

[needs to be updated for a new DOL ltr]

ERISA ISSUES IN INSURANCE COMPANY DEMUTUALIZATIONS

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Insurance Company Demutualization

A "demutualization" occurs when a mutual life insurance company changes its structure to a stock life insurance company owned by its shareholders. Many large insurance companies, including Equitable, John Hancock, Metropolitan Life, Mutual of New York, and Guarantee Mutual, have demutualized to gain access to capital markets. Other large companies are undergoing or considering demutualization. As a mutual company, an insurer is owned by its policyholders. That ownership is represented by "membership interests." Upon conversion to a stock company, policyholders receive compensation (in the form of stock, cash, or "policy credits") in exchange for their membership interests. The receipt of this compensation for policies held by or in connection with employee benefit plans raises various ERISA, state law, and tax implications. We highlight the ERISA issues in this outline.

Issues for ERISA-Covered Plans

There are significant implications associated with the receipt of demutualization compensation by or in connection with ERISA-covered plans. Key ERISA requirements and the various demutualization issues are summarized below.

Fiduciary Responsibilities

ERISA imposes fiduciary duties on those who administer ERISA-covered plans. ERISA §§ 403, 404(a), 406. It also imposes significant liability and penalties for breach of fiduciary duties. See e.g., ERISA §§ 409, 502(i), 502(l). The U.S. Department of Labor ("DOL") and individual plan participants, beneficiaries, and fiduciaries may sue under ERISA to enforce these duties. ERISA § 502(a). If the policy was issued in connection with an ERISA-covered plan, and if the policy or all or part of the compensation is a plan asset, the plan administrator or other fiduciary may be subject to these fiduciary duties in considering the following key issues:

- If qualified to vote, whether to vote in favor of, or against, the insurer's Plan of Reorganization;
- If given the choice, whether to elect stock in lieu of receiving cash under the Plan of Reorganization;
- If receiving stock, whether to hold or sell the stock;
- The role of the stock in the benefit plan's overall investment portfolio (i.e., whether the stock is an appropriate plan investment considering issues such as diversification and prudence);
- In the case of most group policies, whether, and how, to use or otherwise allocate the compensation among individuals or entities covered under the terms of the group policy or benefit plan;
- How the compensation must be held (e.g., in a trust) and what steps must be taken to implement that decision; and
- The tax implications of the receipt of compensation and related tax matters.

See ERISA § 404(a); DOL §§ 2509.94-1, 2550.404a-1.

Prohibited Transaction Exemptions ("PTEs") for Demutualizations

Generally, each insurance company that has demutualized has requested and received from DOL a prohibited transaction exemption. In general, the exemption provides that the restrictions of section 406(a) of ERISA, and the excise tax resulting from the application of section 4975 of the Code, shall not apply to the receipt of stock, cash or policy credits by or on behalf of an employee benefit plan policyholder, including any eligible policyholder that is a plan covering employees of the insurance company or its affiliates, in exchange for such policyholder's membership interest. See, e.g., PTE 2000-11, 65 Fed. Reg. 13326 (March 13, 2000); PTE 99-41, 64 Fed. Reg. 53744 (Oct. 4, 1999); PTE 99-14, 64 Fed. Reg. 16497 (Apr. 15, 1999).

"Plan Asset" Issues

The ERISA plan fiduciary must determine who owns the compensation received from a demutualizing insurer in connection with an ERISA plan. Specifically, the fiduciary must determine whether the compensation is a "plan

asset." In determining whether certain property is an asset of a plan, DOL has stated that the "ordinary notions of property rights and the terms of any contract to which the plan is a party" will apply. Preamble to Proposed "Plan Assets" Regulation, Prop. 2510.3-101, 50 Fed. Reg. 961 (Jan. 8, 1985).

Until recently, there was no clear guidance from DOL specifically addressing the "plan assets" issue in the context of a demutualization. However, in connection with Prudential Insurance Company's demutualization, DOL recently weighed in on the issue. It indicated that all of the demutualization compensation paid in connection with tax-qualified pension and profit sharing plans should be viewed as an asset of the plan. See Letter from Acting Assistant Secretary Alan Lebowitz, PWBA, U.S. Department of Labor to T. Groom, Groom Law Group Chartered (Feb. 15, 2001); DOL Adv. Op. 2001-02A (Feb. 15, 2001) at 2, n.2. (ERISA requires that pension and profit sharing plans be "funded" and, therefore, a plan is likely to be deemed to have a beneficial ownership interest in the group policy that fulfills the funding requirement under the plan.)

In the case of a welfare plan, the same "ordinary notions of property rights" analysis applies. According to DOL, all of the demutualization compensation paid in connection with a policy funding welfare benefits will be deemed an asset of the welfare plan where (1) the policy is issued to the plan or a trustee of the plan, and (2) policy premiums are paid from trust assets. Id.

In addition, where participants pay a portion of the premium under the policy, the plan fiduciary must treat as plan assets the portion of the demutualization compensation attributable to the participant contributions. In deciding what portion is attributable to those contributions, the fiduciary "should give appropriate consideration to those facts or circumstances that the fiduciary knows or should know are relevant to the determination, including the documents and instruments governing the plan and the proportion of total participant contributions to the total premiums paid over an appropriate period of time." Id.

Restrictions on Use of "Plan Asset"

To the extent the demutualization compensation is a plan asset, the policyholder must decide the form in which compensation should be received and how to use the compensation. DOL has made clear that under section 404(a)(1)(A) of ERISA plan fiduciaries must act solely in the interest of plan participants and beneficiaries in determining how the compensation is allocated, provided that the decision is a fiduciary one and not a settlor

decision exempt from ERISA's fiduciary requirements. DOL Adv. Op. 2001-02A.¹ In addition, ERISA sections 403 and 404 provide that plan assets may not inure to the benefit of the employer and must be used solely to provide benefits and pay the plan's reasonable expenses. Under section 404(a)(1)(D) of ERISA, any disposition of plan assets must also be consistent with the governing plan documents.

Use of Compensation Received by Pension and Profit Sharing Plans

Demutualization compensation might be used to pay plan expenses, provided that the expenses are appropriate expenses of administering the plan and that the payment of the expenses with plan assets is permitted by the governing plan documents. However, we have heard that some DOL field offices might take the view that the compensation may be used to pay only those expenses that the plan (and not the employer) would have otherwise paid.

Demutualization compensation received by a defined benefit plan might be treated as any other asset of the plan and used to fund current or additional plan benefits. See *Hughes Aircraft Co. v. Jacobson*, 119 S.Ct. 755 (1999); *Ruocco v. Bateman, Eichler, Hill, Richards, Inc.*, 903 F.2d 1232, 1238 (9th Cir. 1990). It is possible that DOL or employees could challenge a decision not to increase benefits under the plan; however, the Supreme Court's decision in *Hughes* may support the view that compensation can be used to fund current benefits or expenses and need not be used to increase benefits.

In a defined contribution plan, if the compensation is not used to pay current plan expenses, the compensation must be allocated among participant accounts in accordance with the terms of the plan. Allocation of the compensation may be complicated if the policy/annuity is only one (or a subset) of the investment options under the plan. Allocations could be limited to the participants invested in that investment option (similar to investment income), or could be made to all participants because the compensation is based on many years of experience and participants may have moved in and out of various options under the contract or plan during that time. There are litigation risks associated with all allocation methods. For example, former employees or active employees no longer covered under a plan might claim they are entitled to a share of the demutualization compensation paid with

¹ There is a good argument that certain decisions with respect to the "use" of the demutualization compensation are "settlor" and not "fiduciary" decisions, such as a decision to amend the plan to increase benefits.

respect to a policy funding an ERISA plan. Similarly, employees who later become covered under a plan (and a policy) might also claim entitlement to some portion of the compensation because compensation can be viewed as attributable, at least in part, to future experience under the plan.

Use of Compensation by Welfare Plans

There are a number of options for using demutualization compensation deemed an “asset” of a welfare plan.

- Provide new or increased benefits under the Plan (DOL likes this approach).
- Provide a contribution holiday to plan participants (also a DOL favorite).
- Pay benefits or premiums that the employer might otherwise pay. (DOL and plan participants might challenge this approach as an “inurement” of plan assets to the benefit of the employer. However, in the pension plan context, the Supreme Court’s decision in *Hughes* recognized that the use of plan assets to pay benefits doesn’t violate the anti-inurement rule, even though the use might incidentally benefit the employer.)
- Pay plan expenses, if permitted under the Plan document. Some DOL regional officials have expressed concern about the payment of expenses that the employer would otherwise pay.
- Fund future welfare plan benefits through establishment of a premium or contract stabilization fund or other reserve.

ERISA Trust Requirement

If the demutualization compensation is an asset of an ERISA-covered plan, ERISA’s trust requirement must be met. ERISA requires that all plan assets be held in trust, unless a specific exception applies. ERISA § 403(a). Among the assets statutorily excepted from the trust requirement are insurance contracts, assets of an insurance company and assets of a plan that are held by an insurance company. ERISA § 403(b).

The following options may be available to satisfy the trust requirement for demutualization compensation:

1. If the plan currently has a trustee, and the trustee is the “policyholder” of the policy that will generate the

demutualization compensation, the compensation should be distributed directly to the trustee. If the trustee is not the policyholder, the policy or the compensation might be assigned to the trustee.

2. If there is no existing trust that can receive the demutualization compensation for the ERISA plan, the employer can establish a new trust.
3. The compensation could be deposited with the insurer under an insurance contract in a fund such as a premium stabilization reserve.
4. The insurer might offer to "hold" the plan's compensation in a custodial account until the plan can spend it.
5. If the compensation is received in connection with Prudential Insurance Company's demutualization, a trust would not be required to hold the compensation if the conditions of a "non-enforcement" policy issued by DOL can be met. See Letter from Acting Assistant Secretary Alan Lebowitz, PWBA, U.S. Department of Labor to T. Groom, Groom Law Group Chartered (Feb. 15, 2001)

Form 5500

The insurance company is not required to file any reports with DOL regarding the compensation paid in the demutualization. Most ERISA plans are required to file an Annual Report (Form 5500) with DOL. If the compensation is viewed as an asset of an ERISA plan, the plan's receipt of the compensation should be reflected on the plan's financial statements, if any, and on the plan's Form 5500 (Schedule H). If the plan does not otherwise have a trust, establishing a trust or custody account for the demutualization compensation may trigger CPA audit and other compliance requirements.

Welfare plans that provide benefits exclusively through insurance contracts are exempt from reporting certain financial information on Schedule H and from the requirement of an independent audit of the plan's financial statements. If the demutualization compensation is held outside of an insurance contract, the plan may no longer meet the conditions for this exemption. (Note that plans receiving compensation from Prudential may benefit from special relief from the reporting rules if the compensation is held and used under certain conditions. See A. Lebowitz Letter to T. Groom.)