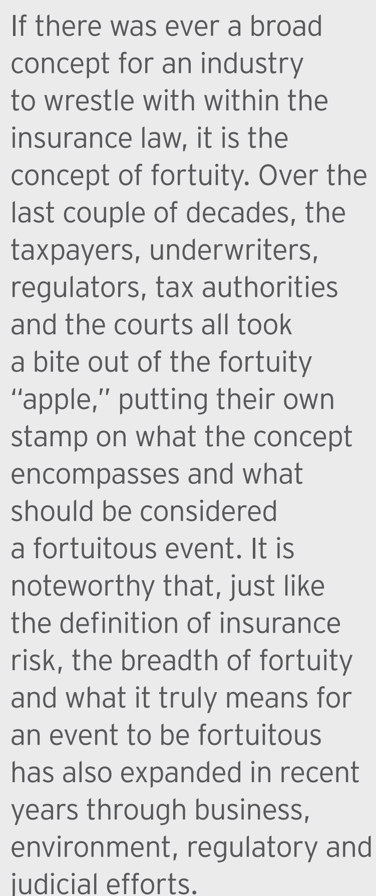
Fortuity

The concept of “unknown”



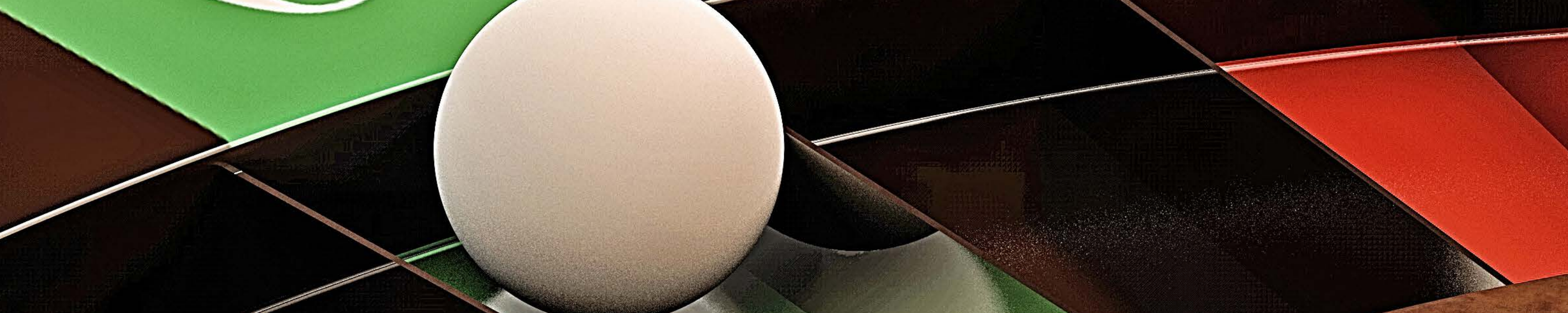
If there was ever a broad concept for an industry to wrestle with within the insurance law, it is the concept of fortuity. Over the last couple of decades, the taxpayers, underwriters, regulators, tax authorities and the courts all took a bite out of the fortuity "apple," putting their own stamp on what the concept encompasses and what should be considered a fortuitous event. It is noteworthy that, just like the definition of insurance risk, the breadth of fortuity and what it truly means for an event to be fortuitous has also expanded in recent years through business, environment, regulatory and judicial efforts.

So what is this mystical concept that so many insurance market participants are wrestling with? In most basic terms, "fortuity" carries the meaning of occurring by chance, being lucky or fortunate. In the practical sense, being lucky or fortunate is more likely to be associated with an unexpected gain or advantage, such as a profit windfall from an event or circumstance. Within insurance, fortuity takes on a slightly different meaning — the insured event is either uncertain to occur or, in case of life insurance, certain to occur but at an uncertain time. One may think that an arrangement that involves "risk," by definition, should have fortuity, as risk involves having an uncertainty about the future outcome and a potential for such outcome to be unfavorable (i.e., causing an insurable event to occur). As we will explore below, this area does not have a clear demarcation line.

Risk unknown?

When talking about fortuity, perhaps the most notable initial piece of guidance that the insurance industry has is Rev. Rul. 89-96, commonly referred to as the MGM Grand ruling (issue at hand — obtaining insurance for an event that has already occurred and whether such an arrangement constitutes insurance risk). In its analysis, the Internal Revenue Service (the Service) did not focus on the narrative defining the coverage within the contract, but rather zeroed in on the economics of the arrangement. In this particular instance, the contract was drafted in such a manner that the only true risk appeared to be investment risk, and the Service concluded that the assumption of an investment risk, by itself, cannot serve as the sole basis of an insurance contract for federal income tax purposes.

It is important to point out that the Service did not argue the fact that the covered risk under this MGM insurance arrangement was not appropriate as a subject matter of an insurance contract. The Service focused on the notion that there can be a difference between the covered risk that is the subject matter of an insurance contract — in this case, claims resulting from a catastrophe — and the type of risk assumed by the insurance company. Focusing on the economics, the Service effectively concluded that the insurance company did not assume the covered risk, or better stated, the only risk that was transferred to the insurance company was an investment risk, as the contract lacked underwriting risk. One may ask — why would not, at least part of this contract, be an underwriting risk? After all, we all know that there are policies out there that insure past events. The answer is — lack of fortuity! In the case of MGM's policy, the coverage provided by the insurance company covered a catastrophe that occurred before the contract was entered into and the policyholder had already incurred the liabilities, which were projected to be in excess of the policy limits. Under the contract, the insurance company established reserves in the amount equal to the maximum exposure (maximum amount that could be paid under the issued policy), based on the known facts and estimates at the time of the contract's execution. Based on the Service's calculations, taking into account the total of the premiums paid under the contract, plus the tax savings to the insurance company on its related loss reserve deduction, plus the investment earnings on the premiums paid, it appeared that the only true variable was the investment yield the company may earn, as the ratio of expected to actual losses automatically defaulted to 1, as all the exposures were known prior to execution of the contract.



The fortuity of it all…

Taking the lesson from the MGM ruling, the industry started looking harder into some of the arrangements that were being structured. In fact, the market started considering what other "knowns" within an insurance arrangement may put an insurance contract in the Service's crosshairs due to the awakening of their new friend — fortuity.

One of the concerns became policies that covered an event(s) that everyone knew would occur; however, no one knew when and/or the magnitude of the exposure. In the post-MGM ruling era, the question remained — does this policy fall within what the Service would see as a fortuitous event? The industry got its refresher of the Service's line of thinking on the issue in Rev. Rul. 2007-47. The ruling involved an event with a virtual certainty of occurrence, but no certainty on the timing or the exposure. Taking into consideration the apparent fortuity of the event, at least from the timing and exposure perspectives, most would consider this policy to have a valid underwriting risk and the insurance policy to qualify as insurance for federal income tax purposes, ceteris paribus. The Service disagreed.

Noting in its ruling that part of the conclusion relies on Rev. Rul. 89-96, the Service did not attempt to reconcile how it achieved a similar result in both cases, given the fundamental factual differences. In Rev. Rul. 2007-47, the ultimate payment/exposure was dependent on a number of contingencies, making it impossible to know the potential exposure beyond reasonable estimate, an estimate that utilized sound insurance and actuarial principles. It therefore becomes rather clear that the policy limit in this case is not simply set at the level of calculated ultimate exposure, as it was in MGM, but rather based on a projected exposure, with a potential for payments being well above such projection.

Despite not being able to reconcile the latest ruling to its predecessor, the Service, in the analysis section of the ruling, stated that the arrangement was merely a pre-funding of the policyholder's future obligations, and that the overall risk assumed by the insurance company was whether the estimated present value of the cost of performing the remediation procedures, which was the premium amount paid by the policyholder, would accrue to the greater of the amount of claims under the insurance contract or the policy limit. It then stated that this risk is similar to the timing and investment risks that Rev. Rul. 89-96 already concluded not to be insurance risks.

Considering the views posed by the Service in Rev. Ruls. 89-96 and 2007-47, one begins to wonder what, if any, deviation can an insurance policy have from a traditional, run of the mill homeowners'-type policy in order for the Service to consider it a qualifying policy for tax purposes? Although both rulings were drastically different, the Service found one niche item, indicating a much broader (and someone confusing) connection in order to equate the situations and render both arrangements not qualified insurance for tax purposes.

Not until the Tax Court's (the Court) decision in the *RVI Guaranty Co. Ltd. v. Commissioner 145 T.C. 9* case (*RVI*) (a case where the Court's broad and pragmatic views helped the insurance market far beyond addressing fortuity), did the industry get additional insight into fortuity and the Court's reluctance to accept the Service's narrow views on it. In a striking contrast to the Service's overall view on fortuity and its decisions in Rev. Ruls. 89-96 and 2017-47, the Court concluded in *RVI* that an insurance contract can involve speculative risk and an investment element. Citing a specific situation in *RVI*, the Court noted that the fact that the lease contracts matured on different dates and covered a multitude of independent risks, albeit similar in nature, did not preclude the contract from being treated as insurance. That singular discussion is a key counterpoint to Rev. Rul. 2007-47 (the impact of the *RVI* decision on Rev. Rul. 89-96 is not as profound, although it does bring into question some of the Service's reasoning).

In *RVI*, the Court noted that the concept of fortuity should be viewed broadly, noting that the Respondent's (i.e., the Service's) insistence that "…the [f]ortuity is essential for…risk pooling and the law of large numbers to qualify an arrangement" betrays the narrow and esoteric sense in which (the Service) employs the term fortuity. The Court recognized the broad lens one should look through in seeking to identify the presence of fortuity in an arrangement, especially when an arrangement, outside of consideration of fortuity, appears to possess and utilize sound insurance and actuarial practices in estimation, shifting and distribution of underlying risk of a policy under review.

Conclusion

Although no one expects the Service or other authorities to forget the concept, it is reasonable to say that with the changing insurance market environment, innovative products, and the Court's broader view on what may constitute fortuity, the market participants will see a more reserved approach from the Service in its challenge of fortuity. The ambiguity of the concept is not going away; however, all parties need to look beyond the mere appearance of a policy and dive into individual details to ascertain whether a policy lacks notions of insurance and aims to mitigate an exposure that should not be considered a valid insurance (i.e., pure investment risk). As always, a sound feasibility study, coupled with professional actuarial and tax opinions, will help the insureds and captives secure peace of mind with respect to broadening advanced pools of risk that are being currently discussed and/or insured in the market.

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