No. 18-9011

In The United States Court Of Appeals
For The Tenth Circuit

RESERVE MECHANICAL CORP.,
Petitioner-Appellant,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

On Appeal from the Decision of the United States Tax Court
Docket No. 14545-16, Hon. Kathleen Kerrigan

REPLY BRIEF OF PETITIONER-APPELLANT RESERVE MECHANICAL CORP.

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Argument

I. APPELLEE'S EFFORTS TO DEFEND THE TAX COURT'S MISAPPLICATION OF THE LEGAL TEST FOR RISK DISTRIBUTION CANNOT WITHSTAND SCRUTINY.

The parties agree that a captive insurer can achieve risk distribution where a substantial part of the insurer's business comes from unrelated sources. *See* Appellee's Brief ("Gov.Br.") 26-27; Reserve's Opening Brief ("Op.Br.") 35-36. They further agree that where, as here, a captive insurer seeks to achieve risk distribution based on the percentage of premiums that it receives from a pool of unrelated insureds, 30% of gross premiums is judicially recognized as demonstrating that the insurer has a sufficient pool of insureds for risk distribution. *Id.* They even agree that at least 30% of Reserve's gross premiums derived from unrelated sources (i.e., not from Reserve's Direct Insureds).[1] Gov.Br.27-28; Op.Br.24, 35-36. That should have put an end to the issue – Reserve distributed risk, and the tax court's risk-distribution approach that focused on whether PoolRe was a bona fide

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[1] Unless otherwise stated, this reply brief uses terms and acronyms defined in the Opening Brief.

insurance company, instead of on whether a sufficient portion of Reserve's gross premiums derived from unrelated sources, was wrong.

Appellee's brief fails to address the threshold issue of the error of the court's risk-distribution approach, an issue reviewed de novo. *See, e.g., Shellito v. Comm'r*, 437 F. App'x 665, 669 (10th Cir. 2011) (unpublished). Instead, Appellee spends several pages rehashing the court's findings underlying its conclusion that PoolRe was not a bona fide insurance company. Gov.Br.28-39. Appellee then urges this Court to find Reserve waived its challenge to that conclusion by not disputing it in Reserve's opening brief or by not moving to reopen the record to offer additional evidence when the court requested briefing regarding *Avrahami v. Commissioner*, 149 T.C. 144 (2017). Gov.Br.39-42.

Appellee's arguments put the cart before the horse. The threshold issue is whether PoolRe must be a bona fide insurance company for Reserve to distribute risk through its reinsurance arrangements with PoolRe. Obviously, if the answer is "*no*," the court misapplied the legal test because whether Reserve distributed risk would not turn on PoolRe being a bona fide insurance company. In that situation, there would be no need

to address whether PoolRe was a bona fide insurance company, let alone, whether the court's underlying findings were erroneous.[2]

But that is precisely the situation here. As shown by the well-settled caselaw recognizing insurance for federal tax purposes even where *no insurance company exists*, the existence of a bona fide insurance company is *not* necessary for risk distribution to exist. *E.g., Ross v. Odom*, 401 F.2d 464, 465-70 (5th Cir. 1968); *Comm'r v. Treganowan*, 183 F.2d 288, 290-91 (2d Cir. 1950). Notably, citing to *Ross* and *Treganowan*, Appellee concedes that Reserve is correct in this regard. Gov.Br.40.

A. Appellee's "Substantive-Functions-of-an-Insurance-Company" Argument Is Unavailing.

Recognizing the fatal nature of the court's error, Appellee does not defend the court's risk-distribution approach on the merits. Instead, Appellee attempts to recast it as an inquiry concerning whether PoolRe

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[2] If the findings are reviewed at all, they should be reviewed for harmless error, not clear error, because they were based on an erroneous view of the law governing risk distribution. *Valley Improvement Ass'n v. U.S. Fid. & Guar. Corp.*, 129 F.3d 1108, 1123 (10th Cir. 1997). Under the correct view, the only reasonable conclusion the court could have reached given the undisputed facts is that Reserve distributed risk. Under these circumstances, it cannot be said that the court's legal error was harmless.

performed the substantive functions of an insurance company. Gov.Br.40-41.

Appellee's revisionist portrayal of the court's approach is unavailing. Appellee provides no record citations for this purported "substantive-functions-of-an-insurance-company" inquiry. Nor is there any to be found. The court was clear – it considered the dispositive issue to be "whether PoolRe was a bona fide insurance company," not whether PoolRe performed the substantive functions of an insurance company. App.Vol.3.p.887.

Furthermore, recasting the court's approach in this way does not save it from conflicting with authorities recognizing that risk distribution is to be analyzed in the same manner regardless of whether the transaction concerns direct insurance or reinsurance. *See, e.g., Ocean Drilling & Exploration Co. v. United States*, 988 F.2d 1135, 1153 n.25 (Fed. Cir. 1993); Rev. Rul. 2009-26, 2009-38 I.R.B. 366. That means the court should have conducted its analysis from the perspective of Reserve (the reinsurer), not PoolRe (the reinsured), and by solely looking through the reinsurance arrangements to the pool of risks Reserve reinsured, not by looking at

whether PoolRe performed the substantive functions of an insurance company. *See id.*

Appellee cannot identify any authority in which the risk-distribution determination turned on the "substantive-functions-of-an-insurance-company" inquiry. Nor can Appellee reconcile his argument here with his position previously taken in his own guidance. *See, e.g.,* Rev. Rul. 2009-26, 2009-38 I.R.B. 366 (acknowledging that courts have looked through a fronting arrangement to the pool of risks a captive insurer reinsured in analyzing whether risk distribution exists); *see also* I.R.C. § 831(b)(2)(D) (acknowledging the look-through concept in the context of reinsurance and fronting arrangements).

Nor does recasting the court's approach in this way save it from conflicting with cases recognizing insurance where there was no insurance company, either *formally* or *functionally*, such as *Ross* and *Treganowan*. The fact that the State of Georgia in *Ross* and the NYSE in *Treganowan* were not insurance companies formally or functionally did not affect the conclusions in those cases that the arrangements at issue distributed risk and were insurance for federal tax purposes. *Ross*, 401 F.2d at 465-70; *Treganowan*, 183 F.2d at 290-91. In evaluating risk distribution, the courts in those cases

focused only on whether the risk of loss was sufficiently diffused by spreading the costs throughout a group. *Id.*

Appellee nonetheless baldly claims that nothing in the court's analysis undermines cases like *Ross* and *Treganowan* because "the relevant inquiry is whether the entity that the captive[] reinsure[s] performs the substantive functions of an insurance company, not whether it is licensed and regulated as an insurance company." Gov.Br.41. In that same breath, however, Appellee acknowledges that very formality – whether PoolRe was licensed and regulated as an insurance company – was one of the factors in the court's purported "substantive-functions-of-an-insurance-company" analysis. Gov.Br.41. It is unclear which, if any, of the remaining five factors considered as part of the court's analysis constitutes a substantive function of an insurance company. What is clear, however, is that the courts in *Ross* and *Treganowan* determined that the arrangements at issue distributed risk without regard for any of those five factors.

<u>Circular flow of funds, arm's-length contracts, and actuarially-determined premiums</u>: In evaluating risk distribution, the courts in *Ross* and *Treganowan* did not consider whether the arrangements at issue involved a circular flow of funds, were arm's-length contracts, or had

actuarially-determined premiums. In fact, whereas the tax court focused on these factors in criticizing the so-called "perfect matching of payments" between stop-loss premium amounts paid to PoolRe and quota-share premium amounts paid to Reserve and the other captive insurers participating in the reinsurance risk pool, and the purported "one-size-fits-all rate" for the stop-loss premiums PoolRe charged, App.Vol.3.p.889-92, the court in *Ross* rejected the argument that payment of premiums had anything to do with risk distribution as neither good economics nor good law, 401 F.2d at 468-69 (citing *Haynes v. United States*, 353 U.S. 81, 84 (1957)).

In considering these three factors, the tax court looked at the stop-loss/quota-share premium structure with a jaundiced eye, despite the evidence proving the premium structure was constructed using actuarial methods and objective criteria purposely to facilitate risk-pooling and risk distribution. App.Vol.2.p.480, Vol.4.p.910, Vol.5.p.1209-10, 1239-42, 1374, Vol.11.p.3250-60, Vol.12.p.3389-400, 3522-33, 3560-69, Vol.13.p.3712, 3770-72. But the assertion that there is something awry about the premium structure is completely unfounded. Rather, it reveals the court's failure to understand that this structure, as explained in the Amicus Brief ("Amicus.Br."), is typical of such risk-pooling arrangements and necessary

for the pool to operate. *See* Amicus.Br.14-16, 18-19, 23-28; *see also* Letter from U.S. Senator Cory Gardner to Treasury Secretary Steven T. Mnuchin and IRS Commissioner Charles P. Rettig (Aug. 24, 2020) (Addendum A). "The amount of risk each participant puts into the pool and the amount of risk they take back must be the same in order for the pool to be fair. Premium is merely a proxy for that risk." Amicus.Br.25. Accordingly, under the quota-share arrangements here, "[b]ecause the quantity of risk ceded to the pool and assumed from the pool were the same, the premiums ceded and assumed were the same." Amicus.Br.24. Without such an equitable distribution of premium, the pooling arrangement would have been unfair and therefore, untenable among the pool participants, all of whom were unrelated to each other. *See* Amicus.Br.24; Captive Insurance Companies Association, *Commercial Ins. & Captive Ins. Indus.: Commonly Accepted Practices* at 5-7 (Jan. 31, 2019), https://www.cicaworld.com/docs/default-source/default-documentlibrary/cica_commonly_accepted_insurance_practices_risk_pools_jan2019.pdf?sfvrsn=0; *see also* Op.Br.18-22; App.Vol.4.p.1193-94, Vol.5.p.1429, Vol.13.p.3702, 3712-16, 3725, Vol.18.p.5383, Vol.19.p.5441.

The court's skepticism of the stop-loss/quota-share premium structure also reflects its misunderstanding of how risk-pooling facilitates risk distribution. As Dr. Neil A. Doherty explained, "even with heterogeneous exposures, risk can still be effectively reduced by distribution and pooling." App.Vol.13.p.3759. Distributing risk through a risk pool thus does not depend on the industries, locations, operations, types of risk, and exposure to risk of pool participants being comparable in scale or homogenous. As Appellee's own expert witness conceded, the risk-pooling here distributed risk. App.Vol.6.p.1536, Vol.19.p.5625.

Appellee gloms onto the court's suspect view of the stop-loss/quota-share premium structure, but provides no authority to support invalidating quota-share arrangements. Gov.Br.30-34. Notably, Appellee does not even attempt to reconcile his position here with his own private letter rulings that Reserve cited showing Appellee's approval of quota-share arrangements with this same structure. Op.Br.21-22. Reserve does not contend that these rulings are precedential, but it is beyond dispute that

Appellee has routinely approved of such arrangements. Appellee has provided no persuasive reason why this time is any different.[3]

Instead, Appellee puts forward the novel argument that PoolRe and the pool participants were "effectively under common control" because they delegated their administration, operations, and recordkeeping to Capstone, so that "their relationship cannot fairly be characterized as arm's-length." Gov.Br.32. But Appellee's newly-invented standard that unrelated entities that share a third-party service-provider of administrative or other back-office services are thereby "under common control" is simply a bridge too far. Were this Court to adopt that standard, it would ignore the economic realities for why companies engage such service-providers and lead to nonsensical results. Indeed, if that is the new standard, companies that hire human resources management companies like ADP or Paychex to handle administrative or other back-office work will all be "under common control," and any agreements they execute with each other categorically will not be arm's-length agreements. Appellee's

[3] Although Appellee "is entitled to change his mind, he ought to do more than stride to the dais and simply argue in the opposite direction." *Transco Exploration Co. v. Comm'r*, 949 F.2d 837, 840 (5th Cir. 1992).

argument cannot withstand scrutiny and threatens to upend well-established caselaw recognizing that agreements between unrelated parties are inherently arm's-length agreements. *See United Parcel Serv. of Am., Inc. v. Comm'r*, 254 F.3d 1014, 1018 (11th Cir. 2001).

Actual and insurable risk: In *Ross* and *Treganowan*, the arrangements at issue were death-benefit funds that insured against the risk of loss from premature death. *Ross*, 401 F.2d at 465-70; *Treganowan*, 183 F.2d at 290-91. In evaluating risk distribution, however, the courts' focus was not on the likelihood a loss would materialize or the severity should it occur, but on whether the risk of loss was sufficiently diffused by spreading the costs throughout a group. *See id.* Notably, as the court recognized in *Treganowan*, "[f]rom an insurance standpoint, there is no risk unless there is uncertainty or, to use a better term, fortuitousness," and "[i]t may be uncertain whether the risk will materialize in any particular case." 183 F.2d at 290.

Here, in contrast, the tax court fixated on the likelihood or severity of a loss on PoolRe and determined that "PoolRe was removed far from any actual risk associated with the business or operations of Reserve's insureds." App.Vol.3.p.893. This finding, however, is based on a

misreading of Reserve's direct-written policies as providing only excess coverage and a fundamental misunderstanding of how stop-loss coverage works.

Appellee does not refute Reserve's argument that the court misread Reserve's direct-written policies as providing only excess coverage. Nor does Appellee address the court's finding that "Reserve's policies covered only losses that were not covered by Peak's third-party policies." App.Vol.4.p.905. Instead, Appellee argues that the "other insurance" clauses of Reserve's policies "provided an additional barrier between the underlying risks and PoolRe." Gov.Br.34-36. The only support Appellee cites for his argument is an inconsistent statement in the feasibility study saying Peak had limited pollution liability coverage under its commercial general liability and products liability policies. Gov.Br.36.

As a preliminary matter, Appellee's characterization of the feasibility study as "the *post hoc* feasibility study" misstates the facts. Gov.Br.36. The evidence unequivocally shows that "the feasibility study was drafted a few weeks after the site visit" in August 2008, App.Vol.5.p.1254 (403:23-404:1); *see also* App.Vol.4.p.1087, and its conclusions were used in Reserve's application for an Anguillan insurance license in October 2008,

App.Vol.7.p.1880-83. And while the feasibility study does contain the inconsistency Appellee cites, any pollution liability coverage under Peak's commercial policies would have been narrow coverage generally available only as exceptions to exclusions. App.Vol.10.p.2810, 2916, 2920, 2978, 2999.

More importantly, however, to the extent that there was any overlap in coverage for a type of loss, Reserve's policies would nonetheless have provided primary, *not excess*, coverage because Peak's commercial policies and Reserve's policies both contained "other insurance" clauses. App.Vol.10.p.2812, 2863, 2924. The legal effect of such clauses "is to provide that each insurer shall not be liable for any greater proportion of any loss which may occur than the amount named in the policy bears to the entire amount of the insurance coverage available." *State Farm Fire & Cas. Co. v. Griffin*, 888 S.W.2d 150, 155 (Tex. App.—1994, no writ). Accordingly, the "other insurance" clauses of Reserve's policies would *not* provide an additional barrier between the underlying risks and PoolRe.

Furthermore, Appellee's argument that there is something meaningful in the absence of losses affecting the higher layer of stop-loss coverage during the three-year period at issue is misplaced. Gov.Br.33. The purpose of stop-loss coverage is to serve as a layer of coverage to

protect against large or catastrophic claims exceeding a predetermined amount. *Reich v. Lancaster*, 55 F.3d 1034, 1041 n.4 (5th Cir. 1995). Accordingly, "[s]top loss [coverage] should never attach at the 1 in 1 or 1 in 3 year expected loss scenario; it is a protection against a catastrophic deterioration in loss frequency and as such should attach beyond the 1 in 10 year expected loss scenario." Oliver Schofield, *Reserve Mechanical: Judge Kerrigan Shows "Limited Knowledge" of Reinsurance Market* (June 28, 2018), https://irp-cdn.multiscreensite.com/ea743ce7/files/uploaded/London%20reinsurance%20expert%20criticises%20%E2%80%9Climited%20knowledge%E2%80%9D%20of%20Reserve%20Mechanical%20judge%20-%20article%20-%20Captive%20Review%20Jun%202018.pdf. To conclude that something is amiss based on just a few years of results is to misunderstand the fundamental purpose behind stop-loss coverage.

Notably, however, while the tax years in issue did not see the type of worldwide turmoil seen today from the coronavirus pandemic, had the pandemic occurred during those years, the stop-loss coverage most assuredly would have been triggered. For example, had the pandemic occurred in 2009, Reserve's regulatory-changes policy would have covered

losses from government-mandated shutdowns; Reserve's loss-of-services policy would have covered losses of key employees due to sickness; and Reserve's loss-of-major-customer policy would have covered losses of orders from major customers as a result of business slowdown. App.Vol.11.p.3297-Vol.12.p.3303, Vol.12.p.3320-28, 3368-74. The stop-loss coverage would have been the only insurance available to prevent catastrophic losses from jeopardizing Reserve's ability to respond to such claims.[4] In fact, because Reserve had already paid a large claim by Peak under Reserve's loss-of-major-customer policy totaling $339,820 in 2009, if Reserve had received one more claim from Peak for at least $110,000, PoolRe's stop-loss coverage would have responded. App.Vol.2.p.377-78, Vol.4.p.1127-29, Vol.12.p.3411-20, 3552-59.

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[4] During the current crisis, while commercial carriers are denying pandemic-related claims, the broad coverages written by captives have allowed many businesses to remain viable. *See* Leslie Scism, *Companies Hit by Covid-19 Want Insurance Payouts. Insurers Say No.*, Wall St. J., June 30, 2020 (Addendum B); Christopher Hanewald, *Insight: Denied Business Interruption Claims Could Spur Boom in Captive Insurance*, Bloomberg Daily Tax Report, May 15, 2020 (Addendum C). The current crisis is a case study for why captive insurance is necessary and should exist right alongside commercial insurance.

Created for legitimate nontax reasons: In evaluating risk distribution, the courts in *Ross* and *Treganowan* did not consider whether the arrangements at issue were created for legitimate nontax reasons. *Ross*, 401 F.2d at 465-70; *Treganowan*, 183 F.2d at 290-91. Rather, their focus was on whether the arrangements – regardless of why they were created – distributed risk. *See id.* Here, the tax court determined that PoolRe was not created or operated for legitimate nontax reasons. App.Vol.3.p.894. The court's determination, however, was based on its view of the facts and circumstances, which, as discussed above, was riddled with misunderstandings and ignored the incontrovertible fact that PoolRe was an independent entity that executed binding arm's-length agreements imposing genuine obligations with unrelated entities. *See United Parcel Serv.*, 254 F.3d at 1018.

B. Appellee's Coinsurance Arguments Conflict with Well-Established Caselaw and Ignore Limitations on Treaty Reinsurers.

At trial, Reserve met its burden of producing evidence to establish the existence of the coinsurance arrangements through documentary evidence, including the coinsurance contracts between PoolRe and Reserve, audited financial statements and general ledgers showing the premiums

earned and claims paid by Reserve under the arrangements, and testimony of witnesses. App.Vol.5.p.1283-86, 1416-25, Vol.9.p.2463-508, Vol.11.p.3261-69, Vol.12.p.3401-10, 3534-44, Vol.18.p.5376-87. Neither the court nor Appellee has articulated any persuasive reason why Reserve's evidence establishing the existence of the coinsurance arrangements was insufficient.

Appellee's brief argues without any legal support that Reserve could not prove that the coinsurance arrangements distributed risk without "first establishing the existence of the vehicle service contracts, ceding agreements, and claims paid." Gov.Br.45. Appellee's argument, however, fares no better than his arguments attacking the quota-share arrangements because it likewise undermines the well-established caselaw recognizing risk distribution and insurance for federal tax purposes in the absence of an insurance contract.

Ross is particularly illustrative. In that case, the Fifth Circuit recognized that the insurance arrangement did not need to be in the form of "a traditional bilateral agreement, or for that matter, even a unilateral one signed by one party and accepted by the other." 401 F.2d at 467. Instead, for insurance to exist, the critical factors were "the presence in a

binding arrangement of risk-shifting and risk distribution." *Id.* In evaluating risk distribution, the court was thus unconcerned with whether it had before it documentary evidence establishing the arrangement's existence. Rather, the court focused on whether the risk of loss was sufficiently diffused by spreading the costs throughout a group and determined that the arrangement met the risk-distribution requirement. *Id.* at 468. Having found both risk shifting and risk distribution existed, the court turned to and disposed of a number of arguments made by "[t]he Government ... in the hopes of overcoming, probably more accurately, of escaping from this undeniable risk shifting and risk distribution," all of which followed "a persistent theme that there must be a traditional 'contract,' a contract for insurance, and therefore necessarily executed by one qualified to write insurance as such." *Id.*

No reason appears in Appellee's response or the court's opinion explaining why it would be necessary for Reserve to submit the underlying contracts into evidence to prove that the coinsurance arrangements distributed risk. Where, as here, the terms of the coinsurance arrangements are undisputed, it is pedantic to insist on the production of the underlying contracts and other documents evidencing such collateral matters,

especially when Appellee should know that Reserve, as a treaty reinsurer, would not have the right to access them.

As Reserve explained, unlike a facultative reinsurer who underwrites each risk prior to determining whether to reinsure the risk, a treaty reinsurer does not engage in such underwriting of its own of the reinsured risks. Op.Br.9-11, 44-45. Accordingly, once a reinsurance treaty is written, considerations such as whether the underlying policies have been written, whether the reinsured correctly underwrote the reinsured risks, and whether claims on the underlying policies are accurately paid, are of no significance to a treaty reinsurer – the treaty reinsurer is bound to indemnify the reinsured for any good faith payment regardless. *See id.*

Despite the foregoing, Appellee insists that Reserve should or could have done more to submit into evidence the vehicle service contracts Lyndon issued, earlier ceding agreements, or documents regarding claims Lyndon paid on the contracts. Gov.Br.43-45. To that end, Appellee points to Reserve's contractual right to obtain coinsurance-related documents PoolRe maintained. Gov.Br.43. Appellee's point, however, is rather unremarkable because he ignores the fact that PoolRe, like Reserve, is also

a treaty reinsurer under a treaty with CreditRe and thus would likewise not have had access to such coinsurance documents. App.Vol.13.p.3867-68.

Finally, as with the quota-share arrangements, the court incorrectly determined that the coinsurance arrangements did not involve actual risk by focusing on the amount of risk of the overall pool of vehicle service contracts PoolRe and, in turn, Reserve, assumed. App.Vol.3.p.896. As the caselaw shows, however, the court should have analyzed whether Reserve distributed risk by spreading the risk of loss among the policyholders of the vehicle service contracts. *E.g., Ross*, 401 F.2d at 465-70; *see also* I.R.C. § 831(b)(2)(D). It is unknown what, if any, relevance the amount of the overall pooled risk assumed has on risk distribution, and no explanation can be found in the court's opinion or Appellee's brief. It is also unknown how the court could reasonably conclude that the amount of risk involved was "de minimis" when, over the three-year period at issue, Reserve paid almost $190,000 in losses under the coinsurance arrangements, and received coinsurance premiums comprising a material portion of its gross premiums. App.Vol.9.p.2478, 2490-91, 2504, Vol.19.p.5416. The caselaw is clear that circumstances less compelling than those here nonetheless give rise to actual risk. *See United Parcel Serv.*, 254

F.3d at 1018 (holding that the reinsurance treaty between the captive insurer and its reinsured should be respected even though such treaty significantly reduced the odds of loss, since the obligations thereunder were susceptible to default).

For the foregoing reasons and those discussed in Reserve's opening brief, this Court should reverse the tax court's determination that Reserve did not distribute risk through its reinsurance arrangements.

II. RESERVE'S TRANSACTIONS WERE INSURANCE IN THE COMMONLY ACCEPTED SENSE.

Appellee concedes that the tax court, in analyzing whether Reserve's transactions were insurance in the commonly accepted sense, acknowledged that (1) Reserve had adequate capitalization; (2) Reserve's "direct-written policies 'contained the necessary terms to make them valid and binding insurance' and ... were properly executed"; and (3) Reserve paid claims. Gov.Br.53, 62. Despite expending pages rehashing those settled factors, Appellee does not contend that any were wrongly decided. Accordingly, only two factors remain in dispute – whether Reserve was operated like an insurance company and whether Reserve's premiums

were reasonable and negotiated at arm's length. Reserve satisfied both factors, and Appellee's arguments to the contrary are wrong on both accounts.

A. Reserve Was Operated as an Insurance Company.

The crucial question here is whether a captive insurer that has no employees, and whose owners delegate operational functions, financial reporting, regulatory compliance, and day-to-day tasks to hired professionals instead of handling such responsibilities firsthand, can operate as an insurance company. If the answer is "*yes*," Appellee's argument should be rejected and the tax court's determination that Reserve was not operated as an insurance company should be reversed.

Appellee's brief argues that Reserve was not operated as an insurance company because Reserve operated without any employees and engaged Capstone and other professionals for operations and oversight of Reserve, but provides no citation to any authority suggesting that this state of affairs is inconsistent with operating as an insurance company. Gov.Br.47-48. That is because it is not. As discussed in Reserve's opening brief, the caselaw shows that most captive insurers operate without employees and routinely delegate such matters to captive managers and

other professionals. Op.Br.57-61. It would neither be good economics nor good law if the situation were otherwise. This Court should reject Appellee's invitation to go down that path.

Appellee does not address Reserve's authorities or the merits of Reserve's argument that such state of affairs is entirely reasonable and consistent with operating as an insurance company, especially where, as here, Reserve's owners were new to the insurance business. Reserve operated through a team of insurance professionals, including attorneys, underwriters, insurance accountants, claims processors, and actuaries, all engaged to handle Reserve's day-to-day operations. App.Vol.5.p.1372-74. On Reserve's behalf, those professionals handled, among other responsibilities, underwriting, premium calculations, processing and payment of claims, and due diligence prior to Reserve issuing direct-written policies and entering into the quota-share and coinsurance reinsurance arrangements here.[5] *Id*. It is not apparent and Appellee

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[5] Appellee argues (ironically, in a footnote) that Reserve waived the argument that treaty reinsurance is different from facultative reinsurance by raising the distinction in a footnote in a supplemental brief. Gov.Br.50 n.11. Appellee's cited authority, however, simply stands for the unremarkable proposition that arguments raised for the first time *on appeal*

provides no persuasive reason why Reserve operating through its hired team of insurance professionals is any less consistent with operating as an insurance company than Reserve's owners handling such responsibilities firsthand. The tax court's conclusion that Reserve was not operated as an insurance company should be reversed.

B. Appellee Ignores the Tax Court's Misreading of Reserve's Direct-Written Policies as Providing Only Excess Coverage.

Reserve demonstrated in its opening brief that the tax court misinterpreted Reserve's direct-written policies as providing only excess coverage based on its misreading of the "other insurance" clauses of Reserve's policies. Op.Br.48-52. By misreading Reserve's policies in this way, the court inevitably and erroneously found that (1) Reserve's premiums were unreasonable and not negotiated at arm's length, (2) there

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are waived. That is not the case here. Nor can Appellee point to any authority showing that an argument raised in supplemental briefing that the court decided is nonetheless waived because it was raised in a footnote. Moreover, Appellee's argument presumes that the court did not consider the entire brief that it requested. There is no law granting such a presumption. If arguments raised in footnotes are waived, then Appellee has waived his waiver argument by raising it in a footnote.

was no "real business purpose" for Reserve's policies, and (3) Peak lacked "a genuine need for acquiring additional insurance." Op.Br.53-57.

As noted above, Appellee does not defend the court's misreading of Reserve's policies. Instead of directly addressing the court's error on the merits, Appellee simply ignores it, and argues that the record supports the court's determination that Reserve's premiums were unreasonable and not negotiated at arm's length. Gov.Br.55-61.

Appellee's argument, which effectively consists of a rehashing of the tax court's analysis, is unavailing because Appellee fails to account for the fact that the court's analysis of Reserve's premiums, its determination that they were unreasonable and not negotiated at arm's length, and its ultimate conclusion that Reserve's transactions were not insurance in the commonly accepted sense, were all built on the flawed premise that Reserve's policies provided only excess coverage. Appellee's own words show this to be true. On brief, Appellee writes that "[a]s the starting point of its analysis [of whether premiums were reasonable and the result of arm's-length dealing], the court noted that Peak's insurance expenses dramatically increased as a result of the captive arrangement," and that "Peak continued to maintain all of its commercial insurance *plus*

supplemental coverage[.]" Gov.Br.55 (second emphasis added). The court's misapprehension of the increase in Peak's insurance expenses flowed directly from its misreading of Reserve's policies as providing only *supplemental* coverage (i.e., *excess* coverage). Similarly, the court's criticism of Peak for maintaining all its commercial insurance even after paying for additional coverage from Reserve incorrectly presumes that Peak should have discontinued its commercial insurance after purchasing coverage from Reserve because of the court's misunderstanding that both sets of policies *covered the same risks*.

The tax court's *undisputed* misreading of Reserve's direct-written policies infects its entire analysis of Reserve's premium pricing. This Court should reverse the tax court's determination that Reserve's premiums were unreasonable and not negotiated at arm's length.

III. If Amounts Received as Premiums Were Not for Insurance, Such Amounts Were Capital Contributions.

On brief, Appellee misstates Reserve's position on this issue.[6] Reserve has never claimed that Revenue Ruling 2005-40, 2005-2 C.B. 4,

[6] As a preliminary matter, Appellee argues that this issue is reviewable for clear error. Gov.Br.63-64. Contrary to Appellee's contention, the relevant

contains an exhaustive list of possible characterizations for a failed insurance arrangement. Reserve's point has always been that any characterization of the amounts as income to Reserve, including the characterizations described therein *or otherwise*, would have a business purpose, and because the tax court determined that there was no such purpose here for Reserve's receipt of the payments, the payments Reserve received could only be characterized as nontaxable capital contributions. Op.Br.63-68.

Nor has Reserve claimed that distinguishing between the alternative characterizations does not require consideration of all the facts and circumstances. Rather, that is precisely what Reserve argues should have occurred here. The difference between the parties lies in what those facts and circumstances are from each party's perspective. Appellee insists only

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issue is not whether Reserve met its burden of proving that the payments to Reserve were intended to be capital contributions. Rather, it is whether the court applied the correct legal standard in evaluating whether the payments Reserve received were properly characterized as taxable income instead of nontaxable capital contributions. Op.Br.62. Appellee's own cited authority makes clear that whether the court applied the correct legal standard in evaluating the proper tax treatment of a transaction is reviewed de novo. *See Washington Mutual, Inc. v. United States*, 856 F.3d 711, 721 (9th Cir. 2017).

"the intent or motive of the transferor matters." Gov.Br.64 n.16, 67; *see also* Appellee's Rule 28(j) Letter (dated September 3, 2020) (discussing *Commissioner v. BrokerTec Holdings, Inc.*, 967 F.3d 317 (3d Cir. 2020)). But the caselaw Appellee relies on is distinguishable because his cited cases concern *non-shareholder payments between unrelated entities* and thus are not analogous to the situation here, which involves *shareholder payments between commonly controlled entities.*

For its part, Reserve believes this Court should consider the tax court's determination that there was no legitimate nontax reason for Reserve's receipt of the payments and the underlying analysis. In doing so, this Court should hold, pursuant to the two-part test under *Sammons v. Commissioner*, 472 F.2d 449 (5th Cir. 1972), that the payments Reserve received could only be characterized as nontaxable capital contributions. *Id.* at 451-54 (providing that a payment is recharacterized as a deemed dividend to the common shareholders and a capital contribution by such shareholders to the recipient corporation when (1) the common shareholder is able to exercise control over the payment through control of the payee corporation, and (2) the payment primarily benefited the common shareholder and the payor corporation obtained no substantial

nontax business benefit from the payment); *see also* James R. Browne, "*Reserve Mechanical and Syzygy: Income from Nothing*," 163 Tax Notes 1665, 1668 (June 10, 2019). In *Sammons*, the court's focus was on whether the recipient of the payment received a substantial nontax business benefit from its commonly controlled entity in exchange for the payment at issue *regardless of the payor's intent*. 472 F.2d at 451-54.[7]

No additional evidence of the payor's intent is necessary in these circumstances. The court determined Reserve's transactions did not constitute insurance and that there was no business purpose for the payments Reserve received. App.Vol.4.p.911. Whether a payment is taxable income turns on the *substance* of the transaction based on the facts and circumstances found by the court, and a payment between commonly controlled entities with no business purpose simply cannot be income to

[7] While Appellee attempts to distance the case before this Court from the result required under *Sammons*, even Appellee does not dispute that *Sammons* is applicable here. Indeed, Appellee's use of the "*cf.*" signal with his citation to *Sammons* can fairly be described as a concession in this regard. Gov.Br.72.

the recipient.[8] *Sammons*, 472 F.2d at 452-54; Rev. Rul. 69-630, 1969-2 C.B. 112; Rev. Rul. 78-83, 1978-1 C.B. 79.

Appellee's argument that Reserve is attempting to "turn the purpose of the substance-over-form doctrine on its head" is also misplaced. Gov.Br.70. Contrary to Appellee's assertion, Reserve is not "attempting to recast the payments from its perspective (*i.e.*, as capital contributions from its indirect owners, Zumbaum and Weikel) without a symmetrical recasting of those same payments from the affiliated insureds' perspective (*i.e.*, as nondeductible distributions to their owners, Zumbaum and Weikel, for contribution to taxpayer)." Gov.Br.69-70. Rather, Reserve maintains that this Court should determine the proper tax consequences of the payments to Reserve as the only party before it.

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[8] Appellee argues that "[t]axpayer "ha[d] the burden of establishing that [Appellee]'s determination of income ... [was] incorrect" and emphasizes that "[o]n appeal, taxpayer does not dispute that it had the burden of proving that the amounts at issue were not FDAP income." Gov.Br.65. However, if the court had applied the correct legal test, it would have determined that (1) common owners controlled the insurance company, and (2) the operating companies obtained no substantial nontax business benefit for the payments (a determination the tax court made notwithstanding Reserve's evidence to the contrary). In this way, Reserve's applicable burden of proof was met by the tax court's own determinations in this regard.

Nor is Reserve attempting to disavow the form of its transactions. Gov.Br.69-70. Reserve continues to maintain that its transactions are insurance. Both the payors (the Direct Insureds) and the payee (Reserve) undeniably intended the payments to be insurance premiums, App.Vol.4.p.1237-38, Vol.13.p.3701-26, but the court rejected the evidence demonstrating this fact. Having done so and having determined that such payments had no business purpose, the court should have determined that such payments did not constitute income to Reserve. Appellee's own authorities confirm that would have been the proper outcome. *E.g.,* Rev. Rul. 69-630, 1969-2 C.B. 112; Rev. Rul. 78-83, 1978-1 C.B. 79.

The "substance-over-form" doctrine taxes a transaction based on its economic substance if the economic substance varies from its legal form. *See Tracinda Corp. v. Comm'r*, 111 T.C. 315, 326 (1998). In this case, the tax court held that the "substance" of the transaction was not insurance and that there was no business purpose for the payments that Reserve received. If this Court affirms the tax court in this regard, *the substance-over-form doctrine mandates that the payments be characterized as capital contributions*.

A. Appellee's Attempt to Distinguish Reserve's Cited Authorities Fails.

Appellee argues that Reserve's reliance on *Carnation Co. v. Commissioner*, 71 T.C. 400 (1978), *aff'd*, 640 F.2d 1010 (9th Cir. 1981), is misplaced, by arguing that, in *Carnation*, (1) the insured did not "advance an alternative characterization of the purported insurance premiums if the court found otherwise"; (2) the tax court affirmed Appellee's determination that the premiums should be recharacterized as capital contributions based on the "presumption of correctness" that attached thereto; and (3) the tax court had no occasion to elucidate the "facts and circumstances" under which purported insurance premiums should be recharacterized as capital contributions. Gov.Br.70-71.

Appellee's attempt to distinguish *Carnation* on each of these grounds fails. Contrary to Appellee's assertion, even where Appellee contended that amounts paid as premiums to a putative insurance company were nevertheless income to the recipient (i.e., the opposite of what occurred in *Carnation*), the tax court has followed *Carnation*. *E.g., Chapman Glen Ltd. v. Comm'r*, 140 T.C. 294, 350 (2013). For example, applying *Carnation*, the tax court in *Chapman Glen* held that such amounts were capital contributions

where the tax court had determined that amounts paid as premiums were not for insurance premiums because there was no insurance company for tax purposes. 140 T.C. at 350.

Appellee cites *Gulf Oil Corp. v. Commissioner*, 914 F.2d 396 (3d Cir. 1990), as a situation where the court found the "arrangements did not constitute insurance contracts for tax purposes but declin[ed] … to recharacterize payments made thereunder as capital contributions." Gov.Br.71. That case, however, does not support Appellee's position here because Appellee fails to recognize that the court in *Gulf Oil* properly applied the two-part *Sammons* test *where the payments at issue were determined to have a business purpose*. *Gulf Oil*, 914 F.2d at 413. Unlike in *Gulf Oil*, the tax court here specifically determined that the payments to Reserve had no valid nontax business purpose. Properly applying the *Sammons* test to the facts and circumstances here mandates the payments Reserve received be recharacterized as deemed distributions by Peak and capital contributions to Reserve.[9]

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[9] Seeking to have his cake and eat it too, Appellee emphasizes in his brief that he argued below that "the payments should be characterized as amounts moved offshore to self-insure against business losses – analogous

Appellee's attempt to distinguish Revenue Ruling 78-83, 1978-1 C.B. 79, is also unavailing.[10] Gov.Br.71-72. The ruling is clear that the excess over the correct amount (even if the amount is zero) is the amount that is treated as a distribution to the parent and a contribution to the recipient of the payment. In the present context, this means that the total premium amount received by Reserve would be a capital contribution.

Under the facts and circumstances here, this Court should determine that Reserve had no taxable income.

Conclusion

Reserve renews its prayer at page 68 in its opening brief.

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to underwriting or guarantee income under I.R.C. § 861(a)(7) and (a)(9) – and subject to tax under I.R.C. § 881(a)." Gov.Br.66-67. The court, however, made no such determinations. In any event, such determinations would be *inconsistent* with its determination that the payments to Reserve lacked a legitimate business purpose.

[10] Appellee incorrectly suggests that Reserve waived the right to cite this revenue ruling. You waive arguments and issues, not authorities. This ruling supports the very arguments that Reserve made in the tax court, and this Court should consider it. *See* App.Vol.3.p.636-38. No rule or caselaw confines Reserve to the precise authorities cited below.

Respectfully submitted,

/s/ Val J. Albright

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Certificate of Compliance

Pursuant to Federal Rule of Appellate Procedure 32(g), I certify that the foregoing brief:

(1) complies with the typeface and type style requirements of Federal Rules of Appellate Procedure 32(a)(5) and (6) and Tenth Circuit Local Rule 32(A) because it was prepared in a proportionally spaced typeface using Microsoft Office Word 2016 in 14-point Book-Antiqua font; and

(2) complies with the type-volume limitation of Federal Rule of Appellate Procedure 32(a)(7)(B) because it contains 6,387 words, excluding the parts of the brief exempted by Federal Rule of Appellate Procedure 32(f) and Tenth Circuit Local Rule 32(B).

/s/ Val J. Albright
Val J. Albright

Certificate of Digital Submission

With respect to the foregoing brief, I certify that:

(1) all required privacy redactions have been made per Tenth Circuit Local Rule 25.5;

(2) the version of this brief submitted electronically to this Court via its CM/ECF system is an exact copy of the hard copies of this brief to be submitted to the Court; and

(3) the version of this brief submitted electronically to this Court via its CM/ECF system was scanned for viruses with the most recent version of a commercial virus scanning program, and is free of viruses.

/s/ Val J. Albright
Val J. Albright

Certificate of Service

I certify that a copy of this document was served by sending it to counsel listed below on September 25, 2020 via this Court's CM/ECF system:

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Addenda

Addendum A

Letter from

U.S. Senator Cory Gardner to Treasury Secretary Steven T. Mnuchin and IRS Commissioner Charles P. Rettig (Aug. 24, 2020)

CORY GARDNER
COLORADO

SUITE SR-354
SENATE RUSSELL OFFICE BUILDING
WASHINGTON, DC 20510

United States Senate

COMMITTEES:

COMMERCE, SCIENCE, AND TRANSPORTATION
ENERGY AND NATURAL RESOURCES
FOREIGN RELATIONS

August 24, 2020

The Honorable Steven T. Mnuchin
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, D.C. 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue NW
Washington, D.C. 20224

Received Treas Exec Sec
Digitally signed by Received Treas Exec Sec
Date: 2020.08.24 17:57:33 -04'00'

Dear Secretary Mnuchin and Commissioner Rettig:

Thank you for the tireless work you have given our country addressing the challenges the coronavirus pandemic has brought upon our nation. We face an extraordinary challenge, and I appreciate your dedication to helping the American People persevere. I write, however, concerning the Internal Revenue Service's scrutiny of the enterprise risk captive (micro-captive) insurance industry operating under Internal Revenue Code § 831(b). While I support the IRS's goal of eliminating bad actors in the industry, I respectfully request that the Service suspend its broad review of the industry until resolution of the current litigation in the United States Court of Appeals for the 10th Circuit.

It has come to my attention that on March 20, 2020—just days into the nation's coronavirus crisis—the IRS sent a letter (IRS Letter 6336 (3-2020)) to various companies demanding a response by May 4. Aside from poor timing given the fast-developing public health crisis, the letter also requested information, under penalty of perjury, that many may not be able to provide. More importantly, the Tenth Circuit is currently considering an appeal that will likely provide significant guidance for the industry.

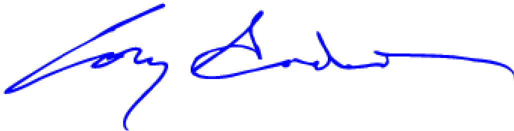
The United States Tax Court's decision in *Reserve Mechanical Corp. v. Commissioner*, No. 014545-16, presents significant issues for the captive insurance industry. As the *amici curiae* brief for various state agencies and the Self-Insurance Institute of America, Inc. makes clear, there is serious concern within the industry that the Tax Court's decision is contrary to established law and creates a marked change in the rules for the industry. The case is currently pending before the Tenth Circuit (Case No. 18-9011).

To the extent *Reserve Mechanical* is one of the "[s]everal recent U.S. Tax Court decisions" referenced in the May 20 letter, I request that the IRS suspend action on the letter until resolution of the case. A decision affirming the Tax Court's ruling would provide important guidance for participants in the industry to consider in deciding whether to continue to utilize the statutorily-created tax deductions for these arrangements. A decision reversing the Tax Court's ruling will aid the IRS in deciding whether it is prudent to continue to deploy "several examination teams" to scrutinize the industry.

I am confident that all sides will be better served with greater clarity regarding the rules under which micro-captives operate: be it from *Reserve Mechanical* or more guidance related to § 831(b) arising from the Protecting Americans from Tax Hikes (PATH Act) or the Consolidated Appropriations Act of 2018 (Pub. Law No. 115-141).

I respectfully request that the IRS suspend its requests in the May 20 letter. Thank you again for your service to our nation.

Sincerely,



Cory Gardner
United States Senator

Addendum B

Leslie Scism, ***Companies Hit by Covid-19 Want Insurance Payouts.***

Insurers Say No.,

Wall St. J., June 30, 2020

Appellate Case: 18-9011 Document: 010110414330 Date Filed: 09/25/2020 Page: 49

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https://www.wsj.com/articles/companies-hit-by-covid-19-want-insurance-payouts-insurers-say-no-11593527047

Companies Hit by Covid-19 Want Insurance Payouts. Insurers Say No.

A battle looms over 'business interruption' coverage, which insurers say doesn't apply unless there is physical damage, like from a fire.

By Leslie Scism
June 30, 2020 10:24 am ET

One of the biggest legal fights in the history of insurance has begun.

A cavalcade of restaurateurs, retailers and others hurt by pandemic shutdowns have sued to force their insurers to cover billions in business losses. A video berating the industry ran for most of June on a giant screen in New York's Times Square, four times each hour around the clock.

"Insurance companies: Do the right thing," was the chorus at the end of the video. Repeating the words were a musician, a dancer, a chef, a rabbi, comedian Whoopi Goldberg —and a New Orleans plaintiffs' lawyer, John Houghtaling II, who paid for the video.

Millions of businesses across the U.S. have "business interruption" insurance. The pandemic, no question, interrupted their businesses.

But insurance companies have largely refused to pay claims under this coverage, citing a standard requirement for physical damage. That is a legacy of its origins in the early 1900s as part of property insurance protecting manufacturers from broken boilers or other failing equipment that closed factories. The insurance is also known as "business income" coverage.

More than half of property policies in force today specifically exclude viruses. The firms filing the lawsuits mostly hold policies without that exclusion. Their argument for getting around the physical-damage requirement is that the coronavirus sticks to surfaces and renders workplaces unsafe.

Lawyers have found past rulings that say events rendering a property unusable

may constitute property damage. In one case, a New Jersey manufacturer prevailed with its argument that an ammonia leak made its property unfit for use.

John Houghtaling II, at his home in New Orleans, formed a coalition to seek payouts under business-interruption insurance for losses due to the pandemic.

PHOTO: ANNIE FLANAGAN FOR THE WALL STREET JOURNAL

In Oregon, a policyholder obtained a favorable ruling when wildfire smoke led to canceled outdoor theater performances. In New Hampshire, the state's highest court said physical loss didn't include only changes that could be seen or touched, in a case about cat-urine odor in a condo building.

"Lawyers and the trial bar will attempt to torture the language on standard industry forms and try to prove something exists that actually doesn't exist," Chubb Ltd. Chief Executive Evan Greenberg said on an earnings call in April. "The industry will fight this tooth and nail. We will pay what we owe."

Hundreds of lawsuits have been filed, and lawyers anticipate many more. Some plaintiffs' lawyers speculate the issue could deal losses to insurers rivaling their liability from asbestos litigation about 30 years ago. That was about $100 billion, according to A.M. Best Co. A Wells Fargo Securities analyst puts insurers' worst-case business-interruption liability at $25 billion, which would match losses from some Category 5 hurricanes.

The volume of plaintiffs and variety of venues raise the chance of sympathetic judges or juries finding for small-business plaintiffs, some lawyers say.

"Which side of the state line you are on can influence the outcome," said Randy Maniloff, an attorney at White & Williams LLP who represents insurers.

Cases are arriving from established coverage-dispute law firms, class-action

lawyers who typically sue businesses, prominent litigators such as Boies Schiller Flexner and smaller shops ordinarily focused on personal injury. Some are advertising on TV and social media for clients.

Mr. Houghtaling has emerged as the most visible player.

He is no stranger to insurance companies after suing them, and racking up wealth, in disputed claims from Hurricane Katrina and superstorm Sandy. He has co-founded a "Business Interruption Group" with celebrity chefs to draw attention to claim denials, and squared off against an industry executive at a congressionally sponsored forum.

Chef Daniel Boulud, lawyer John Houghtaling II and Andrew Rigie, executive director of the New York City Hospitality Alliance, in Times Square for the debut of the video calling on insurers to pay under business-interruption coverage.
PHOTO: LEV RADIN/PACIFIC PRESS/ZUMA PRESS

The spark for Mr. Houghtaling's campaign was a dinner party at his historic New Orleans mansion on St. Charles Avenue. The evening included a four-course French meal at tables graced with hand-painted Mardi Gras masks. Chef Jerome Bocuse, a longtime friend of Mr. Houghtaling, organized the March 12 meal. The night turned into a coronavirus strategy session.

The World Health Organization had just declared a pandemic, and Italy was restricting travel. As the diners arrived, Walt Disney Co. had announced closings of its theme parks, home to Mr. Bocuse's Chefs de France restaurant.

"Jerome, you need to get me your insurance policy," Mr. Houghtaling recalls saying. He already had seen an analysis by a legal defense firm for insurers saying that business-interruption claims were likely and in most instances could be rejected for lack of physical property damage.

THE JOURNAL.

Businesses Tell Insurance Companies: Pay Up

00:00 / 19:24

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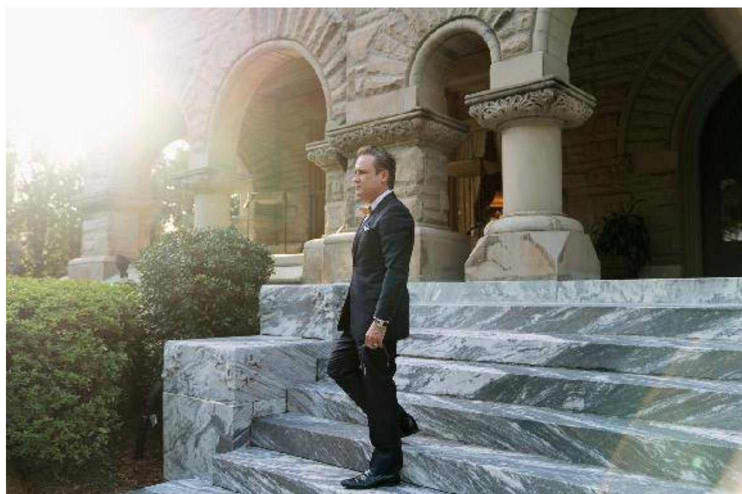
He and associates at Gauthier Murphy & Houghtaling LLC reviewed the Lloyd's of London policy of a French Quarter eatery, Oceana Grill, which they had in hand from a prior matter. In a few days, Oceana's became what's widely considered the first coronavirus coverage dispute to land in court. A Lloyd's spokesman declined to comment. The legal action is pending.

In building a legal argument, Mr. Houghtaling drew on conversations with the manager of a vintage-car racing team he has in Italy and with people in China, where he has an office for an energy firm he leads, American Ethane Co. In both hard-hit places, "the danger of this virus wasn't just person-to-person" but surface-to-person, he said.

Research was indicating the coronavirus could stay on some surfaces for possibly weeks. Current scientific thinking is that it isn't very common to contract the coronavirus from a contaminated surface—that the main mode of transmission is person-to-person contact for an extended period.

He focused on a subset of business-interruption coverage that addresses orders from civil authorities. In typical policy language, the policies refer to prohibited access to facilities due to "physical loss of or damage to property away from the insured premises," according to Michael Menapace, a legal scholar at the Insurance Information Institute trade group.



John Houghtaling II at his home in New Orleans.
PHOTO: ANNIE FLANAGAN FOR THE WALL STREET JOURNAL

Mr. Houghtaling figured it might aid policyholders' cause if civil shutdown orders said the virus adhered to surfaces and caused physical damage. That could help counter any argument from insurers that household cleaners could wipe the virus away.

He and Business Interruption Group members called an array of contacts to get the word to public officials, Mr. Houghtaling said. Subsequently, more than a dozen shutdown orders specifically addressed the issue, he said.

One from New York Mayor Bill de Blasio in March included a line saying "the virus physically is causing property loss and damage."

Learning of it, Mr. Houghtaling said, "This is epic."

SHARE YOUR THOUGHTS

Should business-interruption insurance cover losses from the pandemic? Join the conversation below.

The mayor's office said it "spoke with people who had concerns about insurance and worked with them to add the clause" to help small businesses.

Four members of Mr. Houghtaling's group—celebrity chefs Daniel Boulud, Thomas Keller, Wolfgang Puck and Jean-Georges Vongerichten —spoke by phone to President Trump in late March, asking for help in pushing insurers to pay up. They left details to Mr. Houghtaling, who said he pulled an all-nighter to write a four-page letter.

The president raised the subject at an April briefing, saying restaurateurs had told him they paid for business-interruption coverage for decades but now they need it and insurers don't want to pay. He said he understood that some policies have pandemic exclusions, adding: "I would like to see the insurance companies pay if they need to pay, if it's fair."

Insurers have some conceptual backing for their stance that business-interruption coverage isn't meant for pandemics. The National Association of Insurance Commissioners, a standards-setting group for state regulators, says pandemics violate a cardinal principle of insurance, which is that large numbers of policyholders pool their risk to fund a few losses at any one time. In a pandemic, almost all policyholders suffer losses, and simultaneously.

Still, one state, California, has cautioned insurers to fairly investigate all business-interruption claims. Insurance Commissioner Ricardo Lara said in an

April notice his department had received numerous complaints of insurance-industry representatives "attempting to dissuade business policyholders" from making claims and refusing to investigate those filed.

The virus exclusion that many policies now contain arose after the SARS scare in the early 2000s. It was the work of the Insurance Services Office Inc., a private-sector firm with functions that include writing insurance-policy forms.

The firm told regulators that while exclusions already addressed contamination, it wanted to add language to avoid policyholders seeking to expand coverage during a pandemic, contrary to policy intent. "EXCLUSION OF LOSS DUE TO VIRUS OR BACTERIA," it reads at the top of a page.

When Big Onion Tavern Group in Chicago received a notice rejecting its business-interruption claim, "It was a feeling of utter helplessness...the biggest gut punch," said Erik Baylis, the firm's owner.

Erik Baylis at his Fatpour Tap Works restaurant in April.
PHOTO: TNS/ZUMA PRESS

Mr. Baylis had just furloughed 473 employees following a state halt to dine-in service, and was counting on a payout to help cover rent, utilities and reopening costs for six restaurants. "This is what insurance is for, in my mind: to prepare for the unexpected," he said.

His attorneys at King & Spalding thought a lawsuit against Society Insurance Co. would have merit because Big Onion's policy didn't expressly exclude infectious diseases or pandemics. The lawsuit says the policy was written to cover all risks not specifically excluded.

The denial letter from the insurer cited language requiring a "direct physical

loss" to property for a business-interruption claim to be valid.

Like Mr. Houghtaling, Mr. Baylis's lawyers maintain the coronavirus created a dangerous physical condition. Filed in federal court in Chicago, the suit also alleges Society misled plaintiffs by sending a note in late March "to discourage policyholders from even filing claims...by citing a pandemic exclusion that does not exist" in their policies.

The insurer, a mutual company, declined to comment on the suit. A spokeswoman said today's "undeniably challenging" circumstances don't alter the terms of insurance contracts.

Evan Greenberg, CEO of Chubb Ltd., seen at a media and technology conference in Sun Valley, Idaho, in July 2019.
PHOTO: PATRICK T. FALLON/BLOOMBERG NEWS

As litigation has mounted, insurance executives have penned opinion pieces, including one by Chubb's Mr. Greenberg for The Wall Street Journal. The industry launched a website that is dueling with one from Mr. Houghtaling's Business Interruption Group.

Called the Future of American Insurance and Reinsurance, or FAIR, campaign, the insurance site highlights what it calls the property-and-casualty industry's contributions to communities, such as hundreds of billions of dollars in claims paid.

Part of the industry's effort involves trying to dispel the notion it is deep-pocketed enough to resolve businesses' woes. The U.S. property-casualty insurance industry has about $800 billion of "surplus," its term for assets minus liabilities. Many insurers lay off risk to reinsurers, which have additional capital of $400 billion, according to Wells Fargo Securities analyst Elyse Greenspan.

She estimated the U.S. industry could absorb $150 billion in losses without significant impact. Insurance trade groups say much of their capital backs up existing reserves for various types of claims or is needed for future hurricanes and wildfires.

The insurance industry got a bit of good news in May when a federal judge sided with an insurer's interpretation of New York state law.

District Judge Valerie Caproni said at a hearing she would rule against a publisher seeking to force an insurer to pay $197,000 on a claim. A lawyer for Social Life Magazine said the coronavirus had damaged its property, to which the judge responded: "It damages lungs. It does not damage printing presses," according to a transcript.

The judge said she felt bad for suffering small businesses, "but New York law is clear that this kind of business interruption needs some damage to the property….You get a gold star for creativity."

Before she issued a written opinion, lawyer Gabriel Fischbarg withdrew the case. He said his client aims to refile.

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Addendum C

Christopher Hanewald, ***Insight:***

Denied Business Interruption Claims Could Spur Boom in Captive Insurance,

Bloomberg Daily Tax Report, May 15, 2020

Daily Tax Report ®

INSIGHT: Denied Business Interruption Claims Could Spur Boom in Captive Insurance

By Christopher R. Hanewald

May 15, 2020, 8:01 AM

Many businesses are discovering that their business interruption policy doesn't cover pandemics. This may spur a boom in captive insurance, writes Christopher Hanewald of Wyatt, Tarrant & Combs.

The insurance industry is built on a foundation of actuarial certainty.

Individuals and businesses pay significant premiums—$1.22 trillion in 2018—to have something they hope they never will need. The Covid-19 pandemic has put that certainty in jeopardy.

As government mandated lockdowns began to wreak havoc on revenues in early March, business owners scrambled to review property and casualty policies for what they thought might be their saving grace—business interruption policies believed to be the buffer that would insulate businesses from the pandemic-induced trauma. As many articles have discussed; however, their hopes were short lived. Insurance underwriters had learned from past experience and added exclusions to limit or exclude coverage for unpredictable events, such as pandemics following the SARs outbreak in the early 2000s.

The realization among businesses that policy payouts were not forthcoming was met with a harsh reaction directed at the insurance industry, including a slew of negative media reaction and, in some cases, litigation. The plight of policyholders has even become a bi-partisan talking point as politicians discuss ways to force insurers to cover business losses. Yet, practical hurdles stand in the way, including at its most basic level, whether insurance companies can afford to pay out an estimated $255-$431 billion in monthly small business losses just in the U.S.

As this pervasive uncertainty continues to grip business owners, those that manage to emerge from the Covid-19 crisis likely will be left with a jaded view of traditional insurance options. As a result, will this experience diminish interest in business interruption policies as business owners question the large sums of money annually spent on a product that left them without help when they needed it?

Perhaps the answer may lie with an overlooked and sometimes misunderstood alternative to traditional insurance: captive insurance.

While the history of the insurance industry dates back centuries to Lloyd's of London's coverage of shipping cargo, the captive insurance segment represents a much more recent development with a complicated history. Originally pioneered by Fred Reiss in 1957 with Youngstown Sheet and Tube Co., the idea was to allow a company to own and operate its own insurance company. With large enough scale, a company could create a subsidiary allowing for the company to pay premiums to itself while either reinsuring risk or providing coverage for previously uninsured risks. Although radical at the time, this idea since has been adopted by a majority of Fortune 500 companies.

The proliferation of captives was not initially welcomed by the Internal Revenue Service due to skepticism regarding the related entity structure and concern that captive insurance companies were functioning as tax shelters. The IRS pursued taxpayers through a number of cases and revenue rulings. Other issues, including that all captives were initially forced to domicile in Bermuda and the Cayman Islands, did not aid in taxpayer's arguments of legitimacy. Eventually, individual states allowed captives to move on shore. Moreover, other early issues subsided as a result of the Tax Reform Act of 1986, which altered the definition of controlled foreign corporations and introduced a new code section expanding the utility of a captive for smaller businesses.

The introduction of tax code Section 831(b) was critical as this provision encouraged the creation of so-called "micro-captives" which were permitted to receive up to $1.2 million—a number that has increased to $2.2 million—in annual premiums tax-free while simultaneously allowing the 100% deductibility of such premiums paid by the operating business. Accordingly, a business with a micro-captive subsidiary could utilize the entity to insure against risks that were previously uninsured or were prohibitively expensive in the traditional marketplace while only being taxed on the income earned from invested premiums.

Given the potential of such a tool for businesses, bad actors seized on opportunities for abuse in light of those changes. Throughout the last three decades, the IRS has continued to pursue less-than-legitimate structures in which either a captive was utilized to insure unlikely risks or simply as a tax shelter. While those cases stand out, the IRS has lost a number of cases when taxpayers can demonstrate a shifting of risk and a proportional distribution of said risk among captive insurance companies in a given reinsurance pool. Time and again the case history has proven that well-run captives operating for legitimate purposes can be an effective and efficient tool for businesses seeking to lower insurance costs.

Considering the current environment, it now seems imperative that businesses recognize the opportunity captives may offer, especially to those businesses denied interruption claims as a result of the pandemic. One of the greatest benefits of a captive insurance company is the ability of the owners to tailor insurance coverage to the needs of an organization—or group of organizations. While many large businesses routinely expend enough in premiums for a wholly-owned captive to make fiscal sense, flexibility in structure can allow for multiple businesses to come together to pool their insurance expenditures in a group captive for those in similar industries or who face similar types of risk. Moreover, association captives are another popular option for professional service companies seeking to manage practice-specific risks.

While there are a number of industries that could benefit, the restaurant industry in particular may be predisposed to accept such a change given the wide-scale pain felt as a result of forced closures. A group captive tailored to restaurants may be especially marketable if it can provide some semblance of certainty and coverage for those that survive.

Admittedly, captive insurance companies are not the singular answer to the pain and disruption caused by the Covid-19 pandemic. The unpredictability and wide scale effects of our current situation means that even a hypothetical, perfectly run captive would still struggle to cover the entirety of losses of a business or industry group. Yet, certainly there is value in the peace of mind associated with ownership in the insurance company and knowing that a policy does not contain surreptitious exclusions that will leave the insured out to dry when the next claim comes around.

This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.

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