

A Look **AHEAD**

A Beecher Carlson Publication

Keeping Directors and Officers at the Forefront of What's Happening in Executive Liability Risk Management

Will the Plaintiffs' Bar Usurp the QSERP? Why Pensions May Become the Next Battleground In The War over Executive Compensation By David Finz

Introduction

As Human Resources professionals will attest, recruiting and retaining top talent has never been more challenging for large and mid-size companies. For example, CFO Magazine recently reported that the average tenure of Chief Financial Officers is now less than 36 months. One way that businesses have been seeking to attract industry leaders is through generous retirement benefits. However, this strategy may soon come under attack from lawyers representing so-called "rank and file" employees alleging that their pension plans are being raided to fund the retirements of senior executives.

Federal law confers a tax deduction on employers when they contribute to a qualified pension plan for their workers. Employees benefit from having their nest egg grow tax free as well. Executives may legitimately participate in these plans. However, Internal Revenue Service ("IRS") rules require that such plans not "discriminate" in favor of "highly compensated employees." These rules are designed to prevent employers from using their "rank and file" plans to fund a disproportionately large share of benefits for those in a company's top echelons.

As a result, many companies must utilize supplemental executive pensions, which do not typically feature the same tax advantages as a traditional pension plan.



Rough Road Ahead? Some employers may soon be facing a retirement benefit traffic jam.

Increasingly, though, companies are enlisting the help of actuaries and other professional consultants to determine the maximum benefits that can be rolled into their traditional pension plans without running afoul of the "discrimination test" used by the IRS to determine a plan's eligibility for preferential tax treatment. Some employers have even taken to counting Social Security benefits as part of an employee's total retirement package, thus raising the proportion of lower-

wage employees' total benefits relative to that of their highly compensated officers.

The net effect of these practices is to allow employers to classify the pensions of some of their senior managers as QSERPs (Qualified Supplemental Executive Retirement Plans), and thereby reap an immediate tax deduction for any contributions made to them. While the IRS has generally accepted employer representations regarding the integrity of their retirement plans, some employees have grown uneasy regarding the security of their own pensions. The concern is that, by burdening itself with increasingly large payouts for senior managers, an employer may be diluting the funds available to the rest of its workforce in retirement.

Fiduciary Claims over Executive Compensation – Blazing a Trail, Or Heading Down a Dead End Street?

Although it is too soon to say if we are seeing the beginning of a trend, there have already been at least two Federal lawsuits challenging this practice.

¹ Schultz, Ellen E., and Theo Francis, "Companies Tap Pension Plans to Fund Executive Benefits," The Wall Street Journal, August 4, 2008, Page A1.

Each of these actions was dismissed, but for reasons which may not apply to future litigation. In the first lawsuit, *Gromala v. Royal & Sun Alliance*, the United States Court of Appeals for the Sixth Circuit affirmed a lower court decision dismissing the Plaintiff's complaint in which he alleged his former employer breached its fiduciary duty when it amended his pension plan to provide a slightly larger benefit to him but allegedly awarded a disproportionately larger increase to senior managers.

The Circuit Court did not find these arguments persuasive. Relying on precedent holding that courts should hesitate to substitute their own judgment for that of employers, the Circuit Court agreed with the District Court Judge that the equitable distribution of benefits was a business decision, and that no fiduciary duty had been breached. Nevertheless, it is not clear how the Court might have ruled had the Plaintiff been able to show that he suffered a decrease in benefits as a result of executives having been included in his plan, rather than simply a small increase in his monthly payment.

The second case, *Thomas A. Paulsen, et al v. CNF, Inc., et al*, involved such a decrease, but the lawsuit was not brought against the former employer, who had filed for bankruptcy, but rather against the consulting firm that had advised the employer and the Pension Benefit Guaranty Corporation ("PBGC"), a government entity that essentially serves as a backstop for employee pensions within certain limits. Here, the employer added executive benefits to the pension plan of rank and file employees, although it is unclear to what extent the funds were diluted as a direct result. While the consulting firm had initially maintained that the pension plan was fully funded, it was later revealed that the plan lacked sufficient funds to pay all vested benefits owed to plan participants. The Plaintiffs alleged that the PBGC breached its duty by failing to bring suit over the failure of

the employer plan, and further that the consulting firm had committed professional negligence by rendering advice to the employer that arguably jeopardized the pension plan's solvency.

The United States District Court for the Northern District of California disagreed. It held that there was no statutory requirement for the PBGC to file suit over the plan failure. As to the consulting firm, the Court found that the Plaintiffs lacked standing to bring the action, and further concluded that any monies recovered from the consulting firm would inure to the benefit of the PBGC, not to the Plaintiffs.

Could an employer that has not filed for bankruptcy be held liable for allocating benefits under a pension plan in such a way that it amounts to a breach of fiduciary duty? If so, would the lack of a challenge to the plan by the IRS under the "discrimination test" constitute an adequate argument for the Defendants? One actuary familiar with executive retirement plans who spoke to Beecher Carlson on the condition of anonymity believes there are adequate safeguards in place to prevent such abuses, but also conceded that if there is a creative approach to pleading such cases that would survive summary judgment the Plaintiffs' bar will find it.

Fiduciary Liability Insurance – Like Roadside Assistance for Employers

Many employers find it prudent to transfer some of the risk associated with defending themselves against an action brought by their employees or retirees involving benefits to a Fiduciary Liability Insurance Policy. Such a policy comes into play when an employer is sued under the Employee Retirement Security Income Act of 1974 ("ERISA") and related laws. While such policies do not pay benefits due, they typically cover defense costs as well as certain liabilities associated with the settlement and adjudication of ERISA claims, such as prevailing party attorney fees. A qualified insurance bro-

ker can help you explore what types of policies are commercially available and determine whether such coverage is right for your company.

Insurance and Risk Management With Specialized Industry Focus.

At Beecher Carlson, we've found success in our ability to be inventive. We see things upside down and inside out – from different angles. We're a team of seasoned and spirited professionals who take personal interest in our client's goals and never waiver in our commitment to put them first.

David Finz, a Vice President in Beecher Carlson's Executive Liability Practice, holds a J.D. from Brooklyn Law School. A former Senior Enforcement Attorney with the IRS Office of Professional Responsibility, he has written several white papers on Executive Liability, and has lectured on professional ethics at numerous Continuing Education seminars. David can be reached at dfinz@beechercarlson.com

Disclaimer

This article is intended for informational purposes only. It is not a guarantee of coverage and should not be used as a substitute for an individualized assessment of one's need for insurance or alternative risk services. Nor should it be relied upon as legal advice, which should only be rendered by a competent attorney familiar with the facts and circumstances of a particular matter.

© 2008 Beecher Carlson Insurance Services, LLC. All Rights Reserved.

