The Impact of ERISA's "Top Hat" Exemption on Non-Qualified Deferred Compensation Plans

Whether you realize it or not, the question of who can participate in a non-qualified deferred compensation plan puts the financial professional, case designer, human resources representative and tax advisor directly in the cross-hairs of ERISA. Non-qualified deferred compensation plans are intentionally designed to be exempt from Title I of ERISA. If a plan isn't exempt, it has to comply with the coverage, participation, vesting, fiduciary and funding standards of ERISA. In other words, the plan would be treated as if it were a "qualified" plan for ERISA purposes. So, how do we know if the plan will be exempt from ERISA?

Background

The Employee Retirement Income Security Act of 1974 ("ERISA") imposes many rules and regulations on employers to protect the interests of participants of employee benefit plans and their beneficiaries. ERISA mandates disclosure of financial and other information concerning the plan; establishes standards of conduct for plan fiduciaries; establishes minimum funding requirements for certain plans; provides for appropriate remedies and access to the federal courts; and creates many other requirements. As a result, many employers who wish to provide more benefits for their executives and top employees, seek to create employee benefit plans that are exempt from ERISA's requirements.

The most commonly used exemption from ERISA is the so-called "top hat" plan exemption. Under this exemption, any plan which 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, but instead, is subject to the limited reporting and disclosure requirements of ERISA.

The consequences of a plan not falling within the "top hat" exemption are severe. 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 employer in federal court. In one case, an employer lost a $13.5 million lawsuit brought by employees who successfully challenged a plan's top hat status. *Carrabba v. Randalls Food Markets*, 252 F.3d. 721 (5th Cir. 2001).

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 the phrase "top hat" group. ERISA specialists are not unanimous in the definition of what qualifies for a "top hat" exemption. In addition, in 1987, the Department of Labor informally indicated that certain DOL Advisory Opinions that it issued prior to 1980, interpreting who qualified for the "top hat" group, would be rescinded.

Nevertheless, post-1980 DOL Advisory Opinions and case law can help financial professionals 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 bright line tests or general rules, the following is a closer look at four key factors courts and the DOL have looked at when asked whether a "select group of management or highly compensated employees" exists in a given business.

1. 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' overall workforce. The result of this "ratio test" can be quite revealing. For example, in *Belka v. Rowe Furniture Corp.,* 571 F. Supp. 1249 (D. Md. 1983) the plan covered 4.6% of the workforce and a select group of management-highly compensated employees was found to exist. In *Duggan v. Hobbs*, 99 F.3d 307 (9th Cir. 1996), the plan was found to be a top hat plan where the one participant equated to less than 5% of the workforce. At the other end of the spectrum, however, is *Darden v. Nationwide Mutual Insurance Co.*, 717 F. Supp. 388 (SDNY 1989), where a plan covering 18% of Nationwide's workforce was held not to be a top hat plan. Lying somewhere in between is *Demery v. Extebank Deferred Compensation Plan.*, 216 F.3d 283 (2nd Cir. 2000), where a plan for bank officers consisting of 15.34% of the workforce was considered a top hat plan.

Financial professionals need to be cautious about reading too much into the ratio test. For instance, a plan that covered 50 employees on the firm's "executive payroll" in a company that had a total employee base of 750 was found not to be a "top hat" plan, despite a ratio test under 7%. *DOL Advisory Opinion 85-37A*. There clearly were 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.

2. Minimum Compensation Level: Some financial professionals are under the assumption that setting eligibility for a plan using the definition of "highly compensated employee" ("HCEs") in Internal Revenue Code Section 414(q) ($120,000 in 2015) will, as a general rule, guarantee top hat status. This assumption is incorrect. The regulations under IRC Sec. 414(q) state that this section will not control the ERISA issue as to whether a plan meets the top hat exemption.

Similarly, plans have attempted to define the class of "eligible employees" by establishing a minimum compensation threshold. At least one court has held that an employee earning $194,092 per year wasn't sufficient to place that employee in the class of "highly compensated employees," and went on to deny the plan top hat status. *Simpson v. Ernst & Young*, 879 F. Supp. 802 (S.D. Ohio 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.

3. Job Description vs. Actual Management Responsibility: Labeling rank-and-file employees as "executives" to move them into the ranks of "select management" is also not a viable strategy. 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% of the group was comprised of non-supervisory clerical positions, while another 38% were 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.,* 70 F.3d 724 (2nd Cir. 1995).

4. Ability to Influence Plan Design and Operation: The strongest signal the DOL has given, to date, concerning how it will view whether or not plan participants will meet the "top hat" exemption was stated in a 1990 advisory opinion. In this opinion, the DOL stated that: ". . . [I]t 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 [ERISA]." *DOL Advisory Opinion 90-14A.*

This raises the difficult question as to how many participants 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. It is unclear how much of an impact these provisions will have.

Conclusion

While non-qualified deferred compensation plans can be powerful planning tools for rewarding and retaining key executives, if the plan includes those who are not considered "top hat," the consequences can be severe. Experience indicates that employers can be over-inclusive in whom they select to participate, and it is up to their advisors to guide them through the ERISA minefield so that they reach the correct result.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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