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How many participants is too many for a top hat plan?

by Eric D. Altholz on April 12, 2022

A client recently reviewed a census of participants in its deferred compensation plan and found that the covered group amounted to nearly 15% of its total workforce. Mindful of the need to limit the number of participants in a top hat plan, this compliance-oriented organization asked whether it should consider changing the eligibility criteria to hold down, or even reduce, the size of the covered group. That is a good question.

You will not find the term "top hat plan" in ERISA or in Department of Labor (DOL) regulations, but the general description is well known to those who work in the areas of employee benefits and executive compensation. 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."* (See Sections 201(2), 301(a)(3) and 401(a)(1) of ERISA, emphasis added.) Top hat plans are exempt from virtually all of the substantive requirements of ERISA because, as the DOL explains in Advisory Opinion 90-14A (May 8, 1990), "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, and, therefore, would not need the substantive rights and protections of Title I [of ERISA]." In general, federal courts dealing with top hat plan determinations have referenced this general principle with approval.

We know several things about how the DOL interprets the phrase "select group of management or highly compensated employees." For example, we know that it interprets the phrase to apply "select group" and "management or highly compensated employees" as distinct requirements, both of which must be met to establish the top hat status of a deferred compensation plan. The DOL has declined to establish bright line thresholds either for determining the selectivity of the group (as a percentage of the employer's workforce) or for determining management or highly compensated status. So it has been up to federal courts to develop qualitative and quantitative standards for determining whether a given group of covered employees constitute a good "top hat group," including how many employees may be too many for a plan to qualify as a top hat plan.

For the most part, federal courts have found that a "select group" exists with coverage percentages ranging from about 5% to about 15%, and at least one federal court has declared that a plan covering 18.7% of the employer's workforce could not be

considered a top hat plan.[1] Importantly, not all federal courts accept the DOL's formulation in Advisory Opinion 90-14A, particularly when it comes to the identification of management or highly compensated employees. For example, in the case of *Alexander v. Brigham and Women's Physician Organization, Inc.*, 513 F.3d 37 (1st Cir. 2008), the First Circuit rejected the idea that each participant in a top hat plan should have the ability to affect or substantially influence the design and operation of the plan. Instead, the court concluded that the relevant attributes should be applied on a group wide basis. But even the *Alexander* court focused on the coverage percentage of the plan (8.7% in that case, applying a very limited view of the relevant participant group).[2]

Given the policy principles underlying the top hat plan exemption, one might reasonably ask why any coverage percentage is too high so long as the covered group is comprised exclusively of employees who share the requisite attributes. Suppose a software startup has four employees, each a software engineer, who together own 50% of the company (the other 50% being owned by private equity investors). Each engineer is paid $250,000 a year and actively participates in management. Clearly, each employee is sophisticated enough and sufficiently well positioned within the company to understand the risks of participating in an unfunded deferred compensation plan that pays out when a certain milestone is reached, and they would be able to influence the design and operation of the plan. Therefore, no one in the covered group should need the protections of ERISA. Nevertheless, no federal court is likely to find that the company's deferred compensation plan – which covers 100% of its workforce made up entirely of management and highly compensated employees – would be qualify as a top hat plan. In fact, it appears that this would be true even if the four covered employees comprised 20% or more of the company's workforce.

Unfortunately, this kind of speculation seems unlikely to sway the minds of regulators and members of Congress who read the 2020 report on top hat plan participation and reporting prepared by the Advisory Council on Employee Welfare and Pension Benefit Plans. Among other things, the Council suggests that the DOL should consider developing more robust reporting requirements that would include more data

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[1] See e.g., *Belka v. Rowe Furniture Corp.*, 571 F.Supp. 1249 (D. Md. 1983) (4.6% coverage); *Duggan v. Hobbs*, 99 F.3d 307 (9th Cir. 1996) (5% coverage); *Demery v. Extebank Deferred Compensation Plan*, 216 F.3d 283 (2d Cir. 2000) (15.34% coverage); and *Darden v. Nationwide Mutual Insurance Co.*, 717 F.Supp. 388 (E.D.N.C. 1989) aff'd, 922 F.2d 203 (4th Cir. 1991), rev'd on other grounds, 503 U.S. 318 (1992) (18.7% coverage is too high for a top hat plan).

[2] Roughly 30% of the relevant workforce were eligible to participate in the plan by virtue of their status as surgeons, but the productivity-based performance requirements limited actual participation (*i.e.*, contributions) to about 8.7% of the employer's workforce during the period at issue. The court found that a plan can be said to be "maintained" by an employer only for those employees who actually make contributions or otherwise earn benefits under the plan, regardless of how many could potentially participate.

regarding the covered group – including the coverage percentage (or data that would allow the coverage percentage to be determined.)

For now, employers are well advised to stay within the "safe" coverage range of 5% to 15% when establishing and monitoring their top hat plans and consult with legal counsel about what to do if the covered group begins to drift above the upper limit. If your top hat plan is at or near that limit, please contact a member of Verrill's Employee Benefits & Executive Compensation Group. We stand ready to help.

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