

The Metropolitan Corporate Counsel

www.metrocorp-counsel.com

Volume 14, No. 7

© 2006 The Metropolitan Corporate Counsel, Inc.

July 2006

Challenges To In-House Counsel From Benefit Plans: Practical Considerations

Robert H. Louis

SAUL EWING LLP

The world of employee benefit plans is full of challenges and opportunities for in-house counsel. There are several reasons, both of "macro" and "micro" types, for this situation:

- Employee benefits of certain categories are expected: health insurance at least; perhaps also, life and disability insurance. But health insurance in particular has become a significant and growing expense to businesses.

- Retirement plans are valuable to employees at many levels of a business. ERISA, the federal law relating to retirement plans, is amended on a regular basis, and proposals for further amendments are made almost weekly. As members of the baby boom generation approach the age of retirement, there will be more pressure on employers to increase retirement income. There are also questions about appropriate costs associated with retirement plans.

- Nonqualified deferred compensation has recently undergone a dramatic change. This category of employee benefits comes in many forms, from stock appreciation rights to various forms of incentive compensation. Until recently, there was little regula-

Robert H. (Bob) Louis is a Partner in and Co-Chair of Saul Ewing's Personal Wealth, Estates and Trusts Department. In his practice, Mr. Louis works on various aspects of the process of acquiring, preserving and passing on the wealth of individual clients and their businesses. He specializes in areas such as executive compensation, retirement plans, employee benefits, and tax and estate planning for these kinds of benefits.



Robert H. Louis

tion and much discretion in the design of these programs. Now, a new world of federal regulations has begun.

Let's examine each of these categories in turn, to see what specific challenges have been addressed recently and, if not fully met, how counsel have dealt with them.

Health, Disability And Life Insurance

Of these three benefits, health insurance will be the most expensive and subject to the greatest change. The cost of such insurance has risen dramatically in the past few years, and it appears that increases will continue.

Most employers believe that they must continue to offer health insurance in some form, since a national health insurance is unlikely in the next few years, and the option of forcing employees to use governmental assistance programs is distasteful to most employers. Some employers have responded to these increases by "asking" employees to make a contribution to the cost of such coverage. That contribution might

be in the form of payment of a share of the monthly premium. Another method of dealing with cost is to add or increase co-pays and deductibles. What is the difference? Apparently, asking employees to pay a sort of usage fee reduces the use of health insurance and can hold down insurance cost increases. Employers usually have the option of changing co-pays and deductibles each year, and of asking their carrier or their health insurance consultant the effect of such changes on the premium cost. Co-pays and deductibles can encourage employees to be careful consumers of health benefits, but there is a risk of employees not getting health care that they really need, and a risk of creating bad feelings. Clearly some judgment and "packaging" is needed to achieve the best result. The use of health insurance consultants, as compared to dealing directly with insurers, often makes the process of choosing a health plan provider and the terms of the plan more effective. The process of choosing health insurance providers and options has become too complicated for individual employers to make the necessary choices without third party guidance.

Whatever choice is made with respect to health insurance cannot be considered a "final" choice. A review of health insurance arrangements will be necessary each year. Competitive changes in the market, as new providers enter and existing providers adjust to competitive pressures, will change the cost structure of health insurance.

Other changes will occur. Many employers will opt for some form of self-insurance. For most employers, this will be new territory. They are accustomed to receiving a notice from their health insurers stating what health insurance will cost on a fully-insured basis. With a self-insurance program, employers assume part of the risk of health insurance. By assuming that risk in a carefully planned way, employers might be able

Please email the author at rlouis@saul.com with questions about this article.

to realize substantial savings over a fully-insured plan. Many employers have already begun to explore the benefits of self-insurance, especially those with large numbers of employees. The challenge to smaller employers will be to determine if self-insurance can be used with a smaller group of employees, such as 500-1,000. One of the key factors in making such a decision will be past experience in health insurance claims. It will be vitally important that employers obtain access to claims experience. Not every health insurer has been willing to release such information to smaller groups, perhaps for competitive reasons, and it is here that employers must be insistent.

Another method of financing health insurance costs has been suggested recently: the use of pre-funding through third party financial sources. An employer may pay several years of health insurance costs in advance, by borrowing the necessary funds. Why would an employer do so? Only if it reduced costs, of course. How would such a financing reduce costs? First, because the insurer received all of its charges up front and had a guarantee that the employer would stay with it for some period of time, such as three years, it would be likely to reduce its costs. Second, the consultants involved in this type of financing claim greater knowledge of health insurance economics and, consequently, a greater ability to understand what health insurers might give up in exchange for certainty. This type of financing has been used in the past by public employers and is now being offered to private employers. This is merely one technique being suggested as a means of controlling the almost uncontrollable rise in health insurance costs. More techniques are undoubtedly to come, and it will be the task of counsel to ensure that employers are aware of all they can do to control cost and risk.

Retirement Plan Issues

In a similar way, the world of retirement plans is undergoing a dramatic change:

- There is increasing discussion of the need to save more for retirement, and employees will be looking to employers to help them achieve that goal. In recent years, the "standard" type of plan has been the 401(k), but there is a limit to how much can be saved through a 401(k) plan. In earlier years, many employers sponsored defined benefit pension plans, which, at least for older employees, could result in a greater accumulation of benefits than was possible in defined contribution plans, such as 401(k) plans. But defined benefit plans can develop large unfunded liabilities, which in recent

years have begun migrating to the liabilities section of the employer's balance sheet, as a result of changes in accounting standards. More recently, a shift has begun from defined benefit pension plans to cash balance plans. Despite some uncertainty as to whether these plans violated age discrimination laws, they now seem well established and capable of assisting employers in controlling future costs.

Much attention has been devoted in recent times to investments in retirement plans. The recent financial inquiries into costs in the insurance and securities industries are spreading to retirement plan assets, and litigation is sure to follow. What does it cost to invest in retirement plan assets and to administer retirement plans? This inquiry has been generally overlooked, with the result that financial professionals and administrators have sometimes been compensated far beyond the value of their services. If so, plan participants are not being treated fairly, and have a right to complain. The basis of this problem is the revenue sharing that is paid for mutual funds and others. In effect, revenue is paid to someone because the plan's assets are invested in the mutual funds. The revenue is being "earned" by the participants' contributions, but they often do not enjoy any portion of these revenues.

The appropriate inquiry for in-house counsel is what services are being provided to the retirement plan, what they should reasonably cost, and what service providers are earning. If there is a difference between the last two numbers, perhaps there should not be. As with health insurance, this inquiry generally cannot be made without expert assistance but, with expert assistance, counsel can ensure that participants in retirement plans are getting the greatest benefits from their contributions and can avoid claims that employers have failed to carry out their responsibilities for stewardship of retirement plans.

Nonqualified Deferred Compensation

Deferred compensation can include any arrangement by which a right to compensation payments is earned at one period but paid in another. Retirement plans are a form of deferred compensation under that inclusive definition. Nonqualified deferred compensation refers to arrangements that do not satisfy the detailed rules of the Internal Revenue Code for qualified status, from which follows the various tax benefits of qualified retirement plans. For many years, nonqualified deferred compensation was subject to very little regulation. A wide range of types of nonqualified deferred compensation had developed, including stock appreciation

rights, phantom stock plans, supplemental executive retirement plans, 401(k) mirror plans, management incentive plans and many others. Nonqualified deferred compensation plans could be tailored to specific circumstances and could cover select groups of employees, which made up for the loss of some of the favorable tax consequences of qualified plans.

This form of benefit planning changed substantially with the enactment of new Section 409A of the Internal Revenue Code, as part of the American Jobs Creation Act in 2004. That new law put significant restrictions on the form that nonqualified deferred compensation might take. Limitations were placed on:

- when compensation could be deferred
- when distributions of deferred compensation could be made
- when acceleration of payment was permissible
- when further deferral of payment was permissible
- certain types of funding techniques

In addition, and of some significance, the providers of deferred compensation plans will now have to report the amount deferred on Form W-2, even if that amount is not currently taxable. For the first time, the Internal Revenue Service will have information about how much income that would otherwise be taxable is being deferred. Many practitioners believe that collecting that information is a step toward further regulation and limitations on deferred compensation.

What steps should counsel take in response to this change in law? First, they need to acquire some basic knowledge of the changes. Armed with that knowledge, and with the assistance of outside counsel, they should gather information about the variety of nonqualified deferred compensation plans currently in effect. This fact-gathering process might identify issues unrelated to the new law, such as a failure to have adequate documentation and records of such plans. In addition, this inquiry will identify potential problems of compliance with the new law. Following that, counsel can participate in the decision how to revise such plans. Overall, a new level of awareness will be required, and an ongoing discussion as to the proper management of nonqualified deferred compensation plans.

The world of employee benefits is one of the most diverse and fast-changing areas of business management. Achieving the best results for employers requires much attention and outside assistance, but doing so can have significant financial benefits to employers and employees.