Blitman&King LLP

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CUEd In:

The Law and Business of Employee Benefits for Credit Union Executives

In this Issue

Future Events

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During the latter half of this year, we will be conducting an educational webinar for credit union executives on various topics of interest. We will be providing you with additional information on the webinar in the next few months.

Welcome to the second issue of *CUEd In*, our guide to the law and business of employee benefits for credit union executives. In this issue, we take a look at how the new application of nondiscrimination requirements under health care reform may affect your executive health care arrangements. We highlight the U.S. Department of Labor's intention to cover individual retirement accounts (IRAs) under the new proposed definition of "fiduciary." We provide you with notice of future sweeping guidance from the Internal Revenue Service, on nonqualified deferred compensation plans subject to Internal Revenue Code Section 457(f), expected by year end. Finally, we discuss the purpose of Executive Retention Agreements and preview future discussions of change in control agreements, severance agreements and employment agreements.

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For now, let's dive head first into this issue of *CUEd In* ...

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How Big Is This?

Health Care Reform May Impact Your Executive Employment and Severance Agreements

Credit union executives should be aware of the new application of non-discrimination rules under the Patient Protection and Affordable Care Act of 2010, as amended ("PPACA" or "Act")—commonly known as health care reform—that will prevent highly compensated employees from being rewarded with more favorable eligibility terms or richer benefit levels in connection with health insurance.

In many employment and severance agreements for credit union executives, the credit union agrees to provide to the executive, or former executive, tax-free health benefits under the credit union's group health plan that are richer than the health plan benefits offered to other active or former employees. Typically, in these instances, the credit union will pay all or a larger portion of the health care premiums associated with the continued coverage than the credit union otherwise does for other active or former employees.

Another form of executive health benefits may include the credit union agreeing to continue health plan benefits for a period of time longer than what the credit union is otherwise required to do under the Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA). In these instances, for example, the credit union may offer tax-free continuation coverage until the executive is eligible for Medicare coverage.

Since the 1980s, credit unions have used fully insured plans as a vehicle to provide executives and key employees with more generous health benefits. Historically, there were no penalties or tax issues associated with providing a higher level of health benefits to executives if the health benefits were fully-insured through an insurance company. However, with the implementation of PPACA that will no longer be the case. The Act's non-discrimination rules will take effect once the Internal Revenue Service ("IRS") issues further guidance.

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Notably, under the Act, "highly compensated" is not defined by the amount of income an executive earns. Instead, a highly compensated individual is generally defined as one of the five highest paid officers or among the highest paid 25% of all credit union employees.

Under the Act's nondiscrimination rules, a credit union's health insurance plan must satisfy two separate tests: eligibility and benefits. The eligibility test may be satisfied if:

• 70% or more of all credit union employees are covered by the plan; or

• 70% of all credit union employees are at least eligible to participate in the plan and 80% of those eligible employees are covered.

Alternatively, a credit union may satisfy the eligibility rules by classifying employees on a nondiscriminatory basis; however, such classifications may have less predictability because they will likely be scrutinized by the IRS on a facts and circumstances basis. It should be noted that certain credit union employees may be excluded from eligibility testing altogether including employees with less than three years of service, employees under age twenty-five, and part-time employees.

To satisfy the benefits test, all benefits provided to highly compensated individuals, including their dependents that participate in the credit union's plan, must be provided to all other credit union employees that participate in the plan.

Credit unions that fail to satisfy these requirements may face an excise tax equal to $100.00 per day during the period of noncompliance for each "affected employee." For this purpose, the IRS has defined affected employees to include each employee who is discriminated against as a result of the arrangement. If the violation is the result of an unintentional failure the maximum penalty is the lesser of (i) 10% of the total amount paid by the credit union in the previous year with respect to health insurance, or (ii) $500,000. The penalty is enforced on a voluntary self-reporting basis whereby the IRS requires violating credit unions to file a special tax return. More draconian penalties apply if the IRS discovers the violation in connection with an audit.

These rules will likely catch credit union executives, and their institutions, by surprise since this portion of health care reform has, to date, received little attention. Depending on exactly how the IRS interprets and implements these new rules, they could have a broad impact across a wide range of employment and severance agreements. In this regard, it is important to note that the new law does not contain an exception for existing arrangements.

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Based on recent comments from the IRS that these new rules will be "a very challenging provision to apply," credit union executives, and credit unions as institutions, should start to take steps to survey and outline their current health care arrangements. Once further IRS guidance is issued, existing and new health care arrangements will need to be reviewed to ensure that the credit union may continue to administer the arrangement without incurring significant penalties. If prohibited, these arrangements will need to be restructured in a compliant manner. We will continue to keep you apprised of new developments.

"This is a big %@$^%$# deal"
— Joseph R. Biden, Jr., Vice President of the United States, March 22, 2010

Will the Proposed Definition of ERISA "Fiduciary" Contain a Carve-Out for IRAs?

No, according to recent comments by the U.S. Department of Labor ("Department"), the final regulation will not contain a blanket exception for IRAs. As such, IRA service providers—including credit unions that, as custodians of IRAs, provide asset valuation—should anticipate expanded enforcement of the prohibited transaction rules under the Employee Retiree Income Security Act of 1974, as amended ("ERISA").

As we previewed in our inaugural issue, the Department has proposed an amendment to the regulations defining fiduciary status under ERISA. The proposal would substantially expand the classes of service providers subject to ERISA's fiduciary duty and prohibited transaction rules by more broadly defining the activities and circumstances by which individuals render "investment advice."

The Department recently confirmed that it intends the final regulation to cover IRAs and therefore, the Department will not be carving out the IRA retail space from the application of ERISA's prohibited transaction rules. Indeed, the Department advised that the primary reason for including IRAs under the proposed fiduciary regulation is to extend ERISA's prohibited transaction rules to IRAs as "[t]hose rules are meant to deal with situations that are fraught with the potential for abuse."

ERISA prohibits fiduciaries from engaging in non-exempt prohibited transactions, self-dealing and certain transactions that present conflicts of interest. Prohibited transactions will generally encompass transactions between the plan (here, the IRA) and "parties in interest" which generally include plan sponsors, fiduciaries and service providers to the IRA. Specifically, unless an existing exemption applies or the Department grants an individual exemption, ERISA Section 406(a), in relevant part, prohibits the direct or indirect (i) furnishing of services (brokerage services, investment advisory services, etc.) to a plan by a party in interest and (ii) the transfer to, or use by, a party in interest of plan assets. In addition, ERISA Section 406(b) sets forth general prohibitions against a fiduciary engaging in transactions involving self-dealing, breaches of loyalty and conflicts of interest.

Historically, the government has not expended significant resources on enforcing prohibited transaction rules among financial service providers to IRAs. However, additional enforcement and government resources may come through the new Consumer Financial Protection Bureau created by Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The Department recently confirmed that it intends the final regulation to cover IRAs and therefore, the Department will not be carving out the IRA retail space from the application of ERISA's prohibited transaction rules.

Based on the Department's comments, once the proposed regulation becomes final, credit unions that provide an IRA product will need to examine transactions and service provider relationships with respect to the IRA. In particular, due attention will need to be given to specific financial practices and fee compensation arrangements with respect to the IRA. In the event that no existing exemption applies, transactions with the IRA will need to be restructured in a compliant manner or an individual exemption should be sought from the Department.

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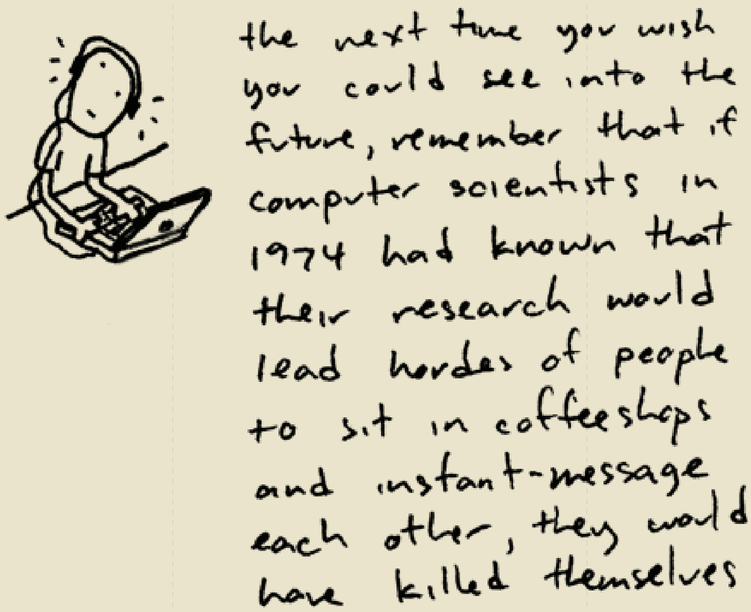
Future Guidance on Section 457(f) Plans is in Clearance

Credit union executives should be aware that future guidance on nonqualified deferred compensation plans under tax code Section 457(f) —a type of plan regularly maintained by credit unions for executives—is in the clearance process at the Treasury Department and Internal Revenue Service and might be released in September 2011 according to senior counsel in the IRS's Office of Chief Counsel.

This is "going to be a pretty big piece of guidance" according to the individual and will cover various nonqualified plans, including supplemental executive retirement plans (SERPs), severance and vacation pay plans, maintained by federal credit unions. The specific issues to be addressed in the guidance include the definition of substantial risk of forfeiture (vesting related events), calculation of amounts deferred, and the relationship between Internal Revenue Code Sections 409A—which places stringent rules and restrictions on nonqualified deferred compensation plans—and 457(f). Interestingly, the IRS indicates that the guidance will be "setting the rules straight" as "[t]here is a lot of confusion on the nonqualified side."



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Executive Retention Agreements

The use of Executive Retention Agreements ("Agreement" or "Agreements") generally occurs in two broad situations. First, the agreement is a reward in recognition of the executive's significant contribution to the creation of value and leadership within the credit union. Alternatively, an executive may know or suspect their credit union is going to be acquired or their employment security is in danger for another reason outside of the executive's control.

The benefit of a change in control provision is peace of mind—the executive knows he or she will receive compensation and benefits if the executive loses their position under certain circumstances following, for example, a merger of the credit union.

In these situations, credit unions, who want to ensure the executive's continuing loyalty and commitment and believe that it is in their member's best interests, will provide the executive additional incentive to continue his or her employment. Such Agreements ensure that the executive will continue to maximize the value of the credit union instead of focusing on the potential loss of their position. The motivation usually takes the form of bonus compensation, severance, or both, as well as the provision of other benefits that the credit union deems necessary to retain the executive.

In addition, executives should seek the protection of a change in control provision. Although such provisions generally appear in employment and severance agreements, we have successfully negotiated these provisions either as a stand-alone agreement or as part of an Executive Retention Agreement. The benefit of a change in control provision is peace of mind—the executive knows he or she will receive compensation and benefits if the executive loses their position under certain circumstances following, for example, a merger of the credit union.

Such Agreements ensure that the executive will continue to maximize the value of the credit union instead of focusing on the potential loss of their position.

Such provisions are sometimes called "golden parachutes" because they provide protection for executives that exit the credit union. There are single trigger and double trigger change in control provisions. Single trigger provisions simply require the occurrence of change in control event, such as a merger, for the executive to obtain a vested right to the compensation. A double trigger change in control provision requires the occurrence of a control event, such as a merger, plus the executive's subsequent separation from service. Following the executive's separation—either for involuntary termination or voluntary resignation with good reason—compensation would be paid to the executive.

In future issues of CUEd In, we will detail the ins and outs, and points of negotiation, of several different types of individual executive agreements including change in control agreements, employment agreements, severance agreements, deferred compensation agreements and retention agreements ....stayed tuned.

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Questions regarding the foregoing may be directed to:

Jonathan M. Cerrito
(Employee Benefits)

315.422.7111
jmcerrito@bklawyers.com

Jules L. Smith
(Employment)

585.232.5600
jlsmith@bklawyers.com

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Albany

800 Troy-Schenectady Road
2nd Floor
Latham, New York 12110
Telephone: 518-785-4387

Rochester

16 West Main Street
5th Floor
Rochester, New York 14614
Telephone: 585-232-5600

Syracuse

443 North Franklin Street
3rd Floor
Syracuse, New York 13204
Telephone: 315-422-7111