

**SERP COMPENSATION DEFINITION:
COUNTING SEVERANCE PAY**

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There are certain "bad pennies" that seem to return again and again in disputes over executive compensation. One is the question of what nonrecurring compensation is to be counted for the purpose of calculating benefits under a SERP (that is, a defined benefit nonqualified deferred compensation arrangement). A common source of disagreement is whether taxable income resulting from the exercise of stock options is counted as compensation. A recent decision by the federal appeals court for the Ninth Circuit addresses a close cousin to the stock option compensation question. The Ninth Circuit was asked to determine whether severance pay counted as compensation under a SERP. The court concluded that severance pay did not constitute "earnings" for purposes of calculating an executive's benefit under the particular nonqualified top-hat plan at issue. The case is *Gilliam v. Nevada Power Company*.

In *Gilliam*, the court considered a former executive's claim that her benefit under a SERP's final average pay formula should take into account a severance payment to her of \$512,500. Taking into account this severance payment would increase the former executive's annual benefit under the SERP from approximately \$60,000 to just over \$145,000.

The plan calculated benefits based on "Service Earnings." The plan included no definition of that term, but did define "Service" and "Earnings." The term "Earnings" meant "a Participant's total wages and salary as reported by the Company for federal income tax purposes for the calendar year." The Ninth Circuit began by noting a split among the federal appeals courts in terms of the proper standard of review for decisions by plan administrators of top-hat plans, but did not decide whether the *Firestone* standard of review framework applies to top-hat plans because it would reach the same conclusion under either standard of review.

The court focused on the definition of the phrase "wages and salary." Although the plan's definition of "earnings" made reference to amounts reported by the company for federal income tax purposes, the court did not find it necessary to consider what the term "wages and salary" might mean under the federal tax code. That was because the plan did not define earnings in reference to wages and salary within the meaning of the tax code, but instead as *reported* by the Company for federal income tax purposes. The court looked to *Black's Law Dictionary* for definitions of the terms "wage" and "salary." It concluded, after doing so, that the term "wages and salary," and therefore the term "earnings" in the top-hat plan, included only payment for *services*. Because the former executive's severance pay was not for services, but was instead for her voluntary termination of employment, confidentiality, noncompetition, and waiver of claims against her former employer, the term could not be interpreted to

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include severance pay given to her for no longer working, even though that severance pay might be subject to federal income tax. The court found this conclusion to be strengthened by the plan's reference to "service earnings," rather than simply "earnings," when describing how benefits are to be calculated.

Lesson. Nonqualified deferred compensation arrangements typically employ a number of terms which, absent careful definition, are inherently ambiguous. One of those is the definition of "compensation" or "earnings" used to calculate benefits under a SERP. Given the great import of that definition, and the real potential for an executive receiving large, nonrecurring items of compensation while still employed, employers should give careful thought to what types of compensation are intended to be counted, and reflect that thinking as clearly as possible in the plan document.

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