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Deferred comp: ERISA and "top-hat" eligibility

Nonqualified deferred compensation arrangements, sometimes called "top-hat" plans, are contractual obligations of an employer to an employee or an independent contractor. While these arrangements must be 'unfunded' for ERISA purposes and to avoid current taxation, they are often informally financed from unrestricted assets of the plan sponsor, which are subject to the plan sponsor's general creditors in the event of bankruptcy, even those assets held in a trust.

A common misconception is that top-hat plans are not subject to the requirements of ERISA. Deferred comp plans covering employees are generally subject to Title I of ERISA, while arrangements covering solely independent contractors are not.

There are five parts contained in Title I of ERISA. For deferred comp plans covering only a top-hat group, there are significant exemptions from ERISA provisions. If a nonqualified plan is maintained by an employer "**primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees**", the plan is not subject to Parts 2, 3, and 4 of Title I. These provisions pertain to plan participation and anti-discrimination rules, and vesting, funding, spousal consent, and fiduciary requirements. In addition, by filing a simple notification with the Department of Labor at plan inception, the employer is also not subject to Part 1 of Title I. This provision pertains to plan reporting and disclosure requirements, including the requirement to file an annual Form 5500. This leaves only Part 5 of ERISA in effect for top-hat groups, this part typically being covered in nonqualified plan documents by including ERISA claims procedures.

A common concern of employers sponsoring nonqualified plans is whether they have satisfied the top-hat exemption requirements of ERISA. Unfortunately, the Department of Labor has never issued regulations regarding top-hat issues. Therefore, employers must generally rely on the guidance from court cases interpreting the top-hat definition and on industry "best practices" that have evolved from those cases.

Department of Labor guidance

In 1990, DOL Advisory Opinion 90-14A was issued. In this opinion, the department set out broad requirements for an employee's inclusion in a top-hat group:

- Management responsibilities or high compensation
- Ability to influence plan design
- Ability to appreciate the risks in a nonqualified plan regarding the lack of ERISA protection and employer bankruptcy risk

Court cases and “best practices”

Three general themes emerge for employers trying to determine if their plan participation meets the top-hat rules:

- “**Select group.”** Court cases have generally addressed the size of the participant group in the nonqualified plan vs. the total number of employees in the organization. Although some court cases have allowed top-hat groups to be as large as 15% of the total workforce, a more common rule of thumb is between 5% and 10% of total workforce.
- “**Management.**” The DOL Advisory Opinion and court cases clearly indicate that it’s important to address this issue in determining plan participation. Whether an employee is considered “management” can be based on job title, job classification, or job responsibilities. Including employees in a nonqualified plan who are clearly not management can cause top-hat issues.
- “**Highly compensated.**” Unfortunately, the definition of highly compensated for qualified plans does not provide a safe harbor for nonqualified plan top-hat determination. Courts have looked at absolute compensation levels, average compensation of the top-hat group vs. non top-hat employees, and geographic considerations in determining whether an employee is considered to be highly compensated for top-hat purposes.

As can be seen above, the determination of a “top-hat” group for participation in a nonqualified plan can be highly subjective. Employers should always consult with legal counsel to determine top-hat eligibility.

Groom Law Group in Washington, D.C. has provided a memo discussing top-hat issues and cases for our client’s use. Please refer to the following memo for more detailed information.

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MEMORANDUM

November 27, 2007

Select Group Requirement for ERISA Top Hat Plans

We discuss below how the courts and Department of Labor ("DOL") have interpreted the ERISA requirement that participation in a "top hat" plan be limited to a "select group of management or highly compensated employees" (the "Select Group").

I. Legal Requirements

Although a non-qualified deferred compensation plan typically is a pension plan subject to ERISA requirements, a "top hat" pension plan is exempt from the participation, funding, vesting and fiduciary responsibility rules of ERISA.[1] In order to qualify as a top hat plan, a plan must be unfunded and "maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees."[2]

The DOL has never issued regulations interpreting the meaning of this Select Group requirement. The DOL did address the issue in several Advisory Opinions, but not since 1992. Further, there is very little guidance in the legislative history of ERISA on this Select Group requirement.

Most of the useful, and all of the recent, guidance on this issue has come from the federal and bankruptcy court cases discussed below. These cases typically arise when participants in a nonqualified deferred compensation plan do not receive the benefits they expected from the plan. The participants sue the employer and/or the plan's administrator claiming that the plan is not a top hat plan because participation was not limited to a Select Group.[3] Thus, the participants claim the plan was required to comply with all the requirements of ERISA for pension plans, including the participant-favorable rules regarding, for example, eligibility, vesting, fiduciary

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[1] ERISA §§ 201(2), 301(a)(3) and 401(a)(1). We say "typically" because some courts have ruled that very simple plans, especially those covering only one or two persons, are not ERISA "plans" at all. See, e.g., Sheer v. Israel Disc. Bank of N.Y., No. 06 Civ. 4995(PAC), 2007 WL 700822 (S.D.N.Y. Mar. 7, 2007).

[2] Id.

[3] In one case, a non-participant vice-president/general manager was denied benefits provided under a severance agreement offered to other managers. The employee, although a non-participant, sued the employer alleging the severance agreements constituted an employee benefit plan within the meaning of ERISA. The court assessed the employer's liability in accordance with the top hat standards of ERISA § 401(a)(1) and excluded the employee from participation in the severance plan. Pane v. RCA Corp., 868 F.2d 631 (3rd Cir. 1989).

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responsibility and/or funding. The courts have taken varied and sometimes conflicting approaches to the issue in these cases. However, most have focused on specific objective measures, such as the percentage of the workforce covered by the plan and the average salary of the covered employees compared to the average for the workforce, in trying to determine whether a plan covers a Select Group.

In its earlier efforts to address the issue in Advisory Opinions, the DOL looked at similar objective factors in performing the Select Group analysis. However, in a 1990 Opinion, the DOL indicated a shift in its thinking on this issue. As discussed below, several courts have incorporated the DOL's thoughts into their Select Group analysis.

One thing that is clear from the case law and the DOL Advisory Opinions is that the Select Group determination is based on a consideration of all the relevant facts and circumstances, and no single factor is determinative or consistently applied from one jurisdiction to another. We have addressed below the key factors the courts and the DOL have considered in their analyses.

A. Plan Documents

The starting point for the Select Group analysis is a plan's language regarding purpose and eligibility. Typically, a top hat plan limits eligibility to participate in the plan to a select group of management or highly compensated employees designated by a committee of the board.

In one case, the district court looked first to the plan documents to determine if the plan was primarily for the purpose of providing deferred compensation for a Select Group of employees.[4] The court, after determining the company intended the plan to be a top hat plan based on its language, stated "the mere fact that [the company] intended the plan to be a 'top hat' plan does not necessarily satisfy the requirement that it is a 'top hat' plan" and continued its analysis based on the relative number, pay levels and positions of employees covered under the plan.[5] Similarly, in In re New Valley Corp,[6] the Third Circuit, in assessing whether a plan was a top hat plan, required that the plan document exhibit an intention that the plan constitute a top hat plan and also assessed other factors courts have generally focused on, including: (i) the percentage of employees who participate in the plan, (ii) the average salaries of the participants in comparison to the entire employee base, and (iii) the titles and responsibilities of the participants. These requirements are discussed in detail below.

B. Percentage of Workforce Covered

One factor that has frequently been addressed by the courts and the DOL in performing the Select Group analysis is the percentage of a company's workforce covered by the plan.

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4 Bakri v. Venture Mfg. Co., No. 3-:03-CV-405, 2005 WL 2850142 (S.D. Ohio Oct. 31, 2005), rev'd on other grounds 473 F.3d 677 (6th Cir. 2007).

5 Id. at 4-5.

6 In re New Valley Corp., 89 F.3d 143, 148 (3rd Cir. 1996), cert. denied, 519 U.S. 1110 (1997).

Generally, the smaller the percentage, the more likely it is that the participants are members of a Select Group. However, the relevant authorities do not establish a bright-line rule as to what percentage is sufficiently small.

The U.S. Court of Appeals for the Second Circuit held, in Demery v. Extebank Deferred Compensation Plan (B),[7] that a plan available to 15.34% of an employer's workforce covered a Select Group. However, the Second Circuit did note that this level of coverage was probably "at or near the upper limit of the acceptable size for a 'select group.'"[8] One court has held that a plan covering 18.7% of the work-force did not cover a Select Group.[9] The courts and the DOL have generally upheld the top hat status of plans with coverage percentages in the 4-5% range.[10] However, courts and the DOL have ruled that plans with percentages in this range are not top hat plans when other unfavorable factors were present.[11]

One recent development involves the question of who to count when determining the percentage of workforce covered. Generally, courts have focused on the number of employees eligible or invited to contribute to a plan when determining whether they were a Select Group.[12] However, the U.S. District Court for the District of Massachusetts made a distinction in Alexander v. Brigham and Women's Physicians Org., Inc.[13] between optional participation and required participation. In this case, the defendant maintained two deferred compensation plans, the Faculty Retirement Benefit Plan and the Unfunded Deferred Compensation Plan, for its surgeons who were also members of the medical school's faculty.[14] The surgeons with private practices that earned more than the medical school's salary cap were required to defer the excess salary into these two plans.[15] The plaintiff, a highly paid surgeon, filed suit after termination and the reduction of his accounts by the amount of his practice deficit, as provided in the plans.[16]

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[7] 216 F.3d 283 (2d Cir. 2000).

[8] Id. at 289.

[9] Darden v. Nationwide Mut. Ins. Co., 717 F. Supp. 388, 397 (E.D.N.C. 1989), aff'd on other grounds, 922 F.2d 203 (4th Cir. 1991), rev'd on other grounds, 503 U.S. 318 (1992).

[10] See, e.g., Duggan v. Hobbs, 99 F.3d 307 (9th Cir. 1996) (5% coverage); Belka v. Rowe Furniture Corp., 571 F. Supp. 1249 (D. Md. 1983) (4.6% coverage); DOL Adv. Op. 75-64 (Aug. 1, 1975) (4% coverage).

[11] See Carrabba v. Randalls Food Markets, Inc., 38 F. Supp. 2d 468 (N.D. Tex. 1999) (coverage less than 5%); DOL Adv. Op. 85-37A (Oct. 25, 1985) (coverage less than 7%).

[12] See, e.g., Demery, 216 F.3d at 285; Carrabba, 38 F. Supp. 2d at 473-74; Guiragoss v. Khoury, 444 F. Supp. 2d 649, 653-54 (E.D. Va. 2006).

[13] 467 F. Supp. 2d 136 (D. Mass. 2006).

[14] See id. at 139.

[15] See id. at 139-40.

[16] See Alexander, 467 F. Supp. 2d at 140.

The court in Alexander made a distinction and reasoned that if participation is optional, the percentage of employees covered includes all employees invited to participate.[17] However, if participation is required and available only to the highest earning employees, the court deemed it appropriate to consider only the actual participants in the plan in determining such percentage.[18] Thus, even though approximately 30% of the employees were eligible to participate in the plans, only the most profitable surgeons were required to defer salary into the plans, which resulted in required participation percentages of 8.7% and 5.8%, respectively.[19] The court held that the two plans were maintained for the purpose of providing deferred compensation to a select group of highly compensated employees and qualified as top hat plans.[20]

Two issues the courts and the DOL have not yet explicitly addressed are: (1) whether the percentage of employees covered is based on the employee population of a plan sponsor or, where applicable, the plan sponsor's entire controlled group;[21] and (2) whether the percentage of employees covered should include former employees in "pay status." First, although not explicitly addressed, the facts in Demery imply that a court may look to the employees of the plan sponsor (i.e., determine percentage at the subsidiary level) rather than all employees of the entire controlled group.[22] Second, most courts only mention current employees when determining the percentage of coverage. However, in one case, the court took into account former employees who still had an account in the plan.[23] Generally, the statutory language requires coverage of a "select group of management or highly compensated employees."[24] By definition, a former employee is not management or a highly compensated employee. Thus, even though a former employee may still be a participant in the plan,[25] it seems unlikely that a court considering the issue would take into account former employees.

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17 See id. at 143-44.

18 See id.

19 See id.

20 See Alexander, 467 F. Supp. 2d at 148.

21 We note that certain ERISA participation requirements expressly apply on a controlled group basis (See ERISA § 210(c)).

22 In Demery, the court referred to a corporate parent, while the percentage analysis focused only on the workforce of Extebank, the subsidiary and plan sponsor. Participants in the plan in this case were all employees of one subsidiary, the plan sponsor.

23 The court in Belka included both present and former employees in calculating the percentage of employees covered.

24 ERISA §§ 201(2), 301(a)(3) and 401(a)(1).

25 The definition of "participant" under ERISA is "any employee or former employee… who is or may become eligible to receive a benefit of any kind from an employee benefit plan." ERISA § 3(7).

C. Average Salary Comparison

Many courts and the DOL have also taken into account how the average salary of plan participants compares to the average salary of all employees. The larger the difference is between plan participants' average salary and the average salary of employees generally, the greater the likelihood of a finding of a Select Group. One district court upheld a plan's status as a top hat plan where the average salary of plan participants was approximately 3½ times that of the average of all employees.[26] Similarly, the Second Circuit in Demery upheld a plan's status as a top hat plan where the average salary of participants was "more than double" the average salary of employees generally.[27]

D. "Management or Highly Compensated"

As discussed above, a Select Group must be made up of management or highly compensated employees. Indeed, one district court even required evidence that the participants in a plan were "a select group" of a larger group of management or highly compensated employees.[28] The courts and the DOL have looked carefully at the job titles of individuals eligible to participate in a plan to determine if they are "management."[29] The courts and the DOL have also looked at the individual salaries of covered employees (apart from comparing average salaries) to determine whether they are "highly compensated."[30]

Both the DOL and IRS have stated that the definition of "highly compensated employee" found in Code § 414(q) (generally employees with taxable income of $100,000 or more for 2007) ("HCE") is not a "safe harbor" definition for this purpose.[31] Thus, in most cases, use of the Code § 414(q) definition to determine plan eligibility may be considered aggressive. Nevertheless, a Delaware bankruptcy court ruled that a plan covering participants having pay levels at $100,000 met the Select Group requirement.[32] The court reviewed both titles and pay levels of participants with respect to the qualitative requirement that plan participants must be "high level" employees, either "management" or "highly compensated."[33] The court concluded

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[26] See Belka, 571 F. Supp. at 1252-53.

[27] Demery, 216 F.3d at 289.

[28] See Carrabba, 38 F. Supp. 2d at 478.

[29] See, e.g., Carrabba, 38 F. Supp. 2d at 474-75; Demery, 216 F.3d at 289; DOL Adv. Op. 85-37A (Oct. 25, 1985).

[30] See, e.g., Carrabba, 38 F. Supp. 2d at 473-75; DOL Adv. Op. 85-37A (Oct. 25, 1985).

[31] See preamble to Code § 414(q) regulations, 53 Fed. Reg. 4965, 4967 (Feb. 18, 1988) ("The Departments of Treasury and Labor concur in the view that a broad extension of 414(q) to determinations under [the top hat exemption] would be inconsistent with the tax and retirement policy objectives of encouraging employers to maintain tax-qualified plans that provide meaningful benefits to rank and file employees.").

[32] See In re IT Group, Inc., 305 B.R. 402 (Bankr. D. Del. 2004).

[33] Id. at 410.

that the $100,000 floor on participants' salaries was itself sufficient to satisfy the "highly compensated" criteria to qualify as a top hat plan.[34] Whether all courts would rule the same way is unclear. However, this case provides a recent example of flexible criteria a court may use in the Select Group analysis.

Thus, although no bright-line guidance has emerged from the analyses of the DOL and the courts on these issues, reasonable efforts should be made to determine whether the covered employees may fairly be considered to be management and/or highly compensated.

E. "Bargaining Power" of Participants

As noted above, the DOL shifted its focus regarding the Select Group analysis in 1990. According to the DOL, Congress adopted the top hat plan exemption because it recognized that:

> certain individuals, by reason of their position or compensation level, have the ability to affect or substantially influence, through negotiation or otherwise, the design and operation of their deferred compensation plan, taking into consideration any risks attendant thereto, and, therefore, would not need the substantive rights and protections of Title I [of ERISA].[35]

The DOL, however, cited nothing in the legislative history to support its view. The DOL also did not expressly state that the ability to negotiate the terms of a plan would need to be considered as the factor (or even as one of many factors) in actually performing the Select Group analysis. Finally, the DOL did not disavow its previous Advisory Opinions on the issue which had focused on the more objective factors described above.

Several courts have agreed with the DOL's view of Congressional intent.[36] Some courts have also indicated that the ability to negotiate the terms of a plan should be one of the factors considered in the Select Group analysis, although they did not seem to place much emphasis on this factor.[37] The U.S. Court of Appeals for the Ninth Circuit, however, placed significant emphasis on this factor in its lone "Select Group" decision, Duggan v. Hobbs.[38]

In addition, the Sixth Circuit recently reversed and remanded a liberal interpretation of the Select Group requirement that had been applied by the district court in granting summary

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[34] See id.

[35] DOL Adv. Op. 90-14A (May 8, 1990); see also DOL Adv. Op. 92-13A, n.1 (May 19, 1992) (repeating same position).

[36] See, e.g., Demery, 216 F.3d at 289; Spacek v. Maritime Assoc.-I.L.A. Pension Plan, 134 F.3d 283, 296 n.12 (5th Cir. 1998) (abrogated on other grounds).

[37] See, e.g., Demery, 216 F.3d at 289 (insufficient evidence to analyze); Carrabba, 38 F. Supp. 2d at 478 (stating that the DOL's view on this issue is "perhaps" correct).

[38] 99 F.3d 307 (9th Cir. 1996); see also In re Battram, 214 B.R. 621 (Bankr. C.D. Cal. 1997) (stating that under Duggan, the two relevant factors are percentage of workforce covered and ability to negotiate).

judgment to the defendant.[39] In Bakri, the Sixth Circuit referred to the DOL's position that top hat plans should be for high-ranking management personnel who have the ability to protect their benefit interests, through negotiations or otherwise. Focusing on this requirement, the Sixth Circuit found that eligible managers and individuals holding secretarial and administrative positions did not have any "supervisory, policy making, or executive responsibility, and had little ability to negotiate pension, pay or bonus compensation."[40] Thus, the court concluded that the deferred compensation plan was not a top hat plan.[41]

As stated above, the DOL did not (and could not) cite any legislative history supporting its view on Congressional intent on this point. The statute itself simply requires that the plan cover a select group of management or highly compensated employees. Thus, covered employees need only be management or highly paid, not both. At the enactment of ERISA (and continuing today), there are highly paid employees (e.g., salespersons or employees in other "fungible" positions) who do not have the ability to bargain over the terms of their nonqualified benefit plans. Presumably, if Congress intended to do so, it could have made clear that a top hat plan could not cover of these types of employees.[42]

In many circumstances, it would also be difficult to apply this "ability to negotiate" test to particular facts. For example, as the Ninth Circuit found in Duggans, it would be easy to apply this test if a deferred compensation plan was negotiated by an attorney on behalf of an executive as part of his severance package.[43] The task, however, would be much more difficult with a typical deferred compensation plan covering a number of employees.[44] There, evidence that the covered employees had negotiated employment or change in control agreements, or otherwise had individualized pay and/or benefits packages (e.g., option grants, incentive arrangements, loans), should help to demonstrate the requisite ability to negotiate over the terms of the plan. However, the fact that covered employees did not negotiate their individual pay and/or benefits packages or the terms of the plan should not foreclose a determination that the plan satisfies the Select Group requirement.

F. The "Primarily" Requirement

The statutory exemptions state that a top hat plan must be maintained "primarily for the purpose of providing deferred compensation for a select group…." Thus, a plan sponsor can argue that as long as a plan covers primarily members of a Select Group, it should be able to

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39 See Bakri, 473 F.3d at 680.

40 Id.

41 See id.

42 See Alexander, 467 F. Supp. 2d at 146-47 (in dicta, court refused to impose "bargaining power" requirement, based on statutory language and absence of legislative history to the contrary).

43 See Duggan, 99 F.3d at 310; see also In re Battram, 214 B.R. 625-26 (the agreement's individualized disability benefits reflect the employee's ability to negotiate).

44 See Carrabba, 38 F. Supp. 2d at 478 (noting the difficulty applying this test).

cover a few other employees without jeopardizing its top hat status. The DOL, however, has stated that it believes "primarily" refers to the purpose of the plan (e.g., the provision of deferred compensation) and not the composition of the group of plan participants.[45] Recently, the court in Alexander interpreted the "primarily" requirement with respect to the purpose of the plan and reasoned that a top hat plan can have multiple secondary purposes such as a company's desire to recruit and retain excellent employees or replace lost benefits from a previous employer.[46]

By applying the term "primarily" to the purpose of the plan rather than the employees covered, the DOL position seems to be that all covered employees must be members of a Select Group in order for a plan to qualify as a top hat plan. The Second Circuit rejected this reasoning in Demery, stating that a plan would not be disqualified from top hat status simply because a "very small number" of plan participants were not members of the Select Group.[47]

G. Burden of Proof

If a participant challenges a plan's top hat status, several courts have held that the employer has the burden of proving that the plan qualifies as a top hat plan.[48] One court stated that ERISA is a remedial statute to be liberally construed in favor of participants, so that exemptions should be confined to their narrow purpose.[49]

II. Consequences of Failing the Select Group Requirement

In the event a plan was found not to satisfy the Select Group requirement, and thus was subject to all of the requirements of ERISA for pension plans, the consequences to the employer and the participants in the plan include:

(1) The company would be required to fully fund amounts credited to notional accounts in the plan;

(2) Amounts transferred to a participant's plan account would immediately be included in the participant's income and would be subject to income tax withholding and employment taxes;

(3) In future years, all highly compensated employees would be taxed on any allocable trust income;

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[45] DOL Adv. Op. 90-14A, n.1.

[46] See Alexander, 467 F. Supp. 2d at 142-43, citing Prior v. Innovative Communications Corp., 360 F. Supp. 2d 704, 708 (D.Vi. 2005); Garratt v. Knowles, 245 F.3d 941, 946 n.4 (7th Cir. 2001); In re Battram, 214 B.R. at 625.

[47] Demery, 216 F.3d at 289; see also Belka, 571 F. Supp. at 1253 (stating that "almost all of [the company's] employees covered by the agreements would fit within the 'select group'"); Carraba, 38 F. Supp. 2d at 478 (stating that a plan must be "primarily . . . for a select group").

[48] See, e.g., Carrabba, 38 F. Supp. 2d at 470; In re The IT Grp., Inc., 305 B.R. at 407; Alexander, 467 F. Supp. 2d at 142.

[49] See Carrabba, 38 F. Supp. 2d at 470.

(4) The company would be required to file all prior and future Annual Form 5500s, subject to applicable penalties; and

(5) The company would be required to provide summary plan descriptions and summary annual reports to participants.

Most importantly, if a plan was determined not to satisfy the Select Group requirement, the plan could likely not distribute the funded amounts even though such amounts would be immediately taxable to the participants. Essentially, this outcome subjects the participants to a current year tax burden without the corresponding liquidity created by immediate payment of the amount includible in income (i.e., a cash flow shortfall).[50]

Unfortunately, this conundrum is created as a result of Code section 409A and its final regulations (the "409A Regulations"). The 409A Regulations will not permit any distribution from a plan as a result of failing to satisfy the Select Group requirement or because amounts are includible in income for a reason other than a violation of Code section 409A. Consequently, drafting or amending a plan to provide for such a distribution would be an impermissible acceleration of payment under Code section 409A. This accelerated payment would violate Code section 409A and cause an additional 20% tax on the total amount includible in income, plus interest from the year of deferral.

As a practical matter, the participants would have two alternatives: (1) satisfy the tax burden caused by funding the plan, with currently available funds (i.e., funds outside the plan); or (2) if permitted by the company, receive an accelerated distribution in violation of Code section 409A and pay the additional income tax and interest. Either alternative above would likely cause severe financial consequences for the company and each participant.

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[50] However, "grandfathered amounts" under the plan (i.e., amounts that were earned and vested before 2005 and exempt from Code section 409A), may be distributed if the plan permits.