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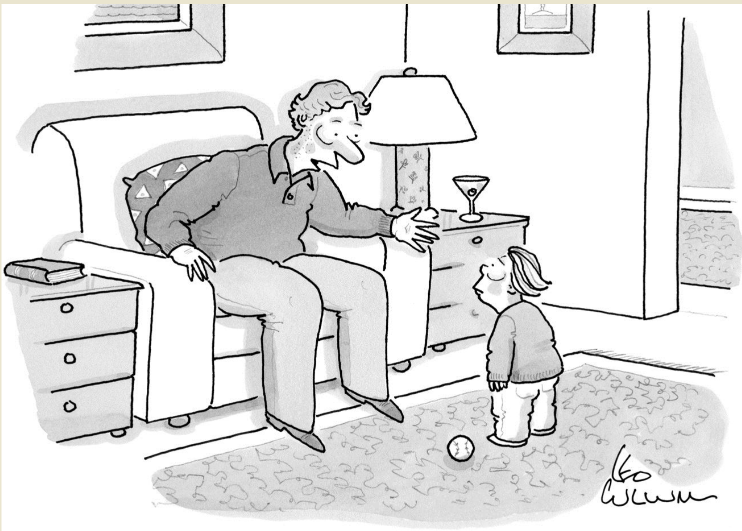
CUEd In:

The Law and Business of Employee Benefits for Credit Union Executives

In this Issue



"We love Santa, but Santa didn't know as much about investing as he thought he did."

Welcome to the next issue of CUEd In, our guide to the law and business of employee benefits for credit union executives. In this issue, we spotlight the importance of understanding "change in control" provisions and the pitfalls of not seeking counsel to review the existing facts and circumstances as to whether such provisions have been triggered in connection with a merger of federal credit unions. To illustrate key principles, we examine two recent court cases involving the merger of banks where both executives at issue were terminated and denied severance benefits on the grounds that the change in control provisions were not triggered.

In addition, we update you on another show-stopper involving the never ending saga of how and if Code Section 457 is applicable to credit unions through discussion of a new notice of proposed rulemaking issued by the Internal Revenue Service.

As a reminder, CUEd In is now a LinkedIn Group. You may visit the CUEd In LinkedIn page and join the group here: http://www.linkedin.com/pub/jonathan-cerrito/37/330/60. Through this group, we will be disseminating information and updates for credit union executives.

This issue is jam-packed with information so let's jump in...

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Not Understanding "Change in Control" Provisions Results in Out of Control Results

In *Toohig v. National City Corp. Amended and Restated Management Severance Plan*,[1] the court denied severance benefits to a banking executive following a change in control where the plan administrator interpreted the provision to require that the executive actually relocate more than fifty miles. This is a case where an additional condition is being imposed following a change in control. In *Caffrey v. Four Oaks Banks & Trust Co.*,[2] the court denied severance benefits to two banking executives "for the simple reason that [the executive was]...terminated well before any change of control took place." This is a case where a change in control is deemed to have not yet occurred. The lesson of these cases is that credit union executives, as participants in an industry that is experiencing continued consolidation, need to take a proactive approach to understanding "change in control" provisions, their scope and how and when they are triggered.

A hypothetical credit union example based on the facts of Toohig: imposition of an additional condition upon change in control. Let's say a credit union executive—named Sean Toohig—begins employment with National City Credit Union ("NCCU") in May 2004, where the individual serves as a Vice President in Cleveland, Ohio. By virtue of his position, Toohig is eligible to participate in NCCU's severance plan. The plan provides, in part, that a participant is entitled to severance benefits if he is required "to have his principal location of work changed, to any location which is in excess of 50 miles from the location thereof immediately prior to the change in control." The plan designates the Compensation Committee of NCCU's Board of Directors ("Committee") to administer the plan. The Committee is vested with the discretionary authority to interpret, construct, and administer the plan and to conduct a case-by-case review of each employee's circumstances when determining eligibility. The plan also sets forth a detailed claim and review procedure.

On December 31, 2008, NCCU becomes a wholly-owned subsidiary of PNC Credit Union ("PNC"). This event constitutes a "Change in Control" under the plan. Soon thereafter, Toohig has conversations with the Board of Directors regarding his role with the company in the wake of the change in control.

On March 16, 2009, Toohig submits a letter of resignation and demands severance benefits under the plan, asserting that PNC is requiring him to move from Cleveland to Pittsburgh. On March 30, 2009, Toohig receives a memo-

1 *Toohig v. National City Corp. Amended and Restated Management Severance Plan*, No. 1:10 CV 657, (N.D. Ohio, June 15, 2011).
2 *Caffrey v. Four Oaks Banks & Trust Co.*, No. 5:10-cv-003441-FL (E.D.N.C., June 29, 2011)

randum from the Board of Directors informing him of the apparent misunderstanding in that he is not required to move to Pittsburgh, but could rather continue working in Cleveland. The memorandum also states that PNC would not consider Toohig's resignation for good cause and would not pay him severance benefits if he did resign.

Notwithstanding PNC's warning, Toohig resigns his employment on April 10, 2009, and submits a claim to the Committee for severance benefits under the plan. The Committee determines that Toohig is not eligible for benefits because of its determination that Toohig was neither involuntarily terminated nor required to move his principal location of work, but instead was informed that he could remain in Cleveland. After the Committee denies Toohig's appeal, Toohig sues PNC under ERISA for the denial of benefits.

What does the court say? In its analysis, the court first notes that when an ERISA plan gives the administrator discretionary authority to determine eligibility for benefits, or to construe the terms of the plan, a court should not reverse a decision denying benefits unless the decision was arbitrary and capricious. In addition, the court points out that the arbitrary and capricious standard is extremely deferential to the administrator, in that the decision will be upheld if it is the result of a deliberate principled reasoning process, if it is supported by substantial evidence, and if it is based upon a reasonable interpretation of the plan. Further, the court notes, when the terms of a plan are ambiguous, the court only requires the administrator's rationale to be rational.

Toohig argues that the plan only required the transfer of the duties of his job to a location more than 50 miles from Cleveland, and that there was no requirement that he actually relocate. The Committee, on the other hand, interpreted the plan to require the transfer of Toohig's employment to Pittsburgh. The court concludes that, seeing how the Committee had discretion to interpret the plan and its interpretation was rational, the court must accept the Committee's interpretation.

In response to Toohig's argument about an inherent conflict of interest – seeing how PNC both funds the severance benefits and evaluates the claims for those benefits – the court agrees that there is such an inherent conflict. However, the court declares that this is merely a factor in the arbitrary and capricious analysis, and it concludes that Toohig has not demonstrated any evidence to show that the conflict actually had a controlling impact upon the Committee's decision in his case.

As a result, the court finds that the denial of benefits by the Committee came as a result of a deliberate principled reasoning process, was supported by substantial evidence, and was based upon a reasonable interpretation of the plan. Therefore, the court concludes, the plan's motion for judgment on the administrative record is granted and the case is dismissed.

A hypothetical credit union example based on the facts of Caffrey: premature conclusion that a change in control occurred. Let's say two individuals receive offers of employment to become credit union executives with Nuestro Credit Union ("Nuestro") in 2007. Each offer contains a severance provision providing for payment following a change of control and a materially adverse effect on their duties or benefits with the credit union.

Toohig argues that the plan only required the transfer of the duties of his job to a location more than 50 miles from Cleveland, and that there was no requirement that he actually relocate. The Committee, on the other hand, interpreted the plan to require the transfer of Toohig's employment to Pittsburgh. The court concludes that, seeing how the Committee had discretion to interpret the plan and its interpretation was rational, the court must accept the Committee's interpretation.

In April 2009, management of Nuestro and Four Oaks Credit Union ("Four Oaks") announce that a merger agreement has been reached whereby Four Oaks will merge with and take control of Nuestro. Although the merger has already been approved by the management of both corporations, it still has to be approved by the National Credit Union Administration and/or state regulators.

At the same time, Four Oaks informs both executives that it does not plan to retain them as employees, and that they will be terminated upon final approval of the merger. In response to their expressed expectation of severance benefits, Nuestro and Four Oaks assert that they have no obligation to make the severance payment. To resolve the dispute, Nuestro and Four Oaks negotiate with both executives to create separate draft separation agreements which call for lump sum payments to each. The terms of the agreements provide that the "[e]mployee may not execute this Agreement prior to the Separation Date," which is the closing date of the merger. Further, the agreements specify that, in order to be able to execute the agreements, the plaintiffs have to be currently employed by Nuestro at the time of closing.

On November 20, 2009, Nuestro terminates the employment of both executives. On December 8, 2009, Four Oaks announces that National Credit Union Administration and/or state regulators have approved the merger, which is finally consummated on December 31, 2009. Four Oaks refuses to pay either executive the severance payment provided for in the agreements because the agreements were never executed. Further, Four Oaks denies enforceability of the earlier employment agreements.

Seem fair? The executives don't see it that way and sue. The court finds that the employment agreements at issue are employee benefit plans subject to ERISA. The court then proceeds to assess the plaintiffs' claims for benefits under ERISA and whether they are entitled to benefits under the terms of the agreements. At issue, therefore, is whether there had been a change of control that created a materially adverse effect on the plaintiffs' duties or benefits.

After noting the general principle of contracts to interpret words using their usual, ordinary and commonly accepted meaning, the court points out that the ordinary and natural meaning of the phrase, "change of control" contemplates a substitution or replacement of the regulating or governing body. The court concludes that this meaning is clear and unambiguous in the context of a corporate merger, as the change of control occurs upon the merger itself, when the merging corporation ceases to exist.

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After determining this meaning, it is clear to the court that a change of control had not yet occurred prior to the plaintiffs being terminated, as they were terminated on November 20, 2009, and the merger did not take place until December 31, 2009. Therefore, because there had been no change of control at the time of their termination, the court holds that the plaintiffs are not entitled to benefits under the change of control provisions. Correspondingly, the court grants Four Oaks' motion for summary judgment based on the pleadings and the executives are denied severance benefits.

What do these cases mean to you? The practical impact of these cases for credit union executives extends beyond the facts considered. The scope and triggering mechanisms of change in control provisions need to be negotiated on the front end and reviewed based on the specific facts and circumstances being confronted by the credit union executive. These cases are instructive in that credit union executives must be cautious to exercise their own independent review of change in control provisions and not rely upon any oral representations in connection with merger activity. Despite what may be initially represented by an acquiring credit union, change in control payments (or payments conditioned upon a change in control such as severance) represent liabilities to an acquiring credit union and any legal means to avoid those liabilities will be employed despite the executive's years of service.

Will the Real Section 457 Please Stand Up

On November 7, 2011, the IRS and Department of the Treasury released advance notices of proposed rulemaking ("Notice") on the definition of "governmental plan" under the Internal Revenue Code of 1986, as amended ("Code"). Section 414(d) of the Code provides that the term generally means a plan established and maintained for its employees by the U.S. Government, the government of any state or a political subdivision thereof, or by any agency or instrumentality of the foregoing. One of the key aspects of this rulemaking is that it will shed light on what exactly an "agency or instrumentality" of the government is for these purposes, and it will correspondingly provide guidance as to whether a federal credit union so qualifies.

The stakes in this rulemaking for federal credit unions are high, as agencies and instrumentalities of the federal government are not "eligible employers" to maintain a nonqualified deferred compensation plan under Section 457 of the Code – including many 457(b) plans that have historically been maintained by credit unions – which are exempt from the harsh tax consequences of Section 409A. Failing to be eligible would therefore require many federal credit unions to overhaul their benefits plans to reflect this conclusion.

As it currently stands, the answer to this issue is temporarily controlled by IRS Notice 2005-58, which provides that a federal credit union that has consistently claimed the status of a non-governmental tax-exempt organization for all employee benefit plan purposes may treat Section 457 as applying to any plan in effect on August 15, 2005. This rule, however, was issued with the caveat that it would apply only pending the issuance of future guidance regarding Section 414(d) of the Code and

3(32) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), which relate to the definition of "governmental plan." Therefore, these new regulations will control this issue.

The proposed regulations issued by the IRS and Treasury Department along with the Notice state that the issue will be controlled by a facts and circumstances test, and list certain factors to be considered when making the determination of whether an entity is an "agency or instrumentality of the United States." These factors include, among other things,[3] whether:

- The entity performs or assists in the performance of a governmental function; and
- The control and supervision of the entity is vested in the Government of the United States. Control must be more than the government's extensive federal regulation of an industry.

Assuming that these relevant factors are carried over into the final regulations, federal credit unions likely will not be considered agencies or instrumentalities of the federal government. The Notice points out that this conclusion would result from the fact that the federal credit union's board of directors is elected by its own members and the directors are not responsible to the U.S. Government, except to the limited extent set forth in the Federal Credit Union Act and regulated by the NCUA. Therefore, federal credit unions will likely be eligible employers who can continue to maintain Section 457 plans.

We will continue to monitor these proposed regulations as they make their way through the administrative process and will report on new action in future editions of *CUEd In*.

3 The additional factors ask whether: the U.S. Government has all of the powers and interests of an owner; the entity is created by the U.S. Government pursuant to a specific enabling statute that prescribes the purposes, powers and manner in which the entity is to be established and operated; the entity receives financial assistance from the U.S. Government; the entity is exempt from federal, state and local tax by an Act of Congress; the entity is determined to be an agency or instrumentality by a federal court; other governmental entities recognize and rely on the entity as an arm of the U.S. Government; and the entity's employees are treated in the same manner as federal employees for purposes other than providing employee benefits.

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