

Pigging out? Special retirement plans for top executives are becoming a target for other stakeholders

Ronald Fink CFO Magazine

THINK SOCIAL security sets up intergenerational conflict? Try deferred compensation for top corporate managers. At financially strapped Delta Air Lines, in fact, a much-publicized dispute over the funding of special retirement plans for highly paid executives pits the company's retired CFO against its current one. ?? The former CFO, 59-year-old Thomas Roeck, is 1 of 30 retired Delta executives who recently demanded in a letter to CEO Leo Mullin that the Atlanta-based company rescind a decision to spend roughly \$45 million to fund separate retirement plans for 33 current executives. That decision comes at a time when the company's troubles put the benefits of the retirees, not to mention those of the current rank-and-file, at risk. Much of that \$45 million is going to Mullin, but others are also receiving sizable sums; for instance, \$790,529 is designed to fund the future benefits of Delta's current CFO, Michele Burns. And those amounts represent only 60 percent of the total earmarked for the executives' special pensions by 2004.

Meanwhile, the special plan that Roeck and his fellow retirees received while employed by Delta is unfunded, while the company's conventional pension plan is underfunded by some \$5 billion, or almost 42 percent.

In a letter rejecting the retirees' demand, Delta's general counsel responded that the current management team has stuck with the company since 9/11 despite its problems, has outperformed managers of other airlines, and "is determined to avoid...all of the pain to all Delta people, both emotional and economic, that would flow from a bankruptcy" (see "Delta Disappointment," page 36).

Roeck, for one, isn't contemplating further action to convince the company to change its mind. The letter to management, he says, represents "my best shot." But the lawyer representing the retirees won't rule out litigation. "Thousands of people have a [complaint]," observes Dean Booth of Atlanta-based Schreeder, Wheeler and Flint LLP, "and others [besides Roeck] have the wherewithal to scratch an itch."

The protest over Delta's funding of its benefits for top management reflects a growing public backlash against such arrangements, which are perceived to be unfair at a time when lower-paid employees are seeing their own benefits cut. At AMR Corp. (the parent of American Airlines), for example, former chief executive Donald Carty was forced out after the company's 10-K for 2002 revealed that the airline had funded its supplemental retirement plan for senior executives just a few months before Carty asked unionized employees to give back some of their own retirement benefits.

Of course, the airline industry is in particularly dire straits. But unless the economy improves dramatically, the backlash is likely to affect other companies making use of such plans. Not only are shareholder activists starting to focus on this issue, but abuses by some companies--particularly those in or nearing Chapter 11--have led Congress to consider action to curb the arrangements.

SERPS UP

Supplemental retirement and compensation plans are certainly widespread at this point. A recent survey of roughly 200 Fortune 1,000 companies by Clark Consulting, a compensation firm in Dallas, found that more than three-fourths had such executive plans in place last year (see table, page 38). And while it's unclear how many companies fund these plans, anecdotal evidence suggests a growing number are doing so as tough times threaten unsecured benefits. In addition to Delta and AMR, companies that have recently funded such nonqualified plans include Abbott Laboratories, Altria Group (formerly Philip Morris), Motorola, Owens-Illinois, and TXU. Motorola, for its part, contributed \$38 million to its supplemental plan last year while adding nothing to its qualified plan for 70,000 employees, even though the qualified plan was underfunded by \$1.4 billion, or roughly a third. (The company intends to add up to \$200 million to that plan this year.)

Under Internal Revenue Service rules, companies can set aside through nonqualified plans amounts above and beyond what is contributed on behalf of highly paid employees to 401(k) plans and other qualified retirement arrangements. Nonqualified plans generally come in two basic forms: deferred compensation plans containing amounts voluntarily set aside by executives, and supplemental executive retirement plans (SERPs) that contain contributions made by companies on their executives' behalf. But while there are no IRS limits on the amounts that can be put into either type of plan, a body of law primarily reflecting court decisions governs the circumstances under which the tax owed by plan participants on those amounts can be deferred.

In fact, executives' personal income taxes on benefits promised by nonqualified plans can be deferred only if the allocated funds are kept within reach of a company's general creditors. So while funding such plans doesn't violate the tax code, the timing can pose legal problems for companies in financial trouble. Under the federal bankruptcy code, management cannot offer itself "avoidable preferences" within 90 days of a bankruptcy filing, and that prohibition extends for as long as 12 months when a manager is a fiduciary--as the five highest-compensated executives of a publicly traded company are. As Dean Booth puts it vis-a-vis Delta: "In the shadow of bankruptcy, you can't go pay yourself money."

Former Delta CFO Roeck contends that previous generations of management would never have contemplated what the current one has done, and cites the airline's previous financial

difficulties as an example. "When we went through pay cuts in the early 1990s, it went without saying that they would apply to us," he says.

OFF-LIMITS

Some consultants contend that companies should not have set up supplemental plans in the first place without funding them. "Had AMR set aside funds on a consistent basis when it first implemented the plan in the 1980s, it would not have had to take the financial and PR hits that it did," says Mel Todd, president and chief executive officer of The Todd Organization, a national executive-benefits consulting firm headquartered in Greensboro, North Carolina.

Al Becker, a spokesman for AMR, concedes as much. "In retrospect, we might have done things differently," he admits, though he points out that the problems now facing the airline industry are unprecedented.

Once a plan is funded, however, it's off-limits to creditors. And that means current management will get its benefits even if the company goes bankrupt. Is that fair? Defenders of such plans note that nonqualified plans, unlike traditional defined-benefit plans, aren't covered by federal insurance. But, of course, that insurance covers only a portion of the promised benefits, and even the full amounts pale in comparison with what top managers usually expect from nonqualified plans. As Roeck puts it, "We're supposed to be in this together."

Adding insult to injury as far as public perception is concerned, companies often pay executives extra money to cover the tax liabilities that result from funding such benefits. Almost half of the \$45 million in payment to the special Delta trusts compensated the executives for their tax liabilities. At Motorola, executive vice president Robert Barnett got \$3 million in 2000 to "gross up" his benefits for taxes.

Such practices are also beginning to raise hackles among shareholder activists. Peter Clapman, chief counsel of institutional money manager TIAACREF, recently complained to Fortune magazine that nonqualified benefits for executives were being funded with no apparent connection to performance. Motorola is perhaps the most likely candidate for pushback from TIAA-CREF, as B. Kenneth West, a senior consultant to the organization, was recently named to its compensation committee.

Some people, like Thomas Roeck, doubt whether supplemental plans can be designed to align management's interests with shareholders'. With the senior executives' benefits secured, asks Roeck, "what incentive does management have to avoid bankruptcy and look out for other stakeholders?"

LEGAL REMEDIES

Congress, meanwhile, is at least threatening to enter the picture. A law enacted in 1978 bars the Treasury Department from issuing new rules for nonqualified plans on its own, and much of what is considered legitimate practice is based on court decisions that follow precedents derived

from earlier rules. After examining apparent abuses at Enron, however, the staff of the Joint Committee on Taxation (JCT) recommended several legislative steps during hearings in April.

It's currently standard practice, for instance, for companies to allow distributions from such plans before retirement if an executive forgoes 10 percent of the benefit. That's in line with the penalty for early withdrawals from 401(k) plans and other qualified retirement plans. But such penalties did little to dissuade Enron executives from tapping their plans in this fashion not long before the company declared bankruptcy.

More than \$53 million in early distributions from its plans were made to 127 former executives of the energy-trading company fewer than 90 days before its bankruptcy filing in December 2001. And the JCT staff claims that other companies, which it did not identify, impose smaller such "haircuts" on early distributions. The staff recommends that Congress tax benefits when plans allow early distributions, control over investments, or other elections by beneficiaries.

What's more, according to the JCT staff, some companies locate trusts designed to formalize such arrangements in offshore tax havens, putting them out of reach of both the IRS and creditors. In testimony before the Senate Finance Committee a year earlier, Kathryn J. Kennedy of Chicago's John Marshall Law School cited as cause for congressional action the increased use of offshore trusts and others designed to fund assets when trigger events such as a credit downgrade occur.

Trusts that fund assets based on a triggering event are used by fewer than 9 percent of all companies with nonqualified plans, according to Clark Consulting. But some experts nonetheless say that tightening some rules here is perfectly reasonable. Offshore trusts in particular are "clearly abusive," says Jim Hauser, a partner in Boston law firm Brown Rudnick Berlack Israels LLP.

But the JCT staff went much further by urging Congress to change the basic standard for allowing deferred compensation to be excluded from taxable income. Currently, taxes can be deferred as long as the recipient is not in "constructive receipt" of the benefits, under which unfunded arrangements typically qualify. The JCT staff recommended, however, that the legal standard be changed so that the amounts would be taxed unless the recipient could show that he or she remains "in substantial risk of forfeiture" of the amounts until they are received.

Under that standard, much if not most deferred compensation would be taxable even when unfunded and put out of reach only of new management, a practice now widespread through the use of so-called rabbi trusts. A change of that magnitude would mean "the end of nonqualified plans," warns Hauser. He also contends that so dramatic a revision of the rules isn't justified. "Enron was terribly aberrational," he insists. "Congress is using a blunt ax where precision surgery is required."

JUDGMENT CALL?

Other supporters of nonqualified plans maintain that given the bankruptcy rules, no legislative changes whatsoever are necessary. "These issues are best left to the bankruptcy courts," says Mel Todd. "Bankruptcy judges have broad powers and authority."

Maybe so, but critics note that the judges can use that leeway to overlook violations, and they cite Polaroid's bankruptcy as a case in point. Roughly \$1.5 million in deferred compensation was paid to Polaroid insiders within the 90-day period prior to a filing when such payments are proscribed by federal law, according to court documents obtained by CFO.

Indeed, some observers say the bankruptcy code is too vague to deal adequately with deferred compensation and should be modified to specify a "claw-back" provision for abuses involving such distributions. "It may be difficult to otherwise prove that contributions to a secured funding vehicle are a fraudulent conveyance, comments Hewitt Associates consultant Dave Sugar.

Yet others contend that Enron's insolvency promises to change the legal climate for such claims. While that case has now dragged on for almost a year and a half, it's far from over, and many experts predict that creditors ultimately will go after questionable distributions there. "Everyone fully expects that to happen," says Todd. And however aberrational Enron's behavior may have been, Hauser notes that creditors are now hunting for similar behavior elsewhere.

All of which poses a paradox for companies in financial difficulty. On the one hand, many are looking to defer more executive compensation to increase free cash flow. But while stakeholders have an obvious interest in improved cash flow, an increasing number are opposed to the idea of deferring compensation to produce it. "There's no way to square everybody's interests here," says Sugar.

Ultimately, proponents of nonqualified arrangements fall back on a standard defense: the compensation, they say, is necessary to retain top executives at a time when their stock options are underwater and they're taking salary cuts along with everyone else. Yet in the current environment, managers of troubled companies are hardly in great demand elsewhere. "Where are they going to go?" questions a critic who asked not to be identified. "Who's going to hire them?"

The message for CFOs: Think twice about demanding such benefits under current conditions unless your performance is superior enough to justify funding them--or you're prepared to take the heat.

TYPE OF PLAN *	NQDC	SERP
Offer plan	86%	76%
Allow early withdrawal less penalty	47%	NA

Protect benefits from creditors through 6% 8%
"springing" or "rabbicular" trusts

* Percentages of respondents to a survey of Fortune 1,000 companies

Source: Clark Consulting

Related Article: Delta Disappointment

LAST FEBRUARY, IN A LETTER SENT TO 30 RETIRED executives who had demanded that the funding of special retirement plans for 33 of Delta Air Lines's current executives be rescinded, the company's general counsel stated that management was "perplexed and disappointed" by the request.

After all, wrote attorney Robert Harkey on behalf of Delta management, eight of the retirees said in an earlier letter that they wanted to be included in plans for the funding. What's more, he said, the value of the severance benefits they received wasn't much less than the \$75 million earmarked for current executives.

But a lawyer for the retired executives says that there's no comparison between the severance payments and the retirement-plan funding. "There's no possible relationship," says Dean Booth of Schreeder, Wheeler and Flint LLP in Atlanta. For one thing, he says, the severance totaled "considerably less" than \$10 million. And 22 of the signatories of the second letter received nothing. In contrast, CEO Leo Mullin could retire in five years and receive about \$1 million a year for the rest of his life.

Booth also points out that the group changed its mind about wanting to be included in the funding because the members--including ex-CFO Thomas Roeck--didn't realize the extent of underfunding of the regular retirement plans' benefits. At first, says Booth, the group thought they were the only current and retired employees who weren't going to get paid. Once the extent of underfunding of the regular plans became clear, however, the retired executives realized 58,000 others also wouldn't get their benefits. In fact, says Booth, "the 33 would be the only ones getting the money."

That's an overstatement, to be sure--but only a mild one. In fact, Delta is proposing to phase out its traditional plan and replace it with a cash-balance plan expected to cut the pensions of older workers by as much as half.

Talk about disappointment.

Beyond Reach?

MOST LARGE COMPANIES now offer nonqualified deferred compensation (NQDC) plans or supplemental executive retirement plans (SERPs) to highly paid executives, according to a 2002 survey by Clark Consulting, an executive compensation consulting firm based in Dallas. While it's unclear what proportion actually funds the benefits, putting them formally out of reach of creditors, nearly half allow early withdrawals from NQDC plans for any reason, and a handful put the benefits of both types of plans into trusts designed to secure the benefits when a triggering event such as a credit downgrade occurs.