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JULY 5, 2012

What To Do with MLR Rebates under Employer-Sponsored Group Health Plans

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The Patient Protection and Affordable Care Act (the "Act") imposes on health insurance issuers or carriers Medical Loss Ratio (MLR) standards which dictate that a certain proportion of the carriers' income be spent on medical care and quality improvement activities. Insurance carriers in the large-group market (generally, those with at least 100 employees) must spend at least 85% of premium dollars on medical care and quality improvement activities. This percentage is reduced to 80% for carriers in the small-group and individual markets. Where a carrier fails to satisfy the MLR requirements, it must issue a rebate. In the case of policies issued in the individual market, the MLR rebate is paid to the policyholder. In the case of group polices that underlie employer-sponsored group health plans, the rules are more complicated, since premium contributions giving rise to the rebate are in many cases split between employee contributions (usually made on a pre-tax basis under a cafeteria plan) and employers' contributions. For the most part, these plans are governed by the Employee Retirement Income Security Act of 1974 (ERISA). As a consequence, MLR rebates are subject to the ERISA "plan asset" rules and fiduciary and prohibited transaction standards. This will generally require that the rebate be apportioned between employees and the employer.

Background

Guidance issued by the U.S. Department of Labor (the "DOL" or "Department") provides that participant contributions are plans assets. Specifically, DOL Reg. 2510.3-102 provides, in relevant part:

"[T]he assets of the plan include amounts (other than union dues) that a participant or beneficiary pays to an employer, or amounts that a participant has withheld from his wages by an employer, for contribution … to the plan …" [1]

ERSIA requires that "plan assets" be held in trust pursuant to a written trust agreement. There is, however, an exception where the assets consist of insurance contracts or policies issued by an insurance company, or where an insurance company holds the assets. The reason for the rule and its exceptions are not difficult to discern: state laws governing the insurance industry are deemed to provide sufficient protections so as to make the trust requirement unnecessary. But once the policy credits are distributed, the "insurance company" exceptions to the ERISA trust requirement are no longer available and the general rule applies.

Carriers, vendors and other service providers sometime return money to an ERISA-covered group health plan by way of a policy credit, demutualization award, MLR rebate, or other mechanism. Where the contributions underlying the return of money come in whole or in part from participant contributions, all or some part of the returned amount will be "plan assets." This will invoke the ERISA trust requirement and fiduciary standards, which will in turn require the plan to share the policy credit, demutualization award, MLR rebate, etc., with participants.

Insurance Company Demutualization Proceeds

Some years ago, the Department considered issues similar to those presented by the receipt of MLR rebates in the context of the apportionment of insurance company demutualization proceeds in respect of polices held by ERISA-covered plans. In two Advisory Opinions[2] and an Information Letter[3] issued in response to the demutualization of Prudential Insurance Company, the Department provided relief to policy holders on the apportionment of demutualization awards where the underlying policy is held in the context of a pension and welfare benefit plan governed by ERISA. While recognizing that a trust would ordinarily be required in connection with the receipt of a demutualization award, the Department determined that it would not assert a violation of the trust requirement if the following criteria were satisfied:[4]

- The assets eligible for the exception to the trust requirement consisted solely of proceeds received by the policyholder in connection with the demutualization;
- Such assets, and earnings thereon, are placed in the name of the plan in an interest bearing account, in the case of cash, or a custodian account, in the case of stock, as soon as reasonable following receipt;
- Such proceeds are applied to the payment of participant premiums or applied to plan benefit enhancements, or distributed to plan participants as soon as reasonably possible but no later than 12 months following receipt;
- Such assets are subject to control by a designated plan fiduciary;
- The plan is not otherwise required to maintain a trust; and
- The designated fiduciary maintains such documents and records as are necessary under ERISA with respect to the foregoing.

The Department also provided the following advice in the case of an ERISA welfare plan (e.g., an employer-sponsored group health plan) that is particularly relevant in this instance:

"[I]n the case of an employee welfare benefit plan with respect to which participants pay a portion of the premiums, the appropriate plan fiduciary must treat as plan assets the portion of the demutualization proceeds attributable to participant contributions. In determining what portion of the proceeds are attributable to participant contributions, the plan fiduciary should give appropriate consideration to those facts and 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 time period."[5]

Proceeds from Late-Trading and Market-Timing Settlements

In the mid-2000s, the Securities and Exchange Commission (SEC) determined that several mutual funds had violated SEC rules by permitting trading in mutual funds after the markets had closed ("late trading") and had engaged in other "market timing" activities. As part of the resolution of these violations, the SEC required restitution to the mutual fund holders and appointed an "independent distribution consultant" for each mutual fund involved who was responsible for developing and implementing the settlement funds' distribution among affected parties. Allocating these settlements proved particularly vexing for ERISA-covered plans. In many cases sufficient records to determine precise allocations were not available or the cost of calculating allocations to individual accounts could exceed the amount provided by the settlement.

DOL Field Assistance Bulletin No. 2006-01[6] provided guidance to 401(k) plan fiduciaries on how to allocate settlements in connection with mutual fund late-trading and market-timing violations. The DOL determined that the settlement fund proceeds would not constitute plan assets prior to their distribution if certain requirements were satisfied. Specifically, settlement proceeds were required to be apportioned in relation to the impact the late trading and market timing activities may have had on the plan. In implementing this approach, allocations to participant accounts were required to be generally in proportion to losses. But the plan fiduciary was not required to use an allocation methodology that would cost more to implement than the plan participants would receive.

DOL Technical Release 2011-04

Drawing on the lessons of the guidance described above, the Department of Labor directly addressed the treatment of MLR rebates in the context of employer-sponsored group health plans in Tech. Rel. 2011-04. There, the Department made clear that MLR rebates are generally considered to be “plan assets” for ERISA purposes. Accordingly, anyone with authority or control over plan assets is a “fiduciary” who is subject to, among other things, the ERISA fiduciary responsibility and prohibited transaction provisions. Moreover, plan assets generally must be held in trust, may not inure to the benefit of any employer, and must be held for the exclusive purpose of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan. Generally, if the plan or its trust is the policyholder, the policy would be an asset of the plan, and in the absence of specific plan or policy language to the contrary, the employer would have no interest in the distribution. Conversely, if the employer is the policyholder (which is often the case where group health insurance in concerned) and the insurance policy or contract, together with other instruments governing the plan, can fairly be read to provide that some part or all of a distribution belongs to the employer, then that language will generally govern, and the employer may retain distributions. According to the DOL, the determination of whether some or all of an MLR rebate constitutes plan assets generally will require a fact-specific, case-by-case analysis of all the relevant facts and circumstances, including the governing plan documents. The technical release establishes the following specific rules to be applied when apportioning an MLR rebate that is paid to the employer/policy holder:

- If the employer paid the entire cost of the insurance coverage, then no part of the rebate with respect to this particular policy is attributable to participant contributions. There are no plan assets in this instance, and the employer is free to retain the entire rebate (unless, of course, the plan documents provide to the contrary).
- If participants paid the entire cost of the insurance coverage, then the entire amount of the rebate would be attributable to participant contributions and considered to be plan assets.
- If the participants and the employer each paid a fixed percentage of the cost, a percentage of the rebate equal to the percentage of the cost paid by participants would be attributable to participant contributions.
- If the employer was required to pay a fixed amount and participants were responsible for paying any additional costs, then the portion of the rebate under the policy that does not exceed the participants’ total amount of prior contributions during the relevant period would be attributable to participant contributions.
- If participants paid a fixed amount and the employer was responsible for paying any additional costs, then the portion of the rebate under such a policy that did not exceed the employer’s total amount of prior contributions during the relevant period would not be attributable to participant contributions.
- Employers that sponsor group health plans that use insurance policies to provide benefits would be prohibited from receiving a rebate amount greater than the total amount of premiums and other plan expenses paid by the employer.

When determining how to apportion an MLR, ERISA requires fiduciaries to act prudently, solely in the interest of the plan participants and beneficiaries, and in accordance with the terms of the plan to the extent consistent with the provisions of ERISA. According to the DOL, a fiduciary also has a duty of impartiality to the plan’s participants. An allocation does not fail to be impartial or “solely in the interest of participants,” however, merely because it does not exactly reflect the premium activity of policy subscribers. A plan fiduciary may instead weigh the costs to the plan and the competing interests of participants or classes of participants when fashioning an allocation method, provided the method ultimately proves reasonable, fair, and objective. Applying these principles, Tech. Rel. 2011-04 provides that, where the cost of distributing shares of a rebate to *former* participants approximates the amount of the proceeds, the fiduciary may properly decide to allocate the proceeds to current participants based upon a reasonable, fair, and objective allocation method. And, if distributing payments to any participants is not cost-

effective (e.g., payments to participants are of de minimis amounts, or would give rise to tax consequences to participants or the plan), the fiduciary may apply the rebate to other permissible plan purposes including applying the rebate toward future participant premium payments (i.e., a "premium holiday") or toward benefit enhancements. One question that the technical release does not answer is how to handle an MLR rebate where the amount is inconsequential (e.g., a dollar per participant). Taking a cue from DOL Field Assistance Bulletin No. 2006-01, a fiduciary should be able to conclude, after analyzing the relative costs, that no allocation is necessary, since the administrative costs of making correction so far exceed the amount of the allocation.

If a plan provides benefits under multiple policies, the fiduciary is instructed to allocate or apply the plan's portion of a rebate for the benefit of participants and beneficiaries who are covered by the policy to which the rebate relates provided doing so would be prudent and solely in the interests of the plan according to the above analysis. But, according to the Department of Labor, "the use of a rebate generated by one plan to benefit the participants of another plan would be a breach of the duty of loyalty to a plan's participants."

Where it is determined that MLR rebates are ERISA plan assets, the ERISA "trust" requirement will not apply if the rebate is used to pay premiums or refunds within three months of their receipt by the employer.

Tax Consequences

On April 19, 2012, the Internal Revenue Service issued a set of Frequently Asked Questions http://www.irs.gov/newsroom/article/0,,id=256167,00.html (the "FAQs") explaining the tax treatment of MLR rebates. We discuss the particulars of the FAQs in our advisory of May 25, 2012. Typically, where employee contributions are made pre-tax under a cafeteria plan, cash rebates are taxable both as income and for employment tax purposes. (A premium holiday would result in the participant receiving greater taxable income, since a smaller sum is diverted to employee premiums by virtue of the premium holiday.)

Conclusion

The obligation to apportion MLR rebates highlights an aspect of ERISA that sometimes is lost on plan sponsors: when purchasing group health insurance, an employer does not "outsource" health benefits; it merely transfers risk. The group health insurance policy is *not* the same as the underlying ERISA-governed plan. Tech. Rel. 2011-04 calls attention to this fundamental distinction. Employers, in their capacity as fiduciaries with respect to their employer-sponsored group health plans, should determine whether they want to adopt particular policies and procedures relating to their handling of MLR rebates. Plan documents and summary plan descriptions should be amended accordingly. This is also a good time to ensure that plan documents are amended to comply generally with the Act.

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Endnotes

[1] 29 U.S.C. § 2510.3-102(a)(1).

[2] DOL Advisory Opinion Nos. 2001-02A (Feb. 15, 2001) and 2001-03A (Feb. 15, 2001).

[3] Information Letter from Acting Assistant Secretary Alan D. Lebowitz, Pension and Welfare Benefit Administration, U.S. Department of Labor, to Theodore R. Groom, Groom Law Group (Feb. 15, 2001).

[4] *Id.* at 2.

[5] *Id.*

[6] Apr. 19, 2006.

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2040-0712-NAT-ELB