NATIONAL REPORT FOR THE UNITED STATES
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The national report for the United States has broken down the major current employment consulting issues into five main sections:

- Economic Report
- Health Coverage Issues
- Retirement Coverage Issues
- Executive Compensation Issues
- Other Human Resource Issues

ECONOMIC REPORT

In late 1993 and in 1994 the United States economy improved markedly as the prior economic recession ended. This improvement was initially buoyed by low interest rates, but as the economy began to "heat up" in early 1994, the federal reserve bank tightened its monetary policy, raising interest rates. Whether this will reverse the current economic recovery remains to be seen. Inflation remains low, interest rates, although higher than in recent years, remain reasonable, and employment continues to grow.

With the improving economy, many of the unresolved structural economic issues have surfaced again; persistent government deficits, low national savings rates, and a large trade deficit, especially with Japan.

The administration of President Clinton undertook to address some of these issues. After a struggle with Congress a budget bill was enacted (OBRA 93) that increased marginal tax rates for the higher-paid from 31 percent to 39.6 percent, and "uncapped" the Medicare tax of 1.45 percent of payroll, making it applicable to all pay, not solely pay up to $135,000 per year. This tax increase, coupled with the improving economy reduced annual deficits from the 300 - 250 billion dollar range to approximately 170 billion dollars. By historical standards, however, such deficits are still quite high and the issues will have to be addressed soon.

American savings rates remain low. Suggestions to offer incentives for increased savings, such as improved tax deductions for individual retirement accounts, fail in light

of the continued government deficits. Congress (and the electorate) stubbornly refuse to consider really significant tax increases (such as an increased gasoline tax or a value-added tax) or spending cuts (such as a reduction in social security benefits), although constituencies for such aggressive steps are beginning to appear, such as the Concord Coalition, founded by former senators Warren Rudman and Paul Tsongas, which supports both types of measures.

The Clinton administration has attempted to ameliorate the trade deficit by engaging in aggressive trade negotiations with Japan, but has had only limited success, partially due to the difficulty the Japanese have had in forming a coalition government after their recent elections.

The completion of the Uruguay Round of the GATT and the approval of the North American free Trade Agreement are both considered trade successes, but the effects on the United States economy are difficult to predict.

Against this background the administration has undertaken a massive program of reform of the way health care is delivered to Americans. At the time of this writing it is too early to predict the outcome.

HEALTH COVERAGE ISSUES

More than 100 health reform bills have been introduced in the 103rd Congress. While this is one barometer of Congress' interest in legislating health reform, the vast majority of these bills will obviously never be enacted into law or even receive committee attention.

Employers need to focus on the proposals most likely to attract enough support to form the basis for compromise. The earlier employers can discern where health reform is headed, the sooner this new reality can be incorporated into their business planning. Based on current information, most legislative activity will center on reform proposals now before the Congress:

President Clinton's Health Security Act. It was introduced in the House and Senate on November 20, 1993. House Majority Leader Dick Gephardt (D-MO) and Senate Majority Leader, George Mitchell (D-ME), are the primary sponsors in their respective chambers. Even though this is the President's bill, party discipline will be no easier to maintain on health reform than it has been on other contentious issues.

The Managed Competition Act, a/k/a **"the Cooper bill."** It is the bill closest to the Jackson Hole proposal, featuring networks of health insurance purchasing cooperatives for small employers, and changes in the tax treatment of health benefits for all employers, but no employer mandate. It also does not regulate health care spending and thus would not address cost-shifting to private sector payers. The Cooper bill has bipartisan support and may represent the "moderate middle" position in the House.

Health Equity Access Reform Today Act, a/k/a **"the Chafee bill"**, S.1770. Senate Republicans worked for over a year on a proposal now championed by Senator Chafee (R-RI). The bill includes **voluntary** purchasing cooperatives, changes in the tax treatment of health benefits for employers and employees, but no employer mandate. It has attracted considerable support in the more conservative Senate including the recent addition of several Democrats.

Affordable Health Care Now Act, a/k/a the **"House GOP bill"**, H.R. 3080. Virtually all of the Republican members of the House (142) have signed on to co-sponsor a low-regulatory approach to health reform developed by the Republican party leadership in the House. Like the Chafee and Cooper bills, this one approaches health coverage by seeking to establish universal access to health insurance, thus highlighting one of the basic differences between the Clinton plan and other approaches.

American Health Security Act, a/k/a the **"single payor bill."** It would displace both employers and insurers from the current health care system, with the federal government assuming risk for all American's health care through payroll taxes and other levies. Despite the number of co-sponsors (about 90), this bill may have already peaked in support in the current Congress. Representative Jim McDermott (D-WA), a physician, is the chief sponsor.

Senator Nickles (R-OK) has also introduced a proposal, a/k/a the **"Nickles bill,"** that would eliminate the employee exclusion for health benefits and replace it with individual income-related tax credits for the purchase of health insurance. The Nickles bill is based on a concept formulated by the conservative Heritage Foundation. This proposal has attracted 25 co-sponsors in the Senate.

Other health care issues

The debate over health care reform has captured Americans' attention, but other health care issues still continue. Of major interest are the continuing trend towards "managed care" and the problems of providing for postretirement

health care for employees.

Managed Care

The financial ramifications of health care cost inflation in employer health plans has made the management of those costs a strategic imperative for most employers. As a result, many varied utilization control features were added to indemnity health plans in the 1980s, while employees were also encouraged to use alternative delivery systems. Despite these efforts and periodic moderations in health cost trend, employers have still wrestled with whether they and their employees are getting consistent value from health plan expenditures.

In the last several years, however, employers have begun to implement a new generation of managed care health plans featuring integrated networks of providers under a common utilization control and quality discipline. In many cases, these managed care networks feature primary care gatekeepers who coordinate comprehensive care. Under some plan designs employees also have the option to secure covered care outside the network at reduced benefit levels.

These arrangements are a response both to management's increasing concern over health costs and the concerns of employers and employees that cost containment efforts might compromise the quality of health care received by employees and their families. Towers Perrin surveys of employers and employees indicate that this generation of managed care plans is effectively responding to both of these concerns. In the future, more of these networks will be contracting with employer plans based not just on financial results but on the quality of health care outcomes as well.

The legal and regulatory issues presented by this new generation of employer managed care plans are a mix of old and new. Employers still face issues like experimental treatments and excluded services, however, they have also been sensitive to the potential for incurring vicarious liability for adverse medical outcomes at the hands of managed care network providers. Many employers have addressed this potential liability by securing hold harmless indemnification from network managers. For ERISA plan sponsors, the preemption of state law causes of action has also been a potential strategic defense.

The managed care network entities that many employers contract with, whether insurance company-owned, HMO or other arrangement, also face efforts at the state level to require "any willing providers" to be included in their networks. An increasing number of states are coming under pressure to

adopt such laws. These laws adversely affect the ability to assemble and manage a network of providers who are selected based on qualitative measures and committed to making managed care work. For this and other reasons, most of the major health care reform initiatives on the federal level include provisions that would preempt state "any willing provider" laws.

Provision of Health Care to Retirees

Employers are now generally required to recognize a current expense for future retiree medical benefits under Financial Accounting Standard No. 106 (FAS 106). The new rule became effective generally for fiscal years beginning after December 15, 1992. Employers responding to FAS 106 have needed to estimate the financial effect of the new rules and to establish a policy covering the selection of assumptions and determining whether the transition obligation will be recognized immediately or amortized. They have also investigated whether to redesign benefits to produce an acceptable level of expense and, if so, to establish the charges and any long-range cost sharing strategy.

Under President Clinton's health care reform proposal, retirees under 65 would be covered under regional health alliances with the government paying 80% of average premium costs. Employer obligations would be limited to the 20% family share on behalf of the retiree. The proposal also provides an outpatient prescription drug benefit for retirees over age 65. Currently, prescription drug costs comprise 30% or more of the costs of an employer-sponsored retiree medical plan. The effect of these two provisions, if enacted, will be to reduce the costs employers will be required to recognize under FAS 106. However, employers whose costs are substantially reduced under this proposal will be assessed a one time charge by the government to pay for the additional early retirements induced by this subsidy.

A modified version of the Clinton plan offered by Rep. Peter Stark (D-CA) would provide little or no reduction in an employer's FAS 106 liability. Stark's proposal would require an employer to pay 80% of the early retirees' premium costs for basic coverage under a new Medicare Part C until such retirees qualify for Medicare Parts A and B. Employers that do not currently offer or contribute to family coverage would be required to offer but not pay for such coverage. When retirees reach age 65, the employer would be required to continue the retirees' coverage under its retiree medical plan as part of a maintenance-of-effort requirement. However, the proposal would provide an outpatient prescription drug benefit under Medicare Part B.

Unlike pensions, retiree life insurance and medical benefits do not vest under the federal benefits law, ERISA. Therefore, courts sort through the facts of particular cases to determine whether already-retired employees have contractually vested rights in post-retirement health and life insurance benefits. One line of cases suggests that when plan documents (including SPDs) do not consistently and unambiguously reserve the employer's right to amend, alter or terminate life or health plan coverage, courts may look to other employer communications (e.g., letters, booklets, oral statements of benefits personnel, etc.) to discern whether a promise of lifetime health benefits was made or implied. Nevertheless, employers in a number of cases have successfully defended changes to current retiree medical coverage by explicitly reserving the right to amend or terminate their plans.

In addition to reserving the right to alter, amend or terminate plans, the employer must prove that it followed the plan's written procedures for such plan changes. One recent court ruling required an employer to explicitly identify the persons who can amend the plan and describe the procedure by which amendments are made.

Comprehensive national health reform is not expected to resolve these controversies. However, if reform brings about the availability of guaranteed issue, noncancellable community-rated coverage for pre-65 citizens, many employers might consider dropping their current plans (assuming there is no maintenance of effort requirement).

Congress has also adopted bankruptcy law amendments that create rules for court-supervised redesign of retiree medical benefits for companies in Chapter 11 bankruptcy reorganization. While benefits could be reduced in such cases, they are less likely to be eliminated.

RETIREMENT COVERAGE ISSUES

Although a large amount of attention is focussed on health care reform, pension issues are of major concern to employers, especially because the Internal Revenue Service as finally issued all of the regulations dealing with nondiscrimination issues. These cover the following sections of the Internal Revenue Code:

- 401(a)(4), dealing with nondiscrimination in benefits or contributions;
- 401(a)(26), dealing with minimum participation;
- 401(l), dealing with permitted disparity;

- 410(b), dealing with coverage; and
- 414(s), dealing with the definition of compensation.
- 401(a)(17), dealing with the $150,000 pay cap, and
- 414(r), dealing with qualified separate lines of business.

These regulations reduce the entire plan qualification process to a set of numerical tests. The new rules apply for plan years beginning after 12/31/93, and they require that every U.S. plan be revised and resubmitted to the IRS for qualification prior to the end on the plan year beginning in 1994.

The new rules provide a number of plan designs that meet "safe harbor" rules. These plans qualify if certain coverage tests are met. Other plan designs will qualify if the coverage tests are met each year, and certain other tests -- called "general testing" are met once every three years.

Deductions for Foreign Plans

IRC section 404A enables employers to take a deduction (or reduction in earnings and profits for foreign tax credit purposes) for contributions to (or reserve additions with respect to) foreign pension plans, if an election is made under that provision and other requirements are met. In April 1985 the IRS proposed regulations implementing IRC section 404A. These proposals sparked considerable interest and generated a number of lengthy comments.

Reproposed 404A regulations, which resolve many of the problems with the earlier proposal but which incorporate a number of harsh positions, were issued in May 1993.

Under the reproposed regulations, if a plan fails to be for the exclusive benefit of employees, the entire amount of assets of the trust must be brought into income. On the favorable side, the new rules allow increased deductions for unfunded reserve plans.

New regulations of Investment Choice

Individual account plans often give employees choices for investing assets held in their accounts, and employers have generally assumed that the employees are legally responsible for any investment directions given. Final Department of Labor (DOL) regulations, issued in October 1992 and

effective January 1, 1994 for calendar year plans now spell out the conditions under which a plan sponsor will not be responsible for losses resulting from a participant's investment decisions.

Compliance with 404(c) requires that a plan give participants the opportunity to choose from a "broad range of investment alternatives" and to "exercise control" over the assets in their accounts. At least three investment options must be made available under the plan in order to satisfy the "broad range" requirement. And in order to exercise control, participants must be permitted to transfer balances among funds at least once in a three month period and receive "sufficient information" to make informed investment decisions.

While compliance with 404(c) is voluntary -- and failure to comply will not violate ERISA -- the risk associated with noncompliance is that fiduciaries could have potential liability for losses resulting from a participant's imprudent investment decisions.

ERISA Enforcement

Department of Labor (DOL) introduced legislation in 1992 to beef up ERISA enforcement powers. The bill would have (1) repealed the limited scope audit exemption; (2) required peer review every three years for independent public accountants who audit employee benefit plans; (3) required plan administrators and auditors to report criminal violations involving plans to DOL; and (4) required plan administrators to report to DOL within seven days any termination of a plan auditor. The DOL is currently putting together a similar bill that it expects to introduce later this year.

The DOL is expected to introduce legislation to overturn the Supreme Court's Mertens v. Hewitt decision. A limited bill, dealing only with annuity purchases passed the Senate last year. The Mertens decision held that employees could not sue a nonfiduciary for monetary damages. The DOL believes such suits are necessary to stop nonfiduciaries from assisting in fiduciary breaches.

The DOL also has underway a comprehensive review of the disclosure rules under ERISA. The agency is trying to determine whether plan participants are receiving all the information they should and whether some types of information are unnecessary.

Pension Benefit Guaranty Corporation Solvency

The failure of several large pension funds has created large deficits under the accounting method used by the PBGC. This has led the PBGC and others to seek statutory amendments that would, among other things, enhance the status of the PBGC in bankruptcy and increase the funded status of plans. One bill, S. 540, would allow the PBGC to sit on creditors' committees in bankruptcy proceedings. Another bill, H.R. 298, would strengthen the minimum funding requirements and prohibit benefit increases by plans less than 90% funded. The Administration PBGC legislative proposal, the "Retirement Protection Act of 1993", H.R. 3396 and S. 1780, has been introduced in Congress. The proposal seeks to strengthen the minimum funding requirements, phase-out the cap on the variable rate premium over 3 years, specify the interest rate and mortality assumptions used to calculate lump sum distributions and expand the list of reportable events to include certain corporate transactions. The proposal would also forbid defined contribution plans from performing nondiscrimination testing on a benefits basis. Congress is not expected to deal with this issue this year because most of Congress' attention and time will be devoted to health care reform.

EXECUTIVE COMPENSATION ISSUES

There remain a number of other consulting issues dealing with human resource issues. The increase in marginal rates to 39.6 percent will probably cause companies to focus more on compensation that provides capital gains (which are still taxed at 28 percent rate) or tax deferral opportunities.

Problems with deferred compensation plans

Many companies maintain plans that provide pension benefits to executives to make up the difference between the plan's formula and the limits the law imposes on benefits from qualified plans for highly paid employees.

OBRA 93 (the Clinton Administration Budget Bill that raised taxes) lowered the limit on compensation that may be taken into account under qualified plans to $150,000. This will increase the number of participants in such plans.

OBRA 93 also uncaps the 1.45% medical tax, making vested accruals in such plans taxable in all cases. This means that employers will have to value such benefits and arrange for tax withholding on vested accruals.

Concern over corporate bankruptcies, takeovers and tax law restrictions on qualified plans (e.g., 415 limits and $150,000 cap on includible compensation) has engendered interest in securing deferred compensation arrangements such

as bonus deferrals, SERPS and excess plan payments. Some security devices (e.g., nonqualified trusts) have immediate tax impact. Others attempt to provide the security without current tax liabilities for the executive (e.g., the so-called "rabbi trusts" or indemnity insurance policies).

In 1992, the IRS issued Rev. Proc. 92-64, providing a model trust that may be adopted by employers. The model clarifies that contributions may be made on a springing basis and that such trusts may invest in employer securities.

Other approaches used to secure benefits include annuity contracts, nonqualified (i.e., secular) trusts, and life insurance.

In 1992, the IRS issued several private letter rulings on secular trusts, which provide clear, if unpalatable, guidance on the taxation of these devices. These letter rulings provide that the rules applicable to disqualified plans -- taxing highly compensated employees on the full value of their accrued benefits -- apply.

In letter rulings, the IRS has allowed employers to condition future contributions of gross-up payments on the establishment of an "employee grantor trust." These rulings make this device attractive to secure deferred compensation promises.

Recently the IRS has approved an insurance program that guarantees the employer's promises. The IRS conditioned its approval on there being no employer involvement in the insurance. Thus the employer cannot indemnify the insurer, for example.

$1,000,000 Pay Cap

For extremely well paid executives, OBRA 93 capped the corporate tax deduction for pay of the five senior executives who are named in corporate proxy statements at $1 million each, effective with the 1994 taxable year. "Performance based" compensation is not subject to the cap. To qualify for the performance-based exception, stock options will have to be subject to individual executive share limits. Annual bonus awards will have to be made on account of the attainment of preestablished, objective performance goals, under plans approved by shareholders and administered by outside directors, in order to qualify for the performance-based exception.

The $1 million cap applies to deductions for the current year. Unfunded deferred compensation accruals would typically be deductible to the corporation only when paid.

To the extent that those accruals are paid to executives after they leave employment -- and consequently after they cease to be proxy-named executives -- they would not be subject to the $1 million cap.

Stock Options - Change in Accounting

The Financial Accounting Standards Board (FASB) has issued an Exposure Draft that will change the accounting treatment for stock based employee compensation. Under the Exposure Draft, employers will have to expense an allowance for the "option" value of stock options, using a formula that takes into account the exercise price, the term, the current stock price, its expected volatility, dividend yield and risk-free interest rate.

The Exposure Draft would also apply to employee stock purchase plans, under which employees can buy stock at prices as low as 85% of fair market value. Under current rules, these plans generally don't generate a compensation expense. The exposure draft would alter this treatment.

The Exposure Draft would apply to awards granted in 1997 and after. While the exposure draft originally called for footnote disclosure starting in 1994, FASB has decided not to require disclosure for 1994 given the delay in issuing a final statement. Also, FASB is holding open the possibility that disclosure of information about 1994 grants might be required in 1995 financial statements.

Several bills have been introduced in Congress to thwart the proposed FASB decision. These have proved controversial, as many people object to Congress defining accounting standards.

Revised Proxy Disclosure

In October 1992 the SEC issued final rules which change how executive compensation and benefits are disclosed in proxy statements and prospectuses.

Under the new rules, companies disclose top executives' compensation through a series of tables. Also, the compensation committee of the board must discuss how pay was determined, and how it relates to company performance.

In addition the proxy has to include a graph showing five-year shareholder return, comparing it to a broad market index and to other companies in the same industry.

In the fall of 1993, the SEC expanded the definition of top executives whose pay must be disclosed to include CEOs who

terminate during the year and up to two other former executives who would have been in the top 5 (based on their actual pay) had they remained employed through the end of the company's fiscal year. For companies electing to disclose a grant date value of stock options using the Black-Scholes method, the rules were also modified to require disclosure of the assumptions used.

OTHER HUMAN RESOURCES ISSUES

Family and Medical Leave

Congress enacted the Family and Medical Leave Act of 1993 (FMLA) shortly after President Clinton assumed office. The law took effect August 5, 1993 and requires employers with 50 or more employees to provide up to 12 weeks unpaid leave per year for the birth or adoption of a child, to care for a spouse, child or parent with a serious illness, or for the employee's own serious illness. FMLA requires covered employers to provide up to 12 weeks of unpaid, job-protected leave to "eligible" employees for certain family and medical reasons. Employees generally are eligible if they have worked for a covered employer for at least one year, and for 1,250 hours over the previous 12 months.

At the employee's or employer's option, certain kinds of paid leave may be substituted for unpaid leave. The employee may be required to provide advance leave notice and medical certification.

The Department of Labor has issued interim regulations interpreting FMLA. The new regulations have specific communication requirements. The regulations require that employers who give "any written guidance to employees concerning employee benefits" include information on FMLA entitlements and employee obligations.

Employee Involvement Initiatives

Late in 1992, the NLRB ruled in the Electromation case that the company's employee committees constituted labor organizations that were unlawfully dominated by the employer in violation of federal labor law. The ruling created much confusion and uncertainty among employers regarding the legality of such committees.

The NLRB stressed that its ruling was limited to the facts in the Electromation case, and should not be interpreted to pass judgment on the validity of other types of employee committees. Despite its limited focus, the Electromation ruling does confirm that a two-step analysis can generally

be used to determine the impact of federal labor law on such committees:

(i) At what point does an employee committee lose its status as merely a communication device and become a labor organization?

(ii) If the committee is a labor organization, what conduct of an employer constitutes unlawful domination or interference with its activities?

For those employers who have established programs that do not pass muster under the two-step test, the ruling is a setback. However, properly designed committees (i.e. not a labor organization, or not dominated by the employer) are not impacted. Many employee involvement programs fall into the gray area -- where it will be difficult to determine whether they have crossed the line under federal labor law. As a starting point, the factors discussed in the Electromation ruling should serve as a checklist to all employers who maintain or who are considering adopting such programs.