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Topic: "Top-Hat Plan" Exemption Compliance for Deferred Compensation Arrangements

MARKET TREND: As key executives continue to seek options for deferring the receipt and taxation of current income, there likely will be a corresponding increase in inquiries from employers as to how to structure nonqualified deferred compensation plans to meet the "top-hat plan" exemption from many ERISA requirements.

SYNOPSIS: Nonqualified deferred compensation plans generally are considered pension plans within the meaning of ERISA and are subject to rules regarding plan design and administration, including funding, vesting and fiduciary duties. These rules, however, do not apply to an unfunded plan maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees (*i.e.,* a "top-hat" plan). While there is no clear-cut guidance defining what constitutes a "select group of management or highly compensated employees" for purposes of a top-hat plan, several cases have considered the issue and have provided parameters that should be considered in establishing such a plan.

TAKE AWAY: As corporate interest in deferred compensation plans increases, advisors can offer significant value to clients who are contemplating the establishment of such plans by guiding them through a top-hat analysis that ensures (1) only a relatively small percentage of the workforce is invited to participate, (2) the plan participants have executive or managerial employment duties, (3) there is significant disparity in the average compensation levels between plan participants and nonparticipants, and (4) the language of plan documents limits participation to a select group of management or highly compensated employees.

PRIOR REPORTS: 2013-30.

MAJOR REFERENCES: *Darden v. Nationwide Mutual Insurance Company, 717 F. Supp. 388 (E.D.N.C. 1989); Demery, et. al. v. Extebank Deferred Compensation Plan, 216 F.3d 283 (2d Cir. 2000); Bakri v. Venture, 473 F. 3d 677 (6th Cir. 2007); Cramer v. Appalachian Regional Healthcare, Inc., No. 5:11-49-KKC (E.D. Ky. Oct. 29, 2012); Daft v. Advest, Inc., 658 F.3d 583 (6th Cir. 2011).*

Recent tax rate increases have generated increased interest in deferring compensation. To achieve this goal effectively, however, nonqualified deferred compensation plans must not only comply with the applicable tax laws (see discussion in Washington Report No. 2013-30), but also qualify for the exemption from important substantive provisions of ERISA.

IMPACT OF ERISA

Most nonqualified deferred compensation plans ("**NQDPs**") are considered "pension plans" within the meaning of ERISA, and, as such, are potentially subject to vesting, funding and fiduciary duty requirements. If those requirements apply to a NQDP, it would, in most cases, produce immediate taxation on the amounts deferred and subject the employer to burdensome fiduciary requirements. To avoid the immediate taxation of deferred amounts, the NQDP would have to satisfy the qualification rules under the Internal Revenue Code ("**Code**" or "**IRC**"), which, most notably, would preclude the NQDP from discriminating in favor of the employer's executives. As a result, it is unlikely any employer would sponsor such an arrangement or any employee would participate in one. An exception from these rules applies, however, for plans that are considered top-hat plans.

TOP-HAT PLANS GENERALLY

The term "top-hat plan" is not used in ERISA. Rather, it is a colloquialism developed to refer concisely to "a plan which is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." A plan that meets this description is exempt from the participation and vesting, funding, and fiduciary duty provisions of ERISA.

The requirements for top-hat plan exemption have been in ERISA, and have remained unchanged, since ERISA was enacted in 1974. In the nearly 40 years since its enactment, the Department of Labor ("**DOL**") has not provided (and likely will not provide) any official or specific guidance clarifying what constitutes a "select group of management or highly compensated employees."

RELEVANT CASE LAW

Notwithstanding the absence of DOL guidance, a handful of court decisions have reviewed whether a plan was a top-hat plan and thus provide some guidance for employers to consider in structuring NQDPs for top-hat plan exemption compliance.

1. ***Darden v. Nationwide Mutual Insurance Company*, 717 F. Supp. 388 (E.D.N.C. 1989)**. The court held that the plan at issue was not a top-hat plan because: (a) it was offered to more than 18% of the company's workforce, which the court did not consider to be a "select group," and (b) in the court's opinion, the differences in the average compensation of plan participants ($31,528) as compared to all non-agent employees ($19,121) and all management employees ($24,501) was not sufficient to consider the plan participants "highly compensated" within the meaning of ERISA.

2. ***Demery, et. al. v. Extebank Deferred Compensation Plan*, 216 F.3d 283 (2d Cir. 2000).** The court found that a plan was a top-hat plan even though it covered 15.34% of the employer's workforce. The court said that "[w]hile this number is probably at or near the upper limit for the acceptable size for a 'select group,' we cannot say that it alone made [the plan] too broad to be a top-hat plan...." As did other courts, the *Demery* court applied a qualitative and quantitative analysis. The court found the following factors favorable to its determination that the plan met the requirements for a top-hat plan: (a) that the plan was limited to "highly valued managerial employees," and (b) the average compensation of plan participants was more than double the average compensation of the entire workforce. Finally, the court noted that the inclusion of two or three employees who were not highly compensated or a select group of management did not prevent the plan from being maintained "primarily" for these employees.

3. ***Bakri v. Venture*, *473 F.* 3d 677 (6th Cir. 2007).** This court articulated essentially a four-part

test for assessing the top-hat status of a plan. Specifically, the court stated: “In determining whether a plan qualifies as a top-hat plan, we consider both qualitative and quantitative factors, including (a) the percentage of the total workforce invited to join the plan (quantitative), (b) the nature of their employment duties (qualitative), (c) the compensation disparity between top-hat plan members and non-members (qualitative), and (d) the actual language of the plan agreement (qualitative).”

Unlike the *Darden* and *Demery* cases, the *Bakri* case did not give specific details about the percentages of employees that participated in the plan or the range of salaries of those eligible and ineligible to participate in the plan. Instead, in holding that the plan was not a top-hat plan, the court noted that top-level company executives did not participate in the plan, certain employees who were promoted to top management ceased to participate in the plan, and participation was not limited to top management or even high-level positions (in fact, administrative employees and those who did not supervise other employees were allowed to participate). Thus, the court felt that the plan at issue did not meet the selectivity requirement for consideration as a top-hat plan.

4. ***Cramer v. Appalachian Regional Healthcare, Inc.*, No. 5:11-49-KKC (E.D. Ky. Oct. 29, 2012).** The court applied the *Bakri* test to conclude that a plan was, in fact, a top-hat plan. In this case, however, the court articulated its application of each of the elements of the *Bakri* test. Specifically:

   a. **Percentage of total workforce invited to join the plan:** Although the court noted that there is no bright-ine rule specifying what percentage of an employer’s workforce can be covered by a top-hat plan, the plan in *Cramer* covered only 0.4% of the total workforce, which the court weighed in favor of meeting the “select group” requirement necessary for top-hat status.

   b. **Nature of plan members’ employment duties:** Evidence presented in the case indicated that some of the participants in the plan did not exercise the authority or control generally associated with management and executive employees. However, noting the facts in other cases, including *Demery*, as well as the DOL’s position in an earlier advisory opinion that provided that the fact that not all employees eligible to participate in a top-hat plan need to be management or highly paid employees, the court found that this factor also weighed in favor of finding the plan to be a top-hat plan.

   c. **Compensation disparity between plan participants and nonparticipants:** The court stated that qualification as a top-hat plan requires a significant disparity between the average compensation of plan participants and the average compensation of non-covered employees. Over the two years the court evaluated, the average W-2 compensation of plan participants was more than 4.5 or 5 times the averages for nonparticipants. The court also noted that the compensation for the lowest paid plan participant was more than twice the average for nonparticipants. The court found that both of these facts supported treatment of the plan as a top-hat plan.

   d. **Actual language of the plan document:** The plan document contained language that properly restricted the group of employees eligible to participate, but the court noted that, notwithstanding the language of the *Bakri* test, a plan will not satisfy this criterion if the plan does not follow its eligibility language in operation.

In light of the foregoing factors, the court concluded the plan was a top-hat plan within the meaning of ERISA.

5. ***Daft v. Advest, Inc.*, 658 F.3d 583 (6th Cir. 2011).** Finally, while not providing the kind of detailed analysis found in the *Cramer* case, the ruling in this case showed the court’s continued support for the *Bakri* test.

TAKE-AWAY

Despite the lack of formal agency guidance on top-hat exemption qualification, the foregoing decisions provide a framework for evaluating whether a NQDP qualifies as a top-hat plan exempt from most ERISA requirements. Advisors can offer significant value to clients who are contemplating the establishment of a NQDP by guiding them through a top-hat analysis that consider the following factors:

1. ***Percentage of Workforce Invited to Participate:*** Only a relatively small percentage of the employer's workforce should be eligible to participate in the plan.

2. ***Nature of Participants' Employment Duties:*** Most, if not all, of the eligible employees should work in positions that provide them with executive or management authority.

3. ***Compensation Disparity between Participants and Nonparticipants:*** There should be a significant disparity in the average compensation of employees eligible to participate in the plan and the average compensation of ineligible employees.

4. ***Language of Plan's Documents & Plan Operation.*** The applicable plan documents should contain language limiting participation to a select group of management or highly compensated employees, and the plan's operation should conform to that standard.

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