Recent Court Decision Sheds New Light on ERISA's Top Hat Plan Exemption

Paul J. Schneider, JD, LLM

Apart from satisfying the requirements of Code Sec. 409A, one of the principal elements of an executive deferred-compensation plan is that it comes within the protection of the exemption found in the Employee Retirement Income Security Act of 1974 (ERISA), as amended, which is commonly referred to as the "top hat plan" exemption. This exemption is found in ERISA Secs. 201(2), 301(a)(3), and 401(a)(1). The effect of these provisions is to exclude top hat plans from ERISA's participation, vesting, benefit accrual, funding, and fiduciary provisions. The plans, however, remain subject to ERISA's reporting and disclosure and administration and enforcement provisions.[1] Thus, maintaining an employee pension benefit plan[2] that qualifies as a top hat plan enables an employer to avoid most of ERISA's burdensome requirements and to avoid adverse tax consequences that might otherwise arise if the plan had to satisfy ERISA's eligibility, vesting, and funding requirements.

However, the meaning of the term "top hat plan" has been the source of considerable uncertainty since ERISA became effective in 1975. The statutory definition of a top hat plan is an unfunded plan that "is maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees."[3] But apart from this definition there is relatively meager guidance as to what the statutory language quoted in the previous sentence really means. The legislative history gives some insight into why the top hat plan exemption was included in the law,[4] but it does not provide any guidance relating to the meaning of the terms used to describe a top hat plan.

The Department of Labor (DOL) has not issued any regulations relating to top hat plans and has clearly avoided publishing any other form of guidance that might set forth any bright line tests as to what a "select group" is or who "highly compensated" employees are. However, over the years the DOL has issued six advisory opinions relating to top hat plans.[5] With only a few exceptions these advisory opinions have not provided any meaningful insight into the nature of a top hat plan. The primary exception is the last advisory opinion issued on this subject, DOL Advisory Opin. Ltr. 90-14A (May 8, 1990). In that opinion the DOL provided two meaningful interpretations. First, in the first footnote it set forth its interpretation of "primarily" as referring only to the purpose of the plan, i.e., the benefits provided, and not to the participant composition of the plan. Some court cases have indicated that a few participants in a top hat plan need not be part of the select group without adversely affecting the status of the plan as a top hat plan. Thus, this footnote showed that as far as the DOL is concerned, if a plan extends coverage to anyone other than a member of a select group of management or highly compensated employees, it could not qualify as a top hat plan.[6] Second, in that same advisory opinion the DOL stated its view that the ability of an employee to negotiate the terms and conditions of a plan and to understand the significance of the risks associated with such compensation arrangements bears on the issue of whether a plan covers a select group and thus qualifies as a top hat plan.

The DOL's earlier advisory opinions looked primarily at the number of employees covered by the plan and the covered job categories, as well as the relative salaries of the covered employees compared to those of the noncovered employees, in order to determine whether the plan was a top hat plan.[7] Advisory Opinion 90-14A clearly was taking a new approach by adding a test that treats only employees who do not require ERISA protection as includible in the select group.

However, that was the last official word that the DOL has had on this subject in the last 18 years. The DOL has failed to issue any other advisory opinions on this subject.[8] This has left financial advisors without any further guidance from the DOL as to what weight, if any, should be given to quantitative and qualitative factors in determining what constitutes a select group and what weight, if any, should be given to the individual employee's bargaining power in making that determination.

Fortunately, the courts have been available to fill the guidance vacuum created by the DOL's failure to issue meaningful interpretations of what

This issue of the Journal went to press in August 2008.

constitutes a top hat plan.[9] However, over the last 25 years there have been only about 15 judicial decisions that have had to address some aspect of what constitutes a top hat plan. Moreover, like the DOL, all of the judicial decisions that have had to focus on the meaning of "select group" generally have taken into account both quantitative and qualitative factors. Thus, in number, the courts want a top hat plan to cover a relatively small portion of the total employees, while in character, the courts want a top hat plan to cover only high level employees.[10]

In fact, a recent court decision finally articulated a four-factor analysis for determining whether a select group is covered by a top hat plan. Pursuant to this analysis the court looked at "(1) the percentage of the total workforce invited to join the plan (quantitative), (2) the nature of their employment duties (qualitative), (3) the compensation disparity between top hat plan members and nonmembers (qualitative), and (4) the actual language of the plan agreement (qualitative)."[11]

Many courts also mention the requirement that, as interpreted by the DOL, the members of a select group must hold positions with their employer of such influence that through direct negotiations they are capable of designing and protecting their deferred-compensation arrangements.[12] However, there does not appear to have been a case where the outcome turned solely on the issue of the bargaining power of the individual members of the select group. In other words, there have been decisions where the quantitative and qualitative factors were not satisfied so that discussion of bargaining power was not required. Conversely, there have been decisions in which the quantitative and qualitative factors were satisfied and the plan was found to be a top hat plan, but the court either assumed that because the requisite qualitative and quantitative factors existed that the members had to have had the necessary bargaining power or that, for other reasons, it was not appropriate for the court to analyze the plan members' ability to negotiate the terms of their plan.[13]

Thus, until recently, a court had not taken the opportunity either to decide whether a plan was or was not a top hat plan solely as a consequence of its analysis of whether the members had sufficient bargaining power or to reject the members' bargaining power as a factor to be used in determining whether a plan qualifies as a top hat plan. In the beginning of this year, however, the First Circuit Court of Appeals showed its willingness to address the issue of the select groups' bargaining power head on. In *Alexander v. Brigham and Women's Physicians Organization, Inc., et al.,* 513 F. 3d 37 (1st Cir. 2008), the court of appeals affirmed the lower court's ruling that two deferred-compensation plans for certain surgeons whose net practice income exceeded an earnings cap imposed by Harvard University constituted top hat plans under ERISA. The court applied the traditional qualitative and quantitative analysis to determine that the deferred-compensation plans in question were maintained for a select group.[14]

However, the plaintiff/appellant (Alexander) who wanted the plans to be subject to ERISA requirements also argued that the district court erred in determining that Alexander's lack of individual bargaining power was irrelevant to the top hat plan determination. Alexander's position was that every member of the select group had to possess sufficient bargaining power to influence the terms of the plan.

In addressing this argument, the appeals court first looked at the terms of the statute. It found no reference to the term "bargaining power" or any other indication that courts should take into consideration the employees' ability to bargain over the terms of their deferred-compensation plans as part of the court's determination of whether a top hat plan exists. The court then turned its attention to DOL Advisory Opinion 90-14A as the primary authority cited by Alexander to support his bargaining power argument. The court quoted the portion of the letter discussed above which acknowledges that the ability of certain individuals to affect or substantially influence the design and operation of their deferred-compensation plans was Congress's reason for the top hat plan exemption.

The court, however, refused to defer to or be persuaded by the DOL letter. The court viewed the letter as only speaking to Congress's purpose in including the top hat provision in ERISA and refused to accept it as an interpretation of the provision's requirements. To emphasize this point, the court went on to say that:

> …relying on that letter to justify a nascent requirement that every employee covered by a top hat plan possess the power to negotiate the terms of that plan is simply too much of a stretch. To our way of thinking, such a reading is both

> unwarranted and unpersuasive. Even without the additional requirement of individual bargaining power, Congress's enactment strikes us as a reasonable effectuation of its purpose. In any event, in limiting the top hat provision to a "select group of management or highly compensated employees," Congress ensured that employees' interests would be sufficiently protected.[15]

In summary, the court found two reasons not to find any requirement for individual bargaining power in the context of a top hat plan. First, neither the statute nor its legislative history contains any indication that Congress intended to have courts consider the employees' ability to bargain over the provisions of their deferred-compensation plans. Second, the DOL opinion letter does not constitute an interpretation of the statutory language and should not become the basis of an independent statutory test. Thus, the First Circuit is very clear in its rejection of the DOL's interpretation of the top hat plan requirements, as found in DOL Advisory Opinion 90-14A.

Following the *Alexander* decision, what conclusions can be drawn about what constitutes a top hat plan? First, the group of covered employees should not constitute more than 15% of the employer's workforce, at least in the Second Circuit. Outside the Second Circuit where *Demery* was decided, it probably should be less than 10% of the workforce in order to be on the safe side. In addition, the covered employees should be identified based on their rank, position, and management characteristics. Second, the members of the top hat group should be highly compensated in both absolute and relative terms. The current dollar limit on highly compensated employees under Code Sec. 414(q) is probably irrelevant.[16] The employer must be able to show a substantial disparity between the compensation paid to the top hat group and the compensation paid to all other workers. For this purpose some courts shy away from using the average compensation of the top hat group, fearing that an average may distort the analysis.[17] Thus, as a rule of thumb, the compensation of the lowest paid covered employee should be more than double or triple the average compensation of the portion of the workforce that is not participating in the plan. Third, employees who are not part of a select group, no matter how few in number, should not be allowed to participate.[18] Finally, as far as individual bargaining power is concerned, in the First Circuit it is no longer a factor. In the Sixth and Ninth Circuits,[19] it is something that needs to be addressed. In other circuits it has yet to face judicial analysis and thus remains a possible consideration. However, the *Alexander* decision provides a basis for persuading other circuit courts of appeal to take a similar position.

Even 34 years after the enactment of ERISA, the parameters of what constitutes a top hat plan have yet to be determined with any degree of certainty. The DOL has maintained an 18-year silence on the subject, even though what it has said in the past has never been particularly helpful to employers. Cases are being decided, but enlightenment is slow in coming. Unfortunately, financial advisors will have to continue to be patient and will have to develop a comfort level with the uncertainties that, for the foreseeable future, will surround the various aspects of what constitutes a top hat plan. ■

Paul J. Schneider, JD, LLM, is senior counsel to Paisner~Litvin LLP, Bala Cynwyd, Pennsylvania, where he has advised clients on taxation and employee benefit matters for more than 30 years. He is a charter fellow of the American College of Employee Benefits Counsel and has served as chairman of the Important Developments Subcommittee of the American Bar Association Tax Section's Employee Benefits Committee. Mr. Schneider is also a member of the Board of Editors of the *Journal of Taxation.*

Mr. Schneider is a graduate of Lehigh University, Columbia University School of Law (JD cum laude), New York University (LLM in Taxation), and LaSalle University (MBA). Mr. Schneider frequently writes articles and lectures on tax and employee benefits-related topics, and is coeditor of *ERISA: A Comprehensive Guide, 3rd Edition* (Aspen, 2007). He may be reached at pschneider@paisnerlitvin.com.

(1) An employer who maintains a top hat plan may satisfy the reporting requirements of Title I of ERISA with respect to that plan by filing a single statement that includes the employer's name, address, identification number, and a declaration that the employer maintains the plan primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees, the number of such plans maintained by the employer, and the number of employees in each plan. See Labor Regs. Sec. 2520.104-23.
(2) An employee pension benefit plan is defined under ERISA Sec. 3(2) as a plan, fund, or program that provides retirement income to employees or results in a deferral of income to employees for periods extending to the termination of covered employment or beyond.
(3) ERISA Secs. 201(2), 301(a)(3) and 401(a)(1).
(4) In the context of discussing the top hat plan's exclusion from ERISA's vesting requirements, the legislative history explains that since

top hat plans are "in effect, controlled by the employees for whose benefit they are established, there is no need to impose the vesting requirements of [ERISA]." This statement has led some to argue that to be covered by a top hat plan an employee must be in a position to influence, through negotiation or otherwise, the design and operation of that plan in order to be part of the select group that Congress intended to exclude from ERISA's protections.

(5) DOL Advisory Opinion Letters 75-63 (July 22, 1975), 75-64 (August 1, 1975), 75-48 (December 23, 1975), 76-100 (November 15, 1976), 85-37A (October 25, 1985), and 90-14A (May 8, 1990). The IRS has also aided the DOL's cause by saying that the definition of "highly compensated employee" in Code Sec. 414(q) is not intended to apply to the determination of whether a top hat plan is maintained for a select group of management or highly compensated employees. See Preamble to Temp. Reg. Sec. 1.414(q)-1T, Q&A-1(d), EE-129-86, T.D. 8173, 53 FR 4965 (Feb. 19, 1988).

(6) Compare *Belka v. Rowe Furniture Corp.,* 571 F. Supp. 1249 (D. Md. 1983) and *Demery v. Extebank Deferred Compensation Plan (B),* 216 F. 3d 283 (2d Cir. 2000) in which the courts interpreted "primarily" as modifying "select group" and "highly compensated."

(7) For example, in Advisory Opinion 75-64, a deferred-compensation plan covered 4% of the active workforce, and the covered employees had an average salary of $28,000 compared to $19,000 for all managerial employees. The DOL advised that this was a top hat plan. See also Advisory Opinion 85-37A where the DOL considered a nonqualified and unfunded pension plan that was established to cover employees on its executive payroll. The executive payroll covered 50 of 750 employees. This group represented higher paid individuals. The average compensation earned by employees in the executive group was slightly less than $30,000 as compared to the 10 highest paid hourly employees, who had an average compensation of $10,000. The type of employees included on the executive payroll were past presidents as well as an assistant in the cost department, an order department clerk, a comptroller, and three foremen. The DOL concluded that in view of the broad range of salaries and positions of the eligible employees, it was not a top hat plan.

(8) One possible reason for this lack of requests for advisory opinions may be that employers and their advisors know that they are not going to like the answers that the DOL is going to give.

(9) It wouldn't be surprising if this approach was premeditated on the part of the DOL. It appears that the DOL would much prefer that the courts, rather than the regulatory process, decide on a case-by-case basis what constitutes a top hat plan.

(10) *In Re: New Valley Corporation, et. al. v. New Valley Corporation Senior Executive Benefit Plan Participants,* 89 F. 3d 143 (3d Cir. 1996). See also *Belka v. Rowe Furniture Corp.,* 571 F. Supp. 1249 (D. Md. 1983); *Darden v. Nationwide Mutual Insurance Company,* 796 F2d 701 (4th Cir. 1986); *Starr v. JCI Data Processing, Inc.,* 757 F. Supp. 390 (D. NJ 1991).

(11) *Bakri v. Venture Mfg. Company,* 473 F. 3d 677 (6th Cir. 2007), at 678.

(12) See *Carrabba v. Randalls Food Markets, Inc.,* 38 F. Supp. 2d 468, 478 (N.D. Tex. 1999).

(13) See *Demery v. Extebank Deferred Compensation Plan* (B), 216 F. 3d 283, 289 (2d Cir. 2000).

(14) The covered employees that participated in the larger of the two top hat plans during the three years at issue represented a high of 8.7% of the aggregate workforce to a low of 4.9%. As far as the disparity in earnings was concerned, the covered employees had earnings that were more than five times the average earnings of the employee population as a whole.

(15) 513 F. 3d 37, 47.

(16) See note 5 above and *Simpson v. Ernst & Young,* 879 F. Supp. 802 (S.D. Ohio 1994).

(17) See *Daft v. Advest, Inc.,* 2008 U.S. Dist. Lexis 7384 (N.D. Ohio 2008).

(18) Some employers address this issue by establishing two plans, one that clearly covers a select group and a second that covers the more questionable employees. However, it may nevertheless be argued that the two plans in fact constitute a single plan. See *Fraver v. North Carolina Farm Bureau Mutual Insurance Company,* 643 F. Supp. 633 (E.D.N.C. 1986), *rev'd on other grounds,* 801 F. 2d 675 (4th Cir. 1986), where the court treated individual contracts as constituting a single plan.

(19) See *Duggan v. Hobbs,* 99 F. 3d 307 (9th Cir. 1996).