

# COBRAS as Early Retirees

## Suggestion

The employer may amend its health care plan document so as to redefine a participant, with contributory early retirement benefits, to be a COBRA. Such amendment would, e.g., extend COBRA to cover the period from (a) early retirement age plus 18 months to (b) age 65.

- ERISA gives the employer the right to so amend.
- Congress crafted COBRA to be a minimum benefit.
- A COBRA and an early retiree are two significantly different types of plan participants and require different treatment.

The significance of the decision for the employer is that FASB 106 requires a *buildup or accrual* of liabilities of such early employer-provided retiree costs during the participant's working lifetime. Such accrual is *not* required for COBRAs.

Every employer, as an ERISA-Demanded act of prudence, should make a conscious and deliberate plan design decision to *amend or not to amend* where early retirees with contributory benefits are involved. Consequences of such decision are reviewed in the next section.

This suggestion applies only to early retiree benefits, which are funded, in part, by participant contributions. Treatment of over-65 retiree benefits is unchanged.

## Consequences

### Legal

The writer believes that such decision to amend or not to amend is a legal non-issue:

- The redefinition amendment must not diminish any promised benefits to such retirees; nor significantly discriminate (either to help the prohibited group or to harm the protected group).
- Existence of any related labor or employment contracts must be considered. The different legal status of such early retirees and COBRAs must be recognized:
- A COBRA for purposes of plan funding is an active participant; an early retiree is an inactive participant. With COBRA, we have one fund. With early retirees we have two funds.

- The COBRA may, prior to the end of such COBRA extension period, return to work and be treated as having unbroken service. Such is normally not the case with an early retiree.
- Each COBRA beneficiary has claimable rights regardless of having employee or dependency status. This is normally not the case with early retirees.
- COBRA benefits are considerably more secure because of the similarly situated requirement of COBRA. This is normally not the case with retiree benefits. The reader should note the plethora of litigation involving retiree benefits.
- COBRA premiums are actuarially-determined while those for early retirees are employer-determined. This may be a great significance to the participant.
- COBRA has secondary events benefits (spouse continuing coverage after a legal separation, e.g.) which are normally not found with early retiree benefits.
- Early retirees with employer-pay-all benefits may be redefined to be COBRA, but may fail to be treated as COBRAs for FASB 106 purposes. This is because the element of election, present with COBRA is absent where the benefits are employer-pay-all.

## Financial

It is absolutely certain that plan administrative costs will decrease because the FASB 106 maintenance costs will disappear. Such cost decrease may be significant.

Employers who seek high reserves (for tax-deferral purposes, e.g.) have the *right* to treat such participants as early retirees. Those who seek low reserves have the *right* to treat such participants as COBRAs.

Benefit costs from such redefining will not be affected measurably. COBRA benefits are a bit more expensive because of the secondary event requirements of COBRA.

With such amendment, the so-called FASB 106 accrued liability drops to \$0. This would, where material, be treated as a change in accounting practice. Where the employer pays any portion of the retiree *costs*, FASB 112 would apply *when* the COBRA event occurs. That is, the present value of the employer's *cost* of the COBRA premiums is a FASB 112 liability.

With early retirees, the plan has two funds (a) actives/COBRAs and (b) early retirees. Where such early retirees have been amended to COBRAs, the plan has but a single fund. Depending on many factors, the *bottom* line cost effect for the COBRAs, early retirees and employer cannot be predicted.

See Exhibit A, attached, for a numerical illustration of how such redefinition will eliminate early retiree reserves.

## Contributory v. Non-Contributory Issue

In Three different early retirement funding situations should be examined:

- One. Participant-Pay-All  
The redefinition suggestion should be fully accepted by the accountants. Funding commonality with early retirees and COBRAs exists.
- Two. Participant and Employer Shared Cost  
The redefinition suggestion should be reviewed by the accountant and accepted or denied on a case-by-case basis. Sufficient funding commonality between early retirees and COBRAs may or may not exist.
- Three. Employer-Pay-All  
The redefinition suggestion should not be accepted and FASB 106 should be applied. Funding commonality between early retirees and COBRA does not exist.

## Government Entity Plans

Since the Government Accounting Standards Board will, in the future, *require* accrued liabilities (as does FASB 106), the suggestion of *amend* or not to *amend* would be most appropriate at such time.

## Publicly-Traded Employers

Consider two competitive publicly-traded employers, A and B, which have similar balance sheets, markets, size, etc. Employer A extended COBRA (thereby redefining early retirees) while Employer B was not advised of its option to do so. Such difference in practice will give Employer A a financial *one-up* on Employer B.

## Responses of Affected Persons

<u>Affected Person</u>	<u>Response</u>
Participants	Favorable; they prefer being COBRAs.
Employers	Very favorable; they appreciate having the freedom to choose.
Attorneys	Neutral – its is an accounting and not a legal issue.
Accountants	Initial response is usually silent, negative or skeptical. However, accountants will normally honor the plan Document language when confronted directly therewith and where the plan is contributory.
Actuaries	Response unknown.
Regulators	No formal response has been sought.
TPAs	Favorable

Consultants	Favorable
Risk Managers	Favorable

## **Bankruptcy of Employer**

When the participant is provided coverage, after active service, prior to age 65, either as (a) a COBRA or (b) a retiree, the effect of the employer's bankruptcy on the security of such benefit is essentially the same.

Consider the following:

1. Neither COBRA nor retiree benefits have any statutory protection for a Chapter 7 bankruptcy.
2. Both COBRA and retiree benefits gain significant statutory protection in a Chapter 11 bankruptcy.
  - a. COBRA  
ERISA specifies that retirees shall be afforded rights as COBRAs in certain instances:
    - i. Loss of coverage is due to a Chapter 11 bankruptcy.
    - ii. Such loss occurred between the period of one year prior to one year after such bankruptcy filing.
    - iii. COBRA rights extend to family members.
    - iv. COBRA continuation period is extended to lifetime.
  - b. Retiree  
Chapter 11 of the Bankruptcy Code provides that retiree health benefits shall be afforded preferential treatment regardless of the funding method (insured v. self-funding, e.g.) of such benefits.

## **COMMENTARY**

This suggestion is not new, but it is not widely known and should be. It does not force anything on anyone, but does offer the employer an ERISA funding option within a small benefit area.

What will we do if Congress forces COBRA to be extended to cover the so-called gap *period*? Will not this issue need to be examined at such a time: Will this suggestion lessen the likelihood of a *forced* COBRA benefit expansion by Congress?

In dealing with such plans, should we not be both logic and prudent? With small plans, the maintenance costs of FASB 106 are usually excessive when measured against the benefits.

Accounting disciplines must be honored. The final decision as to whether such redefinition will, or will not, be honored always is with the accountant.

However, early retirees and COBRAs are significantly different and must be treated. If the accountants believe this suggestion violates sound accounting principles, FASB 106 should be amended so as to clearly distinguish between two classes of COBRAs:

- Class A – COBRAs who should be treated as actives.
- Class B – COBRAs who should be treated as in actives.

# Exhibit A

## Illustrative Reserve Reduction Resulting From Reclassification Of Early Retirees To COBRA

1. Present value of the employer's cost of retiree health care benefits.
  - a. At age 65                      \$20,000
  - b. At age 60                      30,000
  
2. Present value of the employer's cost of retiree health care benefits from age 60 to 65.
  - a. At age 40                      \$10,000
  
3. Consider John, age 45, hired at 30.

The employer will have an accrued liability where John, by the Plan Document, is treated as follows:

  - Retiree  
  
$$\$30,000 \quad (45-30) = \$15,000$$
  
  - COBRA  
  
$$\frac{\$20,000}{65 - 30} \times (45-30) = \$8,571$$

The example results in a \$6,429 reserve reduction.

Note: Significant variables, such as inflation, interest, mortality, morbidity, turnover, probability of early retirement, etc., are ignored to simplify the illustration. Benefit is full medical at employer cost beginning at age 60, if early retired, with 25 years of service. Such early retiree benefits are not employer-pay-all.