Avrahami and Reserve Mechanical: a regulator’s perspective

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The captives world is processing the implications of two high-profile court cases involving captives. Here, John Talley, captive program manager in the Missouri Department of Insurance, gives his perspective on what the cases mean for regulators.

In the past year, the captive insurance world has been shaken by two US Tax Court decisions, *Avrahami v Commissioner of Internal Revenue (Avrahami)* and *Reserve Mechanical Corp v Commissioner of Internal Revenue (Reserve)*. Some commentators have speculated that the decisions will end the existence of micro captives. Others have postulated that these opinions are the death nail in the coffins of 831(b) captives and small captive risk-pooling purveyors.

As a regulator of a captive insurance domicile, I do not know the effect these decisions will have on small captives in the US. But after reading the decisions and the numerous commentaries, I found myself asking one question: what do these cases mean for captives regulators and the domiciles they serve?

The facts

With the thought of lowering their potential income tax burden due to their thriving business ventures, the Avrahamis sought the counsel of their accountant, who then recommended that they consult an estate planning attorney, Neil Hiller.

After being advised the Avrahamis were thinking of forming a captive, Hiller recommended they also consult with captive insurance lawyer, Celia Clark. Feedback Insurance was formed in St. Kitts in November 2007. At that time, Feedback entered into a cross-insurance programme to reinsure terrorism insurance for other small captive insurers through a risk-distribution pool set up by Clark, exclusively for her clients.

The court noted in the first sentences of the decision that the insurance bill for 2006 for the Avrahamis' business was $150,000. In 2009–2010, after the formation of Feedback, the insurance bills increased to more than $1.1 million and $1.3 million, respectively. The court did not indicate that the businesses being insured had substantially changed or increased during those years. It did note that the overwhelming portion of the new premium

was paid to Feedback and that no claims were made on any of Feedback's policies until the Internal Revenue Service (IRS) began its audit of the Avrahamis.

The *Reserve* case has similar and dissimilar facts. Norman Zumbaum and Cory Weikel were co-owners of several businesses including Peak Mechanical & Components (Peak), a mining equipment provider and servicer. Peak employed 13 to 17 employees during the years in question.

Prior to the tax years in question (2008–2010), Zumbaum and Weikel were introduced to Capstone, a captive manager and turnkey captive formation company. Capstone helped Zumbaum and Weikel form Reserve Mechanical Corp in Anguilla on December 4, 2008 and became its captive manager.

In its rendition of the pertinent facts, the court noted that Peak paid premium for its commercial insurance coverage in 2006 and 2007 in the amount of $38,810 and $95,828 respectively. In all years in question, Peak maintained the commercial policies and Reserve wrote only excess policies.

The court indicated that Reserve issued 13 excess policies from December 4, 2008 through January 1, 2009 in the face amount of $13 million and $419,089 in aggregate premium. The total premiums for the excess policies written in 2009 and 2010 were $448,127 and $445,314, respectively.

Regulatory considerations

The Tax Court, in both cases, ruled against the petitioners, finding among other things that the captives were not insurance companies and the risk pools were not viable insurance entities. It's important to note that the judges in each case followed the same reasoning and rationale for their decisions.

Although the cases were primarily decisions on tax matters, the courts cited many insurance company practices and regulatory issues in reaching their decisions My purpose in this article is to review those elements that are or should be essential to captives regulators.

Both court opinions placed a fair amount of weight on the premise that the arrangement must "look like insurance in the commonly accepted sense" (*Avrahami* at page 76, and *Reserve* at page 48). Both courts set forth some factors they considered in making this determination:

1. Whether a company was organised, operated and regulated as an insurance company;
2. Whether the company was adequately capitalised;
3. Whether the policies were valid and binding;
4. Whether the premiums were reasonable and the result of an arm's-length transaction; and
5. Whether claims were paid.

Formation

The court in *Reserve* noted that "the feasibility study was not complete when Reserve issued the direct written policies for 2008 or 2009."

Donald J. Riggin, writing for the International Risk Management Institute in February 2016, stated: “There are three types of captive feasibility studies: comprehensive, close-to-comprehensive (financial-only), and self-serving (non-feasibility).” Riggin further indicated that the only two feasibility studies of merit are the comprehensive and close-to-comprehensive. What is a captive feasibility study, and is it important to the regulator?

There are a variety of definitions for a captive feasibility study and most are too long to explain in this article. In general, elements of a comprehensive captive feasibility study are:

Examination of the owner’s current insurance and risk financing programmes;

Review of the business (or businesses) claims history;

Determination of uninsured or unfinanced risk and the proposed cost of coverage including future costs (actuarial determination or other viable method);

A determination of the best domicile for the captive with a review of the domicile requirement; and

Whether the business is financially capable of forming and operating a captive.

Most US domiciles either require the feasibility study to be filed with the application or, like Missouri, have specific requirements that are a part of a good, comprehensive feasibility study. Hence, US domiciles are mandated under their state’s laws to review and approve the study, or the elements in the study, before licensure is granted. In addition to the feasibility study, Missouri, as most US domiciles, requires filing of the following before receiving a licence:

Amount and liquidity of the assets relative to the risks to be assumed;

Soundness of the plan of operation;

Adequacy of loss prevention programmes of the proposed insureds; and

Any other information relevant to ascertaining whether the proposed captive will be able to meet its policy obligations;

This information will help the US regulator determine that the entity seeking licensure is operating and will operate as an insurance company. Consensus among US regulators is that we license and regulate insurance companies, and that includes captive insurance companies.

Capitalisation

Both courts held that adequate capitalisation for their purpose means that the captive meets the statutory requirements of the domicile. In most domiciles, this is usually stated as a minimum requirement. However, a regulator is concerned with the operation of the captive and adequate capitalisation means more than the statutory minimum capital and surplus.

The capital funds held in the company should be sufficient to cover the risk of loss in the present and future years, including the limit amounts of the policy. This review can cover any reinsurance programme the captive can obtain to cover any major losses.

Policies, premiums and claims

US domicile regulators are concerned about the solvency and liquidity of the operating captive. For this reason, the captive is required to file an unaudited annual financial statement reporting its yearly operations. In addition to the balance sheet reporting of assets and liabilities, the company will report an income statement, which will indicate the premiums collected and the claims and expenses during the reporting period.

A review of the financial statement will indicate the health of the captive. Missouri statutes also require an audited financial statement with an actuarial review of the soundness of the captive premiums and reserves for future claims.

Generally, US domiciles are not mandated to review the captive's policies issued to the insured(s). However, Missouri's statutes require a description of the coverages, deductibles, and coverage limits. Common risk policies such as general liability, property loss, or even business interruption due to weather-related events, are not reviewed if the reasonable explanation of each is given in the business plan.

However, captives can tailor their coverage to risks peculiar to
the insured. For the "exotic" risk coverage being proposed, this regulator has found it prudent to review the proposed policy to determine the type and scope of coverage and probability of losses and claims.

A major part of the captive application review is the actuarial assessment of the actuarial feasibility study proposing premium amount and the reserving requirements. This is an essential review to determine whether the captive will be financially viable for the foreseeable future.

If the business plan presented does not have an actuarial component, the actuary will deduce whether the method used to determine the premium and reserves was rational and reasonable. Although a regulator may not have had access to the owners' prior commercial insurance information, the amount of premium proposed for the coverage will be reviewed for its sufficiency or overstatement.

States such as Missouri that utilise third party actuarial contractors to opine on the sufficiency of the captives plan, can add another layer of comfort for the captive owner that their proposed captive will be successful.

Risk pools

The judges in *Avrahami* and *Reserve* allocated much of their decisions to the risk pool insurance companies in which the captives participated. Each judge noted that risk distribution may be recognised in the subject captive if the entity ceding the risk was, in fact, an insurance company.

Citing prior case law, both decisions listed several factors to consider. I believe the prudent regulator should review a proposed risk pool captive arrangement for the factors enumerated, such as:

Whether there is a circular flow of funds;

Whether there are actuarially determined ceding and retroceding premiums; and

Whether the pooling captive is subject to regulatory control and meets minimum statutory requirements.

The review should also include a reasonable enquiry and request for documents into the claims paid history, reinsurance arrangements including reinsurance premiums and retroceding arrangement. This regulator has even requested information on whether the manager or any of the manager's clientele has been audited by the IRS.

Pooling arrangements do not always take the form of a pooling captive. This regulator has seen a "risk pool" that is a contractual agreement among several captives to pay another captive insurer's claims after a limit has been breached. The common denominator is, as with the Avrahami and Reserve pooling entities, that the captive manager manages all the contracting captives. I believe that the reviewing regulator should approach this arrangement as he/she would a pooling captive situation.

Conclusion

Avrahami and *Reserve* have rocked the captive world regarding small captive insurance companies. As a regulator, I feel that those decisions have validated my belief that the captive is an insurance company, first and foremost. Even in the light of those decisions, I have seen small captives that are well-run insurance companies and expect to see more small, well-run captives in the future. I have seen good, solid captive risk pools that do not have circular ceding and retroceding premiums.

Have *Avrahami* and *Reserve* hammered the final nail in the coffin of micro-enterprise risk small captives? I guess time will tell, but from my perspective, captives will continue to provide risk management benefits and there will always be a place in Missouri for captives that are formed for the right reasons.

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