BRANCH CAPTIVES

By Dick Goff

U.S. corporations that operate captive insurance companies in offshore domiciles such as Bermuda, the Cayman Islands or others are keeping a close eye on developments that may allow them to insure employee benefit programs. In TV parlance, this possibility is now more “reality show” than “Fantasy Island.”

The District of Columbia’s captive insurance regulations already allow formation of branches of captives located elsewhere. Allowable direct lines of coverage include the risks of the parent and affiliates, including property, casualty and liability insurance, excess workers compensation, ERISA and non-ERISA employee benefits.

But, of course, another District of Columbia institution, the U.S. Department of Labor, has more to say on the subject of ERISA benefits. First, DOL requires that any captive insuring ERISA benefits must be based in a U.S. domicile. A U.S.-based branch of a captive located in a reputable offshore domicile is acceptable.

There are several more requirements before DOL will issue a prohibited transaction exemption (PTE) to allow a captive to cover ERISA benefits. Among the most important is for the branch captive to prove to the Labor Department that setting up the branch captive will benefit employees rather than just the corporation.

Beneficial aspects to employees typically would represent some combination of reduction in costs and/or some increase in benefits (additional limits, coverages, etc.). This will be a very important consideration for U.S. companies seeking to establish branch captives to cover ERISA benefits.

A PTE has been issued just once, in August 2000 to Columbia Energy Group’s Vermont branch of its Bermuda captive. CEG began covering long- and short-term disability insurance at the end of that year. The parent company subsequently was acquired by Nisource, which continues to use the captive with apparent success.

Currently another branch captive owned by Archer Daniels Midland has an application pending with DOL. From an outsider’s view, it appears that discussions between the parties are continuing at the government’s usual pace. However, if the ADM branch captive is approved, the future approval pace could speed up considerably.

That’s because the DOL has issued an administration regulation that could provide a “fast track” for future PTE applications. “In short, this would allow for decisions on a PTE within 60 to 90 days if the transaction is substantially similar to two previous PTE approvals by the department,” said Chuck Waldron, a principal in the Hartford office of Milliman USA.

“If the Archer Daniels Midland application is held by the DOL to be substantially similar to Columbia Energy, that could trigger the fast track review process for future applications," Waldron said.

Initial approval by DOL is followed by the agency's periodic review. Waldron provides this list of DOL requirements that must be annually certified by an independent fiduciary:

- The branch captive must be domiciled in the U.S.
- The captive's books must annually be examined by a certified public accountant.
- Increased benefits to plan participants must apply during the initial year.
- There must be an annual review of financial reserves by an independent actuarial firm.
- Premiums must be calculated similarly to other insurance plans for similar programs, and be reasonably within the range of competitive plans.
- No officer of the parent corporation may receive a commission on payments into the captive for employee benefit programs.

Owners of captive insurance companies will readily appreciate the value of establishing a branch captive for managing risks including employee benefits. Here are just four of the many reasons that employee benefit plans can be better managed in a captive insurance company:

- The employer can customize the plan to meet the specific benefit needs of its workforce, as compared to buying a "one-size-fits-all" insurance policy.
- The captive insurance company maintains control over the health plan reserves, enabling maximization of interest income – income that would be otherwise generated by an insurance carrier through the investment of premium dollars.
- The employer does not have to pre-pay for coverage (while observing the liquidity requirements of the domicile), thereby providing for improved cash flow.
- The employer is free to contract with the providers or provider network best suited to meet the benefit needs of its employees.

In many organizations, plans are administered and underwritten by different professional firms and insurance companies. Bringing them together in the captive provides potential massive savings.

All the financial benefits of insurance property and casualty risks through a captive company apply equally to employee benefit programs. Depending on its structure, a captive may provide the opportunity to transform a liability on the corporation's books to an asset of the captive and may provide accelerated tax benefits for the corporation. Naturally, any prudent manager wouldn't take a columnist's word for this, but would consult with their accountant or tax counsel.

Increased future use of branch captives could swell the roster of District of Columbia captives. In addition to being the center of the political world and the home of more than

5,000 associations, DC could become the preferred address of corporations establishing branch captives to streamline their risk management and transfer.

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