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Recent Litigation Provides Lessons for Employers and Executives Regarding Nonqualified Deferred Compensation Plans

BY GREG M. DAUGHERTY

In the past few years, including 2013, we have seen federal court cases that show both employers and their executives who participate in nonqualified deferred compensation (NQDC) plans how to avoid costly litigation and to obtain better protection of NQDC plan benefits in the face of certain financial risks. These risks often are exacerbated by a lack of planning for contingencies that may arise if the employer undergoes a change in control or becomes insolvent. It is a bit surprising that these risks keep coming up because a NQDC plan could have millions of dollars' worth of accruals on behalf of the employer's executives. That should create an incentive to avoid litigation. Two ways to help avoid costly litigation in the future are to (1) design NQDC plans with specific successor liability and change-in-control provisions and (2) fund these plans with rabbi trusts so as to lessen concerns about payouts under the plans.

Designing NQDC plans and rabbi trusts requires careful planning. To execute proper planning as a means to avoid litigation, plan designers should be familiar with (1) general considerations for NQDC plans and rabbi trusts, (2) litigation related to successor liability for an executive's NQDC benefits after a change-in-control event, (3) litigation related to the ability of the employer's creditors to seize rabbi trust assets in the event of that employer's bankruptcy, (4) the ability of an executive's creditors to have a claim on the executive's NQDC plan benefits, and (5) planning lessons for employers and executives derived from this litigation.

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NQDC Plans and Rabbi Trusts

NQDC plans are popular with executives because they allow executives to defer salary and other compensation on a pretax basis and to grow them on a tax-deferred basis. Other contributions can be credited under NQDC plans as well. Of course, qualified retirement plans (such as 401(k) plans) offer the same benefits, and they also allow employers to deduct contributions to the plan at the time of deferral rather than when amounts are paid, as is the case under NQDC plans. Yet, NQDC plans are popular with employers because NQDC plans offer greater flexibility than qualified plans do to both employers and their executives. Significantly, the various dollar limitations that generally limit accruals under qualified plans do not apply to NQDC plans.[1] So, NQDC plans allow executives to enjoy the opportunity to defer essentially unlimited amounts, which is especially attractive in periods in which current income tax rates may be increasing.

In addition, the Employee Retirement Income Security Act imposes strict rules on qualified plans that generally prohibit employers from allowing only a select group of executives to participate in these plans or to receive a more generous rate of contributions or benefits relative to rank-and-file employees.[2] These rules generally do not apply to NQDC plans that are ''top-hat'' plans, or plans that limit participation to a select group of management or highly compensated employ-

[1] Tax code Section 401(a)(17) limits the amount of compensation that can be taken into account by qualified plans (i.e., $255,000 in 2013). Tax code Section 415 limits the maximum amount of combined employer and employee contributions to a participant's account under a defined contribution plan (i.e., $51,000 in 2013). Tax code Section 415(b) limits the maximum retirement benefit that can be paid under a defined benefit pension plan (i.e., $205,000 in 2013).

[2] See generally, tax code Section 410 and 401(a)(4), respectively.

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ees. Top-hat plans are exempt from many of ERISA's requirements, including its nondiscrimination, vesting, and funding rules.

Despite these relative advantages, NQDC plans, unlike qualified plans, represent unfunded and unsecured promises of the employer to pay plan benefits. Therein lies the issue that often leads to concern and litigation. As amounts credited under an NQDC plan grow, executives naturally become more concerned about the unfunded and unsecured nature of these plans. Employers also want to assuage these concerns and accumulate assets that can be used to pay these liabilities. These concerns led to the development of the rabbi trust. The Internal Revenue Service first discussed such a trust in a private letter ruling[3] that involved a trust that a synagogue created to fund benefits ultimately payable to a rabbi. To avoid current tax consequences related to the funding of such a trust, the trust must impose ''substantial'' limits on the NQDC plan participants' ability to receive distributions from the trust, such as limiting distributions only to payment events specified under the NQDC plan. In addition, the trust's assets must be subject to the claims of the employer's general creditors. Participants must be prohibited from assigning, alienating, or encumbering their interests in the trust assets.

The PLR made these ''rabbi trusts'' a popular vehicle to provide greater assurance that NQDC benefits could be paid when due. IRS later issued a model rabbi trust document.[4] To the extent the model rabbi trust is followed (although employers are permitted to make changes to the form of the model), it provides a safe harbor from current taxation for amounts credited under an otherwise valid NQDC plan and funded in the trust. Accordingly, adopting a model rabbi trust, even with some modification, and funding that trust is a fairly simple yet effective method in protecting executives' NQDC plan benefits while still avoiding current taxation. Combining such a trust with clear successor liability provisions in the NQDC plan also can help avoid costly and time-consuming (sometimes lasting for several years) litigation over NQDC benefits.

Litigation Involving NQDC Benefits After a Change in Control

One of the main risks of payment of NQDC plan benefits is a change in control that results in a successor employer's deciding not to pay the promised benefits. Failure to address this situation up front can lead to a variety of litigation claims.

State Law Claims

In *Gardner v. Heartland Industrial Partners L.P.*,[5] the U.S. Court of Appeals for the Sixth Circuit held that former executives could pursue a state law tort claim to compel a seller to pay unfunded NQDC plan benefits that the seller previously tried to void. In *Gardner*, Heartland Industrial Partners (Heartland) had an ownership interest in Metaldyne Corp. In 2006, Heartland agreed to sell its ownership interest. Metaldyne initially failed to disclose to the buyer that the sale would trigger $13 million in SERP[6] payments to Metaldyne's SERP participants. After learning about this liability, the buyer threatened to back out of the deal. Metaldyne's chief executive officer (who also was chairman of the board), convinced Metaldyne's board simply to declare the SERP invalid. The board voided the SERP, and the deal closed. A month later, Metaldyne told the participants that it had invalidated the SERP. The SERP participants sued Heartland, the Metaldyne board members, and the Metaldyne CEO in state court in Michigan under a state law claim of tortious interference of contractual relations for their roles in invalidating the SERP. The defendants removed the case to federal court and filed a motion to dismiss, arguing the state law claim was preempted by ERISA. The district court granted the motion to dismiss, but the Sixth Circuit reversed and remanded with instructions to remove the case back to state court.

The Sixth Circuit first explained ERISA's preemption doctrine. ERISA preempts any and all state laws that ''relate to'' any employee benefits plan.[7] The Sixth Circuit explained that, under U.S. Supreme Court precedent,[8] a state law claim is preempted by ERISA if (1) the plaintiff complains about a denial of benefits only because of the terms of the ERISA plan and (2) the plaintiff does not allege a violation of any legal duty (state or federal) independent of ERISA or the plan terms. Both prongs must be satisfied in order for ERISA to be preempted, and the analysis is facts-and- circumstances based. For example, if a contract recites rights under a plan, then a breach-of-contract claim related to that plan is necessarily derivative of the plan and thus preempted by ERISA. The Sixth Circuit said that this case was different. The duty not to interfere with the payment of SERP benefits came from Michigan tort law, not the SERP itself. The court explained that nobody needed to interpret the SERP to determine that the duty to pay benefits existed. Accordingly, the participants could pursue their state law claim.

Interestingly, the Sixth Circuit reached a different conclusion nearly 10 years earlier under similar circumstances.[9] In *Nester v. Allegiance Healthcare Corporation*, the corporation had promised to pay SERP-type benefits to employees if they transferred to job positions that made them ineligible to participate in the employer's qualified pension plan. When the employer later reneged on the promise, the employees sued under a breach-of-contract claim. The Sixth Circuit held that the claim related to the ERISA plan and thus was preempted. The Sixth Circuit did not address the *Nester* decision when reaching the *Gardner* decision. Instead, it cited a more recent Second Circuit decision[10] with similar facts and that had allowed the state law claim to proceed.

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[3] PLR 8113107.

[4] Rev. Proc. 92-64.

[5] *Gardner v. Heartland Industrial Partners L.P.*, 715 F.3d 609 (6th Cir. 2013) (92 PBD, 5/13/13; 40 BPR 1204, 5/14/13).

[6] A supplemental executive retirement plan, or SERP, is a NQDC plan that can be designed in a variety of ways but typically provides benefits under a defined benefit formula that does not contain the limits on accruals that a qualified plan would have.

[7] ERISA § 514(a), 29 U.S.C. § 1144(a).

[8] *Aetna Health Inc. v. Davila*, 542 U.S. 200, 32 EBC 2569 (2004) (119 PBD, 6/22/04; 31 BPR 1421, 6/29/04).

[9] *Nester v. Allegiance Healthcare Corp.*, 315 F.3d 610, 29 EBC 2286 (6th Cir. 2003) (7 PBD, 1/13/03; 30 BPR 90, 1/14/03).

[10] *Stevenson v. Bank of New York Inc.*, 609 F.3d 56, 49 EBC 1399 (2d Cir. 2009) (114 PBD, 6/16/10; 37 BPR 1436, 6/22/10).

ERISA Section 510 Claim

While the Sixth Circuit's position on these state law claims was evolving, the U.S. Court of Appeals for the Seventh Circuit held that, under these types of circumstances, the plaintiffs could not pursue an ERISA claim against the successor to force payment of the SERP benefits.[11] In *Feinberg v. RM Acquisition LLC*, Rand McNally and Company sponsored a SERP but never funded it. Rand McNally later sold all of its assets to a private equity firm, which did not assume any of Rand McNally's liabilities. The Seventh Circuit first held that the buyer did not incur successor liability because it did not ''connive'' with Rand McNally to deprive participants of benefits. Further, the court held that the plaintiffs did not have a valid claim under ERISA Section 510 for interfering with their rights under the SERP.[12] The court's reasoning was that the buyer never had anything to do with the SERP and that purchasing assets of Rand McNally did not require it to assume Rand McNally's liabilities. According to the court, just as someone who purchases a lawn mower at a hardware store is not liable for the store's debts if the store becomes insolvent, a purchaser of an entity's assets is not responsible for that entity's debts.

Lessons From This Litigation

The main lesson from these cases is that executives trying to compel employers (or former employers) to pay NQDC benefits may have better luck pursuing state law tort or contract claims rather than ERISA claims—at least in situations in which the claim in question is not based on plan provisions. Even that strategy is uncertain, considering that the *Gardner* decision only allows the plaintiffs to bring their state law claim to trial. No decision has been made on the merits in that case.

Even if the plaintiffs in the *Gardner* case recover their SERP benefits, the litigation has been long and costly, dating back to 2006. That shows how planning ahead can save time and money later. The employers in these cases could have made things easier on themselves and their executives by designing their SERPs with clear provisions regarding successor liability and authority to amend or terminate their plans. A detailed claims procedure also would have been helpful because courts typically respect these provisions.[13] Finally, contributing assets to a rabbi trust may have eased concerns of the buyers about having assets to pay the NQDC plan benefits.

Litigation Involving Bankruptcy of Employer

Besides the employer being unwilling to pay executives NQDC plan benefits, the other major risk for executives is that the employer becomes insolvent and thus unable to pay. Yet, even in this scenario, a rabbi trust still may offer protection. In *Bank of America v. Moglia*,[14] Outboard Marine Corp. had filed for Chapter 7 bankruptcy. It had contributed $14 million to a rabbi trust to fund its NQDC plan. The bankruptcy trustee claimed this amount was available to the unsecured creditors of Outboard Marine. Bank of America, the agent for the secured creditors, said that the secured creditors had a claim to this money because the security agreement that Bank of America relied on covered ''general intangibles'' and described rabbi trust assets. The rabbi trust, however, said that the trust assets belonged only to ''general creditors'' of the company. The Seventh Circuit explained that ''general creditors'' means only the unsecured creditors. If the trust had said that the trust assets were subject to the claims of all creditors of the company, then the secured creditors would have the valid claim. As such, the court held that the rabbi trust assets were subject only to the claims of the unsecured creditors.

This result may not seem like much of a victory for employees, but it is important because employees and former employees typically have a high priority ranking among unsecured creditors. As such, in the event of a bankruptcy they still may have a chance at receiving at least a portion of their SERP benefits. If the rabbi trust assets are subject to the claims of the secured creditors, in all likelihood the participants would have much less of a chance of recovering their SERP benefits. From the point of view of protecting the interests of plan participants, this case shows the importance of preparing the rabbi trust language such that the assets are subject only to the unsecured general creditors of the company.

Litigation Involving Bankruptcy of an Executive

The previous section describes methods to protect NQDC plan benefits from an employer's creditors. A recent federal district court case in Maryland highlights how difficult that can be at times.[15] In *Sposato v. First Mariner Bank*, the plaintiff was an executive with Cecil Bank and participated in his employer's SERP. The SERP had an anti-alienation provision, stating that benefits were exempt from claims of creditors of the participants and all levies and garnishments to the fullest extent allowed by law. The executive also owed debt to First Mariner Bank, which had sought to enforce its judgments against him by serving a writ of garnishment on the employer. The question was whether the SERP's anti-alienation provision trumped the garnishment laws of the state.

The court explained that, as a top-hat plan, the SERP was exempt from many of ERISA's requirements, including ERISA's anti-alienation provisions.[16] As such, ERISA's anti-alienation provisions could not protect the executive from Maryland's garnishment laws. Further, Maryland's garnishment laws were laws of general application that only remotely related to employee benefits plans. As such, the garnishment claim was not pre-

[11] *Feinberg v. RM Acquisition LLC*, 629 F.3d 671, 50 EBC 1682 (7th Cir. 2011) (05 PBD, 1/7/11; 38 BPR 59, 1/11/11).

[12] ERISA § 510, 29 U.S.C. § 1140, makes it ''unlawful for any person to discharge, fine, suspend, expel, discipline, or discriminate'' against a participant or beneficiary in an ERISA plan.

[13] See *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 10 EBC 1873 (1989).

[14] *Bank of America N.A. v. Moglia*, 330 F.3d 942, 30 EBC 1705 (7th Cir. 2003) (106 PBD, 6/4/03; 30 BPR 1270, 6/10/03).

[15] *Sposato v. First Mariner Bank*, No. 1:12-cv-01569-CCB, 2013 BL 83891 (S. D. Md. March 28, 2013).

[16] See ERISA § 206(d)(1), 29 U.S.C. § 1056(d)(1).

empted by ERISA.[17] Thus, the court held that the bank could garnish the executive's SERP benefits.

This case could have had the same result even if the employer established and funded a rabbi trust for the executives in the SERP, although that is not clear. Perhaps the real lesson of this case is that as flexible as NQDC plans are, executives should still maximize the deferrals under their employers' qualified plans before contributing to NQDC plans.

Lessons for Employers and Executives

The cases discussed in this article suggest that employers and their executives should consider one or more of the following strategies regarding NQDC plans:

1. maximize executive deferrals to the employer's qualified plan before making deferrals to the NQDC plan;

2. prepare clear successor liability provisions in the NQDC plan;

3. prepare clear amendment and termination provisions in the NQDC plan (in particular, these provisions should address who has authority to amend or terminate the plan and whether amendments may reduce or eliminate participant benefits without participant approval);

4. prepare detailed claims procedures in the NQDC plan, explaining the internal review process for resolving disputes;

5. consider using a rabbi trust to fund NQDC plans, including consideration of whether funding will occur only if and when a change in control occurs or throughout the life of the plan; and

6. if a rabbi trust is used, and if considered helpful to employer goals, make sure that language in the trust makes it clear the assets are subject only to the employer's unsecured creditors (in this regard, note that the language in the IRS-provided safe harbor model states that the assets held by the trust will be subject to the claims of employer's general creditors).

Of course, no strategy is fool proof, but careful planning early on can help prevent a lot of trouble in the future.

[17] This holding was nearly identical to the facts in *Mackey v. Lanier Collection Agency & Service, Inc.*, 486 U.S. 825, 9 EBC 2129 (1988). The Supreme Court held that Georgia's garnishment laws were not preempted by ERISA in that case involving a welfare benefits plan.

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