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Don't Fall Into the Gap!

Beware Of Run-Out Coverage Under Stop-Loss Policies

By Rhonda D. Orin

Each year, most large employers and an increasing number of mid-sized and even small employers choose to self-fund their employee health benefits plans rather than purchasing traditional health insurance. They do so because self-funding offers attractive cost-saving features, such as avoiding premiums, premium taxes and state mandatory benefits laws. Deep within the structure, however, are certain disadvantages that are hard to appreciate or understand until a problem arises. Many of these problems are associated with an important back-drop of the self-funded structure: stop-loss insurance policies.

Stop-loss policies are roughly comparable in function to reinsurance. They are designed to provide insurance to self-funded plans that pay claims over an agreed-upon sum. Stop-loss can be either plan-wide (aggregate stop-loss) or based on a particular individual's annual claims. While many plans choose to purchase individual stop-loss limits, the decision whether to purchase aggregate limits as well can vary considerably by plan.

Stop-loss insurance policies are the only actual insurance products in the self-funded structure. The policyholder, though, is the self-funded plan or the employer, not the plan participants who receive health benefits under the plan. Thus, there is no privity between the plan participants and the stop-loss insurance company. More importantly, a denial of a stop-loss claim by a stop-loss insurance company should not affect the plan participants. Regardless of whether the plan succeeds in recovering insurance company reimbursement of claims that exceed the stop-loss limits, the plan must independently address and resolve its contractual obligations regarding payment of the underlying claims.

> ***"Without run-out insurance coverage, self-funded plans face a risk of being uninsured for claims that fall into the gap and exceed the stop-loss limits."***

Potential Problems

Problems arise between self-funded plans and their stop-loss insurance companies in a myriad of ways. One example involves the issue of run-out insurance coverage. To recognize the importance for such coverage, all that is needed is an understanding of the phrase "incurred but not received." The key point is this: just because a plan's contract year expires at midnight on December 31st and the next one begins at 12:00 a.m. on January 1st necessarily does *not* mean that the plan will have seamless insurance coverage. Instead, there must be a provision requiring the stop-loss insurance company to provide "run-out" coverage—namely, to cover claims that were incurred prior to the turn-over date but not paid until after it.

Such coverage is important because there will

"Don't Fall Into the Gap!" continued p2

A Note from the Editor

Understanding the role of run-out coverage under stop-loss policies of Self-Funding Plans can be challenging. In this issue we will explore potential problems that arise between self-funded plans and their stop-loss insurance companies, coverage issues and the need to avoid a coverage gap. The second article covers proposed captive insurance tax regulations that would affect consolidated groups. Our spotlight section explores the reasons why you may want to consider hiring a dependent auditor when evaluating your health care program.

—Rhonda D. Orin

"Don't Fall Into the Gap!" continued from p1

always be a few claims in the pipeline. That fact is inevitable because health services are continually being provided and also because the plan has no control over when the bills from the third-party providers for previously rendered services will arrive in the plan's mailbox. Without run-out insurance coverage, self-funded plans face a risk of being uninsured for any and all claims that (a) fall into the gap; and (b) exceed the stop-loss limits.

Thus, all corporations that decide to self-fund should be fully informed about run-out coverage that they should purchase or have purchased, and should ensure that it is adequate to serve their needs during a transition.

Coverage Bases

Stop-loss insurance policies typically provide coverage based on one of the following bases:

Policy Basis	Period When Covered Claims May Be Incurred	Period When Covered Claims May Be Paid
"Paid" or "12/12"	During the policy period	During the policy period
"Run-In" or "15/12"	3 months prior to the policy inception date or during the policy period	During the policy period
"Run-Out" or "12/15"	During the policy period	During the policy period or 3 months after the policy terminates

In the first case, a "paid" or "12/12" basis, there is no run-out coverage for a claim that is incurred during one period and paid during the next period, even if the claim hits and exceeds the agreed-upon stop-loss limit when it is paid.

In the second example, there is no run-out coverage, but instead there is "run-in" coverage, meaning coverage for a claim incurred in the final three months of the previous policy period and paid during the current policy period.

In the third example, there is run-out coverage for three months, meaning that claims incurred during the policy period and paid within three months after the policy period are covered.

Avoiding A Coverage Gap

The importance of this issue is illustrated by a recent case in which a self-funded corporation fell into a gap in coverage—but managed to climb out of it.

The corporation's stop-loss policy provided coverage on a "paid" basis. At the end of a policy year, the corporation decided to switch insurance companies. Almost immediately after the start of the new year, the corporation received a substantial number of claims regarding a single claimant, many of which resulted from a back-log in a third-party's billing practices. The claims substantially exceeded the plan's stop-loss limits, so the corporation submitted them to both the original and successor stop-loss insurance companies.

Both stop-loss companies, however, immediately denied coverage. The original insurer advised that it had no obligation to provide run-out coverage and the successor insurer took the same position with regard to run-in coverage. In short, the claims fell right into the gap.

Fortunately, this was not the end of the story. After consulting with counsel, the corporation discovered that the stop-loss company had been obligated by state law to offer run-out coverage to the corporation at the time of contracting—but had not done so. The remedy, under that same state law, was a mandate for the original insurer to provide the run-out coverage regardless.

The corporation immediately informed the stop-loss company of the law. Following a period of reluctant investigation, the stop-loss insurer company paid the claim in full.

Rhonda D. Orin is the managing partner in Anderson Kill & Olick's Washington, D.C. office. Ms. Orin has recovered millions of dollars for self-funded plans from third-party administrators, stop-loss insurers and others, and also has extensive experience in representing policyholders against insurance companies in traditional coverage disputes.
(202) 218-0049
rorin@andersonkill.com

Proposed Captive Insurance Tax Regulations Would Affect Consolidated Groups

By Phillip England and Randall Beckie

On September 28, 2007, the U.S. Treasury Department issued proposed tax accounting regulations that, if adopted, would create a consolidating elimination of deductions for captive insurance reserves. Because the proposed regulations would affect a captive only if it is a member of a U.S. tax consolidated group, some taxpayers have already begun planning how to exclude their captives from consolidated tax returns prospectively. Planning alternatives include:

- Let a non-consolidated holding company own the captive. For example, a life insurance company is excluded from a consolidated tax return unless its non-life parent elects otherwise.
- Redomicile the captive from the U.S. to offshore and operate it as a controlled foreign corporation (CFC). However, premiums paid to an insurance CFC may incur federal excise tax (4% tax on direct premiums, 1% tax on reinsurance premiums) unless the captive is in a treaty country such as Ireland.

According to one survey, 30% of U.S. captives would be affected by the proposed regulations, particularly captives that belong to publicly traded corporations. In contrast, most group captives and closely-held captives would be untouched. Closely-held captives are typically owned by individual family members or trusts, not by a parent of a consolidated group.

Accelerating the deductibility of unpaid losses via insurance company accounting is one of the most significant tax advantages (though not the only one) of forming a captive insurance company. The proposed regulations would essentially eliminate insurance company tax accounting by treating intercompany insurance as non-insurance, notwithstanding case law and IRS revenue rulings that say intercompany insurance really is insurance.

"Proposed Captive Insurance Tax Regulations" continued p4

SPOTLIGHT

Do Your Dependent Audit—*NOW*

By James J. Fournier

A streamlined benefits department dedicated to employee satisfaction is as difficult to achieve as it is admirable. It is precisely that dedication, however, that can contribute to a costly employer oversight—failing to undertake a dependent audit of its health care program participants.

The primary purpose of a dependent audit is to identify and cull ineligible employee dependents from employer health care programs. Dependent ineligibility typically occurs either through divorce, death, or an employee's shifting child-related circumstances.

A dependent audit has several cost-cutting features and compliance benefits. First, depending upon the number of ineligible dependents culled, the savings can be tremendous. Vanderbilt University recently saved more than $650,000 by culling 6% of dependents following a dependent audit. Other employers have saved millions. These savings allow employers to avoid increasing employee contributions, restricting plan benefits or changing the plan design. Second, a dependent audit allows the employer to ensure that claims are not paid to ineligible dependents. Third, a dependent audit avoids potential exposure under the Sarbanes-Oxley Act by allowing an employer's management team to sign off on quarterly figures that incorporate accurate information concerning its health care program costs.

Just Do It

Employers can initiate the audit process by providing an amnesty period for employees to voluntarily come forward to discuss their dependents and to document dependent eligibility by providing marriage certificates, birth certificates, and tax forms. After culling the ineligible dependents, an employer must tighten its procedures to insure that the same pattern is not repeated. It is a win-win process for employees and employers that employers ignore at their own peril.

James J. Fournier is an attorney at Anderson Kill's Washington, D.C. office in the firm's Insurance Recovery group. Mr. Fournier regularly represents policyholders in disputes with their insurance companies.
(202) 218-0046
jfournier@andersonkill.com

"Proposed Captive Insurance Tax Regulations" continued from p3

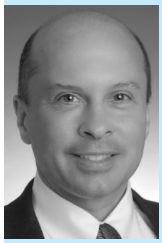
Commentators (including us) are questioning the validity of the proposed regulations; hence, the mainstream is taking a wait-and-see approach. However, anti-avoidance rules in the consolidated return regulations create a logic for restructuring ownership of a captive before Treasury adopts (if it ever will) the proposed regulations. In an important but unheralded private ruling issued earlier this year, TAM 200729035, the IRS disregarded a purchasing cooperative that was used as a non-consolidated holding company for operating subsidiaries. For similar reasons, if the proposed regulations are adopted the IRS perhaps could disregard the non-consolidated ownership structure of a captive insurer. However, the IRS would have difficulty applying the anti-avoidance rules to thwart planning around regulations that are not yet adopted.

Treasury is welcoming public comment about the proposed regulations through December 27, 2007. If the proposed regulations are adopted in 2008, they would go into effect no earlier than 2009 for a calendar year taxpayer. Eventually the courts might invalidate the regulations, but in the meantime the regulations—even in proposed form—will complicate captive insurance planning and make business purpose paramount.

Under an exception tailored for commercial insurance companies, the proposed regulations would not apply where 95% or more of an insurer's premiums comes from unrelated parties. Where a fronting carrier cedes reinsurance premiums to a captive, the proposed regulations suggest the IRS could treat the reinsurance business as related-party business so as to disallow reserve recognition pursuant to anti-avoidance rules. Fortunately, reserves for unrelated risk would continue to be deductible by a captive. The unrelated risk exception may give a boost to captive insurance of employer plans, which constitutes unrelated risk under a look-through rule.

For a fuller discussion, see AKO's article "Proposed Tax Regulations: A Solution without a Problem" in the December 2007 edition of Anderson Kill's *The Captive Report*, which can be found on our website at http://www.andersonkill.com/webpdfext/publications/captive/pdf/captivereport_aut07.pdf.

Phillip England is a shareholder at Anderson Kill in the firm's tax practice. Mr. England has extensive experience in complex tax issues including captive insurance matters.
(212) 278-1483
pengland@andersonkill.com



Randall Beckie, CPA is the Managing Director of Anderson Kill Insurance Services. Mr. Beckie has extensive tax experience in the United States and Europe with concentrations in international taxation and insurance taxation, with an emphasis on captive insurance.
(212) 278-1644
rbeckie@andersonkill.com

More than half of the businesses in America now self-fund their employee benefits plans, rather than purchasing traditional insurance policies. This percentage is likely to increase, due to the up-front cost-savings that can be achieved by self-funding and the opportunity for certain legal protections. Yet self-funding is complicated and its advantages are accompanied by a wide variety of disadvantages. This quarterly publication is dedicated to exploring all aspects of self-funding, with a focus on the practical needs of employers.

If you require more information, legal advice or an opinion with respect to a specific situation, please contact our Editorial Board.

Rhonda D. Orin, Editor	Insurance/ERISA	(202) 218-0049	rorin@andersonkill.com
John N. Ellison	Insurance Recovery	(215) 568-4710	jellison@andersonkill.com
Phillip England	Tax/Captives	(212) 278-1483	pengland@andersonkill.com
Dona S. Kahn	Employment & Labor Law	(212) 278-1812	dkahn@andersonkill.com
Jackie Taylor	Insurance Recovery	(215) 231-3644	jtaylor@andersonkill.com
Sloan J. Zarkin	Employment & Labor Law	(212) 278-1474	szarkin@andersonkill.com

The firm has offices in New York, NY, Washington, DC, Chicago, IL, Philadelphia, PA, Newark, NJ and Greenwich, CT