

BUSINESS LAW TODAY

February 2014

- [Our Mini-Theme: Captive Insurance](#)
- [A Growing Multidisciplinary Practice: Captive Insurance and Wealth Planning](#)
A multidisciplinary practice has been growing in the converging space of captive insurance and wealth planning. This article portrays this cutting-edge practice, describing captive insurance, how it is being integrated with wealth planning, and how this convergence is benefiting families and businesses throughout the country.
- [Current Tax Issues with Captive Insurance Companies](#)
This article discusses a brief history of captive insurance companies (CIC); requirements for CICs including risk shifting and distribution; and certain IRS CIC enforcement areas including excessive premiums and IRC § 831(b) tax shelter issues.
- [Choice of Domicile in Captive Insurance Planning](#)
This article will focus upon a critical inquiry that is inherent in the captive creation process, which is the choice of the jurisdiction where the captive will be formed and domiciled.
- [Observations on Captive Insurance Companies: 10 Worst and 10 Best Things](#)
A captive insurance company can be a wonderful risk management tool when used correctly – but the difference between a poorly-run captive and a well-run captive is often difficult to discern. Here are 10 bad practices followed by 10 good ones.

Departments:

- Keeping Current: [SEC Issues New Guidance on “Bad Actor” Disqualification from Rule 506 Offerings](#)
In December 2013, the SEC Division of Corporation Finance issued new guidance regarding the “bad actor” disqualification provisions of Rules 506(d) and 506(e) through an update to its Securities Act Rules Compliance and Disclosure Interpretations. This article summarizes some of the more significant of these new interpretations.
- Delaware Insider: [Revisiting MAE/MAC Clauses in M&A after Cooper Tire, Huntsman, and Osram](#)
Recently decided cases suggest that short, forward-looking elements of the MAE definition in merger agreements merit more attention by deal practitioners.
- Member Spotlight: [Interview with Harvey Pitt](#)
President George W. Bush named Harvey Pitt as the 26th Chairman of the SEC. Pitt guided the agency amidst the 9/11 tragedy, through the WorldCom and Enron controversies, as well as through the implementation of the Sarbanes Oxley Act of 2002. His remarks presented at the 2014 Midwinter Leadership Meeting on January 18, 2014, are included in this article.

[Inside Business Law](#)

January and early February saw four great committee meetings: the Consumer Financial Services Committee’s 2014 Winter Meeting, the Cyberspace Law Committee’s Cyberspace Law Institute and Winter Working Meeting, the Derivatives & Futures Law Committee’s Winter Meeting, and the Mergers and Acquisitions Committee’s 2014 Stand Alone Meeting. The meetings provided high-quality CLEs, fantastic round tables, productive subcommittee and task force meetings, and lots of camaraderie.

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Our Mini-theme: Captive Insurance

In 2002, the IRS made rulings (Rev. Rulings 2002-89, 90, and 91) which were to result in a cataclysmic change to the way U.S. businesses obtain insurance. These 2002 rulings essentially legitimized for tax purposes the concept of the in-house insurance company, commonly referred to as a “captive insurance company.”

From 2002 to the present, the formation of new captive insurance companies for U.S. business grew by the thousands each year, to where now nearly every major U.S. company, non-profit, and even a very large number of middle-market companies have their own captive insurance company. “Captives,” as they are referred to, allow businesses the multiple advantages of retaining underwriting profits, fine-tuning their enterprise risk-management, and also often providing for better tax efficiency.

To support the growing number of practitioners who were either forming new captives for their clients, or were regularly involved with their clients’ existing captives, the Business Law Section in 2011 formed the Committee on Captive Insurance. Starting as all new committees do with only a small handful of members, the committee has become one of the fastest growing committees within the section, and now makes its debut with this series of articles in *Business Law Today*.

First, Delaware attorney Ed Ianni starts us off with a discussion of the benefits of a captive to private business owners, and how they may structure a captive to fit within

their overall wealth preservation and estate planning structure.

Prof. Beckett Cantley of John Marshall Law School and tax attorney Hale Stewart then lead us through the thicket of common tax issues involving captives, including a very important discussion of the IRS safe harbor rules.

Next, general counsel for one of the largest captive management firms, Dana Sheridan, and I visit the practical factors that professionals should consider in the important decision as to the choice of domicile for a captive insurance company, including whether the captive should be domestic or foreign.

Finally, we end our debut with a collection of my own observations about this new sector, organized by my 10 worst and 10 best things about captives.

We hope that you enjoy these articles, and learn about how captive insurance companies provide daily benefit to the vast majority of significant businesses in the United States, and of their limitations. For those who might desire more, the committee will be sponsoring a presentation at the [2014 Business Law Section Spring Meeting](#) featuring Prof. Beckett Cantley, Dana Sheridan, and tax attorney John Colvin, titled “Captive Insurance and Organizational Risk Management: Issues and Solutions.”

—Jay D. Adkisson
Chair, Committee on
Captive Insurance

ADDITIONAL RESOURCES

For other materials on this topic, please refer to the following.

[Business Law Section 2014 Spring Meeting](#)

Captive Insurance and Organizational Risk Management: Issues and Solutions
Thursday, April 10, 2014 2:30 PM - 4:30 PM
Presented by: Captive Insurance
Co-sponsoring Committee: Middle Market and Small Business

[BLS Programs Material Library](#)

Captive Insurance Companies: Solving the Rubik’s Cube of Regulation (PDF) (Audio)
2012 Spring Meeting
Presented by: Captive Insurance

Captive Insurance Companies: Introduction and Update (PDF) (Audio)
2011 Annual Meeting
Presented by: Captive Insurance

CLE Products

[Using the Captive Insurance Company: New Regulations and New Pitfalls for Your Clients](#) (Audio CD ROM)
Recording Date: May 23, 2012
Running Time: 90 minutes
Credit Hours: 1.5

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A Growing Multidisciplinary Practice: Captive Insurance and Wealth Planning

By [Edmond M. Ianni](#)

A multidisciplinary practice in the United States has been growing in the converging space of captive insurance and wealth planning. Risk management and capital preservation/growth have been the bridge connecting these traditionally unintegrated spaces. Recognizing this evolving practice, the American Bar Association (through its Real Property, Trust and Estate Law Section) held its first webinar on this multidisciplinary topic in 2009. This practice is robust across the United States – and has been accelerated by increasing client demand for risk management and tax-advantaged wealth management strategies, especially in this weak economy and post-American Taxpayer Relief Act of 2012 environment. This article will provide a summary overview of this practice, describing captive insurance in the United States and how it is being integrated with wealth planning.

The Business Context

Privately held businesses and high-net-worth families in the United States have been particularly active in establishing their own captive insurance companies as part of a comprehensive risk and wealth management program. In a study by McKinsey & Company, “wealth management”

was one of five attributes identified for a successful family business, and an integrated “strong risk-management culture” was noted as a principal driver. Considering some statistics, this should not be a surprising observation. Over 80 percent of U.S. businesses are family firms (i.e., a business owned and/or controlled by a family). Most of individual wealth in the United States is concentrated in family businesses. Family businesses are a main driver of the U.S. economy, accounting for approximately 60 percent of the country’s employment and approximately 50 percent of U.S. GDP. In the United States, more than \$40 trillion of assets – much of which are business assets – are expected to transfer intergenerationally in the next four decades. Risk management and wealth management understandably have become integral needs in this context.

Privately held businesses and their owners increasingly have turned to captive insurance companies (or simply “captives”) as a combined risk/wealth management strategy. While the precursor to the modern captive traces its history to 16th century London, the term “captive” was coined in the 1950s to name a self-insurance arrangement for mining operations in the United

States. Today, there are over 5,000 captives worldwide, of which more than 1,000 are domiciled in the United States. Many Fortune 1000 businesses, for example, have established their own captives. The growth of captives in the United States continues, particularly in the converging risk and wealth management space.

Nature of a Captive

Captive insurance is a form of private risk transfer and coverage. Captive insurance essentially involves the transfer of specified business risks from an enterprise to a separate, typically private legal entity (the captive insurer), which economically assumes those risks and is financially responsible for any losses resulting from the realization of those risks. The captive insurer, not the captively-insured enterprise, therefore is responsible for payment of claims on those losses. Depending on the applicable jurisdiction’s laws, a captive may be formed as a corporation, limited liability company, statutory trust, partnership, association, or some other legal form.

A captive generally is regulated by the state of its domicile. In the United States, the majority of states and the District of Columbia currently have captive insurance

laws on their books. State laws are not uniform in this area and, therefore, differ across the country with respect to permissible captive structures, capitalization requirements, licensing and other regulatory issues.

Business Purpose: Risk Management

A captive must have a business purpose in order to be a proper captive insurance company. The underlying business purpose of a captive is risk management: it is designed to cover specified risks facing a business. Those risks may be ones for which commercial insurance coverage is unavailable or prohibitively expensive, such as terrorism risk or environmental liability risk. They may be risks for which commercial insurance does not typically cover, such as employee benefit risk (e.g., healthcare benefits), credit risk, business interruption risk, and equipment warranty liability. The vast majority of existing captives have been established to insure mainstream property and casualty (or “P&C”) risks, including general liability, workers’ compensation, directors and officers liability, product liability, errors and omissions liability, automobile liability, builder’s risk, marine risk, employment practices liability, and professional liability (e.g., medical malpractice).

Building on a risk management purpose, captives are formed for different strategic reasons. They may include, for example: providing insurance coverage for a tranche of business risks that a commercial carrier is unwilling to insure; reducing the costs of the business’ insurance program; captively insuring self-retained risks, such as the deductibles under existing commercial insurance coverage; replacing variable, more expensive commercial premiums with a steadier, less expensive captive premium cashflow; qualifying for direct access to the reinsurance market and its wholesale rates; or simply enhancing the efficiency and effectiveness of a business’ insurance and risk management program.

By replacing a layer of commercial coverage with captive insurance, for example, the business owner typically will achieve cost savings – avoiding the added costs built into the commercial insurer’s premium (such as

administration and overhead for the commercial insurance company). Furthermore, by captively insuring certain business risks (for example, employer-provided healthcare benefits), the business owner presumably will be incentivized to establish better risk controls (such as an employee wellness program to reduce the risks of healthcare benefits claims).

Practical Considerations

The business lawyer in this multidisciplinary practice often guides the client from exploration of the possibility of creating a captive for the client’s business through establishment and ongoing governance of the captive. These services may include providing counsel on, and often partnering with, a banker or other co-adviser on any or all of the following:

- Captive suitability analysis
- Strategy development
- Coordination of an actuarial feasibility analysis
- Legal entity selection and customization
- Choice of state domicile for the prospective captive
- Related wealth management advice (i.e., the integrated wealth planning discussed below)
- Development of captive’s proposed business plan
- Balance sheet architecture
- Financial structuring and capitalization (including issuance of a letter of credit, if needed)
- Possible affiliation or serialization
- Tax advice
- Rendering a legal opinion, if needed
- Reinsurance matters
- Pre-application (for captive licensure) dialogue with the state regulator
- Preparation and submission of license application
- Possible “negotiation” of administrative order, if needed
- Arrangement for, or coordination with, outside professional services (e.g., bankers, accountants, auditors, captive managers, investment managers and custodians)
- Implementation of approved captive

- Ongoing compliance and corporate governance (e.g., conducting annual and special meetings and preparing regulatory reports)

While it is beyond the scope of this article to discuss in detail all of the practical considerations involved here, several of them will be briefly highlighted – taxation, capitalization and costs.

Taxation

Federal and state taxation of captives are always carefully considered for the client. At the federal level, both income tax and transfer tax considerations are made. (As federal transfer taxes – namely, estate tax, gift tax, and generation-skipping transfer (GST) tax – pertain to wealth planning, they will be discussed below.) For many family businesses, they may be able to structure their captive to qualify for favorable federal income tax treatment. One of the most actively used qualifications is Section 831(b) of the Internal Revenue Code, designed for small and middle market captives which do not expect to write annually more than \$1.2 million of captive insurance premium. If the captive qualifies as an 831(b) captive insurer, its premium income is not subject to federal income tax, and only its investment income is so subject. Assuming an otherwise applicable 35 percent federal corporate income tax rate, that benefit could mean up to an annual federal tax savings of \$420,000 – a significant annual preservation of capital for the client. In addition, the payment of the (actuarially designed) captive insurance premium by the insured entity is a deductible ordinary and necessary business expense.

Moreover, if the client desires to captively insure different buckets of risk (e.g., healthcare benefits, product liability, business interruption, and employment practices) which, in the aggregate, would be expected to garner more than \$1.2 million in annual captive premium, the client – with your professional counsel – possibly may be able to legally structure the captive to still qualify for 831(b) treatment, provided the other legal requirements, such as risk transfer and

distribution, are met. That structuring possibly may involve, for example, segmenting each bucket of risk into a separate series business unit captive, which itself is separately expected to write less than \$1.2 million of annual premium and to qualify for favorable 831(b) tax treatment.

State taxation of a captive also is a consideration in advising the client. This varies among the states. Typically, though, domiciliary states impose a modest premium tax (often less than one percent) on the captive's written premium. Some states do not impose any ordinary business income tax (other than a modest premium tax) on a captive licensed in its state. And some states impose a direct placement "procurement" tax on premiums written by a captive which is not licensed in its state (ranging from less than one percent to five percent across the country).

Capitalization and Costs

Capitalization of the captive is a uniform regulatory requirement among the states which have captive licensing laws. The amount of required minimum capitalization, however, varies among the states and is usually set forth in state statutes. It is important to note that these statutory minimums are just that – minimums. The domiciliary regulator (typically, the state's insurance commissioner) usually has the authority to require a higher level of capitalization depending on the nature of the business to be insured, the actuarial analysis, and other regulatory considerations.

The costs of establishing a captive vary according to its nature, size, and complexity. For example, it is not uncommon for start-up costs, including professional fees, to range from approximately \$25,000 to over \$90,000. After the captive has been established and capitalized, there will be administrative costs going forward. These will include the costs of managing the captive's operations, complying with regulatory requirements, and otherwise administering the captive's business. Middle market captives, for example, often budget approximately \$30,000 to \$75,000 per year for these administrative costs.

Integrated Wealth Planning

As noted above, the multidisciplinary business counselor today is often guiding the client in the converging captive insurance and wealth planning space. A captive insurance company has not only risk management implications but also wealth management implications. The creation of a captive is the creation of a business asset – and therefore creates a wealth planning need and opportunity. How this business asset is owned and transferred must be considered for the client.

Generally, if the captive is owned by the *individual* business owner or owners who created the captive, the captive will be included in that business owner's or owners' taxable estate(s), assuming they have a taxable estate upon their death. The top federal estate tax rate is 40 percent. However, the business owner has options for removing this asset from his or her taxable estate.

Planning with a Family Trust

One such option is to place the captive (let's assume it is an 831(b) captive) in an irrevocable family dynasty trust; that is, the family trust will own the captive. The beneficiaries of the trust (per the client's wishes) are the business owner's children, grandchildren, future great-grandchildren, and succeeding generations (hence, the "dynasty" name). This wealth planning strategy has several benefits.

First, the captive asset is removed from the business owner's eventual taxable estate, thereby excluding the value of that asset from estate taxation. Second, as a properly constituted dynasty trust, the trust asset transfers would not be subject to GST tax (the GST tax rate is 40 percent). Third, if the captive itself is structured as a limited liability company (LLC), for example, the transfers of the LLC interests into the family dynasty trust should enjoy valuation discounting for federal gift tax purposes. This would substantially reduce gift tax liability for those transfers, if any, after taking into account any applicable annual gift tax exclusions (\$14,000 per donee for individual donors) and any applicable lifetime gift tax exemptions (in 2014, \$5.34

million for individuals). Fourth, the payment of premium to the captive would not constitute a taxable gift; rather, it would be, as noted above, a deductible ordinary and necessary business expense. Fifth, if the family dynasty trust is established in a jurisdiction, such as Delaware, which does not impose state income or capital gains tax on an irrevocable nongrantor trust whose beneficiaries are residents outside that jurisdiction (and assuming that is true for this business owner's family trust), then that family trust's accumulated income and realized capital gains will not be subject to state income taxation. In short, the federally untaxed underwriting profit in the 831(b) captive combined with the anticipated surplus that the well-managed captive expects to build over the years will be able to be kept in the family without being subject to hefty transfer taxes.

Integrated Charitable Planning

It should be noted that there are other wealth planning strategies in the captive space which can achieve similar client benefits. One other strategy will be noted here: it is one which integrates the client's charitable objectives with its wealth and captive risk management goals. For the client who wishes to benefit a charity but desires to keep the underlying asset in the family, a customized charitable lead trust (CLT) has been used. This is how it works.

The client business owner establishes a CLT and funds it with certain assets. In this case, one of those assets will be the captive insurance company itself. A portion of the income from those trust assets, designated by the client (called the "grantor"), is typically paid annually to one or more qualified charities of the client's choosing (called the "charitable beneficiary" or "income beneficiary" of the trust). The assets remaining in the CLT at the end of its term either revert to the client or are transferred to the client's designated "remainder" beneficiaries, such as his or her family.

The CLT may have a duration, designated by the client, of a specified number of years, the lifetime of the client (or of more than one individual), or a combination of

the two. A CLT may be structured for tax purposes as either a grantor type (where the grantor, as taxpayer, assumes all the income tax benefits and responsibilities of the trust assets) or nongrantor type (where the trust itself, as taxpayer, assumes them).

The CLT may take one of two forms based on the way in which the amount of income is determined for the charitable beneficiary – the charitable lead annuity trust (CLAT) or the charitable lead unitrust (CLUT). In a CLAT, the annual income payable to the charity is a fixed sum, which can be either a specified dollar amount or an amount equal to a fixed percentage of the assets initially transferred into trust. In a CLUT, the annual income payable to the charitable beneficiary is equal to a fixed percentage of the annually-recalculated value of the trust's assets. The client's lawyer or other adviser, such as the client's banker, typically advises the client on the optimal structuring and form of this CLT for the client's situation.

The benefits of incorporating a CLT into the client's wealth and risk management planning are several. First, it is a plan which helps the client achieve his or her charitable gifting objective. This method of charitable giving also provides special tax and other benefits to the client. Second, although the client's gift to charity will be spread over time, a CLT allows the client to take a current income tax deduction for that gift. The amount of that deduction is the present val-

ue, determined by federal formula, of the CLT's payouts to the charity. Furthermore, to the extent that the client cannot utilize all of that deduction in the current tax year, the client generally may carry forward the unused amount of the deduction for the next five years, thereby further reducing the client's income tax liability. Third, the deemed gift to the client's noncharitable, remainder beneficiaries (usually, his or her family) of the assets remaining in the CLT at the end of its term will be discounted for gift tax purposes. This can be a substantial benefit with respect to highly-appreciated trust assets (such as, presumably, the captive business asset).

Fourth, the assets placed in the CLT are effectively removed from the client's taxable estate. The appreciated value of the assets placed in the CLT therefore would pass to the client's family beneficiaries free of estate tax. Fifth, the CLT allows the client to preserve assets for his or her family (or others of the client's choosing) in a tax-advantaged way. It allows the client to share the fruits of the client's success with his or her chosen charity(ies) without the client's family having to part with the assets that the client had placed in trust. Sixth, the CLT also is an effective way of controlling the timing of the client's transfer of assets to family members, especially where the client is concerned that it would be premature to do so now, such as when the client's family beneficiaries are too young or not

yet prepared to handle the responsibilities of ownership.

Conclusion

The comprehensive planning needs of family business clients, especially those in the middle market, are driving the growth of this multidisciplinary practice across the United States. Risk management and wealth management, as the McKinsey study notes, are critical disciplines to be seriously embraced by private businesses and their owners in order for them to succeed. Captive insurance, as an efficient and effective risk management tool, can be customized as an integral part of the client's comprehensive wealth planning. Many family businesses have benefited from this interdisciplinary convergence, and many more are expected to do so with good counsel across the country.

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BUSINESS LAW TODAY

Current Tax Issues with Captive Insurance Companies

By [Beckett G. Cantley](#) and [F. Hale Stewart](#)

Large U.S. companies have been forming captive insurance companies (wholly owned insurance subsidiaries) since the 1950s. In general, such large captives are formed for one of three main reasons. First, some companies are unable to obtain necessary insurance coverage. For example, certain nuclear power companies formed a captive named Nuclear Electric Insurance Limited, because they could find no other insurance coverage. Second, some companies seek to obtain cheaper insurance. For example, the trucking market is currently “hardening” (premiums are increasing), leading to trucking companies forming captives. Third, some companies seek to gain more control over their current insurance program.

The insurance code offers a small insurance company a strategic advantage: Internal Revenue Code (IRC) § 831(b) allows insurance companies with less than \$1.2 million in premiums to be taxed on their investment earnings rather than on their gross income. As a simple example, suppose a small insurance company had \$500,000 in income but earned 5 percent on its total portfolio earning \$25,000 for the year. The company would use the \$25,000 figure as their gross income figure for the year.

A captive can also be formed offshore and still be deemed a U.S. captive, provided it makes an IRC § 953(d) election agreeing to be taxed as a domestic company. For many large captives, forming offshore may provide a great deal of flexibility not found onshore. However, it should be noted that the Internal Revenue Service (IRS) is currently spending a great deal of time focused on offshore tax enforcement. Recently, the IRS refused to issue a positive private letter ruling to a number of foreign captives seeking 831(b) status, which may be an indication of tougher IRS scrutiny in this area. Thus, while a compliant captive should ultimately have nothing to fear from operating internationally, there is at least some chance that doing so may result in some additional compliance costs if it gets caught up in the IRS dragnet.

This article will: (1) provide a brief history of captive insurance companies; (2) outline key requirements for captive insurance including insurance risks, risk shifting, risk distribution, and reinsurance; and (3) discuss certain IRS enforcement areas in captives, including excessive premiums and IRC § 831(b) tax shelter issues.

A Short History of Captive Insurance Companies

The IRS defines a captive insurance company as a “wholly owned insurance subsidiary.” According to the case law of that time, companies started forming captives in the 1950s because they couldn’t find insurance, could only find very expensive insurance, or simply decided that forming their own insurance company made more sense. The taxpayers in both *United States v. Weber Paper Co.*, 320 F.2d 199 (8th Cir. Mo. 1963) and *Consumer’s Oil Corp. of Trenton, NJ v. United States*, 188 F. Supp. 796 (NJ 1960) owned property for which they could not procure flood insurance, leading both to form an insurance company. While the taxpayer in *Beech Aircraft Corp. v. United States*, 797 F.2d 920 (10th Cir. Kan. 1986) did have an insurance policy, its carrier had complete control of its attorneys during litigation. When Beech was sued under a products liability claim in the early 1970s, it filed a motion to remove its insurer-appointed counsel several weeks before trial. The court denied this motion and Beech lost the case. Subsequently, Beech formed a captive to write its own insurance policy. Other cases provide similar examples.

The IRS was concerned by the rise of captive insurance for two inter-related reasons. Their first concern was that the “captive insurer” was in fact a reserve account, defined as “an estimate of a definite liability of indefinite or uncertain amount.” While there is a certain amount of conceptual overlap between a reserve account and insurance (in both, a party is attempting to financially prepare for an anticipated contingency), contributions to a reserve account are non-deductible while premium payments are deductible. This leads to the IRS’ second concern – the rather uncertain nature of the legal definition of insurance. While the Supreme Court in *Helvering v. Le Gierse*, 312 U.S. 531 (U.S. 1941) defined insurance in 1943 as being comprised of both risk shifting and risk distribution, it provided no further guidance for either term. Hence, the IRS could legitimately argue that the captive insurance company was not in fact a bona fide insurance company but instead a reserve account, allowing the IRS to deny the deduction claimed by the parent company for the premium paid to the captive.

Captive litigation can be broken down into pre- and post-*Humana v. Commissioner*, 88 T.C. 197 (1987). From the late 1970s to the late 1980s (pre-*Humana*) the IRS won a majority of their cases due to better preparation, weak taxpayer defenses, and a judiciary unaccustomed to dealing with the technical requirements of insurance. The *Humana* decision changed this, as the structure was well set-up and expertly defended and explained by counsel, leading to a partial taxpayer victory. Between *Humana* in the late 1980s and *United Parcel Service of America v. Commissioner*, 254 F.3d 1014 (11th Circuit 2001) in the early 2000s, the IRS lost most of its cases as taxpayers established better structures, these structures were better defended, and several states passed captive insurance-enabling legislation. The death knell for this initial wave of IRS captive litigation was the *UPS* decision, which the IRS won at trial based on an assignment of income argument, but which the appeals court disagreed with in a tersely worded decision, in which it re-

versed the tax court’s ruling and remanded for further action. Following the *UPS* case, the IRS largely ended its initial quest of litigating to prove the invalidity of captive insurance.

Insurance Risks, Risk Shifting, and Risk Distribution

Counsel interested in recommending a captive to a client needs to be aware of several basic concepts, the first of which is derived from *The Harper Group v. Commiss’r*, 96 T.C. 45, 47 (1991), which states that all captives must comply with the following three factors: (1) the arrangement involves the existence of an “insurance risk”; (2) there is both risk shifting and risk distribution; and (3) the arrangement is for “insurance” in its commonly accepted sense. Points one and three can be reworded to simply say all captives must function as insurance companies; the insured must demonstrate it will be materially harmed (usually through financial loss derived from an ownership interest), and that the harm is “fortuitous” – one which is random and cannot be prevented.

Risk shifting and risk distribution are a bit more complicated. Risk shifting is seen from the insured’s perspective and requires the risk of loss to “shift” from the insured to a third party. This is accomplished via an insurance policy (whose formation and terms are interpreted under basic contract law principles). Risk distribution is seen from the insurer’s perspective, and requires the insurer to pool risk from a sufficient number of resources such that losses smooth out over time. Non-compliance with either of these factors comprised the “economic family argument,” the IRS’ primary anti-captive weapon.

Reinsurance or Safe Harbor IRS Revenue Rulings

One of the largest benefits of a captive is the ability to access the reinsurance market. Reinsurance is often called “insurance for insurance companies” as it allows insurers to spread out the risk of their own portfolios. For example, suppose an insurer was exposed to \$5 million of potential claims

for the year. The insurer could purchase reinsurance, thereby lowering its risk exposure. In our example, the insurer could purchase reinsurance that covered risks of about \$2,000,000. Therefore, if the parent company had losses over \$2,000,000, the reinsurer would be liable.

The IRS has provided two safe harbors for captive insurance companies that decide not to use traditional reinsurance. All captives that wish to take advantage of a safe harbor must comply with one of two fact patterns outlined in specific IRS Revenue Rulings. In Rev. Rul. 2002-89, the captive insurer must derive at least 50 percent of its revenue and risk from a non-parent. For smaller captives, this is usually accomplished through the use of “risk pools” wherein a group of captives shares a portion of their risk with other captives, usually managed by the same captive management company. Participation is usually accomplished through a quota treaty retrocessional reinsurance arrangement. In Rev. Rul. 2002-90, a captive must underwrite risk for at least 12 different subsidiaries, with none comprising less than 5 percent nor more than 15 percent of the total risk underwritten by the captives.

Excessive Premiums

One area that is currently being litigated by the IRS is excessive premium payments beyond what is reasonable for the claimed insurance risks. The IRS has a few cases in the U.S. Tax Court pipeline that address this issue, so it would not be unexpected that more such cases will follow. The IRS is concerned with transactions in which the tax deduction claimed is actually the reason for the existence of the policy. Treasury Regulation § 1.801-3(a) provides that an insurance company is “a company whose primary and predominant business activity . . . is the issuing of insurance or annuity contracts, or the reinsuring of risks underwritten by insurance companies.” When the captive charges commercially unreasonable or non-arm’s length premiums, it may not be treated as bona fide insurance company. Thus, if the true purpose of an insurance company is to provide tax deduc-

tions, then the company may not qualify as an “insurance company” under the IRC.

In the area of small captives, the existence of a \$1.2 million maximum premium payment makes this type of analysis particularly relevant. The IRS requires that a captive operate as an actual insurance company in order for it to receive the economic benefit allowed under IRC § 831(b). It is important to remember that the \$1.2 million can purchase a large amount of commercial insurance, so any small captive claiming policy premiums of that size may come under IRS scrutiny unless it has a very significant amount of provable potential claims.

IRC § 831(b) Tax Shelter Issues

The IRS is aware of certain questionable tax shelter practices in the captive world, especially in connection with small IRC § 831(b) captive insurance companies. While these arrangements are certainly a minority of the larger pool of compliant captives, it is worth noting some of the more prevalent IRS tax shelter issues here.

Some IRC § 831(b) captive policies insure risks that are unrealistic with respect to the insured business. Specifically, certain insurance risk pools centered on terrorism are currently attracting increased IRS attention. The concern arises here because so few businesses may actually have the need for insuring against a terrorist act, making this coverage appear to be too remote to be justified for most insureds. While there are certainly business operations that involve terrorism risk, there are also many businesses that do not have this risk.

The IRS has also become aware of the use of life insurance in IRC § 831(b) captives as a pre-ordained investment. Since life insurance is not generally a deductible business expense, the concern here is that the IRS may see a pre-planned use of an IRC § 831(b) captive as a conduit for life insurance as both undermining the business purpose of the captive, as well as a device for taking a deduction that the business could not otherwise take directly. The judicial doctrines and codified economic substance doctrine could be applicable here.

Since an IRC § 831(b) captive may result in the deferral of realization of ordinary income, over a long period of time, this type of captive may accumulate a very large amount of retained resources. Because a captive is taxed as a C corporation, this type of large reserve could be subject to the Accumulated Earnings Tax (AET). The AET is a 15 percent penalty tax designed to prevent corporations from unreasonably retaining after-tax earnings and profits in lieu of paying current dividends to shareholders. Accumulated taxable income is reduced by a credit for an accumulation amount sufficient to satisfy reasonable current and future anticipated business needs.

Conclusion

Captive insurance companies have been around since the 1950s and are currently a popular alternative vehicle for insuring risks associated with businesses. There are several key requirements that must be met for captive insurance to be deemed proper by the IRS. These include insuring real risks, shifting the risk from the insured business to the insuring captive, and the captive distributing the shifted risk among several other captive insurance companies. The IRS has raised specific tax issues that are currently the subject of IRS enforcement actions. These include the payment of excessive insurance premiums, as well as several IRC § 831(b) tax shelter issues. Overall, captive insurance may be an excellent insurance option for midsize and large businesses, provided that the professionals structuring the arrangements comply with IRS requirements in connection with the formation and maintenance of the captive insurance company.

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ADDITIONAL RESOURCES

For other materials on this topic, please refer to the following.

Beckett G. Cantley, *Repeat as Necessary: Historical IRS Policy Weapons to Combat Conduit Captive Insurance Company Deductible Purchases of Life Insurance*, 13 UC Davis Bus. L.J. 29 (2012).

Available at SSRN: <http://ssrn.com/abstract=2315868>.

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Beckett G. Cantley, *Steering Into the Storm: Amplification of Captive Insurance Company Compliance Issues in the Offshore Tax Crackdown*, 12 Hous. Bus. & Tax L.J. 224 (2012).

Available at SSRN: <http://ssrn.com/abstract=2315896>.

* * *

Beckett G. Cantley, *The Forgotten Taxation Landmine: Application of the Accumulated Earnings Tax to IRC § 831(b) Captive Insurance Companies*, 11 Rich. J. Global L. & Bus. 159 (2012).

Available at SSRN: <http://ssrn.com/abstract=2184420>.

BUSINESS LAW TODAY

Choice of Domicile in Captive Insurance Planning

By [Dana Hentges Sheridan](#) and [Jay Adkisson](#)

A captive insurance company in its most typical form is essentially a new subsidiary that is created by a parent company to underwrite the insurance needs of its operating subsidiaries. The basic idea of a captive is to bring in-house the purchasing of insurance that was previously done from unrelated commercial insurance companies, and retain the underwriting profits for the benefit of shareholders. But even beyond that, captive insurance companies fulfill a large role in making the entire enterprise focus on the management of its various risks of loss and incurring liabilities.

The factors that go into the decision to form a captive insurance company, and the steps to do so, are beyond the scope of this article and are well-treated elsewhere. This article will focus upon a critical inquiry that is inherent in the captive creation process, which is the choice of the jurisdiction where the captive will be formed and domiciled.

Captive insurance companies were originally formed outside the United States, usually in well-known debtors' havens such as Bermuda, the Cayman Islands, and the British Virgin Islands. This is because of a perception that there were certain potential local tax benefits to being formed in those domiciles, but much more impor-

tantly, because the U.S. states did not have captive legislation, and instead treated captives like normal commercial carriers. Doing so made little practical sense, insofar as normal commercial carriers are subject to a wide swath of laws designed to protect the general public, such as requiring large amounts of capital and reserves, public filing of policies, and making premium rate requests. These requirements were, of course, nonsensical in the captive context where there is little need to protect the operating subsidiaries from the captive insurance company ultimately owned by the same parent.

Vermont cracked open the door to captives in 1981, and through sheer persistence and aggressively changing its laws to match or exceed those of the offshore havens in favorability, was able to hold its own and grow its captive business against the likes of Bermuda. The IRS kicked the door wide open in 2002, following its landmark loss in *United Parcel Service v. C.I.R.*, 254 F.3d 1014 (11th Cir. 2001), by issuing Revenue Rulings 2002-89, 2002-90, and 2002-91, that not only recognized the fundamental legitimacy of a properly structured and operated captive insurance arrangement, but also created safe-harbors in the confused

area of risk distribution. Numerous states then flooded the captive marketplace – 37 states as of this writing – by passing captive insurance enabling legislation.

It should be noted that for most tax purposes, there is little difference between an offshore captive (one formed outside the United States) or a domestic one, since the vast bulk of captives make the election under Tax Code § 953(d) to be treated as a domestic company. These days, the reasons for a captive to “go offshore” most often relate to those relatively few captives that for tax reasons do not make the § 953(d) election (captives owned by charitable organizations, for instance, have tax reasons for wanting to be taxed as a controlled foreign corporation instead), or captives where financial privacy or practical immunity to the enforcement of a domestic judgment is at a premium.

The analysis and planning that goes into the formation of a captive insurance arrangement may be likened to the solving of a Rubik's cube, where decisions must be made that will affect several or all sides, and some key issues must be resolved at once as if some juridical algebra problem. Most often, the question of where the captive should be domiciled is one of the last

– not first – issues to be resolved. This is because the resolution of other issues, such as availability of capital, specialty lines of insurance to be written, and particular needs for flexibility in the investment of the captive’s assets, quite often lead to the choice of a particular domicile. There is rarely a need for prospective captive owner to choose the domicile as a first step, and indeed to do so can lead to missed opportunities if the captive arrangement could have been more efficient if formed elsewhere.

But even beyond that, the issue of state taxation of premiums now most often resolves the issue – particularly if the captive owner is headquartered in one of the ever-increasing number of captive-friendly states. In the past, states paid little attention to their fiscal losses occasioned by captive insurance, mainly for the reasons that the very concept of captive insurance was little known to the state tax authorities, and payments to captives (as opposed to ordinary commercial insurance carriers) are inherently difficult for state field auditors to pick up. While some states have long been aggressive in taxing the premiums paid to captives (Texas is probably the best example of this), it has only been recently that other states have taken note of their own fiscal losses and have grown more aggressive in taxing the premiums paid to captives. Yet, at the same time, when a state passes new captive insurance legislation, in order to make that state’s laws more attractive to new captive formations, the state will usually exempt or substantially limit the taxes on premiums paid to its in-state captives. This creates a very powerful incentive for new captive owners to choose their own state (if it is friendly to captives) to form their captive, and puts pressure on existing captive owners to bring their captives back home.

So, the default rule might be well be – if it isn’t already – the best domicile to form your captive is the one you are in. This disregards, however, that some states such as California and Washington do not yet have captive enabling legislation, while other states have either done little or nothing to implement their legislation, or have imple-

mented it very poorly. The upshot of this is that many prospective captive owners will have to look beyond their state’s borders for a place to land their new insurance company. It is for these owners and their advisers that the factors discussed below will be of the most importance.

It would be easy enough at this point to dive into a discussion of the technical nuances of the laws of various jurisdictions. That would not do the subject proper justice. Long experience has shown that the single most important factor in choice of domicile for a captive is not any specific statute or regulation, but that of the amenability of the insurance regulators in the domicile to working with captive owners to make the arrangement a success. Laws and regulations are only so good, or bad, as they are interpreted by their regulators, and in the case of captives this typically means the insurance commissioner’s office or equivalent.

Very simply, a bad insurance commissioner’s office can make hash out of the best captive laws and regulations with the result that the captive owner becomes quite miserable. A good insurance commissioner’s office can, by contrast, work through mediocre laws and regulations to make captives in the state a happy success. Of course, no chart could adequately spell out the differences in how these regulators treat captives, and any such chart would be obsolete as quickly as the personnel changes occurred in the insurance commissioner’s office, which they do with some regularity. Suffice it to say that the best information about regulators must be obtained anecdotally from captive managers and other captive professionals who have done business in the state, while noting that the regulators of some states have a long and consistent history of favorable treatment of captives, while other states have undergone uncomfortable fluctuations dependent upon whomever is in charge at a given time.

With that caveat firmly in mind, we turn to an examination of the statutory and regulatory factors that go into domicile selection for captives. What we will see is that the specific requirements of each juris-

diction are very similar. There is a good reason for that, which may be accurately expressed in a single word: competition. To vie for business, the various domiciles must offer regulations that are as, or more, favorable than that of competing jurisdictions. One may attribute Vermont’s long run of success to the fact that its state legislature, mindful that the captive sector is its second largest industry, has demonstrated a willingness to quickly consider and pass cutting-edge legislation so as to keep Vermont’s captive laws competitive with those of other jurisdictions.

Minimum capitalization, i.e., how much cash the captive will need to qualify and stay qualified for its insurance license, is a significant factor of consideration in choosing a domicile. Obviously, the less money that a captive owner has to tie up in the captive, which moneys may be deployed to greater returns elsewhere, the more efficient the captive arrangement will be. Thus, captive domiciles compete for business by lowering their capital requirements to certain minimum amounts.

It is here that our Rubic’s cube reappears, where we have to solve more than just one side of the puzzle at once. Although captive owners naturally desire to place as little capital as possible in their captive, the requirements of tax law must be taken into consideration. For tax purposes, one of the elements to establish the existence of an insurance contract is the requirement of “risk shifting,” which posits that the captive must have more risk of loss than simply the premium that it takes in from its insured. The captive must have, the slang goes, enough of its “own skin in the game” such that it can satisfy claims against a policy over and above the premium received.

Thus, there are both actuarial and tax variables in the minimum capitalization equation. From the actuarial side, the limits on the maximum potential losses that the captive may underwrite – and thus policy limits – are limited by some combination of the total premiums to be received by the captive, loss expectancy, existing reserves, and capitalization. Plus, while the IRS has provided painfully little guidance on what

constitutes minimum capital for tax purposes, it seems (largely anecdotally) that the captive's capital should not be less than one-third of the premiums received in any given year, i.e., as it is usually articulated, premiums should not exceed capital by a ratio of greater than 3:1.

There seems to be an accepted exception to this ratio for the first year of a captive's existence, when the ratio of premiums to capitalization should not exceed 5:1, and which takes into consideration that relatively few claims are likely to have matured to where they will require payment in the first year. It is this 5:1 ratio that has worked to set the standard for minimum capitalization in most captive domiciles. The vast majority of captives start out as companies that make the Tax Code § 831(b) election, which means that the captive will not be taxed on its premium income so long as its premiums received do not exceed \$1.2 million during the year. Applying the 5:1 ratio to \$1.2 million results in a minimum capitalization requirement for tax purposes of \$240,000 (which has been rounded up for statutory purposes to \$250,000), which represents by far the most common minimum capitalization requirement of domestic domiciles. The states that have higher statutory minimum capital requirements are usually avoided by captive owners.

However, not all new captives will take in the maximum amount of \$1.2 million in premiums the first year, and this is where regulatory flexibility to lower the minimum capital for the first year only can be a very significant advantage for a captive domicile. These exceptions are created by the very practical recognition that by the second year, the premiums paid in the first year for the first year's policies which have not expired, will be available to apply toward the statutory minimum.

Offshore domiciles often have much lower minimum capital requirements (Nevada only requires \$10,000 in capital for a single-owner captive) in consideration that many of the captives they form will not be subject to the minimum capitalization requirements for U.S. tax purposes, as their owners will often have little or no connec-

tion to the United States. But again, the statutory minimum capital requirements are but one side of the captive Rubic's cube for U.S. taxpayers.

Investment flexibility, i.e., the particular domicile's rules about how the captive's assets may be deployed, is a very significant factor in choosing a captive domicile – some might suggest the single most important factor. Non-captive commercial insurance companies are usually subject to “permitted asset” rules, which are an exhaustive list of the things that such insurance companies may invest in, so as to help protect the financial health of those companies from speculative investments (and also the state insurance fund from having to take over the liabilities of an insolvent carrier). The investment rules relating to captives can be much more flexible, and it is here that the domiciles have an opportunity to really compete against each other.

Prior to the 2008 crash, which resulted in the liquidation of not just a few captives whose investments had failed, the investment rules relating to captives were typically very lax. The typical statement was that an investment was appropriate, “so long as it does not threaten the minimum liquidity of the company.” In application, this had an “almost anything goes” air, and led to captives making all sorts of creative, speculative, but often ill-advised investments, of their assets.

After the 2008 market crash, many regulators started to take back the reins over captive investments. This has been most commonly seen in how regulators view a large, single investment that comprises a large percentage of the captive's overall assets, say over 30 percent – regulators now often cringe when so many of the captive's eggs are placed in one basket, and may either refuse to approve the investment or require additional capital to be infused into the company. But it is also seen in regulators occasionally requiring that certain captives abide by the very regimented investment restrictions for non-captive commercial carriers.

As with so many things in the captive sector, the best information regarding a do-

micile's investment flexibility is not necessarily found in its laws or regulations, so much as learned anecdotally from conversations with captive managers and owners of existing captives in that state. It should also be noted that investment flexibility in a particular domicile has the potential to change literally overnight as personnel changes in the insurance commissioner's office bring different attitudes about how captives should be safely investing their assets. This issue can be a moving target, and more than a few captives have left particular domiciles and migrated elsewhere when they felt that investment restrictions had become too strict.

Infrastructure support, i.e., the ability of the insurance commissioner's office to effectively handle captives, is also a very important consideration. Newer domiciles in particular are often unwilling to extend adequate funding to the captive division within the insurance commissioner's office until the economic benefits of captives within the state have been established. Indeed, while 37 states have passed captive enabling legislation, probably a third or so of these states could be said to have adequately funded their insurance commissioners to allocate resources for separate captive regulators; this is why captive development is stillborn in those states.

On the other hand, the legislatures of the handful of states that lead the sector in the number of captives domiciled have seen the economic benefits of captives and have well-funded their insurance commissioners' offices to properly administer them. These states have independent “captive deputy commissioners,” full time staffs, and quality financial analysts and examiners who are highly experienced with captives and their peculiar needs.

But infrastructure support is not just limited to the insurance commissioner's office. The best domiciles will have many quality captive managers who have been at least minimally vetted by the commissioner, and a cadre of other professionals such as accountants and attorneys who are likewise familiar with captives in that state. The availability of numerous of these captive

service providers and professionals gives captive owners both the ability to choose between numerous competent providers and professionals, and the benefits of competition between them to drive down the pricing of their services.

In summary, there is quite a bit of analysis that goes into the selection of the domicile for a captive insurance company, and much of that analysis will be based on anecdotal information obtained from others who have practical experience in particular domiciles. The resolution of other considerations in the planning of the captive will quite often require the elimination from consideration of certain (if not many) domiciles, and make the choice of domicile in the end that much easier. But even if the grass appears greener on the other side of the fence, strong consideration to forming the captive in the state where the operating business is located now should always be made, even if that state's captive laws and regulations are not the best.

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BUSINESS LAW TODAY

Observations on Captive Insurance Companies: 10 Worst and 10 Best Things

By [Jay Adkisson](#)

A captive insurance company (commonly referred to in short as a “captive”) is an insurance subsidiary that is set up by the parent company to underwrite the insurance needs of the other subsidiaries. For example, British Petroleum wisely set up a captive insurance company ([Jupiter Insurance Ltd.](#)) to provide environmental insurance to its operating units, and the moneys from its captive were used to fund in substantial part the Gulf cleanup.

The vast majority of Fortune 500 companies now have captive subsidiaries (and many companies have several captives, including those for employee benefits), and captives are now also routinely used by small companies for the same purpose. Over 30 states now have captive-enabling legislation, most recently North Carolina and Texas, in addition to states such as Delaware, Kentucky, Missouri, Nevada, Utah, and Vermont, which are very active in marketing their states as premier jurisdictions for the formation of captives.

A captive can be a wonderful risk management tool when used correctly; but therein lies the rub, many are not. The difference between a poorly-run captive and a well-run captive is often difficult for novices to discern. So, in reverse order, here are

10 bad practices involving captive insurance companies, followed by 10 good ones.

Dangers of a Bad Captive Arrangement

10. Bogus Risk Pools

A lot of businesses with valid needs for insurance don’t have enough subsidiaries to pass what is known as the “multiple insured” test for risk distribution, and so they instead participate in what is known as a “risk pool” to obtain risk-distribution.

In a nutshell, a “risk pool” is an insurance arrangement involving multiple, usually unrelated captive owners who share certain risks through their individual captives. Risk pools are usually set up by captive managers to facilitate the needs of certain of their captive clients. In various guidance, the IRS has validated the concept of the risk pool when run correctly.

The difficulty is with the “when run correctly” part. The problem with most risk pools is that there is in fact very little sharing of risks, and thus, the large premiums being charged by the pool are neither actuarially sound nor bear anything but a coincidental relationship to reality. The IRS refers to these as “notional risk pools” – there

is a notion of a risk, but not much beyond the mere notion.

Many of these pools have been operated for years with few or no claims, which calls into serious question whether the large premiums they charge are realistic (the answer is that they are not). Maybe in the first year when the pool has no loss history, it can be aggressive in how it prices the premiums paid. By the fifth year, however, a run of large premiums with few or no losses probably indicates that the premiums were mispriced.

By like token, if there is true risk-sharing in a pool, that means that the participants are subject to actual risk of loss – including the total loss of their premiums paid by their operating businesses into the pool. This is where the wink-wink, nod-nod of “That will never happen; actually you’ll never lose anything significant” usually shows up, which is another way of saying the risk pool is just a vehicle to facilitate the appearance of risk-shifting, without actual risk-shifting, i.e., tax fraud.

While the saying around my office is “Pools are for fools!,” the truth is that some clients (including some of mine) cannot meet the test for risk distribution in any other way, and therefore make an informed

business decision to participate in a risk pool. However, for these clients my advice is usually, “Do whatever reorganization of your business is necessary to get out of the risk pool as quickly as you can.” If a client is still in a risk pool after a few years just because they need the risk-distribution for tax purposes, there has been a serious failure in business planning by someone.

9. Failure to Make Feasibility Study Prior to Formation

Before the decision to form the captive is even made, a feasibility study should be conducted that looks at all aspects of the captive and validates its viability and economics, as well as whether the captive will meet critical tests for risk-shifting and risk-distribution.

If for no other reason, a feasibility study that carefully documents the non-tax purposes of the captive (to distinguish it from a tax shelter masquerading as a captive) should be done, since the IRS on audits of captives routinely asks for such documents as part of its evaluation. A good captive feasibility study will go a long way in showing the IRS that the captive is founded on solid business economics and does not exist merely to try to save some bucks in taxes.

8. Ignoring State Tax Issues

There is a misconception that if the underlying business is doing business in State A, and the captive is formed in State B, then by virtue of that alone, State A cannot tax the captive.

Not true. Actually, whether State A can tax the captive depends on a variety of factors. If business decisions regarding the captive are made in State A, for example (probably the most common way to blow this), then State A can probably tax the captive.

Captive owners must be very careful to not let the captive “touch” State A in any way, unless of course the captive is formed in State A (and then it doesn’t matter, which is often the easiest and most sensible approach). This is usually accomplished by using a captive management firm (“captive manager”) to perform all the functions of the captive in State B; but just having a cap-

tive manager in State B isn’t enough – diligence is required not to blow this.

7. Single-Line Myopia

Too often, captives are formed to underwrite one single risk of the organization, without looking at the myriad other risks of the enterprise. This happens the most when the captive is promoted by an insurance broker who is only focusing on helping the client with that one line of business, usually workers compensation, and it misses a lot of benefits for the client.

In a sense, a captive is a lot like a casino – the more games in a casino, the better the risk distribution of the casino. The same is true with a captive having different types of policies; there is more risk distribution. Also, since the costs of a captive are often fixed or not dependent on how much insurance the captive underwrites, the more insurance that it underwrites, the better the economics of the captive. Which is to say that captives are usually the most efficient when they are underwriting all possible lines of coverage for the organization, not just a single line.

Often, when a captive is being evaluated solely for a single line, the conclusion is reached that the captive will not be economical as to that single line only, when it might be very economical if it takes on other risks. It is difficult to understand why those involved with captives would not look to all the possible coverages the captive might underwrite for a particular client, but such myopia occurs very frequently. Frankly, there is a lot of “If I don’t sell it, I’m not going to worry about it” going on with the insurance brokers, but that attitude doesn’t serve their clients well. Good insurance brokers who assist their clients with captives will look at the entirety of the clients’ books of insurance business, as well as where the clients have chosen not to purchase third-party insurance because it is too costly.

Take caution, however, that the IRS now apparently tests for “line-item homogeneity,” meaning it takes the position that each line of coverage must meet the tests for risk distribution separately, i.e., without regard

to other lines of coverage being underwritten by the captive. Many captive tax professionals believe the IRS is flat wrong on that point and will lose a challenge on appeal to a U.S. Court of Appeals, but who wants to pay for that fight?

6. Poorly-Drafted Policies

The policies underwritten by a captive should not be substantially different in their form than policies underwritten by any other insurance company. A good captive manager will use modified standard industry forms to draft policies. By contrast, bad captive managers will draft simplistic policies that often omit key insurance contract terms or else unnecessarily expose the captive to lawsuits by third-party claimants.

There is a reason why there is so much boilerplate in typical insurance contracts – it works. But also, one of the biggest benefits to a client is the ability to custom-tailor coverage to more closely fit their needs by modifying the standard industry forms. Too many captive managers just slap out some basic policies and call it a day; what a shame for their clients to lose a wonderful opportunity.

5. Bogus Insurance Contracts

I’ve actually sat in on meetings where some other adviser has told their prospective client something to the effect that, “You’ll pay premiums, but you don’t have to make claims!” (wink-wink, nod-nod). Then, I’ve had to inform the client that, “If you don’t make and pay valid claims under the policies, then you don’t have a captive, but instead, you just have a tax fraud.”

The U.S. Supreme Court has defined “insurance” as including an “insurance contract.” If there is no valid, binding contract, which is fully honored between the captive and the operating subsidiaries, then there is no insurance. What you have then is simply a sham.

4. Inadequate Capital

About once a month, somebody will call me to inquire about a captive, and say that they have already decided to put the captive in X jurisdiction. When I ask why, they

say that it is because X jurisdiction only requires \$25,000 in capital or some other small number.

The problem here is that while a small amount of capital may be all that is required by local regulatory law, the minimum capital requirements of a captive for tax purposes is usually much higher, and must be set by an actuary. It is very rare that a captive will take in more than five times the amount of its capital in the first year, and more than three times the amount of capital in succeeding years.

The idea is that the captive needs to have some “skin in the game” other than the premiums that it receives from insureds. In fact, the more capital that a captive has, the safer the arrangement will be from a tax standpoint.

Note that this is primarily a first-year problem, since after the first-year’s policies expire, the reserves that back those policies then go into surplus and are available as capital for future underwriting. However, the problem can materialize in later years if there are excessive claims or the captive’s owners distribute too much of profits to themselves, leaving the captive’s capital cupboard bare.

3. Highly Questionable Risks

A big problem with captives that are just disguised tax shelters is that their policies reflect the underwriting of longshot risks. Like, a really big longshot, as in a “10,000,000,000 to 1, an-asteroid-is-likely-to-hit-the-Earth-first” longshot. Think, hurricane insurance for a business whose operations are in Lincoln, Nebraska, or terrorism insurance for a business in Little Rock, Arkansas.

Maybe it is possible that a really huge hurricane could make its way to Lincoln, or Al Qaeda someday decides to take out a firm in Little Rock, but what is the real risk of that happening? And even if one could say with a straight fact that it *might* happen, what is the correct amount of premiums for such a policy? \$1 per \$100,000,000 in coverage? It is sure not \$500,000 for \$2,000,000 in coverage, which is how the promoters of sham captives will often write it.

Where a captive is formed as a tax shelter, sometimes the risks that are underwritten are already covered by insurance; such as where a doctor sets up a captive for tax reasons and tries to underwrite his or her malpractice liability risks, but then keeps an existing malpractice policy in place so that there is in actuality nothing being covered by the policy (since he or she doesn’t want the captive to actually have to pay a claim!).

2. Premiums Not Bearing Any Relationship to Reality

There is an old joke in the captive insurance world, which is that “You don’t go to the bathroom without first getting an actuary to sign off on it.” That is not too far from the truth. Premiums must be set by a qualified actuary, or else they are probably not defensible in tax court. Unfortunately, what happens too often is that a tax attorney and the insurance manager meet with the client and ask, “How much do you want to save in taxes?” They then pull some premium numbers out of the sky to get the client to the desired target.

Sorry, but it doesn’t work that way. The premiums of a captive have to be determined like any other insurance company; setting the premiums as would be done in an arm’s length transaction, which is by, among many other things, assessing the true risks of the operating subsidiaries, their needs for the particular insurance, and the minimum and maximum coverage required.

Going back to the hurricane insurance for the business in Lincoln or the terrorism insurance for the company in Little Rock: what is the correct amount of premiums? It is going to be really low, as in dig-the-loose-change-out-of-your-couch low. It is not going to be \$500,000 or even \$100,000, yet such goofy premium calculations are common with captives that are merely a facade for a tax shelter.

Note that having an actuary sign off on premium calculations is not always going to save you, as those premiums have to be reasonable too. Just like there are real estate appraisers whose first question is “What number do you want?,” there are corrupt

actuaries who will give you either a \$1 or \$10,000,000 premium number for the exact same policy and risk. But remember: if the premium calculation is not reasonable, it will not survive a challenge no matter how lengthy the actuary’s credentials.

1. Captive Insurance Companies Sold as Tax Shelters

The primary use of a captive must be for bona fide risk management purposes, and not to save taxes. Unfortunately, many of the same promoters of tax shelters who a few years ago were selling Son of Boss, CARDS, BLIPS, and other flavor-of-the-day tax shelters, are now selling captives as a way to save taxes, with only the barest lip-service being paid to the risk management function.

Hale Stewart, an author of a book on captive insurance company taxation, told me recently, “Captives sold as a tax mitigation tool and not as a bona fide risk reduction, are not really captives at all. But I keep running into them.” So do I, mostly (but not all) so-called 831(b) captive insurance companies, i.e., captives that have made an election to be taxed as a small insurance company under IRS Code Section 831(b). While the vast majority of 831(b) captives are quite legitimate, there is still probably much more abuse going on with these companies than with non-831(b) companies.

These “tax shelter captives” usually suffer from significant flaws, including inadequate capital, grossly overpriced premiums, insuring non-existent risks, lack of true risk distribution, or as a scheme to buy life insurance with pre-tax dollars. It is probably only a matter of time before these companies, and their owners, come to grief on any number of theories the IRS could assert.

Avoiding the Hazards of a Bad Captive Arrangement

Like any other complex legal and financial structure, the money that one spends on a second opinion from truly independent counsel will be some of the best money they will ever spend. In this context, “truly independent” means somebody that a cli-

ent finds themselves and is not related to or recommended by whoever is pitching them the captive.

A lot of people in the captive world have gotten away for years with some really bad practices only because the IRS has not spent much time or effort looking in to the practices of captive insurance companies. But as the captive market has dramatically expanded, it is unrealistic to think that the IRS's lack of attention will last much longer.

So, either do a captive right, or don't do it at all. Now, on to the good things about captive insurance, also presented in reverse order:

10. Create a Giant War Chest for the Business

Like any insurance company, captives tend to accumulate a considerable amount of assets in reserves and surplus. While these assets back the policies issued by the insurance company, a portion of those assets may be available to the business owner in a worst-case scenario where the business owner needs the funds to cover a larger catastrophe.

While there may be significant tax ramifications to "cashing out the captive" to meet some emergency not covered by a policy, at least the business owner has the option of so doing, and can then weigh the cost/benefit analysis at the time the money is needed. Certainly, getting money out of a captive is easier and more expedient than obtaining a business loan from a bank at a time when the business is in deep distress.

During the 2008 crash, more than a few business owners did exactly that. And while their captives became empty shells for a while, they were able to use the money to save their businesses. While one who is setting up a captive certainly hopes their business never will have such a need, it is nice to know that safety net is there.

9. Retain Key Employees

Occasionally, business owners will award a key employee or two by giving them equity in the captive as part of an overall strategy to retain those employees for the benefit of

the business. Giving key employees stock in the captive is sometimes less messy and troublesome than giving them equity in the business itself, and can avoid the animosity that can sometimes materialize when other employees are not given a stake in the business.

While this situation is rare, it works swimmingly. While ownership in the operating business is difficult to conceal, particularly for businesses with significant accounting staffs, often no one in the business except the owners knows what is going on with the captive, allowing great flexibility in creating key employee arrangements.

8. Enterprise Asset Protection

A collateral benefit to a captive is that each dollar paid by the operating business to the captive reduces the assets of the operating business by that same dollar. Accordingly, if something goes dreadfully wrong for the business, those dollars are no longer available to creditors of the business.

Indeed, captive insurance must rank as one of the best enterprise asset protection strategies ever created. Note that it would be very difficult for creditors of a business to prove that payments to a captive for bona fide insurance coverage would be a fraudulent transfer, since the business received back a substantial economic benefit in the insurance coverage from the captive. Also, the captive may (and usually is) structured to be remote from the underlying business for purposes of bankruptcy, so even if the operating business is forced into bankruptcy, the odds are low that the captive will be swept into the bankruptcy vortex.

7. Cover Risks Otherwise Exposed

Businesses are often forced to effectively self-insure risks (whether they realize it or not) because either the risk is so unusual that insurance cannot be purchased for it at any price, or because the insurance to cover the risk is exorbitantly expensive. These are ideal risks to be covered by a captive, and indeed, this is one of the primary purposes of captive insurance.

Moreover, even where a business has insurance against certain types of risks, the

business will still be exposed to deductibles and exclusions. While in the past, general liability insurance (known in the industry as "GL") covered a very broad range of risks, typical modern exclusions give such a policy more holes than Swiss cheese. These days, the typical GL policy may have exclusions for things like employment practices liability, which exposes the business to claims of sexual harassment, age discrimination, wage and hourly claims, and the like. The insurance provided by captives can fill these gaps.

6. Draft Your Own Policies

Captives can (and should) draft carefully custom-tailored policies to fit the exact needs of the business. This not only means covering areas of exposure and eliminating exclusions, but also drafting the policy in ways that make it nearly impossible for a third-party claimant against the business to assert a claim directly against the policy (unlike most commercial policies).

Because policies can be custom-tailored, they can be much more efficient. With commercial policies, a business might be stuck with \$2 million in coverage of some risk, even though as to that particular risk, the business might only need a more precisely-calculated \$1.45 million in coverage – so the business need not pay for what it doesn't need, and instead allot those same premium dollars to other risks for which the business is exposed.

5. Choose Your Own Counsel

When you buy insurance from a commercial carrier, they typically retain the right to hire an attorney for you. Theoretically, the attorney that your insurance company hires will be your attorney and only look out for your interests even to the detriment of the insurance company – but will he or she really do so?

Insurance defense counsel may be assigned 200 cases from a particular insurance company in a year, only one of which is yours. Who do you think they will really owe their loyalty to? Additionally, insurance companies are notoriously cheap when it comes to hiring counsel – you may

get someone whose primary qualification to handle your defense is that he or she bid lower than any other insurance defense attorney for the work.

My advice has long been that if you are ever sued and your insurance company appoints counsel for you, get your own counsel to ride herd on your insurance company's lawyers; i.e., make sure that they competently represent your interests first and foremost, and if possible, settle the claim within policy limits.

With a captive, a business doesn't have these problems at all. Since the business owners control the captive, they can select the counsel of their choice to handle particular claims. They have the option of not opting for the cheapest insurance defense counsel, but the best. Or, on the flipside, they can retain a good insurance defense attorney to handle most matters at a discount. All this usually has the effect of a better defense at a lower cost to the business.

4. Administer Claims on Your Own Terms

A problem with commercial carriers is that they can allow a small claim to fester, either by not taking care of the claim early or by allowing it to drag on without resolution. Or, the insurance company may settle a frivolous claim just to save defense costs, thus encouraging more such frivolous claims against the business.

With a captive, the business owners can administer their own claims on their own terms, and get on top of claims quickly before they spin into something much larger. The business owners can also choose to not settle frivolous claims, forcing the plaintiff's attorneys to incur time and expense litigating the claims before dismissal, and by doing so, deter future lawsuits.

A captive's ability to draft its own policies, choose its own attorneys, and administer its own claims are all important cost-saving benefits of a captive.

3. Save Money on Insurance

The primary purpose of a captive is to save money on insurance, and in this, captives have no equal. There are three main aspects to this:

First, by underwriting the insurance needs of the business, the captive can capture and retain the underwriting profits that would ordinarily be lost to the commercial carrier. Additionally, considering that commercial carriers have enormous costs that must be priced into their policies, such as the expense of compensating agents, marketing and advertising expenses, and high executive compensation, there is a great deal of fluff having nothing to do with true risk in commercial policies that can be saved through the use of a captive.

Second, even where the business decides to keep commercial insurance in place against particular risks, the captive can be used to reduce costs by raising deductibles, lowering coverage limits, or increasing exclusions – the idea being for the business to find the sweet spot where the commercial insurance is most economical, and then use the captive to insure around that area. Since the greatest expense of most insurance policies is the “first dollar” expense, simply increasing deductibles can result in dramatic premium decreases with commercial policies.

Third, the mere existence of the captive and its ability to underwrite risks can save money even if the captive is never used for that purpose at all. This is because the insurance broker knows that if the premium prices offered to the operating business for insurance are not efficient, the operating business may decide to cover them in the captive instead – and once that particular book of business is lost, it may be forever lost to the broker. Thus, the threat of a captive can be used to significantly barter down the commercial carrier into offering insurance to the operating business at rock-bottom prices.

The combination of all three of these factors can result in very substantial savings to the business enterprise, but the benefits of a captive can extend well beyond the immediate savings of insurance dollars.

2. Forces the Business to Focus on Risk Management

When a business is buying insurance from a commercial carrier, the concept of claims

is only loosely attached to the economic cost to the business in terms of increased premiums. But when claims are being paid from a captive – effectively, from the business owner's pocket – the focus on claims can become intense, and consequently, the business becomes focused (often for the first time) on enterprise risk management.

The benefits of enterprise risk management, while sometimes hard to exactly quantify, are enormous. The focus shifts to analyzing the business so as to spot potential risks. Claims are thus prevented instead of administered. In the end, the business owner gains a better understanding of the business and its limitations, and that is priceless.

1. Create a New Business

Many business owners who form captives think of it for what it does, but they don't realize that they have just created a new business – an insurance company – and thereby cast themselves into the business of insurance. The captive thus acts not just as an enterprise risk management tool, but also as a segue into a whole new business opportunity.

An existing captive with sufficient capital can be converted to a full insurance company that offers insurance to the general public by changing its license and business plan, and meeting certain other state requirements. This usually doesn't mean that the new insurance company owner will throw open the doors to the general public, but instead often limits business to the same business that the owner is familiar with – offering insurance to similar businesses where the insurance company owner can get a good feel as to their claims exposure, and accordingly, price premiums appropriately.

The business of insurance can be a great business, and more than a few business owners find insurance an even better business than the successful business they are already in. I've had more than a dozen clients go from their captive being just another affiliate in their overall business organization, to running an insurance company and conducting the business of insurance as their primary business.

A Final Note

Note that I haven't mentioned tax savings as one of my favorite benefits of captives. While captives can offer certain tax advantages to business owners, my tendency is to view a proposed captive arrangement as tax-neutral and make sure that it works without any regard to any tax benefits. This is because to the extent that a captive offers tax benefits, those are the icing on the cake – the cake is the numerous other non-tax advantages of captives, and the cake by itself is pretty good.

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BUSINESS LAW TODAY

Keeping Current

SEC Issues New Guidance on “Bad Actor” Disqualification from Rule 506 Offerings

By [Lily J. Lu](#), [Ellen K. Fleishhacker](#), [Robert E. Holton](#), [Aron J. Estaver](#),
and [Dora D. Pulido](#)

On December 4, 2013, the staff of the Securities and Exchange Commission (SEC) Division of Corporation Finance issued new guidance regarding the “bad actor” disqualification provisions of Rule 506(d) of Regulation D under the Securities Act of 1933 (Securities Act) and the related disclosure requirements of Rule 506(e) through an update to its [Securities Act Rules Compliance and Disclosure Interpretations](#) (C&DIs). The 14 new CD&Is provide important clarification to the final rules approved by the SEC earlier this year and additional guidance to issuers seeking to comply with the new requirements of Rules 506(d) and 506(e) of Regulation D under the Securities Act. This advisory summarizes some of the more significant of these new CD&Is.

Background

An issuer that seeks to offer and sell securities in the United States must either register the offering under the Securities Act by filing a registration statement with the SEC or rely on an exemption from the registration requirements of the Securities Act. The Rule 506 private placement safe harbor is the most widely used exemption from registration under the Securities Act and is relied upon by numerous issuers, including private funds.

On July 10, 2013, the SEC adopted Rules 506(d) and 506(e), which became effective

on September 23, 2013. Under Rule 506(d), an issuer of securities seeking to rely on the exemption from registration set forth in Rule 506 of Regulation D under the Securities Act generally may *not* rely on that exemption if the issuer or any related “covered person” (including placement agents and certain controlling persons, officers, and affiliates of the issuer) has been subject to any “disqualifying event” specified in that rule. “Disqualifying events” under Rule 506(d) generally include securities-related bad acts, such as criminal convictions in connection with the sale or purchase of any security; bars by certain federal or state regulators from engaging in the business of securities, insurance, or banking or from savings association or credit union activities; certain cease-and-desist and other orders by the SEC; and certain suspensions, expulsions, or bars from association with a registered national securities exchange. If any “[disqualifying event](#)” existed before September 23, 2013, then Rule 506(e) requires the issuer offering securities under Rule 506 to disclose the “disqualifying event” to prospective investors within a reasonable time prior to any sale of securities to such persons.

New SEC Guidance

Some of the more significant CD&Is related to Rules 506(d) and 506(e) include the following:

Reliance on Rule 506 After a Placement Agent’s Disqualifying Event

If a placement agent or one of its covered control persons becomes subject to a disqualifying event while an offering is ongoing, the issuer may continue to rely on Rule 506 going forward in respect of that offering if the issuer terminates its engagement with the placement agent and the placement agent does not receive compensation for any future sales in that offering or, if the disqualifying event affects only a covered control person of the placement agent, if that person is terminated or ceases to perform a role with respect to the placement agent that would cause him or her to be a covered person with respect to the issuer for purposes of Rule 506(d). (CD&I 260.15.)

Compensated Solicitors

All persons who have been or will be paid, directly or indirectly, remuneration for solicitation of investors are covered by Rule 506(d). Such persons may include persons other than brokers registered pursuant to the Securities Exchange Act of 1934 or their associated persons. (CD&I 260.17.)

This CD&I suggests that marketing personnel of the general partner, managing member, or investment manager of a private fund may be “covered persons” for purposes of Rule 506(d).

Disclosure of Past Disqualifying Events of Solicitor

Issuers must provide all prospective investors with the disclosure required under Rule 506(e) (typically, disclosure of “bad acts” occurring prior to September 23, 2013) for all placement agents and other compensated solicitors (and their respective covered control persons) who are involved with the offering at the time of any sale to such persons, regardless of whether or not such placement agents and other compensated solicitors actually sold interests to the prospective investors to whom disclosure is required to be made. In an offering in which the issuer uses multiple placement agents or other compensated solicitors, if disclosure under Rule 506(e) is required with respect to one or more of those agents or solicitors (or their respective covered control persons), the issuer may not selectively provide Rule 506(e) disclosure only to those investors who were solicited by the specific agents or solicitors that triggered the disclosure requirement. (CD&I 260.26.)

It would seem that one could plausibly read Rules 506(d) and 506(e) as only requiring disclosure of any disqualifying event with respect to a placement agent or other compensated solicitor and its covered control persons only to the investors actually solicited by such agent or solicitor in light of: (1) the language of Rule 506(d), which mandates the loss of the exemption from the registration requirements of Securities Act under Rule 506 for a “sale” of securities if any solicitor has been or will be paid in connection “with such sale of securities” (rather than “with the offering of such securities”) and (2) the potential that disclosure regarding all compensated solicitors in an offering could confuse and mislead investors who have only been solicited by specific solicitors. However, the staff of the SEC’s Division of Corporation Finance has taken a different interpretive position in this CD&I.

Affiliated Issuer

“Affiliated issuer” does not include every affiliate of the issuer that has issued securi-

ties. Instead, for purposes of Rule 506(d), an “affiliated issuer” of the issuer is an affiliate (as defined in Rule 501(b) of Regulation D) of the issuer that is issuing securities in the same offering, including offerings subject to integration pursuant to Rule 502(a) of Regulation D. (CD&I 260.16.)

Foreign Disqualifying Events

Disqualification under Rule 506(d) would not be triggered by actions taken in jurisdictions other than the United States. This includes convictions, court orders or injunctions in a non-U.S. court, or regulatory orders issued by non-U.S. regulatory authorities. (CD&I 260.20.)

Reasonable Care Exception

Rule 506(d)(2)(iv) provides a reasonable care exception if the issuer can establish that it did not know and, despite the exercise of reasonable care, could not have known that a disqualification existed under Rule 506(d)(1). The SEC’s guidance explains that this may occur when, despite the exercise of reasonable care, (1) the issuer was unable to determine the existence of a disqualifying event; (2) was unable to determine that a particular person was a covered person; or (3) initially reasonably determined that the person was not a covered person, but subsequently learned that determination was incorrect. If an issuer discovers a Rule 506(d) disqualifying event or covered person during the course of an ongoing offering of securities in reliance on the safe harbor provided under Rule 506, it must then consider what steps would be appropriate to continue permissibly relying on Rule 506. An issuer may need to seek waivers of disqualification from the SEC, terminate the relationship with the applicable covered persons, provide disclosure to investors in accordance with Rule 506(e), or take other remedial steps to address such Rule 506(d) disqualification. (CD&I 260.23.)

Waiver of Obligation to Disclose Past Events

The Rule 506(e) disclosure obligation for past events that would have been disquali-

fying, except that they occurred before September 23, 2013 (the effective date of Rule 506(d)), is not subject to waiver by the SEC. (CD&I 260.24.)

Accordingly, issuers should not attempt to seek such waiver of disclosure from the SEC.

* * *

This article summarizes only some of the more significant CD&Is. We encourage you to read the full text of the SEC’s CD&Is regarding the “bad actor” disqualification provisions of Rule 506(d) and the related disclosure requirements of Rule 506(e), which is available at www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm.

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BUSINESS LAW TODAY

Delaware Insider:

Revisiting MAE/MAC Clauses in M&A after *Cooper Tire, Huntsman, and Osram*

By [Lisa R. Stark](#)

In what is now a familiar scenario, a megamerger unravels after post-signing events make the target less attractive to the acquirer, the acquirer develops considerable buyer's remorse, and the target accuses the acquirer of delaying the deal. If the acquirer has failed to negotiate a termination right triggered by the unforeseen events and also possesses an obligation to close, then the target may have a viable claim for breach of the merger agreement arising from the acquirer's intentional delay.

This fact pattern unfolded after Cooper Tire & Rubber Company announced a proposed \$2.5 billion sale of the company to Apollo Tyres Limited (Apollo Tyres) in June 2013. The United Steelworkers (USW) asserted that the proposed merger required a renegotiation of the union's contract with Cooper. After Apollo Tyres conditioned its participation in negotiations with the USW on Cooper accepting a \$9 reduction in the deal price of \$36, Cooper filed an action in Delaware. Cooper argued that Apollo Tyres breached a covenant to use its "reasonable best efforts" to obtain approvals required for closing. In *Cooper Tire & Rubber Company v. Apollo (Mauritius) Holdings Pvt. Ltd.*, C.A. No. 8980-VCG (Del. Ch. Nov. 8, 2013), the Delaware Court of Chancery rejected Cooper's claims that Apollo Tyres breached the merger agreement, but cautioned Apollo Tyres against continuing to use the union issues to renegotiate the deal

price. Cooper terminated the merger agreement in December 2013.

The Cooper fact pattern was reminiscent of the events that unfolded after Hexion Specialty Chemicals, Inc., and its parent, Apollo Global Management, LLC (Apollo), agreed to acquire Huntsman Corp. in 2007. During the period between signing and closing, Huntsman reported disappointing earnings, and Hexion attempted to extricate itself from the transaction by claiming that Huntsman had suffered a material adverse effect and would be insolvent post-closing. In subsequent litigation, the Delaware Court of Chancery found that the changes in Huntsman's financial performance did not constitute an MAE. *Apollo Global Management, LLC v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008).

More recently, the Delaware Court of Chancery found that short-term changes in financial results could conceivably constitute a material adverse effect under an acquisition agreement for purposes of a motion to dismiss against a backdrop of allegations of fraudulently misconduct by the sellers of a privately-held business. *Osram Sylvania, Inc. v. Townsend Ventures, LLC*, C.A. No. 8123-VCP (Del. Ch. Nov. 19, 2013).

The acquirer's typical protection against undesirable risks from significant changes in the target's business between signing and closing is the material adverse effect or "MAE" clause. As more fully outlined

below, these cases suggest that short-term, forward-looking elements of the MAE definition in merger agreements merit more attention by deal practitioners.

Cooper Tire & Rubber Company v. Apollo (Mauritius) Holdings Pvt. Ltd.

Background

This case arose after labor issues in both the United States and China threatened to unravel Apollo Tyres' proposed \$2.5 billion buyout of Cooper. Workers seized Cooper's largest Chinese facility in July 2013, rendering it unlikely that Cooper could deliver timely, interim financial statements to Apollo Tyres. In addition, the USW filed an arbitration proceeding in Tennessee, alleging that the merger agreement violated the union's collective bargaining agreements with Cooper. Thereafter, an arbitrator issued an order, preventing Cooper from consummating the merger absent renegotiation of its agreements with the USW. As a result, Apollo Tyres and Cooper agreed not to close the merger until the union contracts had been renegotiated. Subsequently, Cooper lowered its forecasted profits for 2013 by one-third, largely as a result of the labor issues. Thereafter, Apollo Tyres made some attempts to renegotiate the USW contracts (without Cooper's input), but eventually halted negotiations because Cooper would not agree to a reduction in the merger price.

Cooper estimated the cost of the USW developments to be about \$10 million over six years, while Apollo Tyres argued that the economic effects would be more severe, warranting a \$9 per share decrease in the merger consideration.

In October 2013, Cooper initiated this action, alleging that Apollo Tyres breached Section 6.12 of the parties' merger agreement by failing to use its "reasonable best efforts" to renegotiate the USW contracts. Cooper focused on Apollo Tyres' decision to condition its participation in negotiations with the USW on a reduction in the merger price despite the parties' exclusion of the impact of the announcement of the merger on Cooper's relationship with its labor unions from the events that would constitute a material adverse effect. Cooper also had listed the possible renegotiation of the USW contracts on its disclosure schedules.

The Court's Decision

Although the court found that Apollo Tyres did try to use the developments with the USW, the events at Cooper's Chinese facility, and Cooper's disappointing interim financials to reduce the merger consideration, it found no breach of Section 6.12. The court reasoned that Apollo Tyres possessed a good-faith but erroneous belief that the developments with the USW might constitute a material adverse effect under the merger agreement. The court also found no evidence that Apollo Tyres otherwise dragged its heels in violation of the reasonable best efforts covenant. Specifically, the court found persuasive evidence that Apollo Tyres' executives and its hired experts immediately travelled to Tennessee to meet with the USW after learning of the arbitrator's order and held meetings over the next several weeks with the USW. The court also found convincing the testimony of the experts hired by Apollo Tyres on the issue of whether Apollo Tyres had used its "reasonable best efforts" to reach the required agreement with the USW.

However, in dicta, the court found unavailing Apollo Tyres' position that it could continue to use the USW developments to renegotiate the deal price without breaching

the reasonable best efforts provision given the parties specifically carved out union developments from the definition of an MAE. Subsequently, Apollo Tyres notified Cooper that financing was unavailable, and Cooper terminated the merger agreement.

Apollo Global Management, LLC v. Huntsman Corp.

Background

In July 2007, Hexion agreed to acquire all outstanding shares of Huntsman for \$10.6 billion. Because Hexion had been eager to be the winner of a competitive bidding process, the merger agreement contained no financing contingency, and Hexion agreed to use its "reasonable best efforts" to consummate the financing, which was being provided by Credit Suisse and Deutsche Bank. In addition, the merger agreement entitled Huntsman to uncapped damages if Hexion "knowingly and intentionally breached" its covenants under the merger agreement. An MAE/MAC clause permitted Hexion to terminate the merger agreement upon the "occurrence, condition, change, event or effect that is materially adverse to the financial condition, business, or results of operations of the Company and its Subsidiaries, taken as a whole."

During the period between signing and closing, Huntsman reported several disappointing quarterly results, missing the numbers it projected at the time the deal was signed. Huntsman's first-half 2008 EBITDA was down 19.9 percent year-over-year from its first-half 2007 EBITDA, and its second-half 2007 EBITDA was 22 percent below the projections Huntsman presented to bidders in June 2007 for the rest of the year. After receiving these financials, Hexion and Apollo began exploring options for extricating Hexion from the transaction. Initially, Hexion focused on arguing that Huntsman had suffered a material adverse effect. Subsequently, Hexion explored ways to disrupt the financing. Hexion (through Apollo) sought a written opinion of Duff and Phelps of the likely insolvency of the combined companies post-closing. After obtaining such an opin-

ion, without any input from, or the knowledge, of Huntsman's management, Hexion forwarded it to Credit Suisse and attached the opinion to the complaint that the company filed in Delaware. Plaintiffs sought a declaration that: (1) Hexion possessed no obligation to consummate the merger if the combined companies were insolvent, and (2) Huntsman had suffered a material adverse effect. Huntsman counterclaimed and sought, among other things, specific performance of the merger agreement. After the filing of the Delaware litigation, Credit Suisse and Deutsche Bank pulled their financing.

The Court's Decision

In reviewing the parties' claims, the court began with Hexion's argument that its obligation to close was excused as a result of Huntsman suffering a material adverse effect. As quoted above, the definition of a "material adverse effect" did not specifically cover changes in short-term prospects. Accordingly, under Delaware law, the court was required to presume that Hexion was purchasing Huntsman as part of a long-term strategy. While Huntsman's interim performance may have been "disappointing," the court was unable to conclude that a change "*consequential to the company's long-term earnings over a period of years*" had occurred. According to the court, at best, Hexion's projections predicated Huntsman's 2009 EBITDA to be 3.6 percent lower than expected at the time of the execution of the merger agreement.

The court found that Hexion intentionally breached its covenant to use its "reasonable best efforts" to consummate the financing for the following reasons. First, the court found the mere fact that Hexion failed to approach Huntsman about the possible insolvency of the combined entity before engaging Duff and Phelps to render an insolvency opinion constituted an intentional breach of the merger agreement. Second, the court found Hexion intentionally breached the merger agreement by publishing the solvency opinion (both by filing it with a complaint and by sending it to Credit Suisse). The court also con-

firm that the solvency of the combined entity was not a condition precedent to any of Hexion's obligations under the merger agreement. However, the court found that it could not order Hexion to close. The merger agreement provided that, in circumstances where Hexion was obligated to consummate the merger, but had not: "Huntsman shall not be entitled to enforce specifically the obligations of [Hexion] to consummate the Merger." The court therefore ordered Hexion to perform its obligations under the merger agreement, other than the obligation to close.

In December 2008, Apollo and Hexion agreed to pay Huntsman \$425 million to settle the litigation, in addition to a \$325 million breakup fee.

Osram Sylvania, Inc. v. Townsend Ventures, LLC

Background

In September 2011, plaintiff Osram Sylvania Inc. (OSI), a preferred stockholder of Encelium Holdings, Inc. (Encelium), agreed to purchase all of Encelium's common stock from Townsend Ventures, LLC, and members of Encelium's management (Townsend) for \$47 million pursuant to a stock purchase agreement (the SPA). In the months leading up to the execution of the SPA, Townsend provided OSI with a management presentation which included Encelium's historical financials and some forecasts. The management presentation revealed that Encelium had a negative EBITDA for calendar year 2010, but projected sales for the calendar year 2011 of approximately \$18 million. The management presentation also disclosed that two of Encelium's employees were responsible for approximately 32 percent of the forecasted sales for 2011. In early July 2011, Townsend reported to OSI that Encelium's actual sales for the second quarter of 2011 were consistent with the forecasted sales numbers contained in the management presentation. Further, Townsend forecasted sales of approximately \$4 million for the third quarter of 2011. In October 2011, the stock sale closed.

After the closing, OSI learned that Encelium's sales for the third quarter of 2011 were only \$2 million, or approximately one-half of defendants' estimates. According to OSI, Townsend knew Encelium's actual sales results for this period prior to closing, but concealed the company's underperformance. OSI also alleged that defendants manipulated the second quarter 2011 numbers to conceal underperformance. Specifically, OSI contended that defendants: (1) held invoices for payment, (2) billed and shipping excess product to create reportable revenue (without disclosing the credits to be applied), and (3) failed to disclose discount policies to inflate revenues. Encelium also allegedly failed to disclose that its top two salespeople resigned during the summer of 2011. OSI supported its allegations with an Encelium internal e-mail, in which one of the defendants stated: "[G]iven where sales are going the distraction with senior management is far too great to keep up any charade on the chance that a deal does happen."

Based on the foregoing, OSI contended that Townsend breached numerous provisions of the SPA, including representations relating to the accuracy of Encelium's financial statements and the absence of a material adverse effect or change. OSI also claimed that Townsend breached Section 6.4 of the SPA, which required defendants to notify OSI of any fact or circumstance that occurred during the period between signing and closing, which had or would reasonably be expected to have, individually or in the aggregate, a material adverse effect. OSI also included counts of fraud in its complaint.

The Court's Decision

In reviewing OSI's claims, the court found that OSI adequately pleaded breaches of a number of Townsend's representations and warranties under the SPA, including Sections 3.5(c) (warranting that the company had been run in the ordinary course of business and that there had been no MAC/MAE since the end of the second quarter of 2011), Section 3.7 (warranting that there had been no event or change since Decem-

ber 31, 2010, that resulted in, or would reasonably be expected to result in an MAC/MAE), and 3.5(b) (warranting the accuracy of the financial statements from 2008 through the second quarter of 2011).

The SPA defined an MAE/MAC as "any effect or change . . . that would be materially adverse to the Business, assets, condition (financial or otherwise), results or operations of [Encelium]." Here, the court found that it was reasonably conceivable that certain of Encelium's business practices, such as the billing and shipping of excess product during the months preceding the signing of the SPA, could have a material adverse effect on the company's "long-term performance." Furthermore, the court found it reasonably conceivable that Encelium's achievement of only one-half of projected revenues for the third quarter of 2011, constituted an MAC or MAE, requiring notification under Section 6.4 of the SPA. The court also found that OSI stated a claim for fraud by alleging that defendants misrepresented the financial condition of the company to induce OSI to purchase Encelium's common stock at an inflated price.

Looking Forward: Lessons from Recent MAE/MAC Decisions

The lessons from *Osram*, *Cooper Tire*, and its predecessors are clear: the definition of an "MAE" in any merger agreement deserves a second look. In public company agreements, the failure of a target to meet earnings or revenue projections is commonly excluded from the list of events that could constitute a MAE, as are developments which result from the announcement of the merger. Further, changes in "prospects" are rarely included in the MAE clause as an event that could constitute an MAE. The elimination or retooling of these exceptions to the MAE definition, coupled with the introduction of more short-term, forward-looking features may give acquirers greater flexibility in responding to events that occur during signing and closing. While the introduction of these definitional elements may not be appropriate or realistically obtainable in most deals, the

foregoing decisions make the case for their consideration.

On the other hand, targets should focus on whether they have the ability to force a buyer to close upon the satisfaction of all conditions precedent to closing and/or to pay a significant reverse termination fee. As the foregoing cases show, targets may enter into agreements with the expectation that they have the ability to force the acquirer to close if all closing conditions are met, but are later disappointed.

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BUSINESS LAW TODAY

Member Spotlight: Interview with Harvey Pitt



Just a month before 9/11, President George W. Bush named Harvey Pitt as the 26th Chairman of the U.S. Securities and Exchange Commission. Serving from 2001 through 2003, Pitt guided the

agency amidst the 9/11 tragedy (including the destruction of the SEC's own New York office), through the WorldCom and Enron controversies, as well as through the implementation of the Sarbanes Oxley Act of 2002.

Pitt first joined the SEC right after graduating from St. John's University School of Law in 1968. (Previously, he'd attended New York's famed Stuyvesant High School and Brooklyn College.) After serving on staff for several years, Pitt was named the Commission's youngest-ever general counsel. Later, he joined the Fried Frank law firm, eventually serving as the firm's co-chair.

Throughout Pitt's years of practice, he taught law at various institutions, including George Washington University Law School and Yale Law School. Today, he regularly appears on CNBC, Bloomberg, and FOX Business as a television commentator explaining financial matters. After leaving the SEC in 2003, he founded the strategic consulting firm Kalorama Partners, and its affiliated law firm, Kalorama Legal Services, where he currently serves as chief executive officer.

* * *

Harvey Pitt's "Insights from Legal Luminaries" remarks presented at the 2014 Midwinter Leadership Meeting of Officers, Council and Committee Chairs in Tucson, Arizona, on January 18, 2014, can be viewed following this article.

What inspired you to attend law school and to practice law?

It was actually a very last-minute decision. I originally had thoughts of focusing on either the mathematics or actuarial fields. The first hint I had that I probably should find a different career path was after my first semester's experience with college-level calculus. Fortunately, political science and urbanism were interests I had too. By the time I was ready to graduate, those interests had become more full-blown. I had a real interest in legal aspects of political science and law school seemed like a natural fit.

Why did you pick the SEC? What about it interested you as a new lawyer?

In law school, I intended to become a labor lawyer. Labor law seemed to me to be a very exciting field. In those days, there really were not very many, if any, securities law courses. Schools offered corporations and advanced corporations courses. But securities laws hadn't yet become a separate course offering. So, the last thing on my mind was securities law.

But in my national moot court competition, the issue posed was a hypothetical based on an actual case, *Fisher v. Kletz*, which raised substantive and procedural

questions about the application of securities laws. I was fascinated and, along the way, a number of SEC officials and staff personnel who were judging various rounds suggested that I give consideration to working at the SEC, which I did.

The SEC's hiring process those days involved taking an exam, which I think many law school graduating seniors frowned upon, but I actually found quite interesting. I received offers from all the divisions, and the general counsel's office seemed to me to be the right place. The SEC seemed an exciting place to work. It has a very clear and interesting mission, and it was involved with very complex financial issues. I went with my instinct, which I always think is anyone's best resource.

It's amazing that if you'd been given a different issue in your moot court competition, you might have had a totally different career, right?

That's absolutely correct. I've told younger lawyers who've asked for career guidance that you need to be alert to opportunities around you and factor them into your decision-making process.

Arthur Matthews, a very dear friend I met at the SEC, and very much like a brother to me, always had an expression, that I found both amusing and right on point. He said you should always position yourself for good luck. It's true. You have to let yourself take advantage of possibilities, and hope that good luck hits. In my case, I never would have thought of becoming an

employee of the Securities and Exchange Commission but for the serendipitous occurrence of having a national moot court issue that was related to securities laws and having SEC officials judge my oral arguments.

Who was your first mentor at the SEC?

My ultimate mentor was Ray Garrett, Jr., the SEC's Chairman from 1972–73. He was like a father to me, as well as a professional mentor. But, my first true mentor at the SEC was Frank Wheat. He was an SEC Commissioner; after I had been at the SEC for about nine months, he had a vacancy in his legal assistant position. I worked with Frank for almost a year before he retired. He was brilliant, and very respectful of the SEC and its staff. The first instruction he gave me was that, whenever I needed to talk with SEC staff members, I should never ask them to come to my office. If I wanted to talk with the staff, I should go to their offices. It may seem like a small thing, but it was a very powerful reflection of his respect for the staff. It was a lesson to which I tried to adhere throughout 45 years (thus far) of my professional career.

I also translated that into a mantra, which is, "There are no insignificant people." I think it's crucial to recognize that everyone, no matter what their position, station, or relationship to you, is significant. Frank took me under his wing; he was a marvelous lawyer but an even better human being, someone you could learn a lot of life's lessons from.

The very first day in his office, I arrived about 7:00 in the morning. I wanted to be sure I arrived ahead of Frank so he would see I was serious and dedicated. At about 8:00, I heard a huge ruckus outside the office, a lot of heaving of breath, and I became very nervous because it sounded like someone might be having a heart attack. I ran out of my office, and there was Frank catching his breath. Our office was on the seventh floor, and every morning Frank climbed up seven flights, two steps at a time, never pausing for air or rest. Frank was a great believer in exercise, a classic lover of all things outdoors, and a preservationist.

In 1975, you became the Commission's youngest-ever general counsel. What was that like?

It was exhilarating and very gratifying, but it also placed a great deal of responsibility on my shoulders. It was a wonderful job and a wonderful opportunity to hone my counseling skills, and assist not just the Commissioners but all the divisions. Those were three incredibly rewarding years.

When you joined Fried Frank, what was it like to transition from government work to private practice?

It was very different, most obviously because I now was on the other side of specific issues. But one thing I took with me when I left the SEC was great compassion for the work of the agency and the difficulties that confront government employees. It's difficult to represent the public interest and deal with criticism from various private interests – not because you aren't representing the public interest well, but because you're not providing help to those private interests. All private interests want government to be more responsive to their needs. It's a legitimate concern on their part. But in the government, your focus is on the mandate of the agency and not how to help certain groups.

The notion that people who leave the agency capitalize on their government positions is really a canard. Coming out of the SEC, I had great respect for its work, its mission, the Commissioners, the agency and most importantly, its employees. As a private practicing lawyer, I either turned down or was not retained by various potential clients when I explained to them how I would approach an issue, frequently because those prospective clients thought I was too sympathetic to the Commission's point of view. My view was I knew the right way to disagree with the SEC and its staff, and I knew the right way to agree with them, yet still promote my clients' interests zealously, as lawyers must do.

Often, people on the outside do not understand why the Commission's staff may take certain positions. Whether or not the position is correct, the staff is thoughtful. Positions

are arrived at honestly and carefully. If you believe a staff position is wrong, one thing an outside lawyer must do is explain that to the staff in ways that will resonate with their view of what the public interest requires. So for me, I felt it was a logical extension of the work I had done at the Commission.

What was the highlight of serving as SEC Chair?

Becoming SEC Chair was for me the pinnacle of my career. I have great affection for the agency. Over 23 years in private practice that preceded my Chairmanship, I thought I had insights into ways the Commission could be even more effective, and I was anxious to help the agency as it started the new millennium. Being SEC Chairman was the only job I ever lusted for. For me, it was the culmination of my professional career.

Being appointed Chairman was incredibly awesome, but also daunting because it's a large responsibility. Ironically, virtually from the moment I walked into the office I had to keep examining the bottom of my shoes to see what I had stepped in – almost instantly, 9/11 occurred, the stock markets all went down and there I was with the responsibility of making decisions designed to get our securities markets back up and running, during a time of great national stress. There was no honeymoon period or time to get the lay of the land. It was basically, "Good morning, we're in a crisis." And it stayed that way through the time I left. Part of that was incredibly exciting, but it also was very draining. I wouldn't have traded that opportunity for anything, and I still wouldn't. It was a privilege to serve the public as SEC Chairman.

Describe your work now with Kalorama Partners, a law and consulting firm.

When I left the Commission the second time, I wanted to become a force for positive change. That meant, as a matter of personal preference, I did not want to be the SEC's adversary. What I wanted to do was create a strategic business-consulting firm that would help companies that wanted to be better. Our principal efforts fall into a number of areas.

A major effort is governance: how companies can govern themselves to be more effective, and to fulfill the demands the public and government place on them. Another major effort is directed at helping companies, directors, and regulated entities understand regulatory obligations. We also devote a great deal of effort to assisting companies, firms, and individuals with complex compliance issues. We also help companies and individuals navigate the complexity of presenting new products, services, and ideas to decisionmakers in ways that promote the public interest and make them acceptable to the government and the public.

If companies are in the middle of an enforcement investigation, I believe that, even if they want to argue that they did nothing wrong, they should nonetheless look at the allegations from the government's perspective, and try to improve or change the way they handle the matters that are now the subject of a governmental accusation. That ensures directors and shareholders that, whatever the outcome of the existing controversy, there are reasonable assurances that similar problems are even less likely to recur. That means that we perform a fair number of internal reviews which are enormously rewarding, because we help companies do better. It's constructive, positive, complex, and intellectually difficult work. At the end of the process, we hope to leave our clients in a better position from the position in which we found them.

How do you like being a regular television commentator?

I guess I must enjoy it, since I do a fair amount of it. It's part of what I described earlier – my desire to bridge the gap between having been at the SEC and now being on the outside, looking in.

People read about SEC actions or decisions, but don't necessarily understand what was behind them. In many cases, even government can't explain all its decisions, for various reasons. I analyze why the government may have done something, or explain to the public what the consequences are of the government's action. I find it interesting and invigorating to try to take a

complex subject and talk about it in ways that non-experts can understand, and point out the benefits and disadvantages of whatever actions may be involved.

In some senses, I'm a perpetual teacher. While at the SEC and in private practice, I regularly taught law school classes and I continue to enjoy doing that. Explaining new initiatives, talking about what those initiatives might mean, and how people can comply with them are things that I very much enjoy.

How have you enjoyed being a part of the ABA's Business Law Section?

I was flattered to be asked and I'm honored to serve as an Advisor. The ABA has some great initiatives. Seeing all the constructive things that the ABA is trying to do and also having the chance to be available to young lawyers is a wonderful opportunity for me. So I have greatly enjoyed it so far and I'm looking forward to its continuation. It reminds me how important the ABA is.

One last sort of personal observation on that: one of my great claims in life is that when Dixie Johnson was starting out as a brand new lawyer, she came to Fried-Frank and unfortunately for her, she was assigned to my group. I have watched her over the years and I got the chance at the Leadership Conference a week or two ago in Arizona to watch her leadership skills. And it was very rewarding to see someone I had identified from early on as a very, very bright, creative, capable professional succeed and develop recognition that she more than deserves. So watching all of that a few weeks ago just made me feel very, very gratified to be a part of the ABA at this particular point in time.

What are your interests outside the law?

My biggest preoccupation is with movies. I'm a devotee of cinematic arts. About 15 years ago, my wife and I built a small movie theater in our home. Over the years, I have amassed a collection of 4,400 DVDs. I find movies often contain a great deal of wisdom. As SEC Chairman, I gave a large number of speeches, almost all of which contained references to movies.

Another strong interest I have is in reading. I love learning about facets of life that I will never get a chance to sample myself.

A third interest is photography. I don't view myself as having great artistic abilities, but I enjoy taking pictures.

Another is travel. My wife and I are empty nesters and we are traveling together as we did in the early years of our marriage. It's very gratifying to know that my soul mate and life mate over the past decades is even better now than she was when we got married. Traveling together is great, because I get to see things not solely through my own eyes, but through hers.

The last non-legal interest, but probably the most significant, is that we're now grandparents. It amazes me because grandparenting is the one aspect of life that is completely underrated. No matter how effusively or hyperbolically one describes grandparenting, it's better than that!

Harvey L. Pitt Remarks at the Business Law Section's Midwinter Leadership Meeting

"Insights from Legal Luminaries" Tucson, Arizona
(Jan. 18, 2014)

Introduction

A gracious good morning!

I was honored, and touched, when I was asked to be an Advisor to the Section, its impressive leadership group, and the Fed Reg Committee. These last two days have only reinforced that feeling on my part, as I participated in yesterday's group discussions, and watched this morning's efforts. It's been particularly gratifying to watch my former partner, and valued friend, Dixie Johnson, in action. She personifies the age-old wisdom that "those who lead well, also serve"! Few do so the way Dixie does, with grace, intelligence, and ease.

When asked if I would speak at this segment of the Midwinter Leadership Conference, with its daunting title – "Insights from Legal Luminaries" – I had two immediate concerns. First, I'm many things (I've also been called many other things), but I don't think of myself as a "Legal Luminary." Second, knowing many of you as I do, I worry that there's little I can offer in the way of insights that you haven't already experienced, and inculcated, long ago. Fortunately, I was able to put these concerns aside when I was told I needed to sum up whatever insights I've gleaned from my 45-year business law career in five minutes or so! That certainly put things in proper perspective!

I'll try to encapsulate my experiences with three vignettes from different phases of my career, instead of offering my top 10 list.

Background/Observations

Lefty Gomez, a fabulous NY Yankees pitcher in the '30s, is well remembered for his apt observation that he'd rather "be lucky than good"! Lefty, of course, was both lucky *and* good. In my case, I've been very, very lucky – and consequently blessed – over the course of the past 45 years.

I went directly to the SEC General Counsel's Office in September, '68, upon graduating from law school, where I met characters straight out of a Damon Runyon story – including Frank Wheat, Stan Sporkin, Manny Cohen, Irv Pollack, Alan Levenson, Phil Loomis, Dave Ferber, Donald Feuerstein, and, my professional mentor and surrogate father, Ray Garrett Jr. – and I had the time of my life. The Commission was different then. It was smaller, cozier, had an *esprit de corps* that was unmatched, and had a large contingent of lifers. The agency was very much a collegial and bipartisan regulator. Courts were responsive to SEC litigation posi-

tions, including the DC Circuit Court of Appeals where, more recently, the SEC has lost every regulatory challenge since 1996! I felt much like Ernie Banks, the great Chicago Cubs shortstop, who said of his ball-playing days: “I never worked a day in my life. I always loved what I was doing, had a passion for it.” I spent the last three years of my first professional decade at the SEC as its General Counsel, and thought I’d died and gone to heaven!

Of course, not all courts were uniformly enamored of SEC litigation positions. In the mid-’70s, the Supremes began finding fault with the SEC, capped, perhaps, by their decision in *Sloan v. SEC*, which I personally argued. Section 12 of the ’34 Act gave the Commission the power to suspend trading in a stock “for a period not to exceed ten days.” Virtually since its formation, the Commission added three little words on to that provision – “at a time”! Sam Sloan was defrocked as a broker-dealer by the Commission for violating its net capital rule because the shares of stock the SEC suspended from trading for over a year – 10 days at a time – counted as zero towards his required net capital. I told the Commission it would lose the case, and was rewarded by being told to argue the case, after the Solicitor General refused to argue it, a rare occurrence. We lost 9–0, to a *pro se* non-lawyer, leading Harold Williams, who was then Chairman to remark, at my farewell party, that I was a fabulous Supreme Court advocate, having never lost a case I argued myself before the Supreme Court, where the opposing party was represented by counsel!!

One lesson I took from that experience was that there is honor even in losing. I argued the case well, and gave my client good representation, even though my client pursued a course that I had argued against. The other lesson – a recurrent theme in my 45 years as an attorney – is that it’s not about you personally; it’s about your client. And every experience gives you something to build upon, if you conduct yourself appropriately.

When I left the SEC after 10-plus years for private practice, I had two fears – the first was that no one would call, and the second was that someone might! I suppose I was lucky that the latter fear proved valid – because private practice was complicated and challenging, but nonetheless rewarding. I represented a large number of clients who no longer exist (but not because of my representation, I hasten to add!). Perhaps one of my most interesting clients was Ivan Boesky. Ivan was wound very tightly, and was very controlling, even when facing serious criminal and civil liabilities. Ivan was more than a handful.

One Saturday morning, well into our Boesky representation, Saree and I hosted Saree’s brother, Jim, and his wife, Lorre, for the weekend. At about 6:30 a.m., the phone rang, and it was Ivan. The only other person who ever called me at that ungodly hour on business was Sam Harris, my former firm’s legendary senior partner! In any event, Ivan called me to run one of his hair-brained schemes by me, and I moved to our bathroom to take the call. Our bathroom backed upon on the room where Jim and Lorre were sleeping. After about 30 minutes of trying gentle persuasion with Ivan, I used the only tactic that worked – I raised my voice and sternly warned him: “If you want to self-destruct, do it by yourself. I won’t let you

jeopardize yourself and all those trying to help you. If you persist, you'll have to go it alone." As typical, that worked; Ivan relented, and apologized.

At about 9:00 a.m. that same morning, Saree and I had moved downstairs, prepared to eat breakfast, but our guests were nowhere to be seen. By 11:00 a.m., I was becoming a bit miffed by their tardiness, so Saree went upstairs to see what was going on. She entered the guest bedroom and saw Jim and Lorre huddled together, looking very worried. Lorre timidly asked Saree if she and I were getting divorced. Saree said "No, why would you even think that?," to which Lorre replied, "Because we heard Harvey screaming at you, and telling you the two of you would part ways."

Two important lessons I learned from this event were, first, that sometimes, you have to be forceful with your clients, even if it means parting ways with them and losing fees and, second, being forceful with clients is fine, but not with family around!

When I returned to the SEC as its Chairman in 2001, I had the only job I ever lusted after. I hoped to serve longer, but voluntarily left a bit shy of two years later. It was a great time, and we accomplished some important things, including my baptism by fire – getting our markets back up and running after the 9/11 terrorist attack – and getting dozens of Sarbanes-Oxley rules done, unanimously and all on time! But, more was left undone that I had planned to accomplish. People frequently ask me if I regret having gone back to the Commission, and my answer is unequivocally "No!" I have no regrets, because I buy into Teddy Roosevelt's wisdom that

It's not the critic who counts; nor the man who points out how a strong man or woman stumbles, or where the doer of deeds could have done them better. Credit belongs to those who are actually in the arena, whose faces are marred by dust and sweat and blood; who strive valiantly; who err, who come up short, because there's no effort without error and shortcoming; but who spends himself or herself in a worthy cause; and who at the worst, if he or she fails, at least fails while daring greatly, so that his or her place shall never be with those timid souls who neither know victory nor defeat.

Serving as SEC Chairman gave me a new perspective on advising clients. It's easier to give sound pragmatic advice if you know what those who control the outcome are thinking. My tenure as head of the SEC also taught me the wisdom of Nietzsche's observation that, "if it doesn't kill you, it will make you stronger." I feel far stronger for having served a wonderful Agency at a difficult time.

Conclusion

In closing, let me note that each of you, in this room, has enjoyed fabulous experiences in your professional careers and in getting to your ABA leadership positions. This is a great Section that will become even better, because of your efforts. I'm extremely grateful for this opportunity to watch your efforts up close.

Thank you.

BUSINESS LAW TODAY

Inside Business Law:

Highlights of Committee Work Product

January and early February saw four great stand-alone committee meetings by the Consumer Financial Services Committee, the Cyberspace Law Committee, the Derivatives & Futures Law Committee, and the Mergers and Acquisition Committee.

The Consumer Financial Services Committee 2014 Winter Meeting

The [Consumer Financial Services](#) Committee, chaired by Nicole F. Munro, held its 2014 Winter Meeting in Park City, Utah, from January 11 through 14, 2014. In addition to numerous working subcommittee meetings, the committee presented CLE programs on a wide variety of topics related to consumer finance. The materials from those programs, including audio recordings of several of the panels, are available through the Section's [program materials](#) website. A few highlights are the following:

New Technologies and Old (and New) Legal Issues

Veronica McGregor chaired and Eric Johnson and Mark Furletti vice-chaired "[New Technologies and Old \(and New\) Legal Issues](#)" (audio), a panel of Mark Furletti, Veronica McGregor, Malini Mithal, Tara Sugiyama Potashnik, and Mercedes Tunstall discussing the legal issues associated with new technologies involving the delivery of consumer financial services including (1) connected devices and the "Internet of Things," (2) mobile cramming and WAP

billing, and (3) the use of prepaid cards in card-not-present transactions over mobile phones.

Tribal Sovereign Immunity and Consumer Protection: Who Can Regulate a Tribe That Provides Financial Services to Consumers?

David Beam chaired and Lauren Campisi and David Scheffel vice-chaired a panel discussion titled "[Tribal Sovereign Immunity and Consumer Protection: Who Can Regulate a Tribe that Provides Financial Services to Consumers?](#)" (audio), among Richard P. Eckman, Jennifer H. Weddle, Christopher Peterson, and Malini Mithal. The panel discussed whether and to what extent online lending activities of tribes are subject to federal and state consumer financial protection laws and the jurisdiction of federal and state regulators over tribal lenders. The panel outlined disputes that have arisen between tribes and federal and state regulators over tribal lenders, analyzed the positions being advanced by both sides in litigation, addressed likely outcomes of those cases, and discussed the implications for tribes and consumers.

The Rise of Claims Under the False Claims Act and FIRREA against Mortgage Lenders and Servicers – A Look at the Law and the Litigation

Sandy Shatz chaired and David Permut and Melissa Klimkiewicz vice-chaired "[The](#)

[Rise of Claims Arising Under the False Claims Act and FIRREA against Mortgage Lenders and Servicers – A Look at the Law and the Litigation](#)" (audio), a panel moderated by Melissa Klimkiewicz, with speakers William J. Harrington and Andrew W. Schilling. In the wake of the last banking crisis, enforcement authorities turned to the False Claims Act and FIRREA as ways to recover from the originators of loans leading up to the crisis. The panelists, who were on the front lines of developments in this area, discussed the lessons learned from these cases and commented on existing and potential future enforcement actions.

The Cyberspace Law Institute and Winter Working Meeting

The [Cyberspace Law](#) Committee, chaired by Jonathan Tiger Rubens, held its Cyberspace Law Institute and Winter Working Meeting in Denver, Colorado, from January 31 through February 1, 2014. The Cyberspace Law Institute presented numerous panels and round tables addressing legal, business, and consumer issues affected by emerging technologies. [Program materials](#) from the institute are available through the committee's website. Some of the highlights of the presentations at the Institute are as follows:

Brainspray and the Law

Theodore F. Claypoole presented "[Brainspray and the Law](#)," a discussion of the scientific, technical, and legal issues raised

by the harvesting of brainspray, externally readable brain signals, for medical or commercial purposes, and the ways in which lawyers can work to shape the development of the right laws concerning this new scientific development.

[Bitcoins: Where They Came From and Where They Are Headed](#)

Andrew Shipe presented "[Bitcoins: Where They Came From and Where They Are Headed](#)," a discussion of the evolution of bitcoin, from an algorithm generated by a group of anonymous computer geeks to a digital currency that has captured international attention, and the future of bitcoin, including the SEC filing for a bitcoin trust issuing ETFs backed by bitcoin and the developing alternative digital currencies, such as Peer Coin and Litecoin.

[Snooping, Spying, and Cyber Espionage: Civil Liberties vs. Theft of Trade Secrets](#)

Konrad L. Trope and Jim Spertus presented "[Snooping, Spying, and Cyber Espionage: Civil Liberties vs. Theft of Trade Secrets](#)." They discussed the threats posed to data networks by the standards imposed by various governments upon telecommunications systems in order to assist law enforcement – specifically the history of wiretapping by governments around the world, the current technology protocols imposed by world governments for facilitating government eavesdropping, and how those protocols might be the very reason that rogue regimes so often bombard the Internet security walls of private industry.

[The Derivatives & Futures Law Committee Winter Meeting](#)

The [Derivatives and Futures Law](#) Committee, chaired by Susan C. Ervin, held its 2014 Winter Meeting in Naples, Florida, from February 6 through 8, 2014. In addition to several receptions, dinners, and luncheons, the meeting featured 10 interesting CLE panels. A few of the highlights of the meeting were:

[Algorithmic and High Frequency Trading](#)

"[Algorithmic and High Frequency Trading](#)," a panel chaired by Gary DeWaal, with

panelists Vince McGonagle, Stephen J. Obie, Stephen L. Ratner, Patricia L. Levy, Paul M. Architzel, Allison Lurton, and Jim Moran, examined issues concerning algorithmic and high frequency trading (HFT) in derivatives markets. Among other things, the panel touched upon the concerns presented by algorithmic and HFT, the industry's current efforts to address those concerns, the adequacy of those efforts, and additional standards and regulations that should be adopted.

[EMIR & MiFID 101](#)

Andrea Corcoran chaired a panel consisting of Ronald Filler, Richard Tredgett, Nadia Swann, and Christopher K. Bowen titled "[EMIR & MiFID 101](#)." The panel presented a primer on EMIR and MiFID (e.g., mandatory clearing, including front-loading; CCP authorization; reporting, documentation, segregation, margin, securitizations) and discussed headaches faced by practitioners dealing with EMIR and MiFID.

[Cross-Border \(U.S. Developments and Potential Conflicts with Foreign Law\)](#)

Jacqueline Mesa chaired "[Cross-Border \(U.S. Developments and Potential Conflicts with Foreign Law\)](#)," a panel consisting of Annette L. Nazareth, Christopher Bates, Michael J. Otten, Jack I. Habert, and Chris Allen. The panel discussed recent developments regarding the application of the Dodd-Frank Act requirements and CFTC's regulations to cross-border activities, including the implications of the CFTC's recent substituted compliance determinations and the effects of the commission and staff guidance on various cross border situations.

[The Mergers and Acquisitions Committee 2014 Stand Alone Meeting](#)

The [Mergers and Acquisitions](#) Committee, chaired by Mark A. Morton, held its 2014 Stand-Alone Meeting in Laguna Beach, California, from January 31 through February 1, 2014. It was a working meeting, focused on numerous subcommittee and task force meetings. Along with the numerous

subcommittee meetings, the Mergers and Acquisitions Committee's Joint Task Force on Governance Issues in Business Combinations, Joint Task Force on Financial Advisors, Task Force on Two-Step Auctions, and Task Force on Financial Advisors all had productive meetings. The stand-alone meeting also provided a great opportunity for committee members to meet to further the committee's ongoing development of the Revised Model Asset Purchase Agreement.

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