



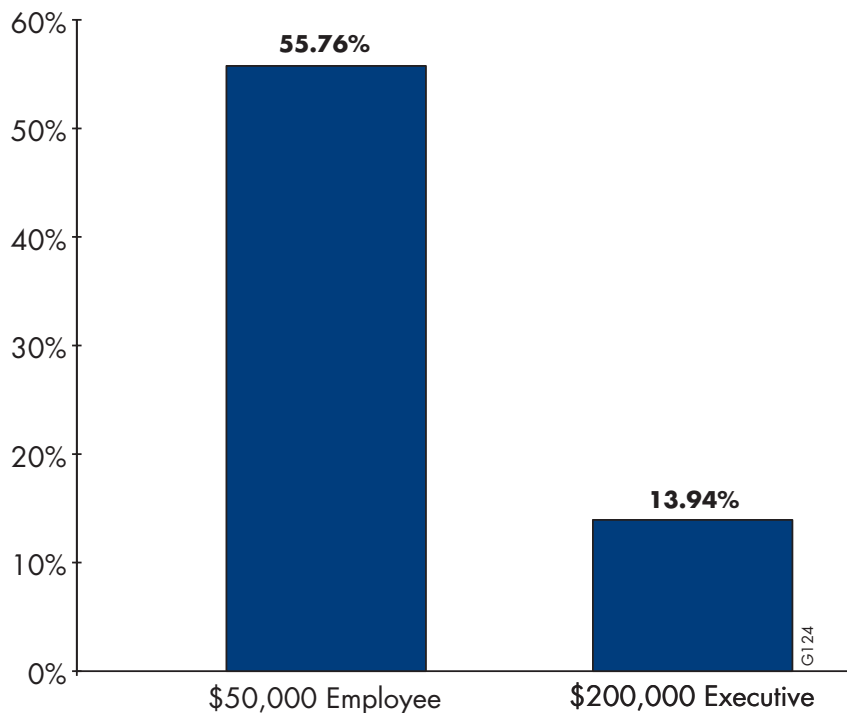
Why Companies Use Rabbi Trusts

Introduction

The Importance of Nonqualified Benefits to Executives. Because of restrictions on levels of contributions and benefits under the Internal Revenue Code, qualified plans cannot offer the same level of retirement income to a company's executives as they can for the company's general employee population. Companies establish nonqualified benefit plans to equalize the replacement income provided to executives and other employees. As a result, nonqualified benefit plans provide an important and growing percentage of executives' retirement income. This can be simply illustrated in the context of a 401(k) plan using the graph below. Similar results would be seen in an analysis of a defined benefit pension plan.

The graph shows the amount of income replacement provided to an executive from a qualified 401(k) plan assuming maximum contributions from age 45 until retirement. The large shortfall will have to be made up from nonqualified plans and other after-tax savings.

Income Replacement Ratio at Age 62



The Insecurity of Nonqualified Benefits/Assuring Payment of Benefits. Unlike qualified plan benefits that are funded in a trust separate and apart from corporate assets, non-qualified plan benefits cannot be funded in a way that makes the funding immune from the claims of the creditors of the employer without adverse tax consequences. Thus, non-qualified plan benefits are subject to the risk of loss whether through the employer's bankruptcy or insolvency or the employer's change of heart. Thus, as the importance of nonqualified plans has grown, so have the measures (attempts) to assure the executive of the payment of the benefits while minimizing funding expense to shareholders and avoiding current taxation to executives.

What is a Rabbi Trust?

Rabbi Trusts. Rabbi trusts have become the vehicle of choice to accomplish the goal of benefit security. Passage of Code Section 409A affirms the propriety, and outlines, in conjunction with prior IRS guidance, the proper use of domestic rabbi trusts. A rabbi trust offers executives a way of ensuring, to the extent permissible, that benefits earned will be paid when due.

Characteristics of a Rabbi Trust. The basic characteristics of a rabbi trust are:

- Assets in the trust are irrevocably set aside to pay benefits to employees and their beneficiaries. They cannot to be used for another purpose, except as described below.
- Assets are owned by, and income derived from such assets is taxed to, the employer. In tax language, the trust is an employer grantor trust.
- Assets are subject to the claims of employer's creditors in the event of the employer's insolvency or bankruptcy. This is generally the only time assets may be used for a corporate purpose other than paying benefits (trusts may, however, have a provision permitting reversion of excess assets to the employer when the trust is overfunded by a predetermined percentage).

Objections to Rabbi Trusts

The most common objections to rabbi trusts are:

- **The Contractual/Bankruptcy Objection.** Rabbi trusts offer no protection in addition to that which an executive already has, that is, a contractual promise by the employer to pay the promised benefits. The only real danger to executives' nonqualified benefits is from corporate insolvency or bankruptcy and a rabbi trust, by definition, is not permitted to protect executives from either insolvency or bankruptcy.
- **The Optics Objection.** The establishment of a rabbi trust will look as if it is done solely to benefit executives at the expense of other employees and shareholders and, consequently, will be criticized as just another unjustified perquisite offered only to rich executives.

These objections are discussed more fully below.

The Contractual/Bankruptcy Objection to the Use of Rabbi Trusts

Summary of Objection. When objections are raised to rabbi trusts, it is often argued that the implementation of a funded rabbi trust in conjunction with a nonqualified plan may give executives greater psychological security but does not, in fact, add any security for or protection of the benefits promised to executives. The argument is:

- The benefits provided are a legally binding corporate contractual liability.
- If, for some reason, whatever the reason, they are not paid, the executive need merely sue for the benefit and a court will enforce the contractual commitment, and the benefit will be paid.
- The only real danger to executives' nonqualified benefits is from corporate insolvency or bankruptcy and a rabbi trust, by definition, is not permitted to protect executives from either insolvency or bankruptcy.

The Facts. From a technical, legal point of view, the argument made above is sound, but it ignores day-to-day experience. A funded rabbi trust can save the loss of some or all of an executive's retirement benefits, which loss, for many executives, can dramatically change their income and lifestyle postretirement.

There are three types of advantages a funded rabbi trust can offer executives: the general benefit of a specific funding source for benefits, protection against corporate financial distress, and benefit protection after a change of control.

Generally Applicable Benefits

- **Negotiating Position.** When there is an asset set aside specifically to pay an executive's benefit, the executive is placed in a better negotiating position whether the question is to pay some, all or none of the benefits, regardless of whether the question arises after a change in control or during a time of financial distress.* This is especially true for retired executives, who generally have no leverage whatsoever with their former employer. Most of today's executives will be retired executives within 20 years. We have seen cases where the existence of the rabbi trust has placed the executives in a position of significant strength that simply would not have existed without a funded trust.
- **Avoidance of Court System.** By establishing an *independent trustee with a formalized dispute resolution method* and source of funds to make payment the claimants can avoid what is typically a more difficult, protracted and expensive dispute resolution through the court system. This advantage may not be realized if the trustee is the employer itself, a subdivision of the employer, or another entity with other ties to the employer.

NOTE

*A long-standing practice of funding a rabbi trust is an important feature of rabbi trust use. A long-established trust removes contentions of conflicts of interest that often arise when protection is sought at or shortly prior to the corporate event precipitating the concern for greater security.

Financial Distress

- **Source of Assets.** Executives who have the option to call their benefits prior to the time they would otherwise be payable often can receive many of the benefits they might otherwise lose in an insolvency or bankruptcy. If there is no source of funds to make the payment, however, such an option may often be an empty right with no ability to make a payment to which the executive is entitled.* We are not aware of any judicial challenges to any of the accelerated distributions that have occurred.
- **Restructuring and Retention of Executives.** During a financial restructuring of a corporation, there is often strong interest in retaining executives to work through the process of rehabilitating the corporation. As part of the restructuring, benefits for these executives are maintained and rabbi trusts and the assets that are held in the trusts are very often left in place by the bankruptcy court to help the company retain the executives. This is illustrated in a case in which a bankruptcy court ordered that the “Superpriority Administrative Claims and Liens” granted to a lender lending money to the bankrupt corporation postbankruptcy shall not apply to the assets included in the corporation’s Nonqualified Plans Master Trust and other trusts funding nonqualified benefits. In Re: LTV STEEL COMPANY, INC., 2001 Bankr. LEXIS 635 (N.D. Ohio, March 20, 2001).

In addition, M Benefit Solutions has had several clients go through a bankruptcy and the existence of a funded rabbi trust, we believe, helped executives there to obtain payment of all or a large percentage of their nonqualified deferred compensation benefits. Whether they would have been able to obtain this result without an asset already set aside to make the benefit payments is difficult to say, but is less likely.

Change in Control

- **Resolution of Disputes After Change in Control.** Disputes as to amounts to be paid after a change in control often arise, and may even occur more often in friendly takeovers than in hostile takeovers because in a hostile takeover the acquirer most often terminates and pays off executives in order to put in its own management team. A rabbi trust may provide that an independent trustee, on appeal from the company decision, can make an independent determination of the amount of benefits that should be paid to former executives. This process provides an independent, objective determination without resort to courts or arbitration, allowing the appeals process to move expeditiously and in a cost-efficient manner. It is especially efficient when groups of executives are affected by the same decision. Ordinarily, each executive would have to fight independently for their benefits. This process allows executives to argue and to be dealt with as a group. In effect, it increases the negotiating leverage of the executives, as discussed above, and reduces the costs to executives of enforcing their rights to benefits.

(Continued on next page)

NOTE

*Internal Revenue Code Section 409A removes the right of executives to exercise such a “call” provision with respect to deferred compensation earned or vested after December 31, 2004.

Change in Control (Cont.)

- **Investment Authority Moved to Trustee After Change in Control.** This allows an independent trustee to invest assets in funds of its choosing, invested in a manner designed to preserve assets for payment of benefits when an acquirer may prefer to invest in a manner designed to reduce the amount of future contributions of the company to the trust. This works especially well when there is a provision in the trust requiring the trust to be fully funded after a change in control, ensuring assets are available to pay benefits to current, former, and retired executives.
- **Limitations on Amendments of Trust After a Change in Control.** Some trusts require a majority of participants to consent to trust amendments after a change in control. Thus, amendments that may not be beneficial to participants can be stopped or more likely never attempted because it would be apparent that such amendments would not be approved by participants.

The Optics Objection to the Use of Rabbi Trusts

Because of the intense scrutiny of executive compensation over the last few years, it is assumed that anything that might benefit an executive, such as increasing the quality of the retirement benefit promise to an executive through the establishment of a funded rabbi trust, will look as if it is done solely to benefit the executive at the expense of other employees and shareholders and, consequently, will be criticized.

The assumption is not supported by fact or history.

- **News Search**—A Google search of 2006 and 2007 news stories turned up no stories commenting negatively on the existence or establishment of a rabbi trust. This is consistent with news searches in prior years. This is not surprising. The use of rabbi trusts has been sanctioned by the IRS since 1981 and their use recently has been noted and approved both by legislation and regulations.
- **Prevalence**—In a recent *Fortune 1000* survey, 67% of respondents that sponsored a SERP and 74% of respondents that sponsored a nonqualified deferral plan reported using a rabbi trust.
- **IRC Section 409A**—This legislation confirmed the use of domestic rabbi trusts is proper and lays out some ground rules for their use.
- **Pension Protection Act of 2006**—Rabbi trusts are mentioned as an example of a funding structure for nonqualified plans without adverse connotation.
- **ISS**—Institutional Shareholder Services, in its 2007 updates to its Corporate Governance Policies, cites a number of actions it considers to be poor compensation practices. Establishment of a rabbi trust is not among these. Their policy statement presents no position on rabbi trusts.
- **Feedback From M Benefit Solutions' Clients**—While the 2007 proxy season has resulted in some feedback from the ISS on benefit design and benefit levels, we are aware of no comments or criticism of the existence, or establishment, of a funded rabbi trust.

Summary

Many companies establish rabbi trusts to increase the quality of the promise made to executives. Because the rabbi trust does not seek to increase executive benefits already promised and earned, but merely seeks to increase the likelihood that such benefits will be paid and to establish a funding source for an already existing corporate liability, the shareholder and financial communities accept the use of rabbi trusts as a legitimate and even advisable corporate practice.

The benefits of a rabbi trust extend to:

- Avoidance of the confusion, costs, and conflicts of the court system.
- Provision of a source of assets to pay earned benefits in the normal course as well as in the event of corporate financial distress.
- Provision of a source of assets to pay benefits to executives sought to be retained post-bankruptcy to aid the corporation through its financial restructuring.
- Provision of a convenient, expeditious means to resolve disputes through an independent trustee after a change in control.
- Provision of a procedure to ensure conservative investment control of the assets after a change in control.
- Restrictions on detrimental changes to benefit plans and the trust after a change in control.
- Improvement of executives' negotiating position.

These are all benefits realized in actual practice. One institutional trustee with whom we have worked has had 80 different clients in which the protections of a rabbi trust has been invoked by executives either after a change of control or during the employer's financial distress and the executives in many cases realized one or more of these benefits. The fact that virtually none of these instances have reached the courts or the media is a testament to the effectiveness of rabbi trust protections.