.

FINANCIAL ADVANTAGES

- Protected cash flow.
- Matching of revenue and expense.
- Performance measurements.
- Underwriting profit not subject to federal income tax if captive is properly structured (investment income is subject to federal income tax).

IS YOUR CAPTIVE AN INSURANCE COMPANY FOR FEDERAL INCOME TAX PURPOSES?

A captive may be formed to fund future loss payments, but this alone does not qualify the entity for accounting and tax status as an insurance company. Such status is accomplished only through proper risk distribution and risk shifting.

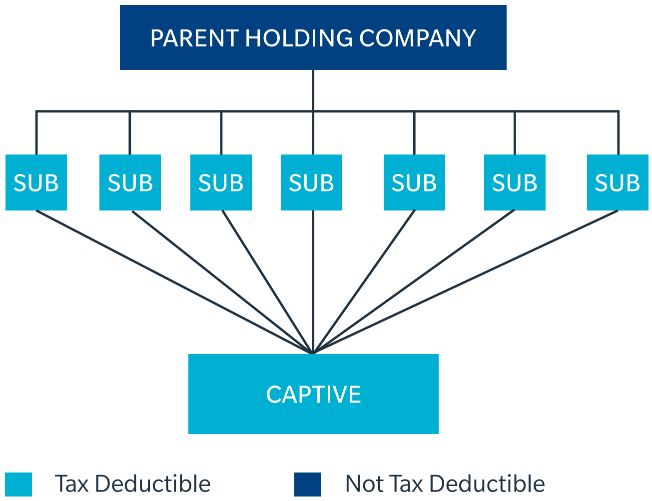
RISK DISTRIBUTION (RISK POOLING)

A captive must first demonstrate proper risk distribution, or "risk pooling," in order to qualify as an insurance company from a US federal tax perspective. There are two structural models for small captives through which captives can achieve this status. These are shown in the diagrams below.

INTERNAL RISK POOLING

"Internal risk pooling" refers to the existence of a sufficient number of separate legal entities within a holding-company structure.

CAPTIVE INSURES A MINIMUM OF SEVEN LEGAL SUBSIDIARIES

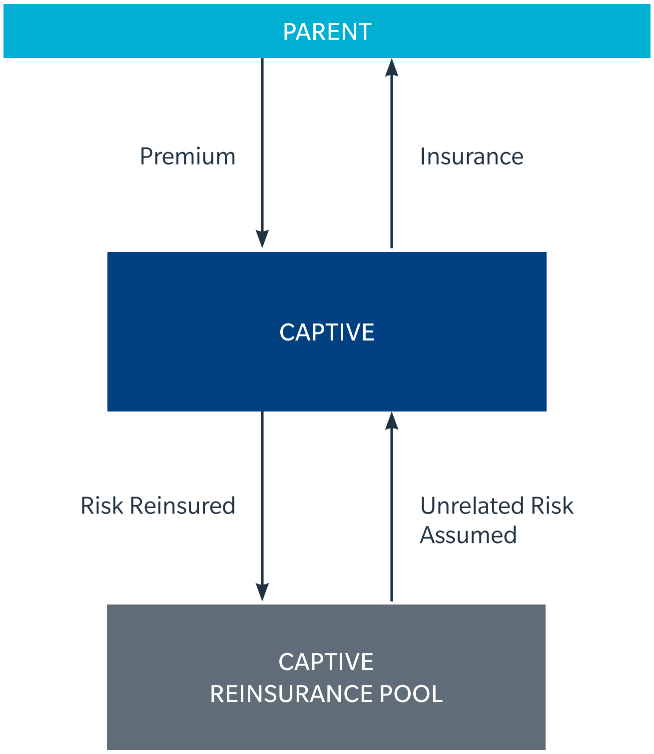


EXTERNAL RISK POOLING

"External risk pooling" occurs when the captive takes on the risk of individuals, or entities other than the sponsor, for example, extended warranties to customers, employee benefits, or risk assumed from reinsurance pools.

Unaffiliated reinsurance pools are created to spread risk from one captive insurer across many. These reinsurance transactions aim to mitigate loss volatility within the captive. Should a captive cede sufficient risk to the reinsurance pool, to the extent that the unrelated risk it assumes in return is at least 30% of its total premium received for the year, then the captive may qualify as an insurance company for US federal tax purposes.

The diagram below shows the flow of premium and risk between the sponsoring entity (parent), the captive, and the captive risk pool.



Minimum of 30% unrelated risk must be present to achieve risk distribution.

RISK SHIFTING

Policies written by a captive must shift risk to qualify as an insurance contract. That is, there needs to be a reasonable chance of a loss to the insurer. There are standards commonly used within the industry to determine this, and clients should consult with their actuaries and accountants when constructing policies and determining premiums.

POTENTIAL INSURANCE COVERAGES

Small captives may insure any number of coverages, but as previously mentioned, those electing to be taxed on their non-underwriting performance often choose to write high-severity/low-frequency type coverages, as outlined below. Providing coverage for these risks enables a small captive to tailor terms to the specific risks of the parent organization, as well as finance large losses through accrual of profits during favorable underwriting cycles.

- Supply chain/contingent business interruption.
- Intellectual property.
- Cyber liability.
- Environmental liability.
- Product liability.
- Product recall.
- Errors and omissions liability.
- Directors and officers liability.
- Political risk.
- Terrorism.

CHALLENGES OF FORMING A SMALL CAPTIVE

There are many benefits in forming a small captive. However, clients should keep in mind that a captive is both a long-term commitment and a fully functioning insurance company. As such, prior to establishing a captive, prospective owners should consider:

CAPITAL COMMITMENTS

The parent company must contribute the capital required to support the captive's business plan, as determined by the insurance regulator in the captive's chosen domicile, generally a minimum of US$250,000. While these funds remain within the parent group, they may not realize the same return as they would if invested in the parent organization's operations.

RISK OF ADVERSE RESULTS

The captive's capital could be eroded by adverse operating results. While underwriting gains may not be subject to federal income tax, underwriting losses may not be used to offset other gains, or carried forward.

OPERATING COSTS

The formation and operation of a captive will incur various expenses and vary by domicile. The benefits outlined previously need to outweigh the associated costs.

Marsh's internal captive resource will work with agents to identify potential prospects and review discussion points in order to introduce the captive structure and concept.

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