

RABBI TRUSTS

Defined

A rabbi trust is typically established by an employer as an “informal” funding¹ vehicle for the non-qualified retirement plans it sponsors for its executive employees in order to promote their retention. Such plans may be excess benefit plans which provide benefits beyond funded tax qualified arrangements capped by IRC Section 415, voluntary deferred compensation plans funded by employees or supplemental executive retirement plans. Plan participants are not taxed on their plan benefits until actually paid or made available to them, and they are generally not entitled to receive a distribution from the trust until retirement, death or employment termination without cause. In the event of the employer’s bankruptcy or insolvency, the assets of the trust are available to the employer’s creditors. Plan participants are unsecured creditors with respect to the trust’s assets. A rabbi trust adds a level of security to the employer’s promise to pay under the plans, and protects the assets held in the trust from a change of heart or change in control (“CinC”) of the employer, by setting aside assets in trust under the management of a professional, institutional trustee. The first IRS ruling on this type of arrangement related to a congregation’s contributions to a trust for their rabbi’s benefit, hence the name “rabbi trust”.

The Trust Agreement

While non-qualified top hat plans and supplemental retirement plans are exempt from ERISA requirements, including funding, vesting and non-discrimination, the rabbi trust agreement must conform to the IRS’ model language on key provisions. In addition, there may be customized provisions that may be incorporated into the document to provide enhanced protection to participant interests. These include:

1. Making the trust irrevocable before a CinC, either upon its establishment, or upon a potential change-in-control.
2. Full-funding of the trust to cover accrued plan liabilities, and ensuring liquidity to pay benefits if illiquid assets are used. For master trusts where assets of multiple plans are commingled for investment purposes, the trust may ensure full-funding by plan, not just in total. (Note: The plans remains technically “unfunded” for purposes of ERISA, and when we refer to funding, we are referring to “informal” funding.)
3. Instituting potential CinC provisions triggering irrevocability, full-funding, restriction on amendment of the trust and replacement of the Trustee, etc.

¹ Plans are unfunded for purposes of ERISA because the assets are subject to the claims of the employer’s creditors.

4. Instituting a legal defense fund, for funding the expense of claims brought by plan participants to enforce their rights.
5. Placing investment responsibility with the Trustee upon CinC, subject to investment guidelines established by the Company prior to CinC.
6. Requiring that termination of the trustee be approved by a majority of trust participants, and that the successor trustee be independent of the acquirer in a CinC. Prior to a CinC, specifying the consultant/recordkeeper in the event of CinC.
7. Company payment of trustee, counsel and agent expenses, rather than from trust.
8. No changes to Payment Schedule upon potential CinC or CinC.
9. Requiring that a resigning trustee post CinC appoint a successor trustee.
10. Incorporating language in the trust agreement disallowing amendments to the trust agreement after a CinC without participant consent unless required by applicable law.
11. Allowing the plan sponsor to receive a “reversion” of trust assets if the plan becomes funded in excess of a certain threshold (e.g. 125% of the liability).
12. Allowing the company to seek reimbursements from the trust for payments made directly to plan participants.

Trustee Responsibilities

Trustee responsibilities are specified in the trust agreement, but the following typically apply:

1. Generally

- Hold trust assets separate and apart from the company’s other funds and ensure they are used exclusively for the uses and purposes of plan participants and company’s general creditors pursuant to the terms of the trust agreement.
- Defend the trust and interests of plan participants against acts of hostile acquirer.
- “Act with care, skill prudence and diligence under the circumstances then prevailing that a prudent person acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims”.

2. Distributions

- Make distributions in accordance with the Payment Schedule provided by the company, showing amounts payable in respect of each plan participant, time of commencement, etc.
- Withhold, report and pay federal and state taxes or determine that such payments have been withheld, reported and paid by the company, issue W2s and prepare Form 1041(U.S. Income Tax Return for Estates and Trusts).
- Company insolvency - in the event of a company insolvency (i.e., the Company is unable to pay debts, or in bankruptcy), the Trustee must discontinue payments to plan

participants or their beneficiaries and hold assets of the trust for the benefit of the company's general creditors. The Trustee may resume payment of benefits after it is satisfied that the company is no longer insolvent.

- Determine participant entitlement and make distributions after CinC, based on the Payment Schedule.
3. Investment Authority (discretion pre/post change-in-control)
 - Full power and authority to invest the Trust Fund, or to act at the direction of an investment advisor.
 - Authority to retain or terminate investment advisors and appoint successor investment advisors.
 - Proxy voting.
 4. Asset Custody and Reporting
 - Hold trust assets
 - Service trust assets (valuation, income collection, reorg. processing, provide proxy material to investment advisor, etc.)
 - Issue periodic statements, setting forth all investments, receipts, disbursement
 - Coordinate with sponsor, investment manager and recordkeeper and on cash and information flows (contributions, distributions, expense).
 5. Consult with legal counsel and hire agents, investment advisors, recordkeepers, consultants, etc. relating to performance of Trustee duties and obligations.

Funding and Investment

While there is no requirement for an employer to set aside funds in trust to satisfy their obligations under non-qualified plan, doing so provides the financial wherewithal to pay participant's their plan benefits. Prior to a CinC, trustees are normally directed by the employer or outside investment managers selected by the employer as to investments. Upon a change in control, however, the trustee normally is vested with investment discretion to ensure the assets are invested in the best interests of the plan participants. Investment of the trust assets is made in accordance with an investment policy statement that takes into account the particular objectives of the trust. Rabbi trust language on investment authority is normally very broad, and does not serve this purpose well. Accordingly, the trustee typically works with the sponsor to develop investment guidelines in conjunction with the investment manager. There are very compelling reasons why the sponsor, as well as the participants who are the ultimate beneficiaries of the trust, have an interest in ensuring appropriate investment guidelines for their rabbi trust. First, because the sponsor ultimately has to make good on its promise to pay plan obligations (absent insolvency), regardless of whether there are sufficient assets in the trust. Second, because mismatches between trust assets and plan liabilities creates financial exposure. Third, because as a grantor trust the rabbi trust's income, deductions and credits must be accounted for by the employer in determining its taxable income. The investment policy statement must therefore be developed with all of these considerations in mind. A well-crafted investment policy statement should include, among other things:

- A statement of the trust's objectives (including time horizon, performance and volatility expectations, asset allocation constraints, and rebalancing of strategic allocation);
- Securities guidelines (equities, fixed income and alternatives);
- Control procedures (duties and responsibilities of investment manager).

In developing the investment policy statement, important elements that must be taken into account are: asset allocation, risk tolerance, time horizon, performance benchmarks, liquidity needs, taxes and special circumstances. In addition, the plan liabilities must be understood. A defined benefit plan will normally have actuarially projectable cashflows associated with the specific participant population and benefit formula, which will be based on certain assumptions, including mortality, discount rate, etc. An investment solution cannot be properly adopted without considering those projected cashflows and the funding status of the plan, i.e., the value of assets relative to the value of liabilities. For defined contribution plans, the actual investments should closely mirror the investment options of the plan, otherwise the sponsor is exposed to potential liability.

After factoring in all of these considerations, examples of possible primary investment objectives associated with rabbi trusts are:

- Liability Driven Investment, which assumes 100% of the asset allocation is in high quality bonds with a duration profile matching the trust's liabilities;
- Capital Preservation, which assumes a conservative asset allocation;
- Balanced Portfolio, which assumes a balanced asset allocation with an equity weighting higher than capital preservation; or
- Capital Appreciation, which has still higher equity weightings.

Each investment objective drives different asset allocations, which may in turn include cash, defensive assets (high quality bonds), credit strategies (fixed income securities that enhance returns through credit risk exposure while minimizing interest rate risk), diversified market strategies (examples may might include TIPS, liquid alternatives), growth assets and illiquid alternatives. Because a rabbi trust is an agency of the corporation, and has the same tax paying characteristics as the corporation, some plan sponsors hold the above investment securities directly, or alternatively some hold them within a Trust Owned Life Insurance structure in order to minimize corporate taxes. Understanding these alternative structures, and the company's objectives, are key aspect of a well-designed rabbi trust.

Questions to Ask a Prospective Trustee

Retaining an institutional trustee is an important responsibility for the sponsor of a non-qualified retirement plan who chooses to establish a rabbi trust. Important considerations in the selection of a trustee include their independence and objectivity, experience, staffing and commitment to the business. Here are some questions to ask a prospective trustee to gauge their ability to serve as trustee of a rabbi trust:

1. What activities do you engage in that could conflict with your serving as an independent trustee and how do you manage such situations?

2. Are you willing to serve in a fiduciary capacity post CinC in which you may have to make benefit entitlement and/or investment decisions that are in the best interests of plan participants but may be counter to the interest of “New Co.”?
3. Describe what you would do in the event of a CinC or a change in heart of the sponsor. Provide case studies of what you did in two change-in-control triggering events.
4. How long have you been providing trustee services for rabbi trusts, how many rabbi trust clients do you have and how much do you have in directed vs. discretionary assets?
5. Describe the staffing that supports your rabbi trust business, and provide biographies of key employees. In addition to trust administrators, do you have dedicated legal staff?
6. Where you have discretion, describe your Reg. 9 review process.
7. Describe your in-house investment capabilities and also how you would manage outside investment managers in the event of a CinC.

Conclusion

Rabbi trusts provide an added level of security for executives who participate in their employer’s non-qualified plans, and that security is enhanced when the trust is administered by an experienced, capable and independent institutional trustee who will serves in the best interest of the plan participants. Those interests are best served when the trustee, in addition to performing custody, distribution and reporting functions, understands the nature of the plan’s liabilities, the investment approach to such liabilities and what to do in the event they become vested with investment and administrative discretion in CinC situations.

Evercore Trust Company, N.A. has served rabbi trust clients as an independent trustee in directed and discretionary roles since 1987.

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