

## Captive News

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### Employee Benefits in Captives? - The ERISA Issue

There's been a lot of talk for years about what has become the ultimate issue in the captive business -- namely, underwriting employee benefits in captive insurance companies. This has always been an "issue", that is, something talked about, written about and discussed at industry meetings. There's been a lot of hot air expended on this point. So little of this business has been written through captives, as either insurance or reinsurance, however, and the issues are, we think, so unclear, we thought that it was time to set the record straight about at least one aspect of this issue -- ERISA.

The Employee Retirement Income Security Act of 1974 (ERISA) was enacted to govern all eligible employee benefit plans and to protect the rights of certain beneficiaries to those plans. ERISA is federal regulation and as such, largely preempts state law regarding bad faith claims for benefits denied. This pre-emption, now under serious challenge in a few states and soon to be in many more, is what has protected HMO's, for example, from medical professional liability lawsuits for many years.

First, a few basics about ERISA:

1. To fall under ERISA regulation, an employee benefit plan must be a plan, fund or program which is established and/or maintained by an employer or by an organization of employees. Plans so regulated, include programs for physician, surgical or hospital care; accident, sickness or disability programs; unemployment and vacation programs; death benefit programs; day care centers, training and scholarship programs, including programs for pre-paid legal services.
2. Examples of non-ERISA regulated programs, are those plans where the employer makes no contribution or where employee participation may be voluntary; those plans where the employer's primary function is to publicize a program to employees or to collect premiums through payroll deductions.
3. ERISA plans are managed by fiduciaries. By definition, a fiduciary is a person who is granted some degree of discretionary authority either by the plan itself, or may have some discretionary authority over the plan's management, its assets or its general control. Fiduciaries have to act in the



**ERISA and Captives? No More Talk -- We've Written it Down.**

interests of plan participants and their beneficiaries. A failure to pay a valid and collectible claim is generally acknowledged to be a "breach of fiduciary responsibility" for which purpose, fiduciary liability insurance is usually purchased

4. Any participant in or beneficiary of a plan can bring a civil action against a fiduciary for breach of duty -- which is akin, from a defense position, to a breach in the standard of care for medical professional liability insurance. ERISA jurisdiction rests in the federal district courts.

5. ERISA is clear, in that it preempts state law with regard to those matters dealing with employee benefit plans. It is important to note that ERISA excludes from its authority a number of plans which, at first blush, might otherwise appear to be ERISA-regulated. Further in this article we discuss some of these exceptions.

In March 1999, Mitch Cole of Tillinghast published an excellent article in Captive Insurance Company Reports, which is a "must read" for everyone interested in the idea of employee benefit programs in a captive. Mitch claims that any plan to consider placing an employee benefits program in a subsidiary or other form of captive insurer, should be put to five tests first. We think he's right. What follows are those tests and our commentary.

1. Does The Transaction Meet Federal Standards?

ERISA - regulated plans require management by fiduciaries. The key objective for any fiduciary when it comes to the captive issue, is to be prudent and to be reasonably certain that the employees covered are not exposed to any more risk than if a captive had not been involved anywhere in the benefit transaction. It is both the element of prudence as well as risk that usually stops, right at the front door of the captive, any employee benefit plan programs from entering.

2. Is The Plan ERISA Regulated To Begin With?

Many do not realize the extent to which ERISA is not involved in certain types of health and welfare plans. Foreign employees covered under foreign plans are exempt from ERISA. Government and Church plans are also exempt. Just as important to note, is that worker's compensation programs, as well as those retirement plans favoring highly compensated individuals are exempt and may be considered for handling through a captive.

3. Does The Transaction Involve A "Party in Interest?"

One of the real stumbling blocks in underwriting employee benefit plans through a captive is the so-called "party in interest" issue. Put simply, no self-dealing is permitted between a plan and a recognizable party in interest to that plan. We know, however, that the Department of Labor has from time to time issued exemptions in this regard. The problem is with equity captives, where the parent is the sole owner of the captive. In these cases, the parent organization may own an equity

captive and may at the same time (in fact almost probably is), a fiduciary of one or more of the company's ERISA-regulated plans. Rent-a-captives and certain structures involving group captives (those captives owned by two or more separate organizations) may create a more favorable environment. There's a lot of talk right now about a revival of rent-a-captives for this purpose. Rent-a-captives, by definition, are entities owned by someone other than the person placing risk through them.

4. Is There A Prohibited Transaction Involving Plans Assets?

Of the five tests, this one, for careful employers, should be the easiest one to pass. The rule of thumb is that if any of the plan's proceeds (all or part of a claim for example) are paid from employer assets -- there is no problem with ERISA. The problem arises when employees have an enforceable right to the insurance coverage provided through any program. Each health and welfare plan must be evaluated separately before being considered for inclusion in a captive program. Based on the savings which can be achieved for large plans, it's worth going to the trouble of a complete review to determine what might be a prohibited transaction and what is not.

5. Does An Exemption Apply Or Will One Be Granted?

Sometimes the Department of Labor will issue, as we have indicated earlier, an exemption to the party in interest rule. A clear case has to be made that the exemption is valid and that, above all else, the employees, and not the employer, ultimately benefit from whatever exemption is given by the DOL. Feasibility analysis and testing is essential in order to make certain that the entire process will pass muster with the Feds. These are the rocks where so many captive employee benefit programs can founder. In general, if employees aren't better off than they were before these programs were run through the captive, the DOL will ask, "why bother?" If they do that -- your program won't make it to second base.

Mitch Cole has done an excellent job explaining the intricacies of this complex and important issue. We recommend the March '99 "CICR" to everyone's attention. If you do not subscribe to CICR and would like to, contact us and we'll put you in touch with the publisher.

**... And The Vermont Beat Goes On**

Vermont recently enacted some key changes to the existing Vermont captive regulations permitting the formation of "Sponsored Captives" (rent-a-captives by another name), as well as "Branch Captives" which are branches of existing off-shore captive companies. We have previously expressed our concern about the Sponsored Captive part of this bill and how we feel that some aspects of this bill represented a real step in the wrong direction for Vermont. We are great fans of Vermont as a domicile, but we don't see Vermont as much of a competitor for what used to be called the "rent-a-captive" business.



**So What is A Sponsored Captive?**

## **In Bermuda, The Only Thing They Have To Fear Is Fear Itself**

Since 1968, the Progressive Labour Party (PLP) has been waiting in the wings for a chance to take the reigns of government in Bermuda. Well, in November 1998 they got their chance, when they routed the United Bermuda Party (UBP) in a well-publicized general election.

As is typical, when governments are run largely by old white men in blue suits, many were predicting gloom and doom if a labor party came to power. You know, the usual scenarios: capital will flee the country; the banks will close; the "commies" will take control - all of the usual nonsense.

The PLP came to power because they focused on the economy. Bermudians are not very good at promoting their island. You know, it's unseemly for gentlemen to talk about themselves and the tourist industry has never really recovered from the decrease in air traffic brought on as a result of the Gulf War.

One Bermuda reinsurance company CEO was quoted as saying "... we're very pleased to see a democratic transfer of power in Bermuda..." Well, what did he expect to see -- blood in the streets? Again, old white men in blue suits have a tendency to be surprised by these things.

Let's hope that the PLP will introduce change - positive, constructive, necessary change to the home of over 1,700 captives. Bermuda is a wonderful place, but can be a parochial and sleepy place in which to do business. It's also time for it to become the world class financial center it can become. Maybe, just maybe, the PLP people can pull it off. Even if they can't, it's clear that Bermuda needs a revival and a revivalist mentality in its government and why not give the PLP a chance - before any more of our favorite hotels close their doors for some so-called "renovations"?

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