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IMPLIED RIGHT TO REDUCE DEFERRED COMPENSATION FOR BAD BEHAVIOR

by
John L. Utz
Utz, Miller & Kuhn, LLC
jutz@utzmiller.com

A federal trial court has made an interesting decision concerning the obligation of a company to pay deferred compensation to an executive who is terminated for bad behavior. The case is *Foley v. American Electric Power*, 2006 WL 571886, 37 EBC 1663 (S.D. Ohio 2006).

The court considered a claim by an executive of an energy company who was terminated after he admitted to engaging in false reporting of energy trading transactions to industry publications. The executive had participated in a phantom equity plan and, in that connection, chosen to defer 90 percent of his phantom equity compensation into an incentive compensation deferral plan. After his termination, the executive made a claim for payment of more than $2 million accrued under the deferral plan. The company denied the executive's claim, asserting that had it been made aware earlier of the executive's misconduct it would have terminated him then, and this would have foreclosed any interest he had in the phantom equity plan that was the basis for his deferrals.

The court did not focus on the company's assertion that it would not have paid the executive the phantom equity compensation had it known earlier of the executive's misbehavior. Instead, it considered the company's ability under the terms of the deferred compensation plan to setoff against amounts owed the executive any portion accrued during the executive's period of "disloyalty" to the company. The court concluded that the company had such a right of setoff. In reaching this conclusion, the court focused intently on the deferred compensation plan's lack of a nonforfeiture provision.

Because the arrangement was a top hat plan exempt from ERISA's nonforfeiture and nonalienation provisions, the court turned to contract principles (which it applied as a matter of federal common law) to determine the rights of the parties. Under the federal common law of contracts, the court explained, contracting parties may expressly preclude setoff between them by agreement. However, a waiver of an employer's (or other party's) right of setoff "cannot be inferred from equivocal language nor deduced from ambiguous expressions." Instead, contractual language must be clear and explicit in explaining the intent of the parties to preclude setoff, if setoff is to be prohibited. The court quoted another court for the conclusion that "few cases have found contractual language to be sufficiently specific and precise to constitute a waiver of setoff." The court held that in the absence of an express prohibition of setoff, the federal common law of contracts authorizes the offsetting of one party's contractual obligation to the other.

"[T]he employer's right to setoff amounts that accrued during periods of disloyalty did not depend on the executive having received any improper personal benefit from that disloyalty."

The executive had argued that as a matter of contract law he was entitled to the disputed monies because the terms of the plan unambiguously provided for the payment of benefits and the plan itself included no forfeiture provision permitting the denial of benefits. In other words, the executive argued, if one simply took the language of the plan at face value, the executive was entitled to his $2 million. This argument has a certain straightforward appeal, but apparently not for the court. The court said, in effect, that if a top hat plan does not protect a participant by expressly prohibiting forfeiture (through a nonforfeiture provision), the employer has an implied right to refuse to pay benefits to the extent the amounts accrued during a period of "disloyalty" to the employer. The court framed this as a right to "setoff," although it seems tantamount to a simple forfeiture since (as explained below) the amount of the benefit reduction does not correspond to the employer's damages, but instead to the period of disloyalty.

The court, in reaching its decision, distinguished a federal appeals court decision, *Fields v. Thompson Printing Co.*, 363 F.3d 259 (3d. Cir. 2004). In *Fields*, the appeals court held that an executive who had misbehaved was nevertheless entitled to post-termination benefits and compensation because his employment contract included an express nonforfeiture clause and that clause did not include any exception relating to the executive's conduct. The *Foley* court said the *Fields* decision involved a different circumstance than was before it because in *Fields* the employment contract *did* include a nonforfeiture provision. In contrast, in *Foley* the deferred compensation plan did not expressly preclude forfeiture. The court said the *Fields* decision simply means that where there is a nonforfeiture provision a court will not imply a conduct-related exception to the obligation to pay benefits.

The *Foley* court also said that the employer's right to setoff amounts that accrued during periods of disloyalty did not depend on the executive having received any improper personal benefit from that disloyalty. The court seemed to say that the amount of setoff would be limited to the benefits accrued during the period of disloyalty, rather than being measured by any larger amount of damages the employer may have suffered (although the employer might, presumably, have a separate right of action to recover the remaining portion of its damages).

The court said it did not have enough information to reach a final conclusion as to the employer's right of setoff, because further factual development was necessary to determine whether the executive was in fact disloyal to the company. In particular, the court raised some question about whether the executive should have been aware of the legal and practical implications of his false reporting. (The court was ruling only on summary judgment motions, so the facts had not been fully developed.)

The court looked to state law in determining what constitutes disloyalty permitting setoff. In this case it looked to Ohio law, which has adopted the "faithless servant doctrine" enunciated by the Kansas Supreme Court. That doctrine provides as follows:

> [D]ishonesty and disloyalty on the part of an employee which permeates his service to his employer will deprive him of his *entire agreed compensation*, due to the failure of such an employee to give the stipulated consideration for the agreed compensation. Further, as public policy mandates, an employee cannot be compensated for his own deceit or wrongdoing. However, an employee's compensation will be denied only during his period of faithlessness.

Utz, Miller & Kuhn, LLC
7285 West 132nd St.
Suite 320
Overland Park, KS 66213

Phone: 913.685.0970
Fax: 913.685.1281

Gregory B. Kuhn
gkuhn@utzmiller.com
Phone: 913.685.0774
Fax: 913.685.1281

Eric N. Miller
emiller@utzmiller.com
Phone: 913.685.8150
Fax: 913.685.1281

John L. Utz
jutz@utzmiller.com
Phone: 913.685.7978
Fax: 913.685.1281

Matthew J. Eickman
meickman@utzmiller.com
Phone: 913.685.0749
Fax: 913.685.1281

www.utzmiller.com

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The court, in indicating that the facts needed to be further developed, not only said that it wished to determine whether the executive was aware of the legal and practical implications of his false reporting, but also that it needed to consider whether the executive's repeated misreporting of trades to outside publications and his attempts to conceal his own and his subordinates' misconduct met the requirement of the faithless servant doctrine that the dishonesty and disloyalty "permeate" the executive's service to the employer.

Lessons. Those who draft plan documents for broad-based programs, such as qualified retirement plans, are used to routinely including anti-alienation and nonforfeiture provisions. They do so, presumably, to satisfy the vesting and anti-alienation requirements of ERISA and the Tax Code's qualified retirement plan rules. The *Foley* decision suggests that it may be best for employers not to unthinkingly include such provisions in their nonqualified deferred compensation programs, instead carefully considering the consequences of including such provisions. Anti-alienation provisions may be helpful in protecting an executive from the claims of creditors, and helping an employer avoid the nuisance of unrelated third parties making claims for benefits. Nonforfeiture provisions, though, are a different matter. Although the inclusion of a nonforfeiture provision may be a matter for negotiation with an executive, it may better protect a company's interests in the event of executive misbehavior not to include such a provision.

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Phone: 913.685.0970
Fax: 913.685.1281

Gregory B. Kuhn
gkuhn@utzmiller.com
Phone: 913.685.0774
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Eric N. Miller
emiller@utzmiller.com
Phone: 913.685.8150
Fax: 913.685.1281

John L. Utz
jutz@utzmiller.com
Phone: 913.685.7978
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Matthew J. Eickman
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