View From Groom: Top Hat Plan Litigation: Beyond the Select Group Analysis

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Over the years, many courts have struggled with whether nonqualified deferred compensation plans qualify as “top hat plans” exempt from the bulk of substantive ERISA requirements. Generally, these cases have focused on whether a plan meets the ERISA definition of a top hat plan, meaning it covers a sufficiently “select group of management or highly compensated employees.” In recent years, there has also been significant growth in litigation over other issues with respect to these plans, including both procedural and substantive issues. Before addressing some of the more interesting and relevant of these cases, we provide a summary of the relevant rules governing ERISA top hat plans. We also provide some suggestions to help employers address these issues.

Background on Top Hat Plans

Although a nonqualified deferred compensation plan typically is a “pension plan” subject to Employee Retirement Income Security Act requirements, a top hat plan is exempt from the participation, funding, vesting and fiduciary rules of ERISA.1 To qualify as a top hat plan exempt from these rules, a plan must be unfunded and “maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees.”2 In exempting top hat plans from ERISA’s participant protections, Congress recognized that top-level or highly compensated employees, unlike the broader-based employee population, are capable of negotiating to protect their own retirement benefits.3

Despite being exempt from much of ERISA, top hat plans are still subject to ERISA’s administrative and enforcement provisions. Thus, most cases involving top hat plans are decided by federal courts under ERISA. Many courts have considered the plans as unilateral contracts, offered by the employer and accepted by the employee through his or her performance.4 Because the plans are exempt from most of the rules under ERISA, the courts have generally analyzed these “contracts” under the federal common law of contracts.5

One specific ERISA requirement that top hat plans are not subject to is the requirement in Section 402 of ERISA that a plan’s terms be contained in a written plan document. Unlike broad-based plans governed by ERISA, a top hat plan’s terms are not necessarily limited to the plan document. Thus, courts have looked to extrinsic evidence outside the plan document to determine a plan’s terms in certain situations.6

1 ERISA §§ 201(2), 301(a)(3), 401(a)(1). We say “typically” as some courts have ruled that simple plans, particularly those covering only one or two persons, are not ERISA “plans” at all. See, e.g., Sheer v. Israel Discount Bank of N.Y., No. 06 Civ. 4995(PAC), 41 EBC 1652, 2007 BL 185576 (S.D.N.Y. Mar. 7, 2007).

2 ERISA §§ 201(2), 301(a)(3), 401(a)(1).

3 See Gallione v. Flahterly, 70 F.3d 724, 727 (2d Cir. 1995) (discussing Congress’s exclusion of “top hat” plans from ERISA’s requirements).


6 See Gilliam v. Nevada Power Co., 488 F.3d 1189, 1194, 40 EBC 2415 (9th Cir. 2007) (“When a plan is ambiguous . . . a court typically ‘will examine extrinsic evidence to determine the intent of the parties’ ” (quoting Richardson v. Pension Plan of Bethlehem Steel Corp., 112 F.3d 982, 985 (9th Cir. 1997))); In re New Valley Corp., 89 F.3d 143, 146, 20 EBC 1537 (3d Cir. 1996). The regulations under § 409A of the tax code also rec-
Emerging Issues in Top Hat Plan Litigation

Determining When ERISA or State Law Applies. A heavily litigated area of employee benefits that increasingly affects top hat plans is ERISA preemption. While it is generally assumed that cases involving a top hat plan will be subject to ERISA rather than state law, this is not always true. Two recent cases have given employers reason to think twice about relying on federal preemption.

In Gardner v. Heartland Indus. Partners, in which a bank's promise to maintain an executive's status as a participant in an ERISA plan for purposes of inducing the executive to transfer was found not to derive from the plan itself, but rather from a separate promise made by the bank. Analogizing to the facts in Stevenson, the Sixth Circuit denied defendants' argument for preemption, reasoning that the investment firm's obligation not to interfere with the executives' supplemental executive retirement plan did not derive from, and was not conditioned upon, the terms of the plan. As a result, the court found that the executives' claim was based upon a duty independent of ERISA and the plan and remanded the case, allowing the executives to pursue their state law tort claims.

Employer Tip: To avoid triggering ERISA coverage, bonus plan documents ideally should not address deferred payment of amounts earned under the plan. Such payments should be addressed under a separate deferred compensation plan.

Determining What is Included in “Compensation.” Significant litigation also occurs over what types of compensation (e.g., equity compensation amounts) are included in a top hat plan's benefit formula. Some of the most frequent claims have focused on whether taxable stock option gains should be included for purposes of calculating benefits under the plan. The Fourth Circuit addressed such an issue in Scipio v. United Bankshares, Inc., reviewing an administrator's decision not to include taxable stock option gains as “earnings” under the plan. Under the plan in Scipio, earnings included “the total earnings received from the [company] during a calendar year,” but excluded participants' bonus compensation.

Employer Tip: Top hat plan documents should provide a clear listing of those compensation elements that are included in the definition of compensation as well as those that are specifically excluded to help avoid participant misunderstandings.

Does the Plan's Amendment Section Really Mean What it Says? Many top hat plans contain very simple amendment sections stating that the company has the right to amend or terminate the plan at any time in any manner.

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15 See Gilliam, 488 F.3d at 1190.

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However, the inclusion of such sweeping statements allowing an employer to amend or terminate a plan does not always provide employers with the flexibility they anticipate. Indeed, courts have looked outside of the plan document to contract principles to find that an employer cannot adversely amend or terminate a plan.

As noted above, extrinsic evidence may be considered by a court in deciding the terms of a top hat plan. According to the Third Circuit, such extrinsic evidence may include “the structure of the contract, the bargaining history, and the conduct of the parties that reflects their understanding of the contract’s meaning.” Thus, even when a top hat plan reserves the right to amend or terminate the plan at any time, including after a participant’s retirement, courts may look to the context of the situation to determine whether such amendment and termination provisions are ambiguous.

In *Kemmerer v. ICI Americas, Inc.*, the employer unilaterally terminated the plan and changed the distribution rules for vested amounts of the executives’ accumulated account balances. Generally, a participant’s account balance in the plan was payable after the participant left the company based on participant elections specifying the manner in which they wanted their benefits paid. When the employer terminated the plan and demanded to distribute the participants’ remaining balances in three annual installments, rather than in accordance with the payment schedules elected by the participants, two former executives brought suit. Applying unilateral contract principles, the Third Circuit held that by complying with the plan’s requirements for obtaining a vested benefit under the plan, the participants had accepted the employer’s offer under the plan. Because the terms of the plan required the employer to distribute the benefits in accordance with the participants’ elections, the employer could not adversely amend or terminate the plan, even if the plan documents had expressly permitted it to do so. The court reasoned that “acceptance by performance closes that door under unilateral contract principles,” and “any other interpretation [of the Plan’s terms] would make the Plan’s several specific and mandatory provisions ineffective, rendering the promises embodied therein completely illusory.”

**Employer Tip:** Top hat plan documents should be clear regarding the amendments that an employer may and may not make—and generally should avoid including “anti-cutback” limitations of the type found in tax-qualified plans—rather than relying on broad language in plan documents that stipulates the plan can be amended or terminated at any time.

**Determining Who is Responsible for Tax Penalties.** Anyone who has worked on a noncorrectable error under Internal Revenue Code Section 409A knows that executives can face large adverse tax consequences based on top hat plan participation. In one recent case, *Sutardja v. United States*, the IRS assessed additional taxes on an executive totaling approximately $3.5 million under Section 409A based on the executive’s discounted stock options. While the litigation is still pending, the court’s rejection of all four of the executive’s arguments for exemption from Section 409A signals a tough road and hefty IRS assessments ahead for executives caught up in Section 409A problems.

While Section 409A penalties start out as an executive’s problem, executives quickly look to their employer to share the pain. The recent case of *Davidson v. Henkel Corp.* suggests that executives may have leverage in such a situation. In *Henkel*, a federal district court ruled that a retired employee could proceed with a challenge to his former employer’s failure to minimize the social security tax on his supplemental retirement benefits. Refusing to dismiss the plaintiff’s ERISA claims to recover benefits and for equitable estoppel, the court reasoned that the plaintiff had relied on his employer’s actions in handling Federal Insurance Contributions Act taxes and found that the company could be liable because the plan gave it “‘discretionary control over participants’ funds and their tax treatment and the Plan authorized and obligated [Henkel] to properly manage the tax withholding from Plaintiff’s benefits.’” Although *Henkel* addresses the treatment of FICA taxes, the court’s logic with regard to employer liability could easily be extended to Section 409A penalties imposed on executives.

**Employer Tip:** Companies may want to address the executive’s responsibility for Section 409A and other tax issues in a top hat plan document to put themselves in the best posture for negotiations over such issues.

**Determining Liabilities for Plan Benefits Post-Transaction.** Parties to a deal will generally address in the transaction documents which party will owe particular top hat plan liabilities at the end of the story when it comes to such liabilities. However, the parties’ agreement may not be the end of the story when it comes to such liabilities.

In a few asset purchase cases, courts have found that a buyer of assets could be responsible for top hat plan liabilities that the parties had negotiated to leave with the seller under a successor liability theory. In one such case, *Feinberg v. RM Acquisition, LLC*, former executives participating in a top hat plan sued the buyer of assets of the executives’ insolvent employer seeking payment of benefits. After emerging from bankruptcy, the executives’ former employer sold all of its assets to a successor company. The contract of sale provided that the successor company would acquire some, but not all, of the former company’s liabilities. The liabilities transferred in the sale did not include those of the top hat plan, but the plan contained a successorship provision designating the purchaser of all company assets as the plan administrator.

While the Seventh Circuit determined the buyer was not liable as the successor plan administrator, it explained that the requirements for imposing successor liability are more lenient for plaintiffs asserting violations of federal rights, such as those protected by ERISA. The court noted that the plaintiff could have proceeded against the purchaser “even if it is a true

16. In re New Valley Corp., 89 F.3d at 150.
18. Id. at 287-88.
21. Id. at 56 BWC 1127.
22. *Feinberg v. RM Acquisition, LLC*, 629 F.3d 671, 673, 50 BWC 1682 (7th Cir. 2011); see also *Brend v. Sames Corp.*, No. 00 C 4677, 28 BWC 2905 (N.D. Ill. July 11, 2002).
sale” provided that (1) the successor had notice of the claim before acquisition, and (2) there had been “substantial continuity in the operation of the business before and after the sale.”

Citing this same two-part test in Jeter v. Century 21 Bob Capes Realtors, Inc.,23 a court denied a successor company’s motion to dismiss a top hat plan participant’s claims that the defendant was liable for plan benefits subsequent to a corporate transaction. Even though the defendant claimed the transaction was an asset sale, the court found that the plaintiff might plead a viable successor liability theory if she amended her complaint.

Employers who transfer top hat plan liabilities to a new entity pursuant to a transaction (e.g., pursuant to the sale or spin-off of a subsidiary) should also note that participants may come back to them seeking payments for plan benefits under a novation theory, i.e., the participants did not agree to have liabilities transferred. Such a theory has been asserted in at least one case where plan liabilities were transferred pursuant to the spin-off of a subsidiary.24

Employer Tip: Employers should consider addressing their right to transfer specific top hat plan liabilities in the plan document and then address the fate of these liabilities when negotiating a disposition.

Conclusion

The above list of issues is by no means a comprehensive list of what employers may encounter with their own top hat plans. However, this list does offer a glimpse into how courts are currently treating top hat plan issues under an evolving body of federal common law. While it is prudent for employers first to make sure that their top hat plans cover a sufficiently select group to avoid ERISA’s substantive requirements, it is increasingly important that employers understand various liability theories that may be asserted by participants. And given the increasing number of successful plaintiffs, employers should continue to review and revise their plans to protect themselves in top hat plan litigation.

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