

“Top Hat” Plans — What are They and How Do You Know If You Have One



WRMarketplace

An AALU Washington Report

This *WR Marketplace* was created exclusively by experts at K&L Gates and the AALU staff, led by **James E. Earle, Matthew R. Jones, Richard H. Nettles, and Rebecca Liu.**

The AALU WR Newswire and WR Marketplace are published by AALU as part of the Essential Wisdom Series, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation’s most advanced life insurance professionals.

Thursday, 1 November 2018

WRM#18-24

TOPIC: “Top Hat” Plans — What are They and How Do You Know If You Have One

MARKET TREND: Recent case law continues to highlight the challenges, and lack of clear guidance, in identifying a company’s “top hat” group, but some common practices can be considered. As the court cases demonstrate, making sure you identify your top hat plans and

appropriately limit eligibility in those plans can be important to avoiding significant litigation risk or ERISA fines.

SYNOPSIS: Nonqualified deferred compensation plans (NQDC), such as 401(k) restoration plans, other elective deferral plans, and supplemental retirement plans (SERPs), must limit their eligibility to a “top hat” group to avoid significant problems under ERISA and the Internal Revenue Code (IRC). ERISA defines this group as a “select group of management or highly compensated employees.” Department of Labor (DOL) guidance and case law conflict as to what this definition actually means. The absence of controlling guidance has led the courts to interpret this phrase in different ways. Ultimately, while there is no bright-line test for identifying a top hat group, certain common practices around limiting eligibility should help manage the risk of claims.

TAKEAWAYS: ERISA fines and legal fees are no joke. Employers should review their benefit plans to determine which ones need to be limited to their top hat group, and then ensure that the eligibility requirements for those plans fall safely within the standards provided by the courts.

What is a “Top Hat” Plan?

A “top hat” plan is an employee benefit 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.”^[1] Many companies use top hat plans to provide additional benefits to executives and other key employees. Most of the substantive requirements of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”) do not apply to top hat plans, such as funding, minimum participation, minimum vesting, etc., as well as ERISA fiduciary duty requirements.^[2] Avoiding ERISA’s funding requirements is critical for NQDC plans’ ability to defer income and deliver their intended benefit to employees.

Top hat plans are, however, subject to certain ERISA requirements, such as claims procedures and ERISA preemption of state law.^[3] These aspects of ERISA can be helpful for employers. Courts may treat benefit claims decided by employers under an ERISA claims procedures with greater deference, and preemption means that certain state law claims (which

may come with potential punitive damages) should not apply. Moreover, top hat plans can comply with ERISA's reporting and disclosure requirements using a simple, one-time filing with the DOL (a top hat plan letter), thereby avoiding annual 5500 filings and summary plan description requirements.[\[4\]](#)

An employee benefit plan that erroneously claims to be a top hat plan potentially subjects the employer to tax penalties, DOL penalties, and lawsuits. For this reason, when setting up a NQDC plan, it is very important to make sure that it qualifies as a top hat plan. Usually, the way this can go wrong is if eligibility for the plan is not limited to a top hat group.[\[5\]](#)

Who is the “Top Hat” Group?

This is the key question, and unfortunately one for which there is no definitive answer.[\[6\]](#)

As noted above, a top hat plan is one that provides unfunded deferred compensation for a “select group” of “management” or “highly compensated” employees. Neither Congress nor any government agency has issued any definitive guidance as to the meaning of “select group,” “management,” or “highly compensated.” This lack of guidance has led to several conflicting views and the absence of any bright-line tests.

The only agency guidance on the definition of top hat plans is found in the DOL's Advisory Opinion 90-14A and withdrawn opinions issued in the 1970s and 1980s. In Advisory Opinion 90-14A, the DOL advanced its view of the purpose of top hat plans as follows:

“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.”

The DOL view in this Advisory Opinion appears to establish a requirement that top hat plans be limited to employees who had the ability to influence the design or operation of the plan. However, the DOL has not issued further Advisory Opinions on this requirement, and

courts have generally not evaluated top hat plan coverage exclusively in such terms, as discussed further below.

Given the relative lack of guidance from the DOL, the federal courts have had to decide on their own how to apply the top hat group definition to specific factual situations. The courts, so far, have not developed a bright-line test to determine whether a group qualifies for “top hat” status. Instead, the determination will depend on the facts and circumstances of the particular plan.

Courts generally apply a mix of quantitative and qualitative factors to make the determination as to whether a group is “select.”^[7]

Quantitative measures: generally focused on the percentage of an employer’s workforce that is eligible to participate.

Qualitative measures: generally focused on the positions, duties, and compensation of those eligible to participate.

Courts have been willing to consider these two measures separately — e.g., a plan that covers a comparatively larger group of employees may still qualify as a top hat plan if those employees are qualitatively a select group, while a plan that covers a smaller group of employees will not qualify as a top hat plan if those employees are not high level in position or compensation.

The details on the factors differ by circuit, but the Sixth Circuit lists the following as relevant factors in determining whether a plan qualifies as a top hat plan that can be a helpful starting point:

“(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).”^[8]

In another formulation, the Third Circuit, “has boiled [the ‘select’ determination] down into a pretty simple formula: ‘the plan must cover relatively few employees...[and] the plan must cover only high-level employees,’” meaning employees who are either management-level or highly compensated.^[9]

Quantitative Measures: Is There a “Safe Harbor” Regarding the Number of Employees in a Top Hat Group?

The courts that review the top hat status of NQDC plans always consider the number of employees covered by the plan in deciding whether the plan is limited to a top hat group. But there is no “safe harbor” percentage of employees that will ensure that a plan is limited to a top hat group.

Generally, plans limiting participation to 15% or less of the workforce are sufficiently “few” in number to potentially qualify for top-hat status (if the group also meets the qualitative requirements), although courts may accept a higher percentage if the qualitative factors are strong.^[10]

For instance, the Second Circuit has held a plan offered to 15.34% of employees constituted a top hat plan, while noting that “this number is probably at or near the upper limit of the acceptable size for a ‘select group.’”^[11] On the other side of the 15% threshold, in *Darden v. National Mutual Insurance Co.*, the Fourth Circuit found a plan which covered 18.7% of the employer’s workforce did not cover a select group of employees because the percentage was too high to be considered a select group, regardless of the qualitative considerations.^[12]

It is unclear whether the employees to be considered are those eligible or those actually participating, which could differ, for example, in a NQDC plan providing for elective deferrals.^[13] The conservative approach, for planning purposes, is to consider all employees eligible for the plan.

Qualitative Measures: Who is a “Management” or “Highly Compensated” Employee for the Top Hat Group Determination?

To constitute a top hat plan, the plan must limit participation to either management or highly compensated employees.

Management: “Management” includes managers, officers, executives, and other similar titles. Several opinions simply state that the plan participants are or are not members of “management” without further explication.^[14]Courts generally do not require employees to fit in a narrow range of the top executives in order to constitute “management,” but have found variants of higher-level managerial employees satisfactory.

Highly compensated: Where plan participants earn on average more than double the average of all employees, courts have considered them “highly compensated.”^[15]Note, however, that “highly compensated” employees for the top hat group are not the same as “highly compensated employees” for IRS rules applicable to 401(k) or other qualified retirement plans.^[16]

Does an Employee’s Bargaining Power Matter for the Top Hat Group Determination?

The answer, unfortunately, depends on where the employer might be sued.

Courts in different circuits find bargaining power, as described in the DOL’s Advisory Opinion, of varying importance to the “select group” status determination. The First and Third Circuits have expressly rejected bargaining power as relevant to determining whether a plan qualifies for top hat status.^[17]The Second, Sixth, and Ninth Circuits all expressly consider bargaining power in determining whether a plan qualifies as a top hat plan, taking the DOL’s Advisory Opinion to be persuasive authority, although they do not adopt bargaining power as a requirement.^[18]In the Fifth Circuit, courts appear to “acknowledge[], but do[] not expressly adopt, a ‘substantial influence’ or ‘bargaining power’ factor for use in determining the top hat issue, and reject[] any argument that each participant must meet a ‘substantial influence’ standard.”^[19]The DOL has recently defended its interpretation of the top hat exemption in an amicus brief, in which it repeatedly referenced the importance of bargaining power in exempting top hat plans from the substantive protections of ERISA.^[20]

Conclusion: What Should Employers Do Given the Uncertainty of the Top Hat Group Definition?

Given the critical nature of the top hat group determination for NQDC plans, care should be taken when setting the eligibility terms for the plan. And given the facts and circumstances nature of the analysis and the varied federal circuit court positions, employers should consider reviewing the issue with their legal counsel. There are some rules of thumb, though, that should be considered:

How many employees, as a percentage of the entire workforce, will be eligible for benefits under the plan? Less than 10% is a good answer, absent bad qualitative factors; 10% – 15% should begin to raise some caution and require closer inspection of the qualitative factors; and over 15% should raise red flags.

What is the average compensation of the employees eligible for the plan compared to the workforce as a whole? More than double is a good answer; less the double begins to raise some red flags.

Is there anyone eligible for the plan who clearly would not appear to be in management or highly paid (such as an executive assistant)? If so, this should be closely reviewed and consideration given to excluding those individuals.

In some cases where an employer wants to extend a plan to a broader group, you can also consider whether the plan could be designed such that it does not provide for deferred compensation. For example, a plan could be designed with employment-based or performance-based vesting conditions that pay out upon vesting, rather than systematically deferring compensation to termination of employment or beyond. Such a “vest-and-pay” program likely would be a bonus program or payroll practice, not a benefit plan, for purposes of a ERISA, and therefore would be excluded from ERISA’s requirements. The top hat requirements would not have to be applied.

If you do have a top hat plan, do not forget the one-time DOL top hat letter filing. The DOL has made this filing easier, with an on-line, electronic process now available through the DOL’s website.[\[21\]](#)

NOTES

[1]29 U.S.C. § 1051(a)(2). Note that top hat plans may also refer to certain executive welfare benefit plans, but this article will focus on NQDC plans.

[2]See 29 U.S.C. §§ 1051(2), 1081(a)(3), 1101(a)(1).

[3]29 U.S.C. § 1133 and § 1144.

[4]29 C.F.R. § 2520.104-23(b)(1).

[5]The circuit courts are split as to which party bears the burden of proving that a plan is, or is not, a top hat plan. The Third Circuit stands alone against its sister circuits in deciding that plaintiff-employees bear the burden of proving a plan is not a top hat plan. The First and Sixth Circuits, on the other hand, place this burden on the defendant-employer who contends that a plan is a top hat plan, as do numerous district courts in the other circuits. See, e.g., *Browe v. CTC Corp.*, No. 2:15-CV-267, 2018 WL 3085201, at *24 (D. Vt. June 22, 2018).

[6]Parties typically do not dispute whether the plan is “unfunded” or provides “deferred compensation,” focusing instead on whether it is maintained for “a select group of management or highly compensated employees.” But see *Duggan v. Hobbs*, 99 F.3d 307, 311 (9th Cir. 1996) (following Treasury regulations to conclude that deferred compensation is any compensation for services substantially after the services were rendered).

[7]*Sikora v. UPMC*, 876 F.3d 110, 113 (3d Cir. 2017); *Bond v. Marriott Int’l, Inc.*, 637 F. App’x 726, 729 (4th Cir. 2016); *Alexander v. Brigham & Women’s Physicians Org., Inc.*, 513 F.3d 37, 46 (1st Cir. 2008); *Bakri v. Venture Mfg. Co.*, 473 F.3d 677, 678 (6th Cir. 2007); *Demery v. Extebank Deferred Comp. Plan (B)*, 216 F.3d 283, 288 (2d Cir. 2000); *Duggan v. Hobbs*, 99 F.3d 307, 312–13 (9th Cir. 1996). The Fifth Circuit appeared to endorse a strange position in affirming a district court’s finding that a plan could not be a top hat plan because plan participants were not “a select group’ out of the broader group of management employees or the broader group of highly compensated employees” (*Carrabba v. Randalls Food Markets, Inc.*, 38 F. Supp. 2d 468, 478 (N.D. Tex. 1999)), stating simply that it could find “no reversible error” in the lower court’s opinions. *Carrabba v. Randalls Food Markets, Inc.*, 252 F.3d 721, 722 (5th Cir. 2001). Perhaps notably, subsequent Fifth Circuit opinions have not favorably cited to the district court *Carrabba* opinion. E.g., *Tolbert v. RBC Capital Markets Corp.*, 758 F.3d 619, 627 (5th Cir. 2014); *Reliable Home Health Care, Inc. v. Union Cent. Ins. Co.*, 295 F.3d 505, 512 (5th Cir. 2002); see also Michael S. Melbinger, “Court Finds that Company’s Stock Bonus Plan May be Subject to ERISA and that No Statute of Limitations Applies,” Executive Compensation Blog, www.winston.com/en/executive-compensation-blog/court-finds-that-company-s-stock-bonus-plan-may-be-subject-to.html (“At the time, this case this appeared to be an aberration. However, it has not been overturned and has encouraged clever plaintiffs’ lawyers.”).

[8] *Bakri v. Venture Mfg. Co.*, 473 F.3d 677, 678 (6th Cir. 2007).

[9] *Sikora v. UPMC*, 153 F. Supp. 3d 820, 824 (W.D. Pa. 2015), *aff'd*, 876 F.3d 110 (3d Cir. 2017) (citing *In re New Valley Corp.*, 89 F.3d 143, 148 (3d Cir. 1996)); *see also Bond v. Marriott Int'l, Inc.*, 637 F. App'x 726, 729 (4th Cir. 2016).

[10] *Demery v. Extebank Deferred Comp. Plan (B)*, 216 F.3d 283, 289 (2d Cir. 2000) (15.34% would not “alone” make plan too broad to be top hat plan “without considering the positions held at the bank by the Plan’s participants,” and concluding plan was top hat plan); *Callan v. Merrill Lynch & Co., Inc.*, No. 09–566, 2010 WL 3452371, at *10 (S.D. Cal. Aug. 30, 2010) (noting that plans limiting participation to 15% or less of workforce are consistently treated as top hat plans).

[11] *Demery v. Extebank Deferred Comp. Plan (B)*, 216 F.3d 283, 289 (2d Cir. 2000). The Second Circuit also appears to hold the position that participation by a single employee who is neither management nor highly compensated would not disqualify the plan from top hat status (*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.”)), contrary to the express language in the DOL’s Advisory Opinion 90-14A.

[12] *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 (1992).

[13] *Compare Sikora*, 876 F.3d at 113 (reviewing actual participants to ascertain quantitative merit) *and Alexander*, 513 F.3d at 44 (approving lower court’s rationale that the plan was “maintained” for those who actually participated rather than those who were or might become eligible) *with Demery*, 216 F.3d at 287–88 (seeming to look at both who plan was offered to and who actually participated).

[14] *E.g.*, *Sikora v. UPMC*, 876 F.3d 110, 114 (3d Cir. 2017).

[15] *E.g.*, *Callan v. Merrill Lynch & Co., Inc.*, 50 EBC 1449 (S.D. Cal. Aug. 30, 2010); *see also Demery*, 216 F.3d at 289 (favorably cited in *Sikora*, 876 F.3d at 114).

[16] In the preamble to regulations under IRC Section 414(q), the Department of the Treasury stated that “section 414(q) is not determinative with respect to provisions of Title I of ERISA, other than those provisions that explicitly incorporate such section by reference...” Because the sections of ERISA that define top hat plans do not incorporate Section 414(q) of the Code by reference, the definition of “highly compensated” under Section 414(q) of the Code cannot be used as a proxy for the ERISA Title I definition.

[17] *Sikora v. UPMC*, 876 F.3d 110 (3d Cir. 2017); *Alexander v. Brigham & Women’s Physicians Org., Inc.*, 513 F.3d 37, 46 (1st Cir. 2008).

[18] *Bakri v. Venture Mfg. Co.*, 473 F.3d 677, 678 (6th Cir. 2007); *Demery v. Extebank Deferred Comp. Plan (B)*, 216 F.3d 283, 288 (2d Cir. 2000); *Duggan v. Hobbs*, 99 F.3d 307, 312–13 (9th Cir. 1996).

[19] *Tolbert v. RBC Capital Markets Corp.*, No. CIV.A. H-11-0107, 2015 WL 2138200, at *8 (S.D. Tex. Apr. 28, 2015)

[20] *Bond v. Marriott Int'l, Inc.*, 637 F. App'x 726, 729 n.1 (4th Cir. 2016).

[21] Go to: <https://www.askebsa.dol.gov/efile/Home/tophat>
