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*"Scipio . . . offers a good lesson to . . . [nonqualified plan] administrative committees . . . on improving their odds at winning lawsuits over alleged plan ambiguities."*

# NONQUALIFIED PLAN DISPUTES: THE IMPORTANCE OF PROCESS, PRECEDENT AND INTENT

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Disputes over nonqualified deferred compensation seem inevitable. After all, nonqualified plan documents are briefer, and sometimes more cryptic, than those for qualified retirement plans, and this can lay the groundwork for disagreement. Perhaps more telling, participants in nonqualified plans are, by their nature, executives who are more likely to have one-on-one discussions with key executives over the terms and effect of their nonqualified programs than are participants in broad-based qualified plans. This interaction – much of it oral and some of it occurring in informal conversations sprinkled over a period of years – can be fertile ground for misunderstanding.

A recent federal appeals court case, *Scipio v. United BankShares, Inc.*, 2004 WL 2980756 (4th Cir. 2004), offers a good lesson to boards of directors, administrative committees, and others who interpret nonqualified plans on improving their odds at winning lawsuits over alleged plan ambiguities. The *Scipio* court, in resolving an ambiguity in favor of the plan administrator's determination, placed heavy weight on the soundness of the process the administrator followed in reaching its conclusion. One may also read the decision as a triumph of employer intent and what the court may, at least *sotto voce*, have considered the common sense result, over what arguably would have been a fairer reading of the plan's language.

**Facts**. The dispute in *Scipio* concerned how to determine compensation when calculating an executive's nonqualified plan benefit. The plan was a defined benefit program. The promised benefit was 70 percent of the executive's "final average earnings," reduced by certain amounts. The executive argued that the plan should, for this purpose, count as earnings the executive's taxable income upon the exercise of stock options. The company's board of directors, which served as the plan administrator, instead found that stock option compensation should not be counted as earnings. The effect of including the executive's stock option compensation would have been considerable, increasing the executive's annual retirement benefit from roughly $74,000 to roughly $128,000.

**Plan Language**. At least to this reader, the plain terms of the plan seemed more supportive of the executive's position. The earnings to be included were "the total earnings received from the [company] during a calendar year," excluding specific bonuses not relevant to the court's decision. The court found the quoted language to be ambiguous. It then reviewed the board's decision as

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plan administrator under an "abuse of discretion" standard, but accorded the board less deference than if the board had no conflict of interest (the conflict resulted from the company's financial interest in limiting benefits under the unfunded plan).

**Court's Analysis**. The factors important to the court in determining whether the board abused its discretion in determining that stock option compensation should not be counted as earnings were (a) whether the board considered adequate materials in making its decision, (b) whether it engaged in a reasoned and principled decision-making process, and (c) whether its ultimate decision was consistent with the plan provisions and the board's earlier interpretations of the plan.

The court found that the board took pains to gather and consider information and material from a number of sources. Notably, the board hired a national employee benefits consulting firm to make the benefit calculation and obtained an opinion from a prominent law firm on the proper interpretation of the plan's language. The court also noted approvingly that the board contacted the former CEO and chairman of the board of directors involved at the time the plan was drafted, as well as other employees, to gain an understanding of the intent behind the plan's provisions. Those parties apparently advised that the plan was not intended to include as earnings gains realized from the exercise of stock options. The board was consistently advised that the intent of the plan was instead to provide retirement benefits for the key executives at roughly 70 percent of their *typical* annual salary. The court also noted that retirement benefits for other similarly situated executives had been computed without including their stock option gains. Finally, the court found support for the board's interpretation in the Tax Code Section 415 rules applicable to qualified retirement plans (although this reader would not have found that argument persuasive). The court, in conclusion, found that the board's determination that earnings for nonqualified plan purposes should exclude stock option gains was "the product of a reasoned and principled decisionmaking process based upon adequate materials and inquiry, and that the decision was consistent with the purposes and goals of the Plan, the Plan provisions, and its earlier interpretations of the Plan."

The executive in *Scipio* was probably fighting an uphill battle in arguing for the inclusion of stock option gains. That is because counting those gains as earnings would, due to one item of nonrecurring compensation, have so dramatically changed the amount of the executive's retirement benefit. It may have been that the court simply did not think it made sense to include large irregular items of compensation in the plan's final average earnings calculation, when it believed the company's intent was instead to replace a percentage of an executive's "typical" compensation.

**Lessons**. The lessons of *Scipio* for employers are threefold. First, nonqualified plan documents should carefully describe the compensation to be counted when calculating benefits, just as would be the case under a qualified retirement plan. Second, nonqualified plans should include *Firestone*-type language, giving the appropriate committee (or other party) broad discretion to interpret the plan's provisions. Third, the process followed by an administrative committee (or other party) in handling nonqualified plan claims may be as important as the reasonableness of the committee's determination. This assumes the committee enjoys an abuse of discretion standard of review (due to the inclusion of proper *Firestone*-type language in the plan document). As a corollary, courts generally smile upon decisionmakers who consult independent professionals. These professionals may, in appropriate circumstances, include outside legal counsel, financial experts, actuaries, or consultants.

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