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ERISA Issues in Distributions from Insurance Company Demutualizations

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In the past couple of years, *Benefits Law Journal* has carried articles alerting readers to the issues resulting from the distribution of proceeds of an insurance company demutualization.[1] Since those articles have been published, The Prudential Insurance Company of America and Principal Financial Group have recently filed plans of demutualization with state departments of insurance.[2] In each case the life insurance company will change its ownership structure from that of a mutual life insurance company to a stock insurance company via an initial public offering ("IPO"). In the process it will distribute to its current policyholders the equity value of the insurer. (Prudential has issued tens of thousands of contracts that provide benefits under ERISA plans, and the total distribution, expected to take place in the second half of 2001, is estimated to be between 15 and 20 billion dollars.) The policyholders generally will receive stock in the new company in exchange for their membership interests under their existing insurance policies. If the policyholder is an ERISA plan or an employer sponsoring an ERISA plan, significant ERISA issues need to be addressed concerning the handling of demutualization proceeds.

Plan Assets

The initial question is to whom the proceeds of a demutualization belong: the employer, the ERISA plan, plan participants, or some combination of the foregoing. The answer depends on whether the proceeds are deemed to be "plan assets." If the proceeds are not plan assets, the employer generally may use the proceeds for any purpose it sees fit. To the extent the proceeds are plan assets, however, ERISA provides that they may not inure to the benefit of the employer and must be used solely to provide benefits to participants and beneficiaries and to pay reasonable plan expenses.

In an advisory opinion concerning the Prudential demutualization, the Department of Labor (DOL) has taken the position that under certain circumstances all demutualization proceeds received by an employer will be considered plan assets.[3] There are three scenarios in which this will be the case. The first situation is where a group annuity contract is used to fund benefits under a pension or profit sharing plan. This position is not surprising given that the Internal Revenue Code requires the pension and profit sharing plans hold assets for the exclusive benefit of plan participants and prohibits the reversion of plan assets to the employer.[4] The second is where the ERISA plan itself is the policyholder. In most cases, however, the employer is the policyholder. The third is where policy premiums have been paid from trust assets rather than from the general assets of the employer.

The policyholder will be entitled to receive its demutualization distribution in stock, but will generally be given the opportunity instead to receive it in cash or policy credits. If some or all of the distribution constitutes a plan asset, the decision to hold the stock or to hold and then later sell the stock are investment decisions subject to the fiduciary standards of ERISA.[5] It is presumed, at least for purposes of this column, that most policyholders will elect to receive the distribution in cash because the holding of stock is likely to be inconsistent with the purposes of the plan.

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Welfare Plans

Where the demutualization proceeds are paid in connection with an ERISA welfare plan and the employer is the policyholder, the employer may be entitled to at least some of the proceeds if it paid a portion of the policy premiums from its general assets. DOL regulations provide that amounts contributed to a plan by participants are plan assets.[6] Consequently, the DOL position is that where participants pay a portion of the premiums, demutualization proceeds attributable to those participant contributions must be treated as plan assets.[7] Conversely, if the employer pays all of the premiums, none of the demutualization proceeds will be deemed to be plan assets, provided that there is no contrary provision in the plan document.

In the case of *Ruocco v. Bateman, Eichler, Hill, Richards, Inc.,* 903 F.2d 1232 (9th Cir. 1990), certiorari denied, 498 U.S. 899 (1990), the court held in a class action suit brought by participants that, when the employer received a demutualization distribution from an insurance company resulting from the employer's ownership of a group long-term policy, the distribution belonged to the participants because they (not the employer) had paid the premiums. This holding is consistent with the DOL position. However, it is not entirely clear that a court would endorse the DOL position if the plan is split-funded by the employer and participants. For example, in *Corley v. The Hecht Co.,* 530 F.Supp. 1155 (D.D.C. 1982), the court held that the employer did not violate ERISA by retaining dividends paid in connection with a group life insurance policy (funded by employee and employer premiums) to reimburse itself for its premium payments. The court looked to the terms of the insurance contract and determined that it permitted the employer to obtain reimbursements for advances to the plan.

ERISA requires every employee benefit plan to provide a procedure for establishing and carrying out a funding policy and method consistent with the objectives of the plan.[8] A plan's funding policy, if clearly articulated in the plan document, may entitle an employer to retain the entire demutualization proceeds, irrespective of the fact that employees may have contributed to the plan. For example, in many cases, the welfare plan may provide for the participants to con-tribute a fixed amount per month for benefits under the plan and for the employer to contribute the balance. The employer's subsidy frequently will not be a fixed amount but rather may vary based upon the plan's claims experience. Such a funding policy could provide that just as the employer subsidy would increase if premiums, claims, or other expenses are higher than anticipated, the subsidy may be reduced if the amount of subsidy needed for the plan is less than expected (such as if there are demutualization proceeds).

Allocation of Plan Assets

Even if the employer was to apply the general rule as enumerated by the DOL (allocation based upon relative amounts of contribution), such a task may be more difficult than expected. The employer may have been the policyholder for many years and the level of employee contributions may have varied over time. In addition, as stated above, employer contributions are usually not a fixed percentage of total premiums, but rather are affected by claims experience, investment experience of the insurer with regard to any reserves under the policy, and other factors. Optional supplemental benefit levels offered by some welfare plans (which are often subsidized by the employer to a lesser extent or not at all) can impact how the plan's experience is determined. Consequently, apportioning the level of contributions made by the employer and by the participants may be more difficult than it may appear initially. An employer would be advised to err on the side of the plan when making the allocation to reduce the risk of litigation from participants or a challenge by DOL.

Use of Plan Assets

Once it is determined that some or all demutualization proceeds constitute plan assets, it needs to be determined what will be done with those assets. Any approach taken by a plan sponsor (or other fiduciary with discretion over the application of plan assets) carries a risk of litigation.

Options are available for sponsors of ERISA welfare benefit plans. One option is to provide temporarily increased benefits under the plan. Alternatively, the plan could use the demutualization proceeds to institute a premium holiday (or partial subsidy) for participants. Depending on the nature of the plan, either of these approaches could have tax consequences to participants which should be considered. (That is, the providing of tax-free benefits may be preferable to paying their contributions for them, which may be taxable. Alternatively, in the case of a disability benefit plan the participants might prefer to recognize tax on the payment of premiums instead of having the benefits taxable.) Another alternative is to distribute cash to participants, which almost certainly is taxable to recipients. Presuming however that the demutualization proceeds belong to an ERISA plan, the plan would likely have to be amended to provide for such distributions because it is presumed that the purpose of the plan is to provide welfare benefits (not cash).

A riskier alternative is to use the demutualization proceeds to pay premiums or benefits that could otherwise have been financed by the employer, thereby benefiting the employer. An argument could be made that this approach violates the exclusive benefit rule of ERISA.[9] Yet the Supreme Court's opinion in *Hughes Aircraft Co. v. Jacobson,* 525 U.S. 432 (1999), may provide support for such use of plan assets. In that case, the Supreme Court held that the use of a defined benefit plan surplus, attributable in part to employee contributions, did not constitute prohibited inurement even though the employer's obligation to fund the plan in the future was reduced by the surplus. Also, as referred to above, the plan's funding policy may be such that employee contributions are fixed at a certain dollar amount and the amount of necessary employer subsidy varies de-pending upon the plan's experience (which may include the favorable variance caused by an insurer's dividend or demutualization distribution).

Another issue to consider is that of former participants. Demutualization proceeds are in part attributable to past experience under the plan. However, in the case of a welfare benefit plan, unless the proceeds are distributed directly to participants (including former participants), the former participants will not receive any benefit from the demutualization. In *Ruocco,* the court awarded the proceeds directly to current and former participants. But the distribution of demutualization proceeds directly to current and former participants will be taxable to them and consequently may not be a particularly tax-efficient use of the proceeds.

If the demutualization proceeds are plan assets of a defined contribution pension plan, the proceeds will be allocated among participant accounts to the extent they are not used to pay plan expenses. ERISA does not require a particular method of allocation. An employer or other appropriate fiduciary may choose simply to divide the proceeds evenly among all participants. Alternatively, the proceeds may be allocated pro-rata based on the amount of each account balance that has accumulated in the investment alternative related to the demutualization. This approach has its own complications because the demutualization proceeds are based in part on past experience and the current allocation of a participant's account may be different from past account balance allocations. In any event, the terms of the plan document should be reviewed before choosing an allocation method to ensure that it does not conflict with any applicable plan provisions or the plan should be amended to address the matter.

ERISA Trust Requirements

ERISA requires that plan assets be held in trust, unless an exception applies.[10] The trust requirements do not apply to plan assets which consist of insurance policies or contracts.[11] Many policyholders do not maintain trusts to hold welfare plan assets because the plans are often funded solely by insurance contracts. Where demutualization proceeds constitute welfare plan assets, plan fiduciaries must revisit the trust requirements.

Welfare plan fiduciaries have some options in addressing the trust requirements as applied to demutualization proceeds. The proceeds could be deposited into a new, or existing trust (either a VEBA or a non-exempt trust). Alternatively, the proceeds could be held by the insurance company for the benefit of the plan, either by enhancing benefits under new or existing insurance policies or contracts or by applying the proceeds toward future premium payments.

In addition to the options described above, fiduciaries may take advantage of interim relief provided by the DOL in connection with the Prudential demutualization.[12] Pending the issuance of further guidance, the DOL will not assert a violation of the trust requirements if certain conditions are satisfied. The conditions are: the relief only applies to demutualization proceeds; the stock must be placed in a custodial account as soon as reasonably possible following receipt (if the distribution is in cash, it must be placed in a separate interest-bearing account); the proceeds must be applied to the payment of participant premiums, applied to benefit enhancements, or distributed to participants as soon as reasonably possible (but not later than 12 months following receipt); the assets must be subject to the control of a designated plan fiduciary; the plan may not otherwise be required by ERISA to maintain a trust; and the designated fiduciary must maintain such documents and records as ERISA requires.

Arrangements Exempt from ERISA

Title I of ERISA generally applies to pension and welfare plans "established or maintained" by employers.[13] Some arrangements, such as group tax-deferred annuities and individual retirement accounts sold under group annuity contracts, are exempt from ERISA pursuant to DOL safe harbor regulations.[14] These regulations generally limit employer involvement in the operation of such on arrangement so that it is not considered to be established or maintained by the employer.

Demutualizations risk subjecting these arrangements to ERISA. For example, if an employer-policyholder handles demutualization proceeds, it may violate a safe harbor. However, in an advisory opinion concerning the Prudential demutualization, the DOL has stated that it believes that an employer may exercise certain rights with respect to an insurance contract as an authorized representative of the participants without exceeding the safe harbor, or at least without causing the arrangement to fall within the scope of ERISA.[15] Consequently, the DOL takes the position that an arrangement will not be treated as an ERISA pension plan solely because an employer-policyholder votes on an insurer's plan of reorganization or selects an allocation method for distributing demutualization proceeds.[16]

Conclusion

Although the recent guidance from DOL relating to the Prudential demutualization gives some insight into what sponsors of ERISA plans can and should do with demutualization proceeds, the correct approach for employers and other plan fiduciaries may not be clear. The guidance from the DOL is general and will not apply to all scenarios. In addition, the plan documents will likely influence what should be done in any particular instance. Employers and other plan fiduciaries would be well-served to begin preparing for anticipated demutualization distributions in advance of receiving the proceeds.

Notes

1. Russell E. Greenblatt, "Demutualizations: The Unanswered Questions from a Recent PLR," 13 *Benefits Law Journal* 3 (Autumn 2000); Jeffrey W. Knapp and Judy C. Bauserman, "Demutualization: Coming to a Welfare Plan Near You," 12 *Benefits Law Journal* 7 (Winter 1999).
2. For additional information regarding the Prudential demutualization, including *Prudential's Plan to Demutualize: A Guide to Issues for Group Contract Holders and Policyholders,* visit the Prudential website at www.prudential.com.
3. ERISA Adv. Op. 2001-02A (Feb. 15, 2001).
4. IRC §401(a)(2).
5. ERISA §404(a).
6. DOL Reg. §2510.3-102(a).
7. ERISA Adv. Op. 2001-02A (Feb. 15, 2001).
8. ERISA §402(b)(1).
9. ERISA §404(a)(1)(A).
10. ERISA §403.
11. ERISA §403(b)(1).
12. See Letter from Pension and Welfare Benefits Administration to Theodore Groom (Feb. 15, 2001).
13. ERISA §3.
14. See DOL Reg. §§2510.3-2(f) and 2510.3-2(d).
15. ERISA Adv. Op. 2001-03A (Feb. 15, 2001).
16. Id.