2013 Summit Round Table

EXECUTIVE COMPENSATION SURVEY

SUMMARY REPORT

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California CREDIT UNION LEAGUE

NEVADA CREDIT UNION LEAGUE

FOUR COMMON DOCUMENTATION ISSUES

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Credit Unions regularly retain us to review their existing deferred compensation arrangements. In the plans we recently examined, we saw four common problems. No plan had all four problems, each had at least one.

Uncertainty

The most common problem is ambiguous terms in the plan. This is an issue in two ways: for the general reason that a contract should be specific as to its terms, and in the specific contexts of section 409A and section 457(f).

For example, one deferred compensation plan we reviewed discussed credits over a 10-year term in the introductory section, but went on in the main body of the agreement to specify annual credits with no clear ending date. We can guess that the credit union intended only to provide 10 credits. But the document left enough uncertainty that the executive could sue the credit union and have a court decide the issue.

Courts favor the non-drafting party when interpreting ambiguity. In executive plans, this means the executive likely wins on vague terms. Therefore, like all contracts, deferred compensation plans should be carefully drafted to ensure that the terms are clear and reflect the parties' intentions.

Sections 409A and 457(f) require carefully structured timing of payments to defer taxes and avoid penalties. Uncertainty could be interpreted by the IRS as non-compliant. For example, severance plans frequently withhold payments until the terminated employee submits a release of claims. This type of arrangement creates an opportunity for the payment date to change, based on the date the release is submitted. This used to be a reasonable practice, but section 409A requires fixed payment dates and leaves no wiggle room, even for claims releases.

Definitions

Many deferred compensation arrangements condition payment on a particular reason for termination, such as cause or good reason. These definitions are sometimes missing, inadequate, or conflict with other plans or employment agreements.

A definition of cause should generally be consistent with the employee's employment agreement. There is no legal requirement for this, but it makes things simpler by eliminating confusion on when an employee has committed "cause."

The definition of good reason must provide a notice and cure period to qualify for section 409A's safe harbor provisions. An employee must notify the employer of the good reason within 90 days of its occurrence, and provide 30 days for the employer to cure the problem. Missing these provisions could cause a 409A violation and trigger its tough penalties.

In one plan we reviewed, the drafter provided for payments upon a change of control, but did not define the term. If there ever were something that looked like a change of control such as a new CEO, the employees could have argued — likely successfully — that they were entitled to the benefit.

Terms with conflicting, incomplete, or missing definitions are a common source of trouble with contracts.

Section 409A issues

To qualify for a key exemption under section 409A (i.e. the short-term deferral exemption), among other thing, all payments must be made by the 15th day of the third month after the separation event. This means that benefits may not be structured as an annuity. One credit union had a plan that provided for a stream of payments in one clause and a lump sum in another with no reconciliation of the two different designs. If audited, the IRS might decide that the plan provides a stream of payments, void the exemption, and impose penalties accordingly.

Section 409A also does not allow for payment times to vary depending on whether the termination is with or without cause, or voluntary or involuntary.

For example, an employer had deferred compensation plans for the CEO that specified an immediate lump sum for an involuntary without cause termination and a defined installment stream for a voluntary termination. To bring the CEO's plans into compliance, they needed to provide for the same time of payment irrespective of whether the termination is voluntary or involuntary, or with or without cause.

Section 457(f) problems

In 2007 the IRS announced it did not like rolling risks of forfeiture and would be issuing rules prohibiting them. (A rolling risk of forfeiture is an arrangement that periodically defers a vesting date while the employment relationship continues.) Notwithstanding this "shot across the bow," we continue to see such designs. We recommend replacing the rolling risk with a different type of vesting schedule. One common design is a series of dates with increasing payments. This can serve a similar function as rolling risks of forfeiture yet complies with section 457(f).

Conclusion

Deferred compensation plans are subject to strict regulation, and even small errors in drafting can have large consequences.

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