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TOPIC: ERISA Funding and the Top Hat Exemption Interpreted by Idaho Supreme Court Case

CITES: *Huber v. Lightforce USA*, 2015 WL 8732519, Supreme Court Idaho, Dec. 15, 2015; *In re IT Grp., Inc.*, 448 F.3d 661, 667 (3d Cir.2006) *as amended* (July 10, 2006); *Dependahl v. Falstaff Brewing Corp.*, 653 F.2d 1208, 1214 (8th Cir.1981); *Belka v. Rowe Furniture Corp*., 571 F. Supp. 1249, 1252 (D.Md.1983).

SUMMARY: The Idaho Supreme Court rejected an employee's claim that a deferred compensation plan did not qualify for exemption from ERISA vesting and anti-forfeiture provisions as a "top hat" plan because the plan was funded, in part, by an individual life insurance policy. The court relied on the fact that (i) the employee had no greater rights under the plan than an unsecured general creditor of the employer, (ii) plan benefits were paid from the policy only under limited circumstances and were otherwise payable from the general assets of the company, and (iii) no premium payments were made by the employee nor were any amounts included in the employee's income under the plan.

This case reiterates the test a court will use to determine whether a plan is funded: "Has the employer set aside funds, *separate* from its general assets, for payment of plan benefits and do plan beneficiaries have a legal right *greater* than that of a general, unsecured creditor to the corporation's assets?"

Furthermore, it provides assurance that the use of life insurance to informally finance the employer's potential obligation under the plan will not be deemed, per se, as an indication that a plan is funded for ERISA purposes. Life insurance will cause a plan to be considered funded only if the covered employee can look to the life insurance policy for the payment of benefits, separate and apart from the general assets of the company.

RELEVANCE: This case illustrates the importance of good drafting and the inclusion of appropriate ERISA language in the plan document, as well as consistent plan administration. Though the court ultimately ruled in favor of the employer, it did so only after a trial and an appeal to the state supreme court. If the plan had included language specifically stating that the plan was intended to be an *unfunded* ERISA top hat plan and the benefits were payable *only* from the general assets of the company, the aggravation, time, and expense of litigation might have been avoided altogether. Because of the potential of ERISA imposing additional liability and reporting obligations on the employer if a plan is considered "funded" versus one considered "informally financed," use of knowledgeable counsel specializing in ERISA law is recommended in such situations. Furthermore, the drafter of any type of deferred compensation plan should take particular effort to carefully define and narrow such terms as "ill health" and "incapacitation" because all too often, such loose language itself leads to litigation.

Many questions are presented by this case which were not addressed by the court, including the likely Section 83 impact when Huber became part owner of what was previously a company-owned policy, and the income tax aspects of what appears to be an arrangement that was most likely taxable under split dollar rules.

FACTS: Mr. Huber was a senior executive at Lightforce USA, a manufacturer of spotlights for night hunting. Mr. Huber was the sole participant in the "Company Share Offer" plan which gave him the right, after six years of service, to a payment equal to 30% of the value of the company's goodwill. The plan provided that Mr. Huber would receive the goodwill payment under the following circumstances:

> a) Death, ill health or incapacitation of Jeff Huber—[the Company will] take out insurance coverage to the value of $1,000,000 on Jeff Huber. At the time Jeff Huber is paid via this insurance policy using his goodwill value... the remaining value of the insurance policy dividends after Jeff Huber's goodwill [is] paid belongs to [the Company] as the owner of the policy.

b) If Jeff Huber elects to leave voluntarily, or employment is terminated due to unsatisfactory performance, then all goodwill is lost.

c) If Jeff Huber retires at a reasonable age and NO sale of business is pending he shall be given the option of exchanging the goodwill accumulated for shares in the company to the value calculated to be the equivalent to goodwill at the time.

Mr. Huber, acting on behalf of the company, bought a $1 million term policy on his life, which designated the company as the owner of the policy and named the company and Mr. Huber's parents as 50/50 beneficiaries. Three years later, Mr. Huber amended the policy, reducing its value to $750,000 and converting the remaining $250,000 into a whole life policy, which named the company and himself as 50/50 owners and designated the company and his wife as equal beneficiaries.

Several years later, Mr. Huber was terminated for poor performance. The company refused to pay the goodwill payment under the plan because Mr. Huber had been terminated for "unsatisfactory performance." Mr. Huber sued the company in Idaho state court, arguing that the plan was an ERISA plan and the anti-forfeiture provision of ERISA prevented the company from taking away the vested goodwill payment. The company agreed that the plan was an ERISA plan but argued that the ERISA anti-forfeiture provisions did not apply, since the plan was an unfunded "top hat" plan.

The trial court ruled against Mr. Huber, on summary judgment, finding that the plan was a "top hat" plan under ERISA, exempt from ERISA's vesting and anti-forfeiture provisions. Mr. Huber appealed to the Idaho Supreme Court.

On appeal, the key issue before the Idaho Supreme Court was whether the plan was unfunded and, therefore, able to qualify for the top hat plan exemption.

The Idaho Supreme Court found that the plan was unfunded and, therefore, a top hat plan exempt from ERISA's anti-forfeiture restrictions. Accordingly, the court upheld the company's refusal to pay the goodwill payment. The test the court applied to determine whether the plan was funded is "whether the corporation has set aside funds, separate from its general assets, for payment of plan benefits and whether the beneficiaries have a legal right greater than that of a general, unsecured creditor to the corporation's assets." *In re IT Grp., Inc.*

The court found that "the mere fact that a plan is funded by an insurance policy is not dispositive of a plan's status as funded or unfunded for ERISA purpose." Rather, the court compared cases such as *Dependahl v. Falstaff Brewing Corp.,* which held that benefit plans financed by whole life insurance policies are funded under ERISA where the employee can look to the life insurance policy for the payment of benefits, separate and apart from the general assets of the company, with cases like *Belka v. Rowe Furniture Corp.,* where the existence of a life insurance policy did not make the plan "funded" because the plan specified that the rights of the employee under the plan were solely those of an unsecured creditor. The court concluded that while the documents in this case were less than clear, there was no indication that Mr. Huber was intended to have a greater claim to benefits under the plan then an unsecure general creditor.

The court bolstered its conclusion with the fact that the life insurance policy was only intended to fund benefits under certain conditions such as death, illness or incapacity and that otherwise the benefits were payable from the general assets of the company.

Finally, the court noted the fact that no contributions to the plan or policy were made by the Mr. Huber and he did not incur any tax liability for premiums paid by the company. (Although he should have been currently taxed on the economic benefits he received under what appeared to be a split-dollar arrangement).

Although Mr. Huber was named as a partial owner on the policy after it was converted, the plan provided that the company would be the owner of the policy. Therefore, the court concluded that the policy was intended to be a general asset of the company and the plan was intended to be unfunded.