

Publications

Funding Employee Benefits Through Captives: ERISA Issues

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Introduction

There has been increased interest in funding employee benefits through captive insurers in the past few years. A major impediment, however, has been the federal law regulating employee benefits, the Employee Retirement Income Security Act of 1974 (ERISA), and the restrictive interpretation of its provisions in the case of captive insurers by the Department of Labor (the “Department”). The purpose of this paper is to summarize our understanding of the current position of the Department, as reflected in its reaction to various requests for exemptions from ERISA, and to discuss how that law applies in certain common situations.

A. The ERISA Problem

The ERISA issues involve the “prohibited transaction” provisions of ERISA, which are found at Section 406 of the Act, 29 U.S.C. § 1106. In general, Congress thought that certain transactions were so fraught with abuse that they should be prohibited, regardless of the particulars. To accomplish that, Congress created a category of “plan insiders” such as the employer sponsor or trustees, called them “parties in interest,” and prohibited transactions between a plan and a “party in interest.”

In the captive area, the prohibited transaction analysis is as follows. Employer-sponsors of plans are parties in interest pursuant to ERISA § 3(14)(C), 29 U.S.C. § 1002(C). Entities that they own more than 50 percent of, or are entitled to more than 50 percent of the profits from, are also parties in interest pursuant to ERISA § 3(14)(G), 29 U.S.C. § 1002(14)(G). Thus, as discussed below, captives owned by employer-sponsors, or cells within a rent-a-captive where the employer is entitled to more than 50 percent of the profits, would also be considered parties in interest.

ERISA § 406(a)(1)(D), 29 U.S.C. § 1106(a)(1)(D), prohibits the “transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan.” Therefore, the issue has been whether the payment of premiums to a captive insurer which is a party in

interest constitutes a prohibited transaction. If it does, the potential penalties are so severe that most employers are unwilling to take any risk in this area.¹ In addition to the Section 406(a) prohibited transaction issue, there is concern that ERISA § 406(b), 29 U.S.C. § 1106(b), might also be applicable. The three subsections of § 406 essentially prohibit self-dealing transactions.²

The argument is that, where the employer is also the fiduciary of its own plan, and arranges for that plan to enter into an arrangement that ultimately benefits the employer through its ownership interest in the captive, then that constitutes self-dealing within the meaning of § 406(b).

B. The Prohibited Transaction Arguments

Section 406(a) contains three elements which all must be present in order to have a prohibited transaction. Specifically, there must be a transaction by a fiduciary; the transaction must involve assets of the plan; and the recipient of those assets must be a party in interest. Section 406(b) requires the presence of a fiduciary and assets of the plan, but not necessarily a party in interest.

1. Fiduciary

We do not believe that there would be any dispute that there would be a “fiduciary” for each of the plans that would be involved in any captive arrangement. While many welfare plans, especially insured plans, lack formal documents defining everyone’s roles with respect to the plan, the ERISA definition does not require any kind of formal identification. On the contrary, ERISA defines “fiduciary” to include any person who has “discretionary authority or discretionary control respecting management” of a plan. ERISA § 3(21), 29 U.S.C. § 1002(21). By definition, the person with authority to cause the plan to enter into any insurance arrangement would probably be considered a fiduciary.

2. Assets of the Plan

The issue of what constitutes “plan assets” has always been a difficult issue under ERISA. Certain concepts are quite clear: the money that is used to pay premiums was, at one point, “assets of the plan,” while the policy that is purchased with those assets is itself a plan asset. But it is unclear whether the transaction between a direct insurer and any reinsurer would involve “assets of the plan.” ERISA specifically provides that, where an insurer issues a guaranteed benefit policy to a plan, such as a group term life policy, the assets of the plan include the policy, but not any assets of the insurer. ERISA § 401(b)(2), 29 U.S.C. § 1101(b)(2). In other words, the premium ceases to be plan assets once it has been received by the insurer. Therefore, when the insurer transfers assets to the reinsurer, it is transferring its own assets and not “plan assets.”

The Department has a different view in the case of reinsurance with captives. In 1979, the Department promulgated an exemption to deal with transactions between a plan and an insurer that is an affiliate of the employer sponsor of the plan. The exemption deals only with the situation where the affiliated insurer is the direct insurer of the plan. However, in its preamble to that exemption, the Department discussed whether it should extend the exemption to situations where the affiliated insurer acts as a reinsurer. The Department declined to do so for a number of reasons, but its discussion of the prohibited transaction issue is instructive. First, the Department noted the general rule that

if a plan purchases an insurance contract or policy which funds benefits through the insurer’s general account, the assets in such general account are not considered to be plan assets. Therefore, a subsequent transaction involving the general asset account between a party in interest and the insurance company will not, solely because the plan has been issued such a contract or policy of insurance, be a prohibited transaction.

44 Fed. Reg. 46365, 46368 (August 7, 1979). But the Department went on to say that it would take a different position where there is a prior understanding that the premiums will be ceded to a party in interest reinsurer:

[I]t is the Department’s view that if a plan purchases an insurance contract from a company that is unrelated to the employer pursuant to an agreement, arrangement or understanding, written or oral, under which it is expected that the unrelated company will subsequently reinsure all or part of the risk related to such insurance with an insurance company which is a party in interest of the plan, the purchase of the insurance contract would be a prohibited transaction.

Id. Accordingly, it is advisable to assume that the Department believes that any premiums which end up in a captive continue to be “plan assets,” and are thus subject to the ERISA prohibited transaction rules.

3. Party in Interest

The third element that needs to be present in order to have a prohibited transaction under Section 406(a) is a “party in interest” that receives the plan assets. As noted, the employer that sponsors a plan is defined as a “party in interest,” as well as entities controlling, or controlled by, the employer. In the definition of “party in interest,” “controlling” means the ownership of more than fifty percent of

the stock, or in the case of a non-corporation, the profit interest of an entity. Thus, where an employer owns a captive insurer, the latter is a “party in interest” because of that affiliation. One unanswered question is the status of “cells” within a group captive or rent-a-captive. In our view, it is probable that the Department would take the position that each cell is a de facto company which is essentially owned by the employer. In other words, to the extent premiums are placed within a cell that returns 100 percent of underwriting and investment gains to the employer that pays the premium, then we think the Department would look at the cell as the party in interest, rather than focus on the ownership interests in the facility as a whole.

C. The Prohibited Transaction Exemptions

There are two types of exemptions from the prohibited transaction provisions. See ERISA Section 408(a), 29 U.S.C. § 1108(a). The first is a “class exemption,” which is intended to cover broad classes of transactions. If you fit within the conditions of the class exemption, then you can rely on the exemption without seeking Department approval. The second kind of exemption is an “individual exemption,” which is applicable only to your particular situation. The Department reviews each transaction that is sought to be exempted from the prohibited transaction provisions and then either grants or denies an exemption for it. As set forth below, there are now two different procedures for “individual exemptions” — the “regular” procedure and an “expedited procedure” (known as “ExPro”).

1. The Class Exemption for Direct Insurance

On August 7, 1979, the Department published Prohibited Transaction Exemption 79-41 (“PTE 79-41”), 44 Fed. Reg. 46365. The exemption allows an employer to place its employee benefit plan risks with an affiliated insurer on a direct basis as long as certain conditions are met. These conditions include, among others, the following:

- the insurer is “licensed to sell insurance in at least one of the United States;”³
- the insurer has obtained a Certificate of Compliance from the insurance commissioner of its domiciliary state within the past eighteen months prior to the date of the transaction;
- the insurer has undergone a financial examination by the insurance commissioner within the past five years, or by an independent certified accountant for its last completed fiscal year;
- the plan pays no commissions in connection with the placement of insurance;
- the plan pays no more than “adequate consideration” (that is, a market rate) for the coverage; and
- no more than fifty percent of the insurer’s business is “related” to the employer sponsor of the plan.

This last condition, generally known as the “fifty percent test,” has created the most problems under the exemption. According to the literal wording of the exemption, the test is applied by taking the premiums applicable to the employer-sponsored benefit plan related business and dividing it by total premiums; if the resultant percentage is below fifty percent, then the condition has been satisfied. In other words, premium that is still related to the employer’s own risks counts as part of the denominator as long as it is not benefit plan risk. The result is that, where an employer places little benefit plan risk in a captive, at least in relation to its other risks such as workers compensation or general property coverage, then the fifty percent test as it is written is fairly easy to satisfy.

Beginning several years ago, however, the Department changed its interpretation of the fifty percent test. Now all of the employer’s own risks are part of the numerator along with the benefit plan risks sought to be exempted. The result is that the exemption is not very useful for a true captive because the fifty percent test now requires, in essence, that more than half of the risks insured in a captive be unrelated to the employer that owns it.

2. The Individual Exemptions for Reinsurance Transactions

a. Background

Since reinsurance transactions are not covered by PTE 79-41, one needs an individual exemption. The major difference between a class exemption and an individual exemption lies in the review process. As noted, if your transaction fits within a class exemption, there is no need for Department review at all. If one is compelled to seek an individual exemption, then the review process can be lengthy and difficult.

Section 408(a) provides that the Department may grant an individual exemption if it finds that the exemption is (1) administratively feasible; (2) in the interests of the plan and its participants and beneficiaries; and (3) protective of the rights of the participants and

beneficiaries. In the ordinary case, that process takes time — anywhere from four to nine months, depending on the complexity or novelty of the exemption request. Assuming the Department then decides to grant the exemption, it publishes a proposal to that effect in the Federal Register and allows for a comment period from anywhere between thirty and sixty days. The exemption then becomes final. All documents are open to the public. See generally, 29 C.F.R. §§ 2570.30 through 2570.52.

In 1996, the Department promulgated Prohibited Transaction Exemption 96-62, which allows for “expedited processing” of certain exemption requests. See 61 Fed. Reg. 39988 (July 31, 1996) (referred to herein as “ExPro”). Under this procedure, an applicant merely informs the Department of its intent to enter into a transaction that is “substantially similar” to transactions that have been the subject of at least two prior individual exemptions granted within the previous five years. Upon submission to the Department, the applicant receives “tentative authorization.” That also starts a 45-day period in which the Department may withdraw the tentative authorization. At the expiration of that period, the applicant provides notice to interested persons. Five days after the notice period expires, the authorization becomes “final.” Thus, the time from submission to final authorization under ExPro is generally less than 90 days.

The Department has granted individual exemptions to cover reinsurance transactions under both procedures. As noted, however, the prospects for obtaining such exemptions has been considerably clouded by the Department’s reinterpretation of the fifty percent test. For example, in 1985, Insuratex, a wholly-owned subsidiary of Burlington Industries, sought an exemption for a reinsurance transaction involving the Burlington group life plan. In its exemption application, Insuratex/Burlington represented that it complied with all of the conditions of PTE 79-41 except that it contemplated a reinsurance instead of direct insurance transaction. Notwithstanding the fact that virtually all of Insuratex’s business was related to Burlington, the Department granted the exemption on the basis of its then interpretation of the fifty percent test. See PTE 85-90, 50 Fed Reg. 20150 (May 14, 1985).

When CSX Industries approached the Department for an individual exemption that was virtually identical to the Insuratex/Burlington application, the Department responded with its new, more restrictive interpretation of the fifty percent test. Since most of CSX Insurance Company’s risk was related to CSX, it was unable to obtain an exemption by simply making the representations made by Insuratex/Burlington. While there were numerous discussions with the Department about conditions that could serve as a substitute for the reinterpreted fifty percent test, CSX decided to withdraw its application before there was any resolution.

b. The Columbia Energy Exemption

On October 11, 2000, the Department granted an exemption to Columbia Energy Group to reinsure its disability coverage through its captive. Since Columbia did not meet the new fifty percent test, it offered to retain an independent entity, Milliman and Robertson (“M&R”), to serve as a fiduciary to its disability plan. As an independent fiduciary, M&R represented the following:

- that it had reviewed the Certificate of Authority for the insurer and confirmed that it is licensed to underwrite the proposed risks;
- that the captive’s reserves for the past two years had been reviewed by an independent firm;
- that the captive had undergone an examination by an independent certified public accountant for its last complete fiscal year;
- that the proposed transaction would confer an immediate benefit on the plan’s participants in the form of lower cost for employee contributions or enhanced benefits, or both;
- that, in the first year of the program, the premiums charged under the program were reasonable and within the range of rates charged by competitors for similar coverage under comparable programs (a finding that M&R is required to make in each subsequent year as well);
- that no commissions were paid with respect to the reinsurance transaction (though there were commissions with respect to the direct placement); and
- that the reinsurance agreement was indemnity reinsurance leaving the direct insurer liable for the risk if the reinsuring captive was unable or unwilling to pay.

c. The ExPro Exemption

As noted, the chief drawback to the Columbia Energy exemption request is the level of review which adds time, cost and uncertainty to the process. However, there is an easier route to an exemption if the fifty percent test can be met. For example, Union Carbide received an exemption under ExPro for a reinsurance transaction involving its captive by representing that more than fifty percent of its business is unrelated. See PTE 99-22E (September 28, 1999). Specifically, Union Carbide represented that its request was

“substantially similar” to two prior exemptions that had been granted for reinsurance of the employer’s benefit plans through the employer’s captive. Significantly, those two prior exemptions had been for insurance companies using one of their affiliates for the insurance where the fifty percent test was easily met, while Union Carbide’s captive barely met the test. In addition, Union Carbide had formed a branch of its Bermuda captive in the U.S. Virgin Islands solely to obtain the exemption. Nevertheless, the Department granted the exemption.

We assume that others will seek a Columbia Energy-type exemption in the near future. Once the Department grants one more, all subsequent applicants can also take advantage of the ExPro procedure.

D. Possible Structures

Based on the above, we have set forth below some basic structures that could be used to finance employee benefits through a captive arrangement, together with our overall assessment of the structure and the legal issues that might arise. For purposes of this discussion, the term, “captive,” also includes a cell within a group captive.

1. Direct Insurance Transaction-Unrelated Business Exceeds Fifty Percent

This should be no problem because PTE 79-41 should apply. As indicated, we have assumed that the captive has more than fifty percent unrelated business. The only other issue is whether the other conditions of PTE 79-41 can be met. See Section (C)(1) above.

2. Direct Insurance Transaction-Related Business Exceeds Fifty Percent

If the fifty percent test cannot be met, then one cannot use PTE 79-41. While one could apply for an individual exemption, the Department generally does not grant individual exemptions if the transaction is covered by a class exemption.

3. Reinsurance Transaction-Unrelated Business Exceeds Fifty Percent

The Department would likely grant an individual exemption using the ExPro procedure. One would have to meet all conditions of PTE 79-41 except that the transaction is reinsurance instead of direct insurance. See Section (C)(2)(c).

4. Reinsurance Transaction-Related Business Exceeds Fifty Percent

The Department would likely grant an individual exemption modeled after the Columbia Energy request. The principal conditions added to the PTE 79-41 conditions are that the transaction confer some immediate benefit on the participants in the form of increased benefits or decreased employee contributions, and that an independent fiduciary approve the transaction. See Section (C)(2)(b).

Conclusion

It should be emphasized that the situation with the Department will probably change in the future as more companies look for ways to fund their employee benefit risks through their captives. For example, the Department may decide to promulgate another class exemption in this area, or impose even more stringent requirements. It seems safe to say, however, that the advantages of using captives to fund benefits will continue to cause companies to look for ways to deal with ERISA.

1The penalties for engaging in a prohibited transaction are set forth in ERISA §502(i), 29 U.S.C. § 1132(i). The penalty equals five percent of the “amount involved,” which in this case would be the premium for the year. It is assessed each year the transaction is outstanding and is owed by the party in interest, which would be the captive.

2Specifically, subsection (b)(1) states that a fiduciary shall not “deal with the assets of the plan in his own interest or for his own account”; subsection (b)(2) states that a fiduciary shall not “in his individual or any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or its participants or beneficiaries”; and subsection (b)(3) states that a fiduciary shall not “receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.”

3For purposes of the exemption, the term, “United States,” includes the fifty states plus the District of Columbia, Puerto Rico, the Virgin Islands, American Samoa, Guam, Wake Island, and the Canal Zone. See ERISA § 3(10), 29 U.S.C. § 1002(10).