Matters of Interest

Executive and Director Benefits and COLI

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Featured Articles

President's 2014 Budget Proposal

The President outlined several important individual income tax proposals in his proposed budget for fiscal year 2014, including:

- A prohibition on contributions and accruals to a tax-favored, qualified plan in excess of the amount necessary to provide the maximum annuity allowed under a tax-qualified defined benefit plan. Under current law that maximum is an annual benefit of $205,000 payable in the form of a joint and 100% survivor benefit commencing at age 62 (currently equivalent to approximately $3.4 million lump sum value).
- A limitation on the tax value of specified deductions or exclusions from AGI and all itemized deductions. This limitation would reduce the value to 28% of the specified exclusions and deductions that would otherwise reduce taxable income in the 33%, 35%, or 39.6% tax brackets.
- A minimum tax on households earning $1 million/year or more of 30% of AGI less a credit for charitable contributions.

The President outlined a framework for business tax reform that would:

- Repeal Code Section 264(f) exception from the pro rata interest expense disallowance rule for life insurance contracts covering employees, officers, or directors.
- Eliminate loopholes and subsidies, broaden the tax base and cut the corporate tax rate.
- Be structured to result in no additional revenue.

Executive Benefits at Risk Upon a Change of Control

When we talk to prospects and clients about the importance of protecting executives' benefits against an employer's change of heart, we are often asked whether such a change of heart is a real concern. Unfortunately, two recent cases demonstrate that it is. It is not unusual for an acquirer to seek to reduce or negate benefits to executives promised prior to its acquisition. These cases are stark reminders of that.

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Yarber v. Capital Bank Corporation, 2013 U.S. Dist. LEXIS 36765 (E.D.N.C. 2013)

Yarber worked for Capital Bank as the bank's President and Chief Executive Officer under a written employment agreement. In 2008, Yarber and Capital Bank entered into an Amended and Restated Employment Agreement (the "Employment Contract"). Under the Employment Contract, Yarber was entitled to "change-in-control" severance payments equal to a multiple of Yarber's salary if another corporate entity gained majority control of Capital Bank and Yarber's employment was terminated for any of the reasons specified in the Employment Contract. Capital Bank or Yarber could terminate his employment at any time, for any reason, with thirty days' notice. It also specified that no change or modification of the Employment Contract was valid unless such change or modification was in writing and signed by the parties.

CBFC offered to purchase a controlling interest in Capital Bank in 2010. During negotiations, all parties agreed that Yarber would remain the president of Capital Bank after the purchase.

CBFC sought a discount from the Treasury Department on TARP payments as part of its offer. The Treasury Department refused to give Capital Bank a discount. In response, CBFC threatened to withdraw its offer to purchase a controlling share of Capital Bank unless Yarber and other bank executives signed amendments to their employment agreements relinquishing their right to change-in-control severance payments.

The chairman of Capital Bank's board of directors told Yarber that he had no option but to give up any payments due under his Employment Contract, and that the board of directors would terminate Yarber for cause if he refused to give up his right to change-in-control severance payments and that Capital Bank's shareholders could sue Yarber for breach of fiduciary duty if Yarber refused to amend his Employment Contract. Yarber believed that he could not be fired for cause or sued, but was concerned that his reputation would be damaged if the board of directors terminated him, even for false reasons. On January 14, 2011, Yarber signed an amendment (the "Amendment") to his Employment Contract. The Amendment effectively eliminated Yarber's right to severance payments under the Employment Contract. The Amendment also created a term of employment, with the employment term and contract both expiring on November 4, 2011.

On January 31, 2011, CBFC closed the deal to purchase a controlling share of Capital Bank. Thereafter, Yarber was removed from his position as president and chief executive officer, and was assigned to work as a commercial and retail manager. Yarber continued his employment with Capital Bank until his termination by Capital Bank on November 14, 2011. Yarber never received any change-in-control severance payments under the Employment Contract.

Yarber made various ERISA and contractual claims to the change-in-control severance payments in his original Employment Contract but the Court found that the Amendment to the Employment Contract had been properly entered into, was enforceable, and that since the Amendment deleted the language allowing Yarber to obtain severance payments, Yarber had no right to such payments.

Gardner v. Heartland Industrial Partners, 715 F.3d 609 (6th Cir. 2013)

In this case, defendant Heartland Industrial Partners, L.P., was an investment firm that formerly held an ownership interest in Metaldyne Corporation, an automotive supplier in Michigan. Plaintiffs were former Metaldyne executives.

In August 2006, Heartland agreed to sell its ownership interest in Metaldyne to another investment firm, Ripplewood Holdings. Metaldyne submitted to the SEC a "Schedule 14A and 14C Information" report that detailed the terms of the acquisition.

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The report failed to mention, however, that Metaldyne would owe plaintiffs approximately $13 million as a result of the sale to Ripplewood. That obligation arose under a change-in-control provision in Metaldyne's Supplemental Executive Retirement Plan (SERP), in which plaintiffs were participants. The SERP (like all nonqualified plans) is subject to ERISA.

Ripplewood threatened to back out of the deal when it found out about the $13 million SERP obligation. In response, two Heartland founders who were also Board Members persuaded Metaldyne's Board to declare the SERP invalid. The Board did so on December 18, 2006, though it did not notify plaintiffs of that at the time. The Ripplewood deal closed less than a month later, on January 11, 2007.

A month after the deal closed, Metaldyne notified plaintiffs that it had invalidated the SERP. In response, plaintiffs filed several lawsuits. This suit pled a single state-law claim against Heartland and the two Heartland founders, for tortious interference with contractual relations. The factual basis for the claim was their role in the invalidation of the SERP. Defendants removed the case to federal court, contending that plaintiffs' claim was "completely preempted" under ERISA. Defendants also filed a motion to dismiss the case on that ground. Plaintiffs filed a cross-motion to remand the case to state court. In an order entered September 30, 2010, the district court denied plaintiffs' motion to remand the case to state court and granted defendants' motion to dismiss.

The Sixth Circuit reversed the district court's order and remanded the case to the district court with instructions for the district court to send the case to the state court to allow the state court to determine whether there was a tortuous interference with the executives' contractual rights under the SERP.

Lessons

For executives, the primary lesson is clear: promised benefits may be at risk when there is a change in control. Acquirers want to spend as little money as possible in their acquisition and at least some are willing to be quite aggressive about eliminating previously promised benefits to executives.

The secondary lessons are also clear.

- Executives should not voluntarily give up benefits unless they are given something valuable in return. Yarber, in the first case above, should have bargained for a term as CEO in exchange for his relinquishment of change-in-control severance payments. Absent such a change, he should have held onto his contractual severance benefits.
- Nonqualified deferred compensation benefits should be funded. In *Gardner*, the executives may yet win back their benefits, but clearly they would have been in a better position to collect their SERP benefits had there been an asset set aside for the payment of their SERP benefits. A fully funded rabbi trust is an excellent way to secure such benefits.

We wrote about the importance of rabbi trust funding in our First Quarter 2011 Matters of Interest where we discussed the *Feinberg* case under which former Rand McNally executives lost their SERP benefits when as asset purchaser declined to assume liability for the SERP benefits promised them. As the *Gardner* case demonstrates again, the existence of a fund to pay SERP and other nonqualified benefits is an important security feature of nonqualified benefits for executives.

Anti-Alienation Provision in Plan Does Not Protect Top-Hat Plan Participants

ERISA requires that pension plans prohibit benefits provided under the plan from being assigned or alienated to third parties (anti-alienation provision). However, unfunded deferred compensation plans for high-level executive employees, "top hat" plans, are exempt from this requirement. Nevertheless, many "top hat" plans include such an anti-alienation provision both to protect the employer from having to deal with its employees' creditors and to protect participants from losing their benefits. However, a recent case in the United States District Court for the District of Maryland found that such a provision does not protect participants' benefits.

In *Sposato v. First Mariner Bank*, 2013 WL 1308582 (D. Md. March 29, 2013), a former executive of Cecil Bank was a participant of Cecil Bank's Supplemental Executive Retirement Plan. The Plan provided that "[t]he benefits provided under the Plan may not be alienated, assigned, transferred, pledged or hypothecated by any person, at any time, or to any person whatsoever. Those benefits shall be exempt from the claims of creditors or other claimants of the Participant or Beneficiary and from all orders, decrees, levies, garnishment or executions to the fullest extent allowed by law."

The defendant bank was a creditor of Mr. Sposato that sought to garnish his benefits under the Plan in order to enforce judgments entered against Mr. Sposato in other litigation. The Court first recognized that the Plan was exempt from ERISA's anti-alienation provision mandate. It then considered whether the terms of the Plan's anti-alienation provision controlled over Maryland's garnishment laws by virtue of ERISA's preemption provisions. The Court found in favor of the bank creditor. It relied upon the United States Supreme Court decision of *Mackey v. Lanier Collection Agency & Service, Inc.*, 486 U.S. 825, 108 S. Ct. 2182 (1988), which held that ERISA did not preempt state garnishment laws used to enforce judgments against ERISA welfare benefit plans, which are not subject to ERISA's anti-alienation provision. In this case, the Court found that top-hat plans are similarly not subject to ERISA's anti-alienation provision and similarly are not protected by it.

In addition, the Court held the anti-alienation provision of the Plan was not enforceable against the bank creditor because it was not a party to the Plan agreement with Mr. Sposato and the Plan sponsor. Thus, the Plan's anti-alienation provision did not protect Mr. Sposato's Plan benefits from garnishment under the state statute.

The Court reserved judgment as to whether the federal Consumer Credit Protection Act protects from garnishment 75% of payments received pursuant to a pension or retirement program. However, at least 25% of Mr. Sposato's SERP benefits will be subject to garnishment.

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