



*Will Europe's captive hubs play their cards right?*



# A CAPTIVE'S PURPOSE

Susan Euteneuer and Michael DiMayo, of Oxford Risk, reflect on the key takeaways from the recent Avrahami and Mechanical Reserve decisions

**Captive Review (CR): What are the important takes from the Avrahami decision?**

**Oxford Risk (OR):** There are no new lessons from Avrahami. What the tax court did provide us with, however, is a reiteration of 'what not to do' in relation to forming, organising and managing a small captive programme. The tax court also reviewed some prior decisions regarding large captives and signalled that those decisions provide helpful guideposts that small captives can also follow.

In the Avrahami case, the tax court did not believe that what it saw was determinable as true insurance, because the design was structured to appear like the participants met risk distribution rules, but not actually to issue insurance policies designed to pay claims for unrelated risks. The final test of risk distribution is the actual participation in and payment of insurance claims by unrelated parties. A key lesson from Avrahami and the other recent case, Reserve Mechanical, is that it is necessary for captives to demonstrate they have real risk distribution, and not only on paper. Additionally, the claims process must be formalised and consistent. The methodology of how claims are reviewed and paid needs to be documented. Avrahami and the Mechanical Reserve cases concluded that those captives lacked such support.

Avrahami has reminded the industry that actuarial studies should be substantive and the coverages should be appropriate for the insured entity. Importantly, the actuaries should be able to explain how they developed the pricing that was utilised and to do this in a manner in which those pricing models could be reproduced in the future. If that actuary were to pick up the file 3-5 years from now

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**Michael A. DiMayo**, principal at Oxford, enjoyed a prominent career spanning 29 years as the most successful producer in the history of The Hartford Life, until starting his own insurance company, The Affluence Group, LLC in 2008. DiMayo went on to form the Oxford Risk Management Group family of companies after joining forces with a partner. DiMayo also received the Associate in Captive Insurance (ACI) designation in 2016 and received recognition by *Captive Review* as a Top 20 Influencer for Enterprise Risk Captives.

to ascertain what the prices ought to be, it should be possible to arrive at the same general result.

Several other cases are scheduled for court or are awaiting court decisions. We have heard these have fact patterns similar to Avrahami and Reserve Mechanical, so we are anticipating similar outcomes.

**CR: What, in particular, was learned from the Reserve Mechanical decision, and what do you make of the reference from some that these cases are something of a 'war on small captives'?**

**OR:** I don't think the cases under discussion are representative of a 'war on captives' as

much as a disdain for programmes which purport to be legitimate but are not in compliance with industry best practices.

We are the largest provider of enterprise risk captives in America, and stay current with trends and developments impacting our industry. It is clear the Internal Revenue Service (IRS) is examining small captives – especially those that make the 831(b) election – and scrutinising their activities. I agree that the tax court has identified problematic areas with some providers. As an organisation, we believe that adherence to best practices and the guidance we have been given over the years does mean something, and certainly these two cases are helpful examples, showing that how the practitioners operated did not follow those guideposts.

**CR: Do you think the Reserve Mechanical decision will change the way in which some small captives operate?**

**OR:** By way of analogy, it is fine to have some members of the police force check cars to ensure they are not speeding or tailgating, so we should appreciate the fact that someone is watching how we drive the car down the road. But if someone drives recklessly – if someone organises and maintains a captive recklessly – certainly other drivers should not be concerned with the authorities taking action, as this is exactly what we would expect them to do.

I certainly hope that those in the industry who are not following the rules and guidance as they should be will change the way they behave, because there will be enhanced scrutiny of everyone in this industry as long as there continue to be companies who are not following the rules of the road. Most criticism from the IRS seems to be focused on structures that



are designed to look like insurance, but in reality do not share risk with unrelated parties.

There appears to have been some inconsistency in the way the IRS has addressed some captive examinations so far. But I am optimistic that this will be worked out over time as the service becomes more familiar with all of the programmes available, so they can more effectively police the problem areas and ensure that captive owners are doing what they should.

**CR: What other lessons are to be learned about generating pricing?**

**OR:** Using in-house personnel to generate pricing is not an industry best practice. The programmes the courts seem to respect are those using actuarial studies that come from independent actuaries employing standards recognised by the insurance industry as valid. Tax and legal advice are also necessary and should likewise come from independent practitioners, which were further points of contention in the cases of Avrahami and Reserve Mechanical. For arrangements that the courts are likely to consider to be true insurance, actuarial pricing and risk management simply must come from independent parties.

**CR: Will some clients simply appreciate the fact that these cases have provided clarity regarding some of the ways they can and cannot operate?**

**OR:** Some areas of emphasis by the tax courts in the Avrahami and Reserve Mechanical cases were: how is pricing determined? Is it determined by proper actuaries? Is the actuary able to explain in a reasonable manner what methodology was employed, and was it valid, reliable, and capable of reproduction?

The courts also contemplated whether there was true risk distribution, whether risk was assumed, whether there were losses, and whether the reinsurance was doing what it was supposed to do. The validity and adequacy of risk transfer and distribution were certainly key areas of emphasis for the court.

The programmes that may have extraordinarily high deductibles, where it does not appear that the insureds are sharing risk in the way they are supposed to, where it appears the insureds might never be able to have any claims beyond that high deductible, were not, in the view of the tax court, truly distributing risk.



Certainly, clients should take comfort after learning who in the industry is not operating risk management plans like that. In addition to the federal regulators, state regulators are also reviewing such plans and being advised in advance of actions and changes by the programmes, such as changes to investment plans and confirming that they are appropriate prior to the captive's formation. Captive managers should be able to tell clients that the regulators have confirmed liquidity and determined whether the captive has adequate funds to pay covered claims.

*“A key lesson from these cases is that it’s necessary to have real risk distribution, and not only on paper”*

These are all important expectations of a client. In the case of Reserve Mechanical, they were doing business prior to licensure. The court also questioned whether the insurance policies were suited to the needs of the insured entities.

An underlying theme to these inquiries is the question of ‘why is the captive being established?’ In Reserve Mechanical, the court said it was not demonstrated that the captive was established to meet the needs of the insured entity.

Overall, I think clients and their advisors take comfort in the court decisions in these areas because it helps us to validate

what sound practitioners in the industry have long felt: what are the rules of the road we should follow?

**CR: Will the recent decisions spur captive managers into taking a more hands-on approach with their captives?**

**OR:** There are a lot of good people in this industry. I think court cases you see were victories for the IRS, not victories against captives; they were victories against programmes which failed to follow the rules. Therefore, an insured who would like to own a compliant captive would be wise to hire a captive manager with a hands-on approach.

At Oxford, we have spent an enormous amount of effort focused on the risk management and business purpose elements of every captive programme we implement. We have a team that works with each client’s insurance broker or agent. That broker or agent is often the person in the best position to understand a client’s vulnerabilities and identify areas of risk which cannot be addressed with commercial insurance.

We also encourage our clients to work with an independent risk management consulting firm to review their current policies, business needs, and risk profile, to make sure that before they implement an Oxford captive, the coverages they select are best suited to their risk management needs.

Furthermore, we encourage clients to seek advice from independent legal counsel and tax and business advisors. If there is any uncertainty, we recommend that a client obtain an independent tax opinion from best-in-class counsel.



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