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Employee Benefits Law Report

The Top-Hat Plan Test for Your ERISA Executive Deferred Compensation Plan – *Daft v. Advest, Inc.*

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A recent Sixth Circuit decision provides a tutorial on designing and administering an ERISA executive compensation top-hat plan. In *Daft v. Advest, Inc.*, a U.S. Court of Appeals for the Sixth Circuit reversed the District Court's decision that the executive compensation plan was an ERISA plan but was not a top-hat plan, on the grounds that the District Court should have remanded the matter to the plan administrator for expansion of the administrative record and its own determination on this issue. This is good news for the employer, and presumably good news for the other plan participants, because an executive deferred compensation plan that is an ERISA plan but is not a top-hat plan would seemingly be a tax debacle.

The plan at issue provided deferred compensation benefits for certain executives. The employer apparently intended for the plan to be an ERISA "top-hat plan." A top-hat plan is a plan "which 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." This type of plan is exempt from many of ERISA's provisions, including funding, vesting and fiduciary requirements.

Lessons for the Employer and Administrator

Three important lessons regarding designing and administering an ERISA executive compensation top-hat plan can be gleaned from *Daft v. Advest, Inc.:*

Design top-hat plan terms to comply with ERISA and Internal Revenue Code requirements, keeping in mind that we have limited case law on the parameters of the "select group" and that executives will presumably terminate employment and forfeit benefits before challenging top-hat plan status.

Develop administrative procedures to confirm that the ever-changing requirements are being met. This is a challenging area of the law, and failing to get the counsel needed on the front end can be painful and expensive on the back end.

Recognize the importance of the claim appeal procedure and the administrative record, and the impact this will have in subsequent litigation. Require claimants to fully explain their rationale, ask questions, make certain that the proper legal analysis is being applied, and completely develop the factual record. The *Daft* administrator was given a chance to correct its procedural errors, but only after litigation at both the district court and appellate court level.

Daft Facts and Initial Proceedings

After learning that Advest was being acquired by Merrill Lynch, Daft and other plaintiffs resigned employment with Advest and went to work for Advest competitors. They then filed suit in state court, making state law claims regarding compensation. Defendants removed the case to federal court, arguing that the claims related to an ERISA plan, that ERISA preempted state law claims, and that the executives failed to exhaust the claims administrative procedure as required by ERISA. The District Court stayed the case and remanded the matter to the plan administrator for consideration of the claims.

Under the terms of the plan at issue, the executives forfeited any benefits to which they may have been entitled when they quit to work for competitors. During the administrative procedure, the executives argued that the plan was an ERISA plan but did not satisfy the top-hat plan exemption. Accordingly, they argued, their benefits were vested. Based upon a review of plan terms, the administrator determined that the plan did satisfy the top-hat plan exemption, and that the executives forfeited any benefits.

District Court Decision

Reviewing the administrative record, the District Court held that the defendant had the burden of proof to establish that the top-hat plan exemption applied. The Court concluded that the administrator should have applied a four-factor top-hat plan test, but erred in only applying one factor: plan terms. The Court found that the facts were insufficiently developed to conclude that the top-hat plan exemption applied. Accordingly, the Court held, the exemption was not satisfied, ERISA funding and vesting provisions had to be applied to the plaintiffs. The Court awarded a monetary remedy under ERISA Section 502(a)(1)(B), with prejudgment interest and attorneys fees.

Appellate Court Decision

The Appellate Court held that the District Court erred. The legal questions regarding top-hat plan status and vesting were raised during the administrative process. Where the problem is with the integrity of the decision making process, the appropriate remedy is generally remand to the administrator. Therefore, the District Court should have remanded the case to the plan administrator for factual development and consideration of the top-hat plan test factors, instead of substituting its judgment on an incomplete administrative record. The Appellate Court also rejected the plaintiffs' argument that the case could not be remanded to the administrator because of the administrator's conflict of interest. Finally, the Appellate Court rejected the District Court's approach of treating the vesting claim as a separate statutory claim, as the vesting claim was simply part of the benefit claim. These holdings reinforce the basic principles of ERISA administrative procedure.

What is the Top-Hat Plan Test?

The top-hat plan test is not one test set forth in ERISA, but a test that has been developed over time and that varies among circuits. Some of the tests are more focused on the documentation and intent of the parties; others are more focused on whether the administration properly limits participation to a "select group." For employers that operate in more than one circuit, this presumably means that the test is an amalgamation.

In *Daft,* the courts considered the test set forth in a Sixth Circuit decision, *Bakri v. Venture Mfg., Co.:*

(1) the percentage of the total workforce invited to join the plan,

(2) the nature of their employment duties,

(3) the compensation disparity between top-hat plan members and non-members, and

(4) the actual language of the plan agreement.

It appears that the plan in *Daft* might have been administered, at least initially, in Connecticut, which is in the Second Circuit. The Second Circuit test is set forth in *Demery v. Extebank,* 216 F.3d 283 (2d Cir. 2000), and it is a little different in ways that could be pertinent here. For example, whether the plan is funded is a factor in the *Demery* test, but not the *Bakri* test. In a case brought by a different group of former employees (*Fenwick v. Merrill Lynch & Co., Inc.,* 48 Employee Benefits Cas. 1629, 2009 WL 5184405 (D.Conn. 2009)) a Connecticut District Court ruled after the District Court *Daft* decision that collateral estoppel ("issue preclusion") prevented these same defendants from arguing that this plan was a top-hat plan.

Meanwhile, in Florida (11th Circuit), a district court hearing another case about this plan (*Maynard v. Merrill Lynch & Co. Inc., 46 Employee Benefits Cas. 1133,* 2008 WL 4790670 (M.D.Fla. 2008)) acknowledged the *Daft* decision but treated the plan as a top-hat plan based on the parties' apparent agreement on this issue, and a presumption based on the terms and general approach of a variety of circuits.

As an aside, it is noteworthy that plan documentation was light on claims procedures, which the circuits handled differently and which allowed some of these plaintiffs to successfully argue that exhaustion of procedure was not required.

What is the Tax Debacle and How Does this Relate to Top-Hat Plan Remedies?

The rationale behind the top-hat plan exemption is that executives in this group are sophisticated enough to negotiate their own benefits that are in excess of the benefits provided to the rank-and-file, without the special protections of ERISA. Recognizing that an employer could abuse the top-hat plan exemption, and that an administrator could error in the subjective determination of which employees can be included in the "select group," query whether allowing executives to wait until after they have forfeited benefits to bring this claim, and awarding them a monetary remedy, is consistent with the Internal Revenue Code and ERISA?

Somewhat surprisingly, top-hat plan cases typically contain little or no discussion of tax issues. Under the Internal Revenue Code, "deferred compensation" is immediately taxable unless an exception applies. One of the exceptions is for a "qualified plan," such as a 401(k) plan. A plan that the employer intends to be a top-hat plan cannot be a qualified plan because, among other things, it is designed to discriminate in favor of highly compensated employees. Exceptions are also provided for certain nonqualified deferred compensation, under Section 409A and other provisions. If a plan that the employer intended to be a top-hat plan is required to be modified to comply with the funding and vesting provisions of ERISA, then the special tax provisions for nonqualified deferred compensation will fail to be met. This suggests that all plan participants may have significant delinquent taxes, penalties and interest.

In virtually all the cases that we have seen, executives wait until after they have terminated employment and forfeited benefits before making the argument that the "select group" requirement failed. Of course, if the executives had raised the argument when first eligible, the administrator might have narrowed the "select group," and the executives might have been removed from that select group. This means that executives who were treated more favorably than lower compensated employees enjoyed the benefit of potentially receiving deferred compensation, and the benefit of tax deferral, often for many years.

We also wonder whether some of the top-hat plan tests and remedies will continue to be upheld under ERISA. In *CIGNA v. Amara*, the U.S. Supreme Court reminded us of the important distinction between plan sponsor functions and plan administrator functions. That distinction seems to be largely disregarded in most of the top-hat plan cases and Department of Labor opinion letters, with no explanation regarding who is "inviting" employees to participate in the plan: the plan sponsor via the plan terms, or the plan administrator in the process of administration.

The *CIGNA v. Amara* Court clarified that where a plan administrator makes a mistake, reformation of plan terms is not an available remedy for an ERISA claim for benefits under Section 502(a)(1)(B). Therefore, the plaintiff was not entitled to a benefit that was not provided by the plan terms. Subsequent to *Amara,* we wonder whether courts will begin to reconsider their historical tests regarding whether an ERISA plan exists, and whether that ERISA plan constitutes a top-hat plan. In *Daft,* for example, it seems that the court was satisfied as to plan terms, but lacked sufficient facts regarding plan administration. Applying *Amara,* why would administrative functions be part of the determination of whether the plan sponsor maintains a top-hat plan, how could a court reform the plan terms (i.e., change the plan sponsor's primary purpose and make the top-hat plan exemption inapplicable), and how does a plaintiff become entitled to a monetary remedy for an administrative error?

Bottom Line

When presented with all these issues, the courts may reconsider. In the interim, employers are encouraged to remain current with the top-hat plan tests and remedies in any of the circuits in which they operate and might be sued.