GROOM LAW GROUP

Edward A. Scallet
(202) 861-5422
escallet@groom.com

October 12, 2012

By US Mail
Employee Benefits Security Administration
Office of Exemption Determinations, Division of Individual Exemptions
U.S. Department of Labor
200 Constitution Avenue, N.W.
Room N-5700
Washington, D.C. 20210

Re: Application No. L-11738

Dear Sir/Madam:

This firm has represented many of the applicants for exemptions involving captive reinsurance, and is aware that the Office of Exempt Determinations is considering modifications to its analytical framework. We appreciate the opportunity to present our views on one element of that framework – the requirement that an applicant enhance its benefit plans in order to obtain an exemption.

Analysis

1. Captive Reinsurance Provides Value for Plans and Participants.

Section 408(a) of ERISA grants authority to the Department to grant individual exemptions upon findings that an exemption is (1) administratively feasible; (2) in the interest of the plan and its participants and beneficiaries; and (3) protective of the rights of participants and beneficiaries. While the Department has never articulated its reasons for the benefit enhancement requirement, we assume that it is derived from the "in the interest" condition. But there are benefits to plans from captive reinsurance wholly apart from the type of enhancements the Department has required.

The principal benefit to plans and their participants and beneficiaries from captive reinsurance is the reduction in cost compared to insured plans. At the most basic level, the ultimate cost of any benefit plan is the sum of the incurred claims plus administrative expenses. In the case of insured plans, everything that is included in the calculation of a premium other than the cost of expected claims is often referred to as "margin." Thus, an insurer's margin includes not only what it costs to provide the coverage such as marketing, employee salaries, and the policyholder's allocable share of general and administrative expenses, but also some provision for profit. While the percentage varies, most insurers strive to set the premiums at a level that the eventual claims will cost less than 80% of the gross premiums. That leaves a fair amount of room for profit, which is appropriate since the insurer is taking the risk that the claims will exceed the expected level.

When a company enters into a captive reinsurance transaction, it assumes the insurer's risk that claims will be higher than anticipated. Although the insurance company remains liable to pay the claims under the reinsurance arrangement, it is no longer directly affected by the level of claims since the reinsurer has promised to cover them; instead, it has what is best characterized as a credit risk that the reinsurer will not be financially able to make good on its promise. That is a much smaller risk and there are techniques to deal with it such as requiring the reinsurance premium to be held in trust so the insurer is willing to charge much less for it.

Of course, the insurer could still charge a premium that had a margin for underwriting profit and pass along that pricing structure to the reinsurer; in fact, insurers occasionally enter into reinsurance transactions with parties that are unrelated to their insureds and it often has no impact on the price paid by the insureds because the reinsurer is also looking to make a profit from the margin in the rates. But the plan sponsors with captives enter into these reinsurance transactions not to act like a commercial reinsurer, but rather to recapture the part of the margin in the rates that represents the insurer's expected profit. Since most plans are at least partially contributory, that elimination of underwriting profits in the calculation of the premium results in more value for the same or lower cost for both the employer and employees.

There are other benefits to the participants from captive reinsurance transactions beyond the value created by eliminating the margin for underwriting profit. The large employers that seek these exemptions are all capable of self-insuring their benefit promises. Because of the strict limitations imposed by IRC Sections 419 and 419A on pre-funding welfare benefits, however, most self-insured plans do not pre-fund but rather pay claims from the employer's general assets. This leaves employees exposed to the risk that they could lose both their jobs and their benefits if the employer runs into financial problems. Funding a benefit promise through a contract with a highly-rated insurance company in a captive reinsurance transaction removes that risk.

In addition, most, if not all, of the employers that seek to enter into these captive transactions have reserved the right to change or eliminate benefits. That can be done immediately in a self-insured plan, but where the plan is funded through an insurance contract, changes generally cannot be made for some time. Thus, participants in an insured plan obtain a guarantee of no change in the benefit promise through the term of the insurance contract.

There is a misconception that large companies are always looking to cut employee benefits; in our experience, companies understand the value of benefit plans in retaining and attracting the best possible workforce. But companies are also under pressure to control costs and those who work in Human Resources are acutely conscious that they must find better ways of financing benefits if they want to maintain or improve them. The reason the Department has seen a steady stream of captive reinsurance exemption requests is that companies have learned that these transactions allow a plan to combine the cost savings of self-insurance with the protections and stability afforded by a fully insured program. And that is a very good thing for participants and beneficiaries.

2. These Transactions are not Motivated by Benefits for Employers.

It is true that providing value through the elimination of the margin for profit in insurance rates is not the only benefit of captive reinsurance. Many employers hope to obtain more control over their plans through reinsurance because they become entitled to data on experience and other factors that insurers ordinarily will not share with their insureds but must share with their reinsurers. The idea is that this will eventually allow employers to design more effective benefit plans by, for example, eliminating certain benefit features that participants do not use. Or it may allow employers to discover patterns of use that will then lead to better ways to avoid injury or illness.

There are also potential tax benefits to employers. Although the Department has only rarely inquired about tax benefits, we suspect that there is an unstated assumption at the Department that the principal motivation for these transactions is tax avoidance and that therefore the Department is justified in imposing a toll charge on employers through the benefit enhancement requirement. Thus, an explanation of the tax issue is necessary, and probably overdue, because we do not want the Department to mistakenly believe that applicants stand to achieve large tax savings if these exemptions are granted.

At the outset, it is important to understand that a captive reinsurance transaction does not generally affect the tax consequences of that particular benefits transaction; to the extent that there are any tax advantages, they are quite indirect. When a large employer has property or casualty risks to protect against, such as the possibility that there will be a fire at one of their manufacturing facilities, it can either purchase insurance to cover those risks or self-insure. The same basic pricing methodology discussed above applies to these risks; that is, the premium consists of an estimate of the cost of expected claims plus the insurer's margin. If the employer chooses to self-insure, it will have to pay for the expected losses at some point, but it will not have to pay the margin embedded in the premium rate. Moreover, the timing of the payment of those losses differs because purchasing insurance, in effect, pays for those expected losses up front, whereas the employer that self-insures pays nothing until the loss occurs.

This timing difference between when losses are paid for may be advantageous from a tax standpoint. If an employer purchases insurance for expected losses, the premiums it pays are deductible as ordinary and necessary business expenses at the time they are made. But if it self-insures, then the loss cannot be deducted until it occurs. All other things being equal, the ability to deduct payments for losses sooner rather than later is financially beneficial because of the time value of money. But it is also possible that a loss could occur sooner than anticipated, and in that case, the employer that has chosen self-insurance has probably made the better choice from a tax standpoint.

Any potential tax advantage from pre-funding for losses through insurance versus self-insurance depends on whether the captive is considered to be an insurance company for tax purposes. The Internal Revenue Service and the business community have been arguing about when captives can be considered insurance companies for decades and there are many factors that go into that determination. One of them, however, is whether the captive has business that is unrelated to the corporation that owns it. Twenty years ago, the IRS issued a ruling that suggested that employee benefit plan risks could be considered unrelated to the captive's owner. *See* Rev. Rul. 92-93, 1992-2 C.B. 45. If one assumes that employee benefit plan risk is unrelated in that sense, a corporation that engages in a captive reinsurance transaction involving its benefit plans might then be able to place more of its property or casualty risks in the captive with the same tax consequences as a transaction with an unrelated insurer.

As should be apparent, whatever tax advantage a company may achieve from benefit captive transactions is quite speculative. It depends on whether (1) the company has property and casualty risks that it wishes to insure through its captive; (2) the losses on those risks are realized in the expected timeframe and not before; and (3) the IRS eventually takes a definitive position that reinsuring benefit risks in a captive makes a difference on how property and casualty risks are taxed. It is possible that these stars will align and the company will one day get some tax benefit from reinsuring its benefit plans, but it is also true that it is impossible to quantify such a benefit, and it may never occur.

It is fair to say that the IRS' 1992 ruling that benefit plan risks may be unrelated to the employer's risks encouraged many companies to consider captive benefit transactions. But our experience is that that is not the impetus for the transactions today. As discussed above, there are tangible benefits to plans and their sponsors from these transactions and they have become important tools in creating value in welfare benefit plans. Consequently, we do not believe that the fact that some sponsor may someday reap some indirect tax advantage on a totally unrelated transaction because of the benefits captive transaction is even relevant, much less justifies the benefit enhancement requirement or addresses the concerns with that requirement we discuss below. In our view, the fact that captive reinsurance creates value for a plan and its participants is not only the motivating factor for these transactions, but more than sufficient to satisfy the requirements of Section 408(a).

3. The Benefit Enhancement Requirement Presents Numerous Legal and Practical Problems for Applicants and the Department.

a. The Enhancement Requirement is Unique.

Besides conferring authority on the Department to enact individual exemptions, ERISA includes a number of statutory exemptions set forth in Section 408(b), as well as authority for the Department to issue class exemptions. It is telling that none of the statutory or class exemptions requires any sort of "enhancement" to benefit terms even though it is it is no secret that a large number of exempt transactions confer at least some indirect benefit on a party in interest.

Most telling, however, is the fact that neither the statutory exemption for transactions with affiliated insurance companies in Section 408(b)(5), nor the class exemption for similar transactions, PTE 79-41, requires any sort of benefit enhancement. One might therefore assume that there must be significant differences between the transactions described in Section 408(b)(5) and PTE 79-41, and the captive reinsurance transactions, and that those differences have led the Department to require a benefit enhancement in the latter but not the former. However, there are only two differences in these transactions and neither would justify the benefit enhancement requirement.

The first difference is that the statutory and class exemptions cover direct transactions between affiliated insurers and plans, while the individual exemptions involve reinsurance. But there is no obvious connection between this difference and the benefit enhancement requirement. Indeed, the direct insurance/reinsurance distinction cannot be the basis for the benefit enhancement requirement because it is not imposed when an applicant seeks an individual exemption because it meets all of the conditions of PTE 79-41 except that it intends to enter into a reinsurance arrangement instead of directly insuring the plan. *See, e.g.,* PTE 2011-16.

The other distinction between the captive reinsurance exemptions and the transactions described in Section 408(b)(5) and PTE 79-41 is that the former affiliated insurers receive more than 95% or 50%, respectively, of their premiums from unrelated insureds. There is no legislative history to explain the purpose of the independent business requirement in Section 408(b)(5). The preamble to PTE 79-41 states that "the Department believes that the presence of significant independent customer business will enhance the financial soundness of the insurer and safeguard the plan against less-than-arm's-length transactions." *See* 44 F.R. 46365, 46367 (Aug. 7, 1979). But those concerns are dealt with in the current analytical framework for individual captive exemptions by requiring a review of the rates by an independent fiduciary and the involvement of a highly rated direct insurer that remains liable for the payment of benefits in the event the captive becomes insolvent. Moreover, there is no obvious explanation for why changing the terms of one or more benefit plan would "enhance the financial soundness of the insurer or safeguard the plan against less-than-arm's-length transactions."

As noted, the Department has never set forth any rationale for the enhancement requirement in captive reinsurance exemptions, much less explained why this requirement is necessary or appropriate when persons seeking other types of exemptions are not required to enhance anything. This is true even though many, if not most, of these exemptions potentially allow related parties to make a profit from their dealings with plans, including the affiliated insurer statutory and class exemptions. The unexplained, and unique, nature of the captive reinsurance benefit enhancement requirement casts doubt on its appropriateness.

b. <u>The Enhancement Requirement Operates Outside of ERISA.</u>

As discussed above, Section 408(a) does direct the Department to consider whether an individual exemption would be "in the interest of the plan and its participants and beneficiaries," and we acknowledge that the Department has discretion to interpret that condition, perhaps even in a discriminatory and unexplained manner. But the benefit enhancement requirement in the captive exemption context is not aimed at the plan fiduciaries and their conduct, but rather on an employer in its role as plan sponsor. That too is an unprecedented use of the Department's authority under ERISA. It is one thing to assure that a plan and its participants are not disadvantaged by a party in interest transaction; it is quite another for the Department to require actions that are outside the scope of the provisions of ERISA.

It is well settled that ERISA does not apply to settlor decisions by plan sponsors, which include decisions to establish, terminate or amend employee benefit plans, including welfare plans. *See Curtis-Wright Corp. v. Schoonejongen,* 514 U.S. 73 (1995).

Settlor functions also include decisions about the specific terms of a plan. *See Malia v. Gen'l Electric Co.*, 23 F.3d 838 (3d Cir.), *cert. den.*, 513 U.S. 956 (1994). As the Supreme Court has repeatedly held, "ERISA [does not] mandate what kind of benefits employers must provide if they choose to have . . . a plan." *Lockheed Corp. v. Spink,* 517 U.S. 882, 889 (1996). Accordingly, when the Department requires a plan sponsor applying for an exemption to amend a benefit plan in specific ways, it is using its authority under Section 408(a) in a manner that is outside the scope of the statute. There is no legal difference between requiring an employer to add a will preparation service to a group life plan in order to obtain an exemption and requiring an employer to increase its wages by 1%. Both intrude on an employer's prerogative to design its employee compensation in a way that it thinks is appropriate for its workforce.

Legal considerations aside, the Department's efforts to involve itself in the design decisions of plan sponsors often have unintended consequences. The management of employee benefits is a complicated task at the large employers that seek captive exemptions. Group life plans compete with medical or disability plans for scarce resources; benefit plans compete with salary and other fringe benefits within the general category of employee compensation; and employee compensation itself competes with other corporate expenses. When the Department requires an employer to spend more on a group life plan in order to obtain a captive reinsurance exemption, it will in many cases affect some other aspect of the total compensation package. We think Congress was wise to give employers the exclusive right to design their benefit plans and compensation structure.

c. The Enhancement Requirement is Difficult to Administer.

We appreciate the Department's recognition that the benefit enhancement requirement, as it has been implemented in prior exemptions, could foster an impression among practitioners and plan sponsors that there are no hard and fast, consistently-applied rules for obtaining an exemption. The Department's recent efforts in the enhancement area have unfortunately served mostly to further that impression. For example, the recently imposed condition that an enhancement must "cost an employer something" only spawns more questions: how much additional cost is enough; should that cost be expressed as a percentage of the cost of the plan to the employer or an actual dollar figure; should that cost be over and above whatever savings that would be achieved through the captive assuming the risk of loss from the primary insurer or should it be measured by the before and after cost of the enhancement? However one answers those questions, it cannot help but be perceived as arbitrary since there is no foundation for the "must cost more" concept in the statute or the Department's approach to other exemptions.

We have also seen that the exemption application has become merely a starting point for negotiations about the enhancement. This is true to some extent with exemptions in other areas, but there the negotiations are about building in protections for plans, an area where the Department has considerable experience and expertise. But the negotiations about enhancements have often seemed to reflect the opinions of the reviewers about the merits of certain types of insurance coverage; for example, we have been told that "we do not really like AD&D insurance," even though virtually all large employers include such coverage in their plans. Or we have been told that in-person services are better than on-line services, though many employees would probably prefer the latter. Moreover, as with the employer cost issue, there is no principled way to answer the "how much is enough" enhancement question because there is no precedent in the statute or the Department's other exemptions. For example, one cannot argue with the notion that one hour of free financial planning time is better than thirty minutes, but one also cannot argue that thirty minutes is "not enough" based on anything other than the reviewers' own opinions.

We do not mean to suggest that the Department is deliberately acting in an arbitrary or unfair manner; on the contrary, we have always thought that the Department has been motivated solely by its desire to reach the right result for both participants and applicants. But designing modern-day welfare plans is a very complicated process and there is simply no way to avoid the kinds of problems that we discuss above if the Department persists with a benefit enhancement requirement focused on changing plan terms.

4. The Department's Focus on Underwriting Profit is the Right Approach.

As noted, affiliated insurers that meet the requirements for an exemption under Section 408(b)(5) and PTE 79-41 are likely to make underwriting profits since they can charge the same rates as insurers in the competitive marketplace, and those rates contain a margin for profit. Nonetheless, we support the Department's recent requirement that an applicant for a captive reinsurance exemption represent that it does not intend to make underwriting profits and will plow those profits back into the plan in some manner if they do materialize. This is consistent with the Department's observation in the preamble to PTE 79-41 that insurance companies should not be formed just to make money from the plans of affiliated companies, especially since those profits are likely to be derived, at least in part, from employee contributions. Moreover, we believe that it is appropriate that applicants be held to their representation that the primary purpose of the reinsurance transaction is to provide more value for their plans, not earn underwriting profits from them.

This approach avoids the legal and practical problems with requiring changes in plan terms discussed above. It is administratively feasible because there is an established methodology for calculating underwriting profits and an independent fiduciary is able to review the plan's experience and determine whether such profits have occurred, and, if they have, whether they have been used to provide more value for the plan. Most importantly, this is a much better result for participants. Indeed, the practical difficulties that inevitably arise from a focus on changing plan terms have tended to dominate the exemption process and have often led the Department to discount, or even ignore, the cost savings from the captive reinsurance transactions. Yet most employees would much rather pay less for a plan's core benefits, or obtain more of them for the same cost, than layer ancillary services on top of those core benefits. We respectfully submit that the Department should refocus the "in the interest" requirement of the exemption process on the underwriting profits issue.

Conclusion

We hope that our views are helpful to the Department and we would be pleased to respond to any questions you may have.

Sincerely,

Edward A. Scallet