

# Courts Decide a Select Group of New Top Hat Cases

*By Andrew L. Oringer and Stacy L. DeWalt*

Andrew L. Oringer and Stacy L. DeWalt discuss recent cases addressing whether certain deferred compensation arrangements meet the requirements for “top hat” plan status under ERISA and why employers and employees should review their plans in light of these decisions.

## Introduction

Over the last few months, a number of court cases have been decided that analyze whether certain arrangements meet the requirements for “top hat” status under the Employee Retirement Income Security Act of 1974, as amended (ERISA). These cases may provide additional guidance for employers in reviewing whether their own arrangements do, in both design and operation, satisfy the requirements for top hat status, and may provide relevant guidance for covered employees as well.

## Background

ERISA generally imposes a myriad of participation, vesting, funding and fiduciary requirements on employer-sponsored employee benefit plans and arrangements that provide for retirement income or the deferral of income by employees for periods extending to the termination of employment and beyond. ERISA includes an exception from many of these requirements for certain unfunded plans that are maintained “primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees.”<sup>1</sup> As a result of the so-called “top hat” exemption, employers are able to provide unfunded deferred compensation

plans and arrangements to certain executives that are exempt from certain ERISA requirements.

The legislative history may be an appropriate place to begin when reviewing the need for the top hat exemption. “Although the legislative history does not provide a definition of a ‘select group of highly compensated employees’ it does provide some guidance in this area. In discussing the exemption from ERISA’s vesting requirements, the legislative history states that, because top hat plans are, ‘in effect, controlled by the employees for whose benefits they are established, there is no need to impose the vesting requirements of [ERISA].’”<sup>2</sup>

The determination of top hat plan status is often difficult as neither ERISA nor the regulations thereunder, define or provide any guidance with respect to the meaning of the phrase “primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees.” While the legislative history provides insight into the purpose behind the top hat exemption, Department of Labor (DOL) advisory opinions<sup>3</sup> and case law are the primary tools for analyzing top hat plans. Early DOL advisory opinions addressing the meaning of a “select group of management or highly compensated employees” often compared (1) the number of employees eligible to participate in the top hat plan to the employer’s total workforce, and (2) the eligible employee’s average salary in relation to the average salary of the employer’s total workforce.<sup>4</sup> In Advisory Opinion 90-14A,<sup>5</sup> the DOL stated that “in

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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. ...” Since the release of Advisory Opinion 90-14A, many courts have looked to the DOL’s standards and have performed an analysis of both quantitative and qualitative factors.<sup>6</sup>

The consequences of failing to satisfy the top hat exemption requirements may be significant—not only are there requirements effecting the provisions of the plan applicable to participation and vesting, but there are also (could be) significant funding and other fiduciary effects. Four recent cases, described below, provide additional guidance regarding what plans and arrangements may or may not qualify as top hat plans.

### Recent Cases

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In *Alexander v. Brigham and Women’s Physicians Organization, Inc.*,<sup>7</sup> the U.S. Court of Appeals for the First Circuit upheld the district court’s finding that two deferred compensation plans for surgeons whose earnings exceeded certain limits were top hat plans. In this case, the employer employed a number of surgeons who were also Harvard Medical School (Harvard) faculty members and, as a result, were subject to a Harvard-imposed salary cap. Due to the salary cap, the employer established the deferred compensation plans to which the surgeons’ earnings (subject to certain limitations) in excess of the salary cap would be allocated. The plans did not allow surgeons to opt out of the plans.

Although all surgeons were potentially eligible to contribute to the plans, the court noted that “a plan is ‘maintained’ for a group of employees only if those employees realistically have the capacity to benefit from it” and therefore, in determining whether the plans covered a “select group,” only those surgeons who generated sufficient income to actually participate in the plans were relevant for purposes of determining whether such employees were a select group of highly compensated employees. In analyzing whether the participating surgeons were in fact a select group of highly compensated employees, the court stated that the “status analysis turns on both qualitative and quantitative dimensions.” The court determined that it was clear that the participants

were, in fact, a select group of highly compensated employees since (1) they were “qualitatively select” because they were the highest-earning surgeons (*i.e.*, the average income of participants in one plan was more than five times the average income of the total workforce and the average income of participants in the second plan was even greater), and (2) they were also “quantitatively select” because at no point did they make up more than 8.7 percent of the employer’s total workforce.

In rejecting the participant’s request to read an individual bargaining power requirement into the qualification requirements for top hat plans the court explained “(i) that neither the text nor the legislative history of the statute contains the slightest hint that Congress contemplated that courts would consider employees’ ability to bargain over the terms of their deferred compensation plans and (ii) that the DOL opinion letter does not presume to interpret the statute-militate just as strongly against importing a requirement of collective bargaining power into the top-hat provision.” The court also stated that, while “Congress’s rationale for fashioning the exemption was that the members of a ‘select group of management or highly compensated employees’ could fend for themselves, the statute by its terms does not purport to require proof of power of any sort.”

In *Daft v. Advest Inc.*,<sup>8</sup> the district court denied the employer’s motion to reconsider its earlier holding that the employer’s deferred compensation plan was not a top hat plan within the meaning of ERISA. In this case, the employer, a securities brokerage firm, established a nonqualified plan for a “select group of highly compensated account executives.” Participation in the plan was limited to account executives who satisfied certain gross commission thresholds that had originally been set, at the plan’s inception in 1992, at \$200,000 and had increased over time to \$275,000 in 2005. The court indicated that, in making its decision, it was, “in part, influenced by the fact that the Defendants bore the burden to show that they qualified for the narrow top-hat exemption. ...”

In presenting new evidence to the court that the average annual compensation of the plan participants ranged between two to four times the average compensation of all employees, the court stated that, in determining whether plan participants were “a select group of highly compensated employees,” the range of salaries, rather than the average salary was more useful. Specifically, the court noted that it would have been more relevant to provide a “com-

parison of the salary earned by employees minimally qualifying for participation against the average salary of all employees." The court further stated that "[t]o consider averages and not the minimum salary would not protect the Congressional goal underlying the creation of top hat plan exemptions. Specifically, an average can mask wide divergence in compensation and show little regarding whether participation is restricted to highly compensated individuals."

The court noted that participation by 12.78 percent of the workforce was a significant number of employees that would not change its earlier analysis. In particular, the court declined to conclude that 12.78 percent of the population was so small so as to automatically count as a select group. The court reasoned that, based on the information in the record that more than half of the employer's account managers participated in the plan, the gross commission threshold for plan participation was too low.

In *Deal v. Kegler Brown Hill & Ritter Co. L.P.A.*,<sup>9</sup> the court found that an oral deferred compensation plan for an "of-counsel" attorney in a law firm, which the parties agreed was an unfunded "employee pension benefit plan" within the meaning of ERISA intended to provide deferred compensation, was not a top hat plan. In this case, from 1988 until 2000, the firm used the same formula to compensate its directors and certain of-counsel attorneys, which included the use of "bookkeeping accounts" to record certain allocations and reductions. In 1992, following the firm's adoption of a plan for directors of the firm, the "bookkeeping accounts" were referred to as "retirement accounts." The firm reported the director plan to the DOL as a top hat plan. No separate written deferred compensation plan was created for of-counsel attorneys.

The court noted that a top hat plan not only must "be unfunded, it must exhibit the required purpose and it must also cover a 'select group' of employees." Accordingly, the court stated that the "select group" limitation has both quantitative and qualitative restrictions such that "[i]n number, the plan must cover relatively few employees" and in "character, the plan must cover only high level employees." Recognizing that the burden is on the employer to show that a plan is a top hat plan, the court applied four "qualitative and quantitative factors including (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 non-members

(qualitative) and (4) the actual language of the plan agreement (qualitative)."<sup>10</sup>

According to the court, the employer failed to meet its burden of showing that these factors weighed in favor of finding the plan to be a top hat plan. In addressing the nature of the of-counsel's employment duties, the court rejected the employer's claim that his duties were more similar to those of directors than associate attorneys, explaining that the "[t]op hat plan exemptions from the majority of ERISA's requirements is Congress' recognition that certain individuals do not need the protections afforded by ERISA's substantive rights because, due to their position or level of compensation, they have the ability to substantially influence the design and operation of their deferred compensation." The court held that, on balance, the plan was not a top hat plan where the firm failed to establish that three of the four factors of the select group test weighed in favor of finding that the plan was a top hat plan.

In *Roberts v. Fearless Farris Service Stations, Inc.*,<sup>11</sup> the court found that a deferred compensation plan that provided benefits to certain employees, including administrative staff, payroll clerks, truck drivers and maintenance personnel who generally lacked negotiating power within the company and whose annual salaries ranged between \$22,000 and \$85,000, was not a top hat plan. In making its determination, the court noted that employees participating in a top hat plan must "have sufficient influence within the company to negotiate compensation agreements that will protect their own interests where ERISA provisions do not apply." Although most of the participants were long-term employees who earned various amounts, the court found that they were not a "select group of management or highly compensated employees" because most, if not all, were not highly compensated, they were not all or mostly management and they did not have the ability to negotiate an agreement that protected their own interests. In addition, the court rejected the argument that the participants were "key" due to their role in the company; noting that employees who are not highly compensated or management do not meet the top hat standard.

## Conclusion

In light of the fact that employers may be required to establish affirmatively that their unfunded deferred compensation arrangements satisfy ERISA's requirements for the top hat exemption, employers may wish

to review this recent spate of cases to determine if they continue to have adequate comfort that their plans intended to be limited to a “select group of management or highly compensated employees” are in fact so limited. If an employer’s deferred compensation arrangement fails to meet this standard, the arrangement will be subject not only to ERISA’s participation and vesting, but also to its funding and fiduciary requirements. Many plans not intended to satisfy ERISA would be unlikely to do so and, sometimes as importantly, the potential breach of funding and fiduciary rules could result in unprotected (and possibly even personal) liabilities and responsibilities. The cases may also be helpful to employees who wish to understand their rights and possible claims. Thus, the recent litigation could shed new light on the relevant issues for all affected parties.

### ENDNOTES

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- <sup>1</sup> See ERISA §§ 201(2), 301(a)(3), 401(a)(1).
- <sup>2</sup> See generally, Andrew L. Oringer, Esq. and Jason M. Rothschild, Esq., *Has the Supreme Court Said “Yea-Tes” to §414(q)?—Revisiting Top Hat Plans in Light of Yates*, J. TAX MGMT. COMPENSATION PLAN, Jan. 7, 2005, at 9.
- <sup>3</sup> Advisory opinions, while not binding on a court, may provide an indication of the DOL’s thinking regarding a particular issue.
- <sup>4</sup> See generally, White & Case LLP Executive Compensation, Benefits and Employment Law Focus, *Key Rulings Help Determine Which Employees Qualify for ERISA’s “Top-Hat Plan” Exception*, Sept. 2007.
- <sup>5</sup> DOL Adv. Op. 90-14A (May 8, 1990).
- <sup>6</sup> *Supra* note 4. See also *In re New Valley Corp.*, CA-3, 89 F3d 143 (1996) addressing the “select group” requirement and noting that, “[i]n number the plan must cover relatively few employees. In character, the plan must cover only high level employees.”
- <sup>7</sup> 2008 WL 186385 (1st Cir. 2008).
- <sup>8</sup> N.D. Ohio, No. 5:06-cv-01876 (Jan. 18, 2008).
- <sup>9</sup> S.D. Ohio, No. 06-cv-901 (Jan. 29, 2008).
- <sup>10</sup> *Quoting Bakri v. Venture Mfg. Co.*, CA-6, 473 F3d 677 (2007).
- <sup>11</sup> D. Idaho, No. CIV 05-472-S-WFN (Feb. 6, 2008).

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