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Pure Captive Insurer Was Not in the "Business of Insurance" and So Not Subject to a State Unfair Claims Settlement Practices

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In *Merritt v. Catholic Health Initiatives Inc., No. 2016-CA-001470-MR, 2017 WL 5504916 (Ky. Ct. App. Nov. 17, 2017), reh'g denied (Feb. 27, 2018), review granted (Oct. 25, 2018), not to be published, the Kentucky Court of Appeals addressed the issue of whether the state Unfair Claims Settlement Practices Act ("UCSPA")*, Ky. Rev. Stat. Ann. § 304.12-230 (West), applied to an entity "in the business of captive self-insurance for [a] parent company." The court of appeals held that it did not. The Kentucky Supreme Court has granted discretionary review (Case Number 018-SC000155) and the case is now being briefed.

Merritt sued for the death of his wife and their son during a complicated delivery. Merritt alleged medical negligence against the "medical defendants" – Dr. Smith, KentuckyOne Health Obstetrics & Gynecology Associates, a practice group and a KentuckyOne Health, a health plan. He also sued Catholic Health Initiatives, Inc. (CHI) and its subsidiary, First Initiatives Insurance, Ltd. (FII). CHI was a nonprofit, tax-exempt health-care entity. CHI sponsored KentuckyOne Health. CHI provided "insurance" to that health plan and its affiliates through FII.

Merritt sued CHI and FII for bad faith violation of the UCSPA. The bad faith claims were predicated upon settlement negotiations. Merritt asserted that CHI and FII breached the UCSPA, Ky. Rev. Stat. Ann. § 304.12-230, in refusing to negotiate the claims for the mother and son separately and in only offering a consolidated settlement for both; and in not providing a reasonable explanation for the denial of the separate claims.

Merritt settled with the medical defendants. However, he continued to pursue his bad faith claims against CHI and FII. The trial court denied Merritt's motion for a declaratory judgment, granted CHI and FII's motion for summary judgment and denied Merritt's motion to reconsider. Merritt appealed.

The gist of the case is this. The UCSPA only applies to companies in the "business of insurance." *Davidson v. Am. Freightways, Inc.*, 25 S.W.3d 94, 96, 102 (Ky. 2000). If a company is not in the "business of insurance" it is not subject to the UCSPA. Self-insurers are not in the "business of insurance." *Id. And here the court holds that a "pure captive" – at least this pure captive – is not in the "business of insurance" Therefore it is not subject to the UCSPA.*

Most captives – but not all – are exempt from the UCSPA under a specific provision of the captive law. KRS 340.49-320. But it would seem that a "pure captive" is not in the "business of insurance" and therefore one never gets to the question of applying this exemption.

The exemption may be useful for other, non-pure captives, such as consortium captive insurers, sponsored captive insurers, special purpose captive insurers, agency captive insurers, or industrial insured captive insurers (all defined under the law) formed or issued a certificate of authority under the provisions of the Kentucky captive insurer law, Ky. Rev. Stat. Ann. § 304.49-010 to 304.49-230 (West).

Merritt – the claimant – sought to argue that FII was in "the business of insurance", and thus subject to the UCSPA. FII argued that it was self-insurance, and thus not in "the business of insurance," and thus not subject to the UCSPA.

The UCSPA only applies to entities engaged in the "business of insurance." It does not apply to persons or entities not in the "business of insurance." FII was a foreign captive insurer – meaning that it was organized under the law of another state or another county – specifically the Cayman Islands. That would seem like an easy end to the case for FII to argue it is a foreign captive and that foreign captives, like other captives, are not subject to the act.

But FII argued it was a foreign captive insurance entity and not subject to the UCSPA because it was not engaged in the "business of insurance." The trial court accepted this argument and denied Merritt's motion for declaratory judgment, then granted CHI and FII's motion for summary judgment.

Why didn't FII just argue that it was a pure captive, that captives were statutorily exempted and therefore FII was exempt? One statement by the court seems to adopt this view. "Kentucky has explicit statutory captive provisions, which state that pure captive insurance companies—foreign and domestic—are excluded from the coverage of UCSPA…. Consequently, First Initiatives is not covered by UCSPA because it is captive self-insurance company operated for and by its parent company." But the court goes on to hold that Kentucky's insurance code does not apply to captive insurers because insurance involves two parties entering into a contract. *Self-insurance* does not involve a true "insurance contract." It held that either CHI nor FII is "in the business of entering into contracts of insurance."

But there is a further wrinkle in the statute that stood in the way of the third point. FII was a pure captive but also a foreign captive. KRS 340.49-320 exempted foreign insurers from the UCSPA if (1) lawfully transacting the business of insurance in Kentucky prior to July 14, 2000 *and if* (2) the foreign insurer petitions the insurance commissioner requesting that the captive insurer subtitle be applicable to the foreign captive. However, FII had operated in Kentucky before July 14, 2000 and had not petitioned the insurance commissioner for inclusion with the scope of the captive insurance law, subtitle 49. Thus, FII could not claim exemption under this provision of the Kentucky captive

insurer law. Merritt argued this meant that FII was liable under the UCSPA. The court dismissed this argument as a tautology.

There was a "self-insurance contract," not quoted in more detail in the opinion, which used the terms "indemnify" and "you" and "we." Merritt argued this type of language placed FII in the "business of insurance." The court disagreed finding this to be a red herring.

The court described the FII "captive self-insurance" arrangement as follows:

> CHI does not administer FII like a commercial insurer. FII has no employees; owes no duty to provide claims or risk management services to CHI or its affiliates; and does not adjust or investigate professional liability claims against CHI or its affiliates. The self-insurance agreement states that that all claims and risk management services will be provided by CHI. Under the FII Hospital Professional, Commercial General, and Employment Practices Liability Policy, CHI manages, coordinates, investigates, and settles any claims for damages brought against it.

The financial statements of CHI and all its organizations are consolidated, including FII's financial statements and those of other CHI wholly-owned affiliates, including the medical defendants. Every professional liability claim paid by CHI reduces the assets of CHI and its affiliates. Thus, claim payments affect FII's net income and affect CHI's net income dollar for dollar. There is no risk-shifting or risk distribution in this circumstance. This self-insurance agreement covers all of CHI, its subsidiaries, and employees. It is designed to cover employment activity for CHI and its subsidiary affiliates and protect CHI from any kind of strict liability, *respondeat superiortype claims*. Only CHI pays assessments to First Initiatives for the self-insurance program. CHI affiliates are not permitted to seek insurance from commercial insurance companies.

The court characterized this as "a captive arrangement for self-insurance."

The court held that under Kentucky law "insurance" encompasses risk-shifting and risk distribution. A pure captive insurance company or self-insurance provider does not do these two things. Therefore, under Kentucky's definition of "insurance" FII is not in "the business of insurance." The court noted that self-insured companies do not assume risk. Because of this the UCSPA is not pertinent to self-insurance including [pure] captive insurance. The court also noted that for-profit companies may deduct insurance premiums as ordinary business expenses, but no such deduction is allowed for self-insurance payments. The court found the different tax implications for insurance and self-insurance expenses provide additional support that self-insurance is not analogous with insurance.

Merritt asserted that the trial court conflated two mutually exclusive issues—foreign captive insurer and the "business of insurance." The Court of Appeals held that these two issues are not mutually exclusive. One can be a foreign captive insurer and not in the "business of insurance" "or

vice versa." FII was not engaged in the "business of insurance." Therefore, it is exempt from the UCSPA. The "or vice versa" phrase here is not entirely clear in meaning.

In summary the court held that this pure captive insurer – a foreign pure captive insurer – was not in the "business of insurance" and for that reason it was not subject to the UCSPA.

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