A Top-Hat Plan

Determining whether a plan qualifies as a "top-hat" plan: a brief summary of legal precedence.

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The United States Court of Appeals for the Third Circuit established a framework for analyzing top-hat benefit plans:

> [A] top-hat plan is a unique animal under ERISA's provisions. These plans are intended to compensate only highly-paid executives, and the Department of Labor has expressed the view that such employees are in a strong bargaining position relative to their employers and thus do not require the same substantive protections that are necessary for other employees. See DOL Opin. Letter 90-14A, 1990 WL 123933, at *1 (May 8, 1990). We have held that such plans are more akin to unilateral contracts than to the trust-like structure normally found in ERISA plans (internal citations omitted). Accordingly, top-hat plans are not subject to any of ERISA's substantive provisions, including its requirements for vesting and funding (internal citations omitted).
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> Goldstein v. Johnson & Johnson, 251 F.3d 433, 442 (3d Cir. 2001).

The structure of a nonqualified deferred compensation plan may be in many forms and certain types of arrangements are referred to by specific terms. A "top-hat" plan is a term reserved for certain nonqualified deferred compensation plans that are exempt from most of the substantive requirements of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). A top-hat plan is a plan that 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. ERISA does not provide statutory definitions of the terms "select group," "management," or "highly compensated employees," and the Department of Labor has not issued regulations defining those terms. Employees sometimes claim ERISA protection (e.g., vesting or funding) for a benefit under a nonqualified deferred compensation plan by arguing that it is not a top-hat plan; however, most nonqualified deferred compensation plans are intended to fall under the top-hat plan exemption.

The term "top-hat" refers to a plan described in Sections 201(2), 301(a)(3), and 401(a)(1) of ERISA, as an employee benefit plan which is unfunded and maintained by an employer "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." A top-hat plan is exempt from the substantive provisions of ERISA, Parts 2, 3 and 4 of Title I of ERISA, pertaining to participation, vesting, funding, and fiduciary responsibilities pursuant to the exemptions in Sections 201(2) 301(a)(3), and 401(a)(1) of ERISA. See Carr v. First Nationwide Bank, 816 F. Supp. 1476 (N.D. Cal. 1993). A top-hat plan is not exempt from the reporting and disclosure requirements of Part 1 of Title I of ERISA, or the administration and enforcement provisions of Part 5 of Title I of ERISA. However, the reporting and disclosure requirements are easily satisfied by filing a compliance or registration statement with the Department of Labor within 120 days after the plan becomes subject to ERISA pursuant to Section 2520.104-23 of the Department of Labor Regulations, the alternative method of compliance for pension plans for certain selected employees.

Although the Department of Labor has not issued guidance specifically stating how a top-hat plan is defined for purposes of Sections 201(2), 301(a)(3), and 401(a)(1) of ERISA, the guidance issued by the Department of Labor, the Department of Treasury, and the courts suggests that the eligibility requirements for participation in a nonqualified deferred compensation plan that is intended to satisfy the definition of a top-hat plan should be narrowly applied so that the number of employees who are eligible to participate is limited to a "select group" of high-level employees whose average compensation is significantly greater than the average compensation of all other employees.

The guidance regarding eligibility to participate in a top-hat plan issued by the Department of Labor is limited. In DOL Advisory Opinion 90-14A, 1990 WL 123933 (May 8, 1990); see also DOL Advisory Opinion 92-13A, n.1 (May 19, 1992) (repeating the same position) the Department 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, taking into consideration any risks attendant thereto, and therefore, would not need the substantive rights and protections of Title I [of ERISA].

The Department stated in footnote 1 of Advisory Opinion 90-14A that:

> It also is the Department's position that the term "primarily," as used in the phrase "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees" in sections 201(2), 301(a)(3) and 401(a)(1), refers to the purpose of the plan (i.e., the benefits provided) and not the participant composition of the plan. Therefore, a plan which extends coverage beyond "a select group of management or highly compensated employees" would not constitute a "top-hat" plan for purposes of Parts 2,3 and 4 of Title I of ERISA.

In Demery v. Extebank Deferred Compensation Plan (B), 216 F.3d 283 (2d Cir.2000), the Second Circuit Court of Appeals determined that a bank's deferred compensation plan maintained for a group of management or highly compensated employees, consisting of more than 15 percent of the bank's employees, was a top-hat plan. A significant factor in this determination was whether the group covered by the plan was a "select" group of management or highly compensated employees.

In 1995, Banco Exterior de Espana, a Spanish bank and the corporate parent of Extebank, began negotiating the sale of Extebank to North Fork Bank, a New York bank. The negotiations resulted in a merger between Extebank and North Fork in March 1996, whereby North Fork acquired all of the outstanding shares of Extebank and assumed all of its obligations. The individual defendant, Stephen Maroney, was the president of Extebank and resigned following the merger. The plaintiffs were bank officers of Extebank, all of whom served as vice-president, manager, assistant vice-president or senior vice-president, and participated in its deferred compensation plan, Plan B.

Extebank established Plan B in 1987, in addition to its pension plan. Plan B was offered to assistant vice-presidents, managers, and other senior officers, representing approximately 15 percent of the workforce of Extebank. Approximately 7 percent to 10 percent of Extebank employees actually participated in Plan B, which allowed participants to defer up to 25 percent of their salary as contributions to Plan B. Participants were also permitted to borrow money at the prime rate from Extebank in order to contribute the maximum allowable amount to Plan B. Participants in Plan B would vest upon reaching retirement age, at which time they were to receive a return on their investment at a compounded annual rate of 20 percent. If participants left Extebank before they vested, Plan B provided for repayment of the amount invested, plus interest at a compounded annual rate of 10 percent. In order to help pay for its obligations under Plan B, Extebank purchased, and was the beneficiary of, life insurance contracts on its employees. The proceeds of these contracts were kept in an account entitled the "Deferred Compensation Liability Account."

All of the plaintiffs left Extebank shortly before or soon after the merger with North Fork. Most had not reached retirement age and therefore received a lump sum under Plan B that included their contributions to Plan B, plus compounded interest at 10 percent, less any pre-retirement payments previously disbursed, including amounts received as loans. Only one of the plaintiffs was eligible for full retirement benefits, and he received his contributions, minus any pre-retirement payments, plus interest at 20 percent compounded annually.

The plaintiffs filed a complaint in December 1997, claiming benefits under ERISA and various common law claims. The defendants moved to dismiss the complaint on the basis that Plan B was a top-hat plan exempt from the substantive requirements of ERISA. The district court held that Plan B was a top-hat plan and exempt from the substantive requirements of ERISA.

The sole question in the case was whether Plan B was a top-hat plan and, therefore, exempt from most of the substantive requirements generally imposed on deferred compensation plans by ERISA. To answer this question, the court was required to determine whether Plan B was: (1) unfunded; and (2) maintained primarily for a select group of management or highly compensated employees. The plaintiffs maintained that Plan B was neither; however, the court disagreed.

The plaintiffs argued that Plan B was funded within the meaning of ERISA because: (1) it was funded through the purchase of life insurance contracts on the participants; (2) the proceeds were kept in a separate bank account, the Deferred Compensation Liability Account; and (3) Extebank's documents stated that "the Bank has funded this liability through the purchases of insurance coverage." The court found no merit to this argument. The court stated that it had "previously noted that a plan was unfunded where 'benefits thereunder will be paid… solely from the general assets of the employer.'" The court then reviewed the provisions of Plan B and stated that the terms of Plan B "do not give plaintiffs a greater legal right to the funds in the Deferred Compensation Liability Account than that possessed by an unsecured creditor. The district court correctly found that the revenues from the insurance policies purchased on the participating employees, although deposited in a separate account, 'became part of the general assets of Extebank,' and thus that the Plan was unfunded as a matter of law."

The court next examined the issue of whether Plan B was maintained primarily for a select group of management or highly compensated employees. The court concluded that, viewing Plan B as a whole, Plan B qualified for top-hat status. As a preliminary matter, the court noted that Plan B was supplemental to Extebank's pension plan, and not a substitute for it. In addition, Plan B was established "as a means to retain valuable employees," and the terms of Plan B were quite favorable to the participants, although perhaps in hindsight not as favorable as they would have liked. In terms of being established for a "select group," although Plan B was offered to a relatively large percentage of the workforce, all participants were selected officers of the bank, were in management positions, and were highly compensated in comparison to bank employees at large. Therefore, the court held that Plan B was a top-hat plan as a matter of law.

The plaintiffs argued that the "select group" requirement for a top-hat plan was not met because: (1) participation in Plan B was offered to 15.34 percent of Extebank employees; (2) the participants were not all either management or highly compensated, and (3) the participants did not have the ability to effectively negotiate for themselves.

The court stated that, "[w]hile plans offered to a very small percentage of an employer's workforce often qualify as top-hat plans, … there is no existing authority that establishes when a plan is too large to be deemed 'select.'" The plaintiffs argued that no case has ever held that a plan offered to 15 percent of an employer's workforce was a top-hat plan. The plaintiffs cited one case and one Department of Labor letter in support of their argument. In Darden v. Nationwide Mut. Ins. Co., 717 F. Supp. 388, 397 (E.D. N.C. 1989), aff'd, 922 F.2d 203 (4th Cir.1991), rev'd on other grounds, 503 U.S. 318, 112 S. Ct. 1344, 117 L. Ed. 2d 581 (1992), the court considered the size of the plan and found that 18.7 percent of the workforce was too large a percentage for a benefit plan to qualify as a top-hat plan. On the other hand, the Department of Labor, in DOL Opinion Letter 85-37A, found that a deferred compensation plan offered to 7.5 percent of employees was not a top-hat plan because of the composition of the group, rather than its size.

The Second Circuit stated that the circumstances in Demery were different from those in Darden or the Department of Labor letter. The district court determined that Plan B was offered only to bank officers, most of whom were employed in managerial positions, and found that Plan B participants' average compensation was more than twice the average compensation of Extebank employees. The court also noted that the plaintiffs described themselves in their complaint as a select group and that minutes of the Extebank board reflected the fact that Plan B at its inception was "viewed as a means to retain valuable employees."

The plaintiffs also claimed that despite the fact that all Plan B participants were officers of Extebank, they did not constitute a select group because they were neither key executives nor highly compensated. The court did not find this argument compelling; "[w]hile Plan B participants did include assistant vice presidents and branch managers, and therefore swept more broadly than a narrow range of top executives, it was nonetheless limited to highly valued managerial employees." The court also stated that "the average salary of plan participants was more than double that of the average salary of all Extebank employees."

The court also stated, significantly, that:

> [f]inally, we think it significant that the statute defines a top-hat plan as 'primarily' designed to provide deferred compensation for certain individuals who are management or highly compensated. Id. It suggests that if a plan were principally intended for management and highly compensated employees, it would not be disqualified from top-hat status simply because a very small number of the participants did not meet that criteria, or met one of the criteria but not the other. See, e.g., Belka, 571 F.Supp. at 1252 (participants in valid top-hat plan included 'salesmen and a diverse group of executives, including vice presidents, sales managers, [and] supervisors'). Therefore, we do not find plaintiffs' focus on the two or three employees who were arguably not 'highly compensated' or 'a select group of management' to be dispositive.

Also, and significantly, the plaintiffs claimed that the defendants failed to file registration statements for Plan B with the Department of Labor and the Internal Revenue Service for 10 years and refused to honor their requests for plan documents. The court stated that "a top-hat plan is deemed to have satisfied the reporting and disclosure requirements of ERISA, including the furnishing of a summary plan description and annual reports to plan beneficiaries, by filing a short statement with the Secretary of Labor and providing plan documents to the Secretary upon request." The court determined that the defendants filed a registration statement with the Department of Labor and with the Internal Revenue Service, and thereby satisfied the reporting and disclosure requirements of ERISA. The court stated that "[w]hile we note that this statement was not filed 'within 120 days after the plan becomes subject to Part 1,'… since it was not filed until several years after the Plan was initiated, plaintiffs do not allege any harm from this deficiency. In the absence of prejudice to plaintiffs, we find no abuse of discretion in the district court's decision not to impose the penalties permitted by 29 U.S.C.A. § 1132(c)…."

The court concluded that Plan B was a deferred compensation plan maintained primarily for a select group of management or highly compensated employees, and, therefore, was a top-hat plan as a matter of law.

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