ERISA's "Top-Hat" Exemption and Its Impact on Plan Design

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Consider your reaction to the following conversation between the president of a high-tech company and the head of an executive benefits consulting firm. Competitors recently recruited away a number of employees from the company, and the executive benefits firm was brought in to design a COLI-funded SERP (corporate-owned life-insurance-funded supplemental executive retirement plan) to help the company with its retention issues. The meeting has gone extremely well, with the president giving all the standard "buy" signals.

At the end of the presentation, the president pauses and says: "I really like the plan you've designed, and think it can help us solve some of the retention issues we've been struggling with, but I have a question. The way we've structured the company, we have all kinds of employees we're concerned about losing. What I mean is that some could be described as 'senior management' or 'executive level,' but we also have others who don't manage people. They have 'technical' jobs and can pull down some pretty significant paychecks. Can all these folks be in the SERP you've designed, and who decides?"

Anyone with a passing familiarity with nonqualified plans knows that the president's question is very perceptive. Whether they know it or not, this seemingly harmless question puts the producer, case designer, human resources representative, and tax adviser directly in the crosshairs of ERISA's "top-hat" exemption.

Nonqualified plans are intentionally designed to be exempt from Title I of ERISA. If a plan isn't exempt, it has to comply with ERISA's coverage, participation, vesting, fiduciary, and funding standards. In other words, the plan would be treated as if it were a qualified plan for ERISA purposes.

The most commonly used exemption from ERISA for nonqualified plans is the top-hat plan exemption. Under this exemption, any nonqualified plan that is "maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees" is exempt from the participation, vesting, funding, and fiduciary responsibility rules of ERISA and is instead subject to ERISA's limited reporting and disclosure requirements.

The consequences of a plan not found to be top hat are twofold. First, Title I of ERISA would apply, and the sponsor could be penalized for violating its coverage, participation, vesting, fiduciary, and funding standards. Second, disgruntled employees could file ERISA-based claims against the sponsor in federal court. In one case, an employer was hit with a $13.5 million verdict in a suit brought by employees who were successful in challenging a plan's top-hat status (*Carrabba v. Randalls Food Markets*, 252 F.3d.721, 2001). While this case may be the exception to the rule, it illustrates the importance of getting this issue right.

The problem is that if you ask ERISA specialists who can qualify for the top-hat exemption, you're likely to get a wide range of opinions. One of the difficulties in providing clients with guidance in this area is that the Department of Labor (DOL) has yet to issue regulations that define "top hat." In addition, the DOL informally indicated in 1987 that certain DOL Advisory Opinions, which it issued prior to 1980 interpreting who qualified for the top-hat group, would be rescinded.

Despite this fact, post-1980 DOL Advisory Opinions and case law can help planners and clients make informed choices when it comes to deciding who can be an eligible participant. While it would be misleading to say that there are general rules, the following is a closer look at four key factors that courts and the DOL have looked at when asked whether a "select group of management or highly compensated employees" exists.

Ratio Test

To determine whether a group qualifies for the top-hat exemption, a number of courts have compared the number of employees covered by the plan to the total number of employees in the business's overall workforce. The results of these "ratio test" cases can be quite revealing. For example, in *Belka v. Rowe Furniture Corp.* (571F.Supp.1249, 1983), a "select group of management or highly compensated employees" was found to exist where the plan covered 4.6 percent of the workforce. In *Duggan v. Hobbs* (99F3d307, 1996), the plan was ruled top hat where one participant constituted less than 5 percent of the workforce. At the other end of the spectrum is *Darden v. Nationwide Mutual Insurance Co.* (717F.Supp.388, 1989), where a plan covering 18 percent of Nationwide's workforce was held not to be top hat. Somewhere in between is *Demery v. Extebank Deferred Compensation Plan* (216F3d283, 2000), which held that a plan for bank officers that as a group comprised 15.34 percent of the workforce was top hat.

Planners need to be cautious about reading too much into the ratio test. In one instance where one would ordinarily think the percentage of the workforce participating in a plan would make its likelihood of being classified as top hat fairly good, top-hat status was found not to exist. DOL Advisory Opinion 85-37A involved a plan that covered 50 employees on the firm's "executive payroll." Despite the fact that the firm's total employee base was 750, a plan for the 50 employees on the executive payroll was found not to be top hat, despite a ratio test under 7 percent. There were clearly other factors that influenced the outcome of this Advisory Opinion, but the point is that a low ratio by itself may not be sufficient to guarantee top-hat status.

Minimum Compensation Level

Some planners are under the mistaken assumption that setting eligibility using the definition of "highly compensated employee" (HCE) in Internal Revenue Code Section 414(q) will, as a general rule, guarantee top-hat status. In 2005, the 414(q) threshold is $95,000. This assumption is clearly incorrect, because the regulations under 414(q) take the position that 414(q) will not control the ERISA issue as to whether a plan is top hat.

Along the same lines, plans have commonly attempted to define the class of eligible employees by establishing a minimum compensation threshold. Caution is the watchword in this regard because one court held 10 years ago that an employee earning $194,092 per year wasn't sufficient to place that employee in the class of HCEs and went on to deny the plan top-hat status (*Simpson v. Ernst & Young*, 879F.Supp.802, 1994). Based on the *Simpson* case, a critical factor in designing a plan that truly covers the highly compensated would be to establish where a participant's compensation falls in relation to the average compensation of all plan participants.

Job Description versus Actual Management Responsibility

Labeling rank-and-file employees as "executives" to move them into the ranks of select management will clearly not succeed. In DOL Advisory Opinion 85-37A, a group of 50 executives was found not to be top hat because the group included foremen, a superintendent, an order clerk, an inventory specialist, and an expediter. In this instance, 38 percent of the group was comprised of nonsupervisory clerical positions, while another 38 percent was deemed to actually be upper management. In another case, the entire participant group was found to be top hat because it was comprised solely of the company's upper echelon of management (*Gallione v. Flaherty*, 70F.3d724, 1995).

Ability to Influence Plan Design and Operation

The strongest signal the DOL has given to date concerning its views on this issue is DOL Advisory Opinion 90-14A. In this opinion, the DOL stated:

It is the view of the Department that in providing relief for "top-hat" plans from the broad remedial provisions of ERISA, Congress recognized that certain individuals, by virtue 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.

This raises the difficult question as to whether any participant can be shown to have the ability to influence plan "design or operation." To meet this threshold, some drafters include language in the plan document that affirmatively states that the covered participant can influence plan design and operation.

While nonqualified plans are powerful planning tools, careful analysis needs to be given to minimize any risk to their top-hat status. Returning to the president's question at the outset, how would you frame your response after reading this article?

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