FEDERAL APPEALS CASE COULD CHANGE THE LANDSCAPE OF INSURANCE REGULATION

Written By Karrie Hyatt

W The IRS is challenging the Delaware Department of Insurance (DDOI) in federal court over a section of its state insurance law that protects confidential information from captives. The final decision in the case of the *United States v. the Delaware Department of Insurance* could have a widespread effect on insurance regulators across the country.

THE IRS SUMMONS

As part of it's campaign to find tax fraud in captive insurance companies using the 831(b) tax exemption, in the early 2010s the IRS began an investigation into Artex Risk Solutions, Inc. and Tribeca Strategic Advisors, LLC, a subsidiary of Artex, for promoting abusive tax shelters. The Service issued two summons for information to the companies and when those were not complied with, the IRS took Artex to court. The summons enforcement action was successful (*United States v. Artex Risk Sols.,*

Inc.) and Artex produced the documents required in 2014.

Based on the information received from Artex, the IRS requested information from the Delaware Department of Insurance (DDOI) in 2017 as part of its ongoing investigation. The information requested involved 225 captive insurance companies domiciled in Delaware and managed by Artex. The IRS's summons stated that it wanted, "all electronic mail between [DDOI] and Artex and/or Tribeca related to the captive insurance program."

In November 2017 and April 2018, the DDOI complied to the request with information that it could freely give, information that was not client specific. According to Section 6920 of Delaware's insurance law, the commissioner cannot release an insurance company's propriety information without consent of the company or without the written assurance that the authority requesting the information will keep the information confidential.

The IRS refused to keep the information they requested confidential, and since the DDOI didn't want to break state law by providing client-specific information, the Service referred the matter to the Department of Justice for enforcement. In June 2020, the DDOI provided documents for sixteen of their captive insurance companies after getting their approval. Later on, three additional insurance companies also consented to have their information released. That same month, the IRS sued the DDOI for not fully complying with their information summons.

"I think the [DDOI] did the right thing to follow Delaware law, but the IRS believes it can trump state law,"
said Kevin M. Doherty, member with Dickinson Wright PLLC.

According to Joanne Shaver, senior vice president with The Intuitive Companies and current president of the Delaware Captive Insurance Association, "The regulators at the DDOI protect the public interest and promote the solvency of insurance companies. In order to accomplish these goals, the regulators require certain confidential and proprietary information of insurers. To encourage full and complete disclosure of information in the license and application process, these confidentiality laws ensure that certain items will be held and remain confidential when in the possession of a state regulator."

"Confidentiality laws, such as Delaware's Section 6920, are an important part of regulating the business of insurance, which is a power specifically given to states by Congress under the McCarran-Ferguson Act," said Ryan Work, SIIA's senior vice president of Government Relations.

The IRS has been adamant about getting information from the DDOI, information that it ostensibly has already received from Artex. Looking at it from a single case perspective, Michael W. Teichman, director at Parkowski, Guerke & Swayze, P.A., said, "My assumption is that the IRS wants to make sure it has received complete responses from Artex/Tribeca, and there may be additional responsive documents that the department has that might be relevant to the IRS's case. Until they get the document production they really will not know."

Doherty, looking at it from an industry-wide perspective finds several reasons that the IRS is pursuing this information, "Number one, the IRS is trying to establish the precedent that they can obtain this type of information from the regulators whenever it chooses. Second, the IRS doesn't necessarily trust that the information is exactly the same as what it already has. They are looking for discrepancies. Third, the IRS generally wants to discourage the formation of captives, and this level of scrutiny would stifle the willingness of many captive owners to form captives when their confidential information regarding formation and regulation (including much that is non-financial in nature and that normally would not be disclosed pursuant to tax filings) could be released to the IRS."

THE CASE AND THE DECISION

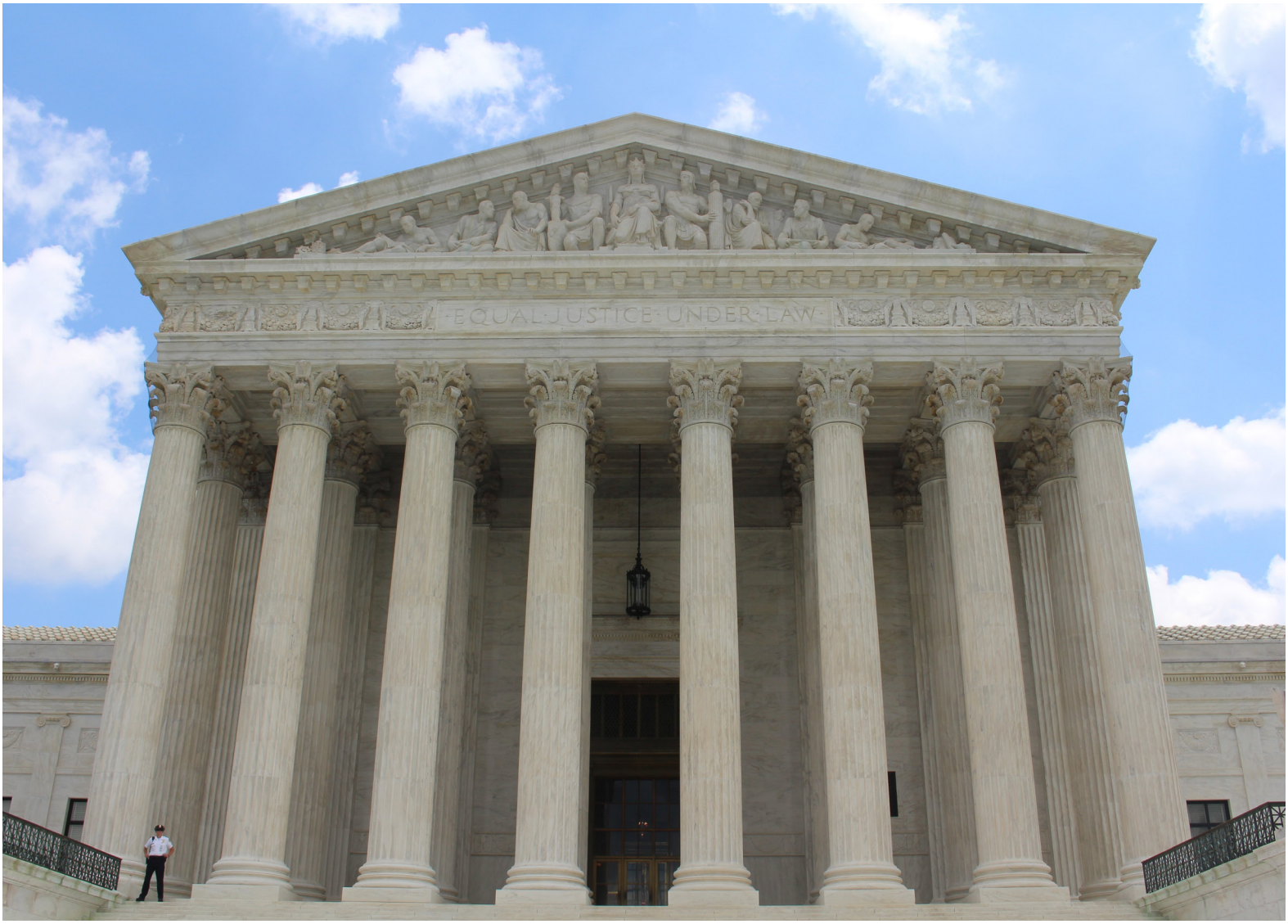
The IRS's suit against the DDOI, *United States v. the Delaware Department of Insurance*, was heard in the New Jersey United States District Court. The IRS relied on The Powell Standard to legitimize their summons to the DDOI. The Powell Standard is based on a 1964 case, *United States v. Powell*, in which the IRS believed the taxpayer to be committing fraud. The taxpayer refused the IRS summons as the Service could not show reasonable grounds or probable cause for the fraud investigation.

The Powell Standard has four factors that must all be met: the IRS investigation must be conducted with a legitimate purpose, the summons must be relevant to the investigation, the information requested is not already in the hands of the IRS, and proper administrative steps have been followed. The IRS contended that it met all four factors.

The DDOI's argument relied heavily on the McCarron-Ferguson Act (MFA), a federal law passed by Congress in 1944, that leaves the business of insurance regulation to each state. As all the captive insurance companies under inquiry by the IRS were licensed and regulated as insurance companies in the state, McCarron-Ferguson should supersede the IRS's federal request for information and the DDOI must adhere to state law regarding the regulation of insurance. The DDOI also argued that the third factor in the Powell Standard was not met, as the IRS already had from Artex the requested documents.

According to Work,

"With McCarran-Ferguson, Congress did not intend for the IRS to be able to subpoena a state insurance department for confidential information pertaining to insurance entities that is collected and maintained only for the purpose of regulating the business of insurance."



The District Court's decision was handed down in July 2021 in favor of the IRS. In the opinion of the Court, Delaware statute 6920 does not relate to the business of insurance. The Court based its decision on a Supreme Court precedent that uses three criteria to determine if a company is participating in the "business of insurance." The three criteria are: if risk is being transferred or spread among policyholders; if the relationship between insurer and insured is primarily about insurance; and if the business is limited to entities within the insurance industry.

The Court found that only one of the criteria favored the DDOI position, the last one. The opinion held that

"It is not about the relationship between the insurer and the insured; it is about the relationship between the insurer and its regulator, or the relationship between the regulator and other insurance regulators or investigatory agencies."

According to Judge Burke's decision, regulating insurance companies does not constitute the "business of insurance."

The DDOI objected to this opinion, but it was upheld in September 2021 after further review.

The DDOI has appealed the District Court's decision. In March of this year, a coalition of nine state captive insurance associations, led by the Delaware Captive Insurance Association, and SIIA joined together to submit an ***Amicus Curiae*** brief on behalf of the DDOI.

Work with Anthem Stop Loss and you'll be in good company

As one of the top 5 Stop Loss carriers* in the nation, Anthem Stop Loss has the size, strength and reputation to deliver solid protection — with NO surprises. So you can budget with confidence and protect your cash flow.

For Stop Loss that's safe, secure and surprisingly nimble, visit **anthemstoploss.com**.

Anthem®
STOP LOSS

*MyHealthGuide. (2019, March). Stop-loss Premium Ranking. *MyHealthGuide Newsletter.* Retrieved from myhealthguide.com.

114827MUBENASL 12/18

The brief delves into the District Court's decision that the information withheld by the DDOI is the "business of insurance" and falls squarely under the MFA. According to the brief, "Because Section 6920 is aimed at receiving, maintaining, and restricting the dissemination of application and licensing information of captive insurers, it is part-and-parcel of the licensing process for Delaware captive insurers, and, accordingly, was enacted for the purpose of regulating the business of insurance. Indeed, a state's regulation of 'the licensing of [insurance] companies' has long been considered to be the 'regulation of the business of insurance.'"

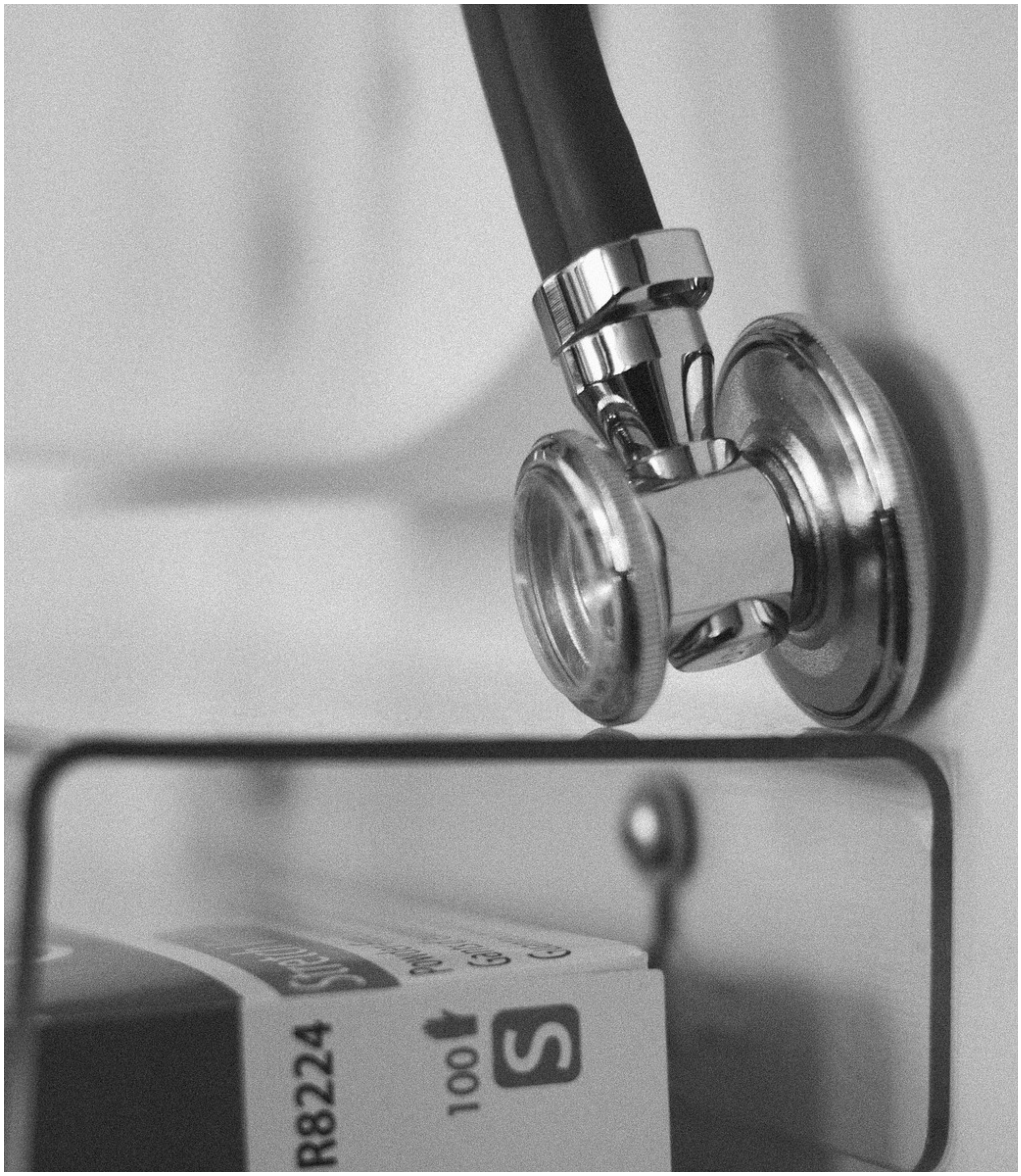
The appellee brief on behalf of the IRS was filed by the Department of Justice in early April. Delaware's reply brief was filed at the end of April. The case will likely be heard this fall with a decision coming in 2023.

WIDER AFFECT OF THE COURT RULING

If the IRS gets its execution of summons, which means overriding Section 6920 of the Delaware insurance code, it could have far reaching affects for insurance regulation nationwide. Delaware is not alone in its confidentiality clause. According to Shaver, "Delaware's confidentiality statute applies to all aspects of insurance regulation and to all insurance companies, not just captives. Although I am not an attorney, my understanding is a ruling in favor of the United States of America could put Delaware's entire confidentiality statute, and those of other U.S. domiciles, at risk."

"If the court requires the State of Delaware to turn over this type of information to the IRS, then it would represent a significant deterioration of the state's right to regulate insurance as set forth in the McCarran Ferguson Act," said Doherty. "As a separation-of-powers matter, it is not appropriate for the executive branch to override the express will of Congress regarding McCarran Ferguson. To do so properly would require a change in the law, which only Congress can initiate."

The *Amicus* brief emphasized the point that if the IRS is allowed this information from the DDOI without assuring confidentiality, that they would be operating outside the MFA and jeopardizing similar laws in other states. The brief maintains, "Putting Congress' intent aside, the District Court's decision negatively effects the insurance industry on a nationwide scale, and public policy factors weigh in favor of protecting the confidential information subject to provisions such as Section 6920. State regulators, such as the Delaware Department of Insurance, protect the public interest and promote the solvency of insurance companies. In order to accomplish these goals, state regulators require certain confidential and proprietary information of insurers."



According to Teichman, "If the IRS prevails, it would create precedent allowing any federal agency with subpoena power to obtain records (including, for example, examination workpapers), whether pertaining to captives or traditional insurers, without regard for the confidentiality provisions in the state insurance code."

"It is the hope of the captive industry, and the larger insurance industry, that the Appeals Court will overturn the District Court's decision," said Work. "That decision is contrary to the intent of Congress and undermines not only Delaware's authority to regulate the business of insurance, but also insurance regulations across the country."

Doherty said,

"By focusing on Artex/Tribeca, the IRS is specifically referring to smaller captives. However, the legal standards are the same, whether it relates to an 831(b) captive or a larger one pursuant to 831(a). The precedent that this case will establish will be equally applicable to large and small captives, which makes this case very important to the captive insurance industry overall."

ABOUT KARRIE HYATT

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: www.karriehyatt.com. ■